EXPROPRIATION OF MINORITY INTERESTS AND CORPORATE DIVERSIFICATION IN MALAYSIA

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ABSTRACT

This study provides evidence on ownership structures and corporate diversification by analysing 355 public listed companies (PLCs) in Malaysia. The majority of the companies in the sample have an ultimate controlling owner, particularly an individual or family. As controlling owners have on average, rights of control over a greater percentage of shares in any given company than their rights to participate in the cash flows from that company, controlling owners may have an incentive to expropriate minority interests through methods such as inefficient corporate diversification. The risk of such expropriation would be expected to be reflected in the value of highly diversified companies. The results of the research provide no evidence to support the argument that diversification reduces the value of companies. However, the finding is consistent with the argument that high control rights of controlling owner might encourage expropriation of minority interests through corporate diversification strategies. Thus, corporate diversification in Malaysia is perceived as a mixed blessing strategy.

Keywords: ownership structure, ultimate owner, corporate diversification, control rights, cash flow rights, Malaysia

INTRODUCTION

Corporate ownership in East Asian countries, including Malaysia, is concentrated in the hands of large owners or controlling owners. The controlling owners are in a position to influence managers in determining corporate strategies. This may lead to unfair situations to minority owners when corporate activities are designed to maximize the utility of the controlling owners rather than the wealth of all owners. Owners' rights provide incentives that affect decision-making in the corporation. Owners' rights to exercise voting control over shares (control rights) may diverge significantly from owners' rights to participate in dividends and other distributions (cash flow rights), as a consequence of pyramid and cross shareholding. This may allow owners of public corporations in East Asia to gain effective control with a minimum amount of cash investment (Claessens, Djankov, Fan & Lang, 1999c). Owners may thus have incentives to expropriate the wealth of minority shareholders through policies such as diversification, especially since protection of minority shareholders is weak in East Asian countries (La Porta, Lopez-de-Silanes, Shleifer & Vishny, 2000).

Previous empirical studies have discovered that diversification is a value-decreasing strategy (Lang & Stulz, 1994; Berger & Ofek, 1995; Comment & Jarrell, 1995; Servaes, 1996; Denis, Denis & Sarin, 1997; Anderson, Bates, Bizjak & Lemmon, 2000; Claessens et al., 1999c; Lins & Servaes, 2002). However, the value of corporate diversification is related to the institutions of a country (Lins & Servaes, 1999; Fauver, Houston & Naranjo, 2003). Some argue that in a country whose external capital markets are underdeveloped, corporate diversification could give beneficial effects through the internal capital market (Khanna & Palepu, 1997; Fauver et al., 2003). Others believe that through corporate diversification, the expropriation of shareholders' interests could be to the benefit of the managers and controlling owners (Claessens et al., 1999c; Lins & Servaes, 2002). We should not expect study of Malaysia alone necessarily to give the same results as previous studies.

Malaysia has different capital market integration, legal system, economic development and country credit risk ranking compared with the other East Asian countries (Fauver et al., 2003). The Asian financial crisis has stimulated the Malaysian authorities more rapidly, compared to other authorities in the region, to reform and restructure corporations by strengthening corporate governance (IMF Staff Country Report, 1999). In relation to corporate diversification, corporations in Malaysia were found expanded and diversified extensively (Fatimah, 2001; Ayoib, Zuaini & Nor Aziah, 2003; Claessens, Djankov, Fan & Lang, 2001; Lins & Servaes, 2002). However, research on corporate diversification with reference to corporate ownership structure in Malaysia is still lacking.

This paper analyses the ultimate ownership structure of Malaysian companies and provides additional evidence showing that the majority of the Malaysian companies have an ultimate controlling owner. This study examines the levels of diversification for different categories of direct shareholding blocks, types of ultimate controlling owners and group affiliation of corporations. The study also provides evidence on the relationship between excess value and diversification, control rights, deviation of control rights from cash flow rights, and group affiliation. The findings show that, in general, diversification increases the value attributed to corporations. However, the existence of high levels of control rights is also associated with diversification, suggesting that controlling owners may have a tendency to expropriate minority interests through choosing diversification strategies that may benefit the controlling owners more than shareholders in general.

The remainder of this paper is structured as follows. In the next section, the theoretical basis for the research is discussed, by reference to agency theory and the theory of corporate ownership. In this section, we also review the literature on corporate diversification, discussing in particular the relationships between diversification strategy and corporate ownership. In the third section, we review the data used in the research involved in tracing ultimate ownership and corporate diversification of Malaysian corporations. The final section contains a discussion and analysis of our results, leading to a brief conclusion.

OWNERSHIP AND DIVERSIFICATION

Agency Theory

From a financial economist's perspective, corporate governance deals with agency problem that arises from the conflicts of interests between managers and shareholders (Hart, 1995). Shareholders are concerned to maximize the market value of their shareholding and they would prefer strategies that lead to maximizing the long run profitability of the corporation. Since shareholders could invest in a diversified portfolio at low cost, they are prepared to hold high risk or high return stocks to eliminate unsystematic risks and to switch out of a corporation when the performance of the corporation starts to decline. Managers are more concerned with their own wealth. They are risk averse since they cannot easily switch out, and they have to bear the consequences of failures in performance. Therefore, shareholders may prefer less corporate diversification because they have nothing to gain from expensive diversification (Hill & Snell, 1988) and managers may prefer corporate diversification to increase the size of the corporation and to reduce their employment risk (Amihud & Lev, 1981). Having argued that diversification reflects the risk preferences of managers

(Byrd, Parrino & Pritsch, 1998), which may be costly to shareholders, the presence of governance structures is expected to mitigate the problem.

The majority of research into corporate governance that uses an agency theory perspective has been undertaken in countries where corporations have a widely dispersed ownership. However, more recent research has pointed out that ownership is not always dispersed. This is especially the case in East Asian countries (La Porta, Lopez-de-Silanes & Shleifer, 1999; La Porta et al., 2000; Claessens, Djankov & Lang, 1999a, 2000). As shown in Figures 1 and 2, different parties are involved in agency conflicts within dispersed and concentrated ownership corporations. Dispersed ownership corporations have a large number of owners, with no dominant owner or single owner holding enough shares to enable that owner to control the corporation. The control of day-to-day decisions is transferred to professional managers (Berle & Means, 1932) whose interests may not coincide with those of the owners. Therefore, the agency problems here are the conflicts between managers and shareholders.
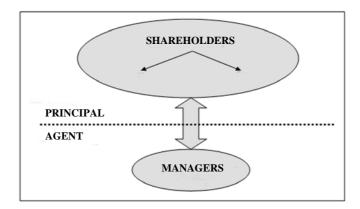

Figure 1. Agency relationship between shareholders and managers (in dispersed ownership corporations)
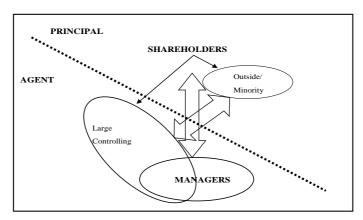
Figure 2. Agency relationship between controlling shareholder/manager and outside shareholders (in large concentrated ownership corporations)

Meanwhile, in concentrated ownership corporations, the existence of an owner of a large block or owners of several large blocks is common, and ownership is highly concentrated. Hence, large owners tend to be controlling owners who normally have the opportunity to control the management. Controlling owners are in the position to influence and control managers in making decisions through either their voting rights or their representation in management or on the board. Hence, the managers are likely to focus on controlling owners' interests rather than maximizing value for outside shareholders. Therefore, managers are acting for controlling owners rather than for shareholders in general. However, since controlling owners do not receive 100% of gains, given the presence of outside minority shareholders, an agency problem might occur (Hart, 1995). In this situation, agency conflicts are not only between managers and shareholders but also between the managers and controlling shareholders on one side and outside or minority shareholders on the other (Fan & Wong, 2002). Thus, the agency conflict arises when the manager neglects minority shareholders' interests.

Ownership Structures

The literature on the agency problem mostly focuses on the agent-principal relationships between managers and shareholders that prevail in the United States (US) and the United Kingdom (UK), where shareholder ownership is dispersed and shareholders have little direct control over management. Corporate ownership outside the US has long been considered as not dispersed (La Porta et al., 1999). Large or controlling shareholders are particularly common for East Asian corporations. Evidence in East Asian corporations suggests that

expropriation of minority shareholders by controlling shareholders takes place (Claessens et al., 1999b). Expropriation of minority shareholders refers to the extraction of private benefits of control by large owners that are not shared by minority shareholders (Shleifer & Vishny, 1997). The business could be structured to serve controlling shareholders' interests (La Porta et al., 2000). Therefore, high concentration of ownership gives rise to the agency problem when the controlling owner can extract private benefits at the expense of minority shareholders. Unless minority protection law is effective, the absence of monitoring of controlling shareholders might lead such shareholders to take actions that are inconsistent with outside shareholders' interests. Several researchers report effects of the agency problem associated with concentrated ownership structures in East Asian corporations. For example, the empirical studies show diminished firm value (Claessens et al., 2001), severe exchange rate depreciation and stock market declines (Johnson, Boone, Breach & Friedman, 2000), the need to employ auditors from Big 5 corporations (who are perceived to have high reputations) to play a monitoring and bonding roles (Fan & Wong, 2005), low corporate performance measured by Tobin's Q (Lemmon & Lins, 2001) and low dividend rates (Facio, Lang & Young, 2001).

Ultimate Owner

Fan and Wong (2002) categorize three types of property rights arising from ownership in public corporations: right to deploy corporate assets (control or voting right); right to receive income (cash flow right); and right to transfer shares to another shareholders (transfer both control and cash flow right). In most countries outside the US and UK, owners enhance their control of corporations through pyramid and cross-shareholding ownership structures (La Porta et al., 1999). In pyramid structures, a corporation is owned indirectly through other corporations. In a cross-shareholding ownership structure, shares in a company are held through several chains that link the owner to the company. These ownership structures create differences between the control exercisable by the ultimate controlling owner (voting/control rights) and that owner's entitlement to share in the company's profits (cash flow rights). The divergence in control rights and cash flow rights of an ultimate controlling shareholder gives incentives to the ultimate controlling shareholder to be involved in expropriation, and at the same time makes such expropriation easier to achieve (Claessens et al., 1999b; Claessens et al., 1999c; Fan & Wong, 2002). When control rights are significantly larger than cash flow rights, a controlling shareholder can expropriate minority shareholders because the controlling shareholder is able to control the corporation. At the same time, the controlling owner has an incentive to expropriate minority shareholders in order to increase economic benefits that flow to the owner, over and above the owner's entitlement from a relatively small

fraction of the equity claim on the corporate cash flows (Bebchuk, Kraakman & Triantis, 1999).

La Porta et al. (1999) provide a pioneer contribution through their investigation of the chain of ownership structures to identify ultimate owners of corporations from the 27 richest countries. Using a 20% cut-off point to define control, La Porta et al. find that 64% of corporations in their sample have a controlling shareholder. Their findings show that family-controlled corporations represent 30% of the sample, state-controlled corporations represent 19% and other categories account for the remaining 15%. Typically, through pyramid ownership structures and involvement in management, the controlling shareholder has control rights significantly in excess of cash flow rights.

Following the method of La Porta et al. (1999) for investigating ultimate control, Claessens et al. (1999a, 1999b, 2000) investigate ownership structures in nine East Asian countries, including Malaysia. They found that ultimate controlling shareholders are common for corporations in East Asia. Claessens et al. (2000) identify two-thirds of the corporations as being controlled by a single ultimate shareholder (one who controls over half of the votes). More than half of the East Asian corporations identified in Claessens et al. (1999a, 2000) are controlled by large families. Both studies found that smaller and older corporations are more likely to be family-controlled corporations. Significant corporate assets are in the hands of a few families (Claessens et al., 2000). Claessens et al. (1999b, 2000) find divergence in voting rights and cash flow rights of ultimate controlling shareholders, where voting rights frequently exceed cash flow rights. Consistent with the theoretical framework of Jensen and Meckling (1976), Claessens et al. (1999b) find that a higher concentration of cash-flow rights is associated with a higher market valuation. For concentration of control rights, their data show that control by families is negatively associated with market valuation. Furthermore, regressing the excess value on control and cash flow rights, they also find that higher cash flow rights are positively related to excess value. Meanwhile, the results show a negative relationship between degrees of control rights by the largest controlling shareholder and excess value. These results suggest that concentration of cash flow rights is beneficial for market valuation and concentration of control rights leads to expropriation of minority shareholders. Family control is the major predictor of expropriation of minority shareholders.

Corporate Diversification

Extensive corporate diversification in Malaysia has been established by researchers such as Ayoib et al. (2003), who found about 53% of the companies in their sample reporting multiple segments in 1995, implying that they were

involved in several industries. Claessens et al. (2001) investigated corporate diversification in the US, Japan and eight other East Asian countries (including Malaysia) for the period of 1990–1996. Malaysia had a high percentage (70%) of multisegment firm-years, while the US had the lowest percentage (20%) of multisegment firm-years. The decision to diversify may have been influenced by the risk preferences of managers, which may be expected to differ from those of outside shareholders.

Corporations may decide to diversify for profit motive (Chatterjee & Wernerfelt, 1991; Hall & Lee, 1999; Amit, Livnat & Zarowin, 1989; Montgomery, 1994). However, financial economists in 1990s started to query the effect of diversifications as value increasing strategies, and they continue to provide empirical studies that diversification is generally a value decreasing strategy. The findings of most of the studies done in the US (Kaplan & Weisbach, 1992; Lang & Stulz, 1994; Berger & Ofek, 1995; Comment & Jarrell, 1995; Servaes, 1996; Denis et al., 1997; Anderson et al., 2000) tend to support agency theory (Jensen & Meckling, 1976), which predicts a negative relationship between corporate diversification and corporate value (Amihud & Lev, 1981; Denis et al., 1997). These researchers conclude that the costs of corporate diversification outweigh the benefits to shareholders. Diversification is increasingly regarded as managerially motivated in which the managers diversify to benefit their own interests at the expense of corporate owners (Hoskisson & Hitt, 1990). Corporate diversification may be a way for managers to reduce their employment risk (Amihud & Lev, 1981). Furthermore, corporate diversification may provide other private benefits to managers. For example, diversification might benefit managers through the power and prestige associated with managing a larger corporation (Jensen, 1986); managerial compensation might be positively related to corporate size (Jensen & Murphy, 1990); and knowledge of the complexities associated with diversification may make managers indispensable to the corporation (Shleifer & Vishny, 1989). Thus, managers have an incentive to reinvest free cash rather than pay it out as dividends to shareholders (Jensen, 1986).

Controlling shareholders are involved in management and their interests in corporate diversification are seemed similar to those of managers. Controlling shareholders are less likely to hold well-diversified portfolios, as their ownership is concentrated in the corporation. They thus have to bear large amount of risks. Controlling owners would see corporate diversification as a way of reducing their risks. This is consistent to the finding of Amihud and Lev (1981) that managers with more ownership choose more diversified acquisitions to reduce their risks.

Results of empirical studies of diversification done outside the US are mixed. Lins and Servaes (1999) found that corporate diversification by listed

companies in Germany had no significant effect on corporate value at the end of 1992 and 1994. However, they found diversification discounts of approximately 10% and 15% respectively for Japanese and UK corporations. Examining a sample of Singaporean companies, Chen and Ho (2000) found negative correlation between Tobin's Q and level of diversification for 1995 data. Other studies suggest that diversification may be more valuable in emerging markets than developed market because of market imperfections. Claessens et al. (1999c) studied nine East Asian countries for the period of 1991–1996 (pooling data for Hong Kong, Japan, Indonesia, Malaysia, Singapore, South Korea, Philippines, Taiwan and Thailand). They found that corporate diversification is associated with a 5% discount of corporate value (using Berger and Ofek's excess value) for the period of 1991–1996. In a different study, Lins and Servaes (2002) used pooled data from seven Asian countries (Hong Kong, India, Indonesia, Malaysia, Singapore, South Korea and Thailand). They found that diversified corporations traded at a discount of 7% compared to single segment corporations in 1995. They noted that this is a lower discount than the ones found in studies of US corporations, and interpreted this lower discount as evidence that the benefits of diversification in emerging markets exceeded those in developed countries.

Khanna and Palepu (1997) pointed out that differences in the structure of capital, product and labour markets, contract enforcement mechanisms and business-government relations in East Asia may lead to different diversification strategies. Fauver et al. (2003) studied 35 countries over the period of 1991–1995 and found that the institutional environment of a country has an effect on the value of diversification. Countries with less developed and segmented capital markets exhibited either a significant diversification premium or no discount. It appears that benefits of diversification offset agency costs in these countries. They also found a smaller diversification discount in countries whose legal system is not English in origin. In their comparative study, Hall and Lee (1999) used accounting and market-based performance measures to investigate manufacturing corporations listed in the US and Korea in the period of 1987–1991. They found opposite relationships between diversification and performance for US and Korean corporations where diversification is negatively correlated with performance in the US but positively correlated in Korea. Their interpretation is that Korean corporations do not seem to experience negative agency effects of diversification in the way that US corporations do.

The evidence also suggested that diversified business groups are prevalent in emerging markets (Claessens et al., 1999c; Lins & Servaes, 2002; Khanna & Palepu, 1997). Both Claessens et al. (1999c), and Lins and Servaes (2002) find that group-affiliated corporations are more likely to diversify than independent corporations in East Asian countries. However, for Malaysian corporations, the studies found that diversified and focused corporations are

equally likely to be group-affiliated. Both studies found that the diversification discount is more substantial in group-affiliated corporations and suggested that diversification is associated with poorer performance for group-affiliated corporations than for individual corporations. This is consistent with the argument that group structures allow for expropriation of minority interests by controlling owners. Claessens et al. (1999c) found that group-affiliated corporations are more likely to diversify in less developed economies than in more developed economies. Diversification destroys more of the value of group-affiliated companies in more developed economies. However, in less developed economies, diversification appears more beneficial for group-affiliated companies than for individual companies.

Ayoib et al. (2003) examined 219 Malaysian companies for 1995 data and found that direct blockholding is negatively associated with diversification levels. Managerial direct ownership does not have a significant effect on diversification levels. The researchers used reported segments to measure the level of diversification. Results of Chen and Ho (2000) on Singaporean corporations are similar to those of Ayoib et al. (2003). In terms of the valuation consequences of diversification, they found that value is lost in low managerial ownership corporations and that there is no impact from outside blockholders. They also support agency theory when they interpret their finding that multiple segment corporations are valued less in the context of low managerial ownership. Further, the explanation given for their result that outside blockholders do not have a significant impact on the value of diversification is that the disciplinary role of outside ownership may not be obvious in Singapore corporations since they have a high concentration of ownership. Considering the high concentration of ownership in East Asian countries, Claessens et al. (1999c) examined whether corporate diversification is influenced by ownership structures. Due to use of pyramid and crossholding structures, ultimate controlling owners are predicted to have influence over corporate activities. Their findings supported the view that ultimate controlling owners have an incentive to use diversification to expropriate minority shareholders when there is divergence in control rights and cash flow rights of ultimate controlling owners.

The literature suggests that managers have an incentive to use diversification to reduce their risk and enhance their rewards. This may not be consistent with investors' preferences, as investors may be able to obtain optimal diversification through capital markets. Hence, diversification may be value-reducing. However, the existence of corporate governance mechanisms such as large blockholders may constrain managerial behaviour. However, the presence of large blockholders may be a mixed blessing. Not only are such investors likely to be represented among management, but they may have less access to diversification through the capital market and thus their interest in firm-level

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diversification aligns with management. Moreover, where large blockholders control corporations through complex ownership structures, but are entitled to relatively less of the corporations' cash flows, they have an incentive to expropriate minority shareholders. So, the presence of large blockholders may not deter diversification that is not in the interests of investors in general, and the possibility of expropriation may reduce the value of highly diversified companies. We thus need to further examine the relations between corporate ownership structures in East Asian countries, including Malaysia, and the level and impact on corporate value of diversification. The present study therefore gathers data on ultimate corporate ownership of Malaysian listed companies, and examines the relationship between controlling owners' control and cash flow rights as well as the level and impact on value of diversification.

SAMPLE SELECTION AND DATA COLLECTION

Sample Selection and Data Sources

The sampling frame for this study consists of non-financial public listed companies (PLCs) of Bursa Malaysia at the end of 2000. Financial institutions were excluded because they are subjected to a regulatory framework that does not apply to other listed companies. In addition, several companies were excluded due to insufficient data on ownership were managed under Special Administrator, changed accounting year-end in 2001, SIC codes cannot be assigned and primary segment is in financial activities – [SIC codes 6000–6999]. These exclusions left a total of 355 companies in the data set.

The data for the study were hand-collected from secondary sources, primarily from companies' annual reports. Apart from annual reports, other sources used were Kuala Lumpur Stock Exchange (KLSE) Annual Handbook, KLSE-RIAM Information System (KLSE-RIS) website, Hydra Net database, Worldscope database and the database of the Commission of Companies Malaysia (CCM). To enhance data accuracy, data collected from one source was verified by reference to other sources whenever this was possible.

Diversification Data

Following other studies (Lang & Stulz, 1994; Berger & Ofek, 1995; Comment & Jarrell 1995; Denis et al., 1997) including studies of East Asian countries (for example, Claessens et al., 1999c, 2000; Lins & Servaes, 2002; Fauver et al., 2003; Feris et al., 2003), this study employed industry segments as disclosed in companies' annual reports to measure diversification. In defining segments,

Standard Industrial Classification (SIC)[1] is used (Lang & Stulz, 1994; Berger & Ofek, 1995; Comment & Jarrell 1995; Denis et al., 1997) because of its objective approach (Ramanujam & Varadarajan, 1989). In addition, using SIC codes is consistent with the definition of diversification in terms of the range of lines of activity.

The number of segments reported and the segment revenue for every company in the sample were collected from the segmental report contained in the companies' annual reports. Unlike the US data, the industry classification for Malaysian PLCs is not ready-made. So, to define diversification using SIC codes, each segment had to be assigned SIC codes manually. The four-digit SIC codes available in the Worldscope database were found very useful in doing this task. Other studies also use this database to obtain an SIC code for the segments reported (Claessens et al., 1999c, 2000; Lins & Sarveas, 2002; Fauver et al., 2003).

We classify corporations as "diversified" or "focused" depending on the number of related segments based on two-digit SIC codes. A **diversified corporation** is one with more than a single segment and where the sales in the primary segment are less than 90% of total sales. A **focused corporation** is one where 90% or more of sales come from one segment (Claessens et al., 1998, 2000; Lins & Servaes, 2002; Fauver et al., 2003).

Four proxies are used for diversification levels (following Lang & Stulz, 1994; Denis et al., 1997):

  i.   the number of segments reported,
  ii. the number of related segments (two-digit SIC codes),
  iii. the Herfindahl index constructed from sales, and
  iv. the Herfindahl index constructed from assets.

The Herfindahl indices are calculated as follows for each company *i:*

$$\text{H sales}_i = \sum(\text{Sales per segment/Total sales})^2$$
$$\text{H assets}_i = \sum(\text{Asset per segment/Total assets})^2$$

The higher the number of segments reported and the number of related segments (two-digit SIC codes), the higher the level of diversification. The Herfindahl indices range from 0 to 1. The closer a Herfindahl index is to one, the more

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[1] The SIC codes were originally established by the US Bureau of the Budget in the 1930s to facilitate the collection and interpretation of business data (Schachner, 1967). The SIC has recently been replaced by the North American Industry Classification System (NAICS).

company's sales or assets are concentrated within a few of its segments. Thus, as the index falls, the level of diversification increases.

Excess Value

The performance of diversified companies is measured by natural logarithm of *excess value*. The excess value is measured using the approach developed by Berger and Ofek (1995) and adjusted by Lins and Servaes (1999, 2002); Claessens et al. (1998, 1999b, 2001) and Fauver et al. (2003). The excess value for a corporation is defined as the natural logarithm of the ratio of the corporation's actual value to its imputed value. Actual value is measured as the corporation's total capital, that is, book value of debt plus market capitalization (market value of equity). Imputed value is the sum of the imputed values of the company's segments (Berger & Ofek, 1995). The value imputed to each segment is determined by multiplying the sales allocated to that segment by the segment's industry median capital-to-sales ratio. The industry median capital-to-sales ratio is constructed using single-segment corporations. This study uses at least three single-segment companies in calculating industry median capital-to-sales ratio (Claessens et al., 2001)[2]. In cases where diversified firms have segments for which insufficient single-segment corporations are available, median market capital-to-sales ratios were determined using broad industry classification, following Campbell (1996) (Lins & Servaes, 1999)[3]. Extreme cases of excess value were eliminated, following Berger and Ofek (1995). These cases were defined as those where the actual value was four times as large or small as the imputed value (Lins & Servaes, 1999; Feris et al., 2003), that is, the excess value took a value of above 1.386 or below –1.386.

Ownership Data

Claessens et al. (2000) and a few other studies (Fan & Wong, 2002; Johnson et al., 2000; Lemmon & Lins, 2001; Lins, 2003) have undertaken studies on ownership that include some Malaysian corporations in their pooled samples. The studies find that corporate ownership structures in Malaysia are associated with indirect/ultimate ownership. Therefore, data on direct ownership of Malaysian corporations is insufficient for determining control. For that reason, this study focuses on ultimate ownership. We followed La Porta et al. (1999) with

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[2] The number of single-segment companies used in determining industry median capital-to-sales ratio is between 3 to 15 companies.

[3] Campbell (1996) groups SIC codes into several industries (petroleum, financial/real estate, consumer durables, basic industry, food/tobacco, construction, capital goods, transportation, utilities, textiles/trade, services and leisure). For example codes 15, 16, 17, 32 and 52 are grouped together as "construction industry".

adjustments to reflect the specific situation in Malaysia and the data that are available. Further, we examine all owners that own at least 5% of the votes. This is a smaller percentage than La Porta et al. (1999), who use a 10% of voting rights. In addition, unlike Fan and Wong (2002) and Claessens et al. (1999a, 1999c, 2000) who limit their attention to the owners who constitute 50% of the direct voting rights, we provide more details by including all block owners (those who own at least 5% of a company's shares). Previous studies may underestimate the percentage of shares controlled by large shareholders and by an ultimate controlling shareholder – our approach should give more reliable estimates.

Claessens et al. (2000) identify ultimate owners using sources of business group information. However, we took more comprehensive steps to trace the corporate ultimate owners. The steps are shown in Figure 3. The process started with the list of 30 largest direct shareholders of each of the listed companies, which was found from the annual reports of the companies. We collected the names of the shareholders and the percentage of shares owned by them. Only blockholders (major shareholders) who owned more than 5% of equity were analysed. Since each account in the list of 30 largest shareholders was disclosed separately, the percentage of shares from different accounts, including non-block accounts (less than 5%) that belonged to the same blockholder, was aggregated.
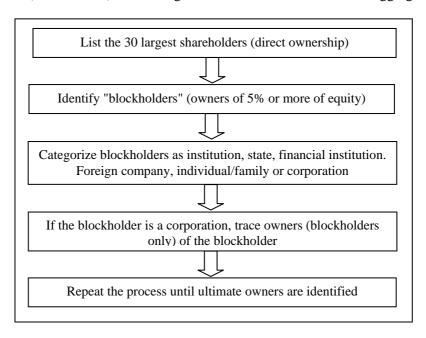

Figure 3. Steps taken to trace ultimate owners

The direct blockholders (holding at least 5% of the shares) are categorized into institution, state, financial institution, foreign company, individual/family and corporation. Institutional shareholders include insurance companies, pension funds and professional fund managers who hold shares on behalf of individuals. A shareholder is categorized as State if it is a statutory body established at federal or state level, for example, Urban Development Authority (UDA), Muda Agricultural Development Authority (MADA), Malaysian Industrial Development Authority (MIDA), Tourist Development Corporation (TDC), Petroliam Nasional Berhad (Petronas) and the various State Economic Development Corporations (SEDCs) (Gomez & Jomo, 1997). Companies are also categorized as state-controlled if they are owned by the government through Ministry of Finance. This includes companies owned by entities such as Khazanah Nasional Bhd., 100% owned by Ministry of Finance. Financial institutions are licensed banking institutions under the Central Bank of Malaysia. They include commercial banks, Islamic banks, finance companies, merchant banks and development finance institutions. La Porta et al. (1999) and Claessens et al. (2000) do not separately identify the financial institution category, but include such companies within their "institution" category. Foreign companies include companies incorporated outside Malaysia but with a place of business or business activity within Malaysia, which are registered with the CCM. If the owner was a company, then the owners of the company were traced further using online records of the company kept by the CCM. The owners of the company and their owners and so on were identified in order to trace the ultimate owner. At all levels, we collected data only for owners with shareholdings of 5% or more.

We define a controlling shareholder as a shareholder with the ability to exercise significant control rights through votes. We measure control rights at 20% cut-off point, as La Porta et al. (1999) consider 20% of voting rights as enough to give effective control of a company. Based on the cut-off point, corporations are first divided into widely-held or ultimate-owned corporations. Then, the ultimate owners of ultimate-owned corporations are further distinguished into institution, state, finance institution, foreign company, individual/family and widely-held corporation. As defined in La Porta et al. (1999), a widely-held corporation is a corporation with no controlling owner. On the other hand, an ultimate-owned corporation has a controlling owner. A controlling owner is a shareholder owning significant control rights (exceeding the cut-off point) who is not controlled by anybody else (La Porta et al., 1999; Claessens et al., 2000).

The control rights of the ultimate owner are its direct and indirect voting rights.[4] The indirect control rights are measured using the weakest link along the control chains connecting the ultimate owner with the corporation (Claessens et al., 2000). Cash flow rights are the sum of the products of the ownership stake along the various chains connecting a PLC to the ultimate owner (Claessens et al., 2000). The ratio of cash flow to control rights is measured using the ultimate owner's cash flow rights and control rights (Claessens et al., 2000).

The data on ultimate ownership represent a more complete analysis than that undertaken in previous research in Malaysia and similar countries. It allows a range of investigations to be undertaken into the relationship between ownership structures, diversification levels and the impact on corporate value of diversification.

RESULTS AND DISCUSSIONS

Diversification Data

Table 1 indicates that 54.6% of the companies in 2001 were diversified and 44.4% were focused. Claessens et al. (2001) discovered that 70% of their Malaysian sample companies were diversified in the period (1990–1996) before the Asian financial crisis.

TABLE 1
NUMBER OF FOCUSED AND DIVERSIFIED COMPANIES

	Frequency	Percent
Focused	161	44.4
Diversified	194	54.6
Total	355	100.0

The mean, standard deviation, minimum and maximum of the four proxies used in measuring diversification are depicted in Table 2. The number of segments ranged from 1 to 10, with an average number of 2.36 segments. This result is comparable to Ayoib et al. (2003), who find 2.3 reported segments on average for their sample of Malaysian corporations in 1995. Denis et al. (1997), and Lang and Stulz (1994) report means of 2.41 and 2.54 segments for US corporations. For two-digit SIC segments, we find that the number of segments ranged from 1 to 9, with an average of 2.29 segments. The averages of

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[4] An individual has indirect control of company X, if he/she has control of company Y which in turn controls company X either directly or through a longer chain of ownership and control.

Herfindahl indices calculated based on two-digit SIC code segments are 0.71 (sales-based) and 0.65 (assets-based) and ranged from 0.17 to 1.00 (sales-based) and 0.15 to 1.00 (assets-based). Ayoib et al. (2003) report Herfindahl index means of 0.32 (sales-based) and 0.27 (assets-based). They used Herfindahl indices based on reported segments that are not necessarily same as two-digit SIC segments; generally, the more segments that are included, the lower will be the value of the Herfindahl index. Denis et al. (1997), and Lang and Stulz (1994) both report average Herfindahl indices of 0.70 (sales-based). For the assets-based index, Denis et al. (1997), and Lang and Stulz (1994) have indices of 0.69 and 0.70, respectively.

TABLE 2
DESCRIPTIVE DATA ON DIVERSIFICATION LEVELS

Measurement of diversification	Mean	Median	SD	Min.	Max.
Number of segments reported	2.36	2.00	1.57	1	10
Number of related segments (2-digit SIC)	2.69	2.00	1.62	1	9
Herfindahl index – sales	0.71	0.71	0.26	0.17	1.00
Herfindahl index – assets	0.65	0.54	0.27	0.15	1.00

Ownership Data

Ownership is assessed in terms of both direct (immediate) and indirect interests. Direct ownership of a company is measured as the percentage of equity shares owned by direct owners. The mean number of direct blockholders (shareholders with more than 5% ownership) in the sample companies is 2.4 with 50.56% of shares on average owned by blockholders as a group. Table 3 shows the distribution of the blockholders into six ownership categories. The most significant category is "corporations". To identify indirect owners, the owners of these corporations were traced further by reference to the indirect ownership structure. Indirect ownership is measured by aggregating the percentage of equity owned both directly and indirectly by owners. Therefore, a corporation's total ownership could be more than 100% when measured in term of indirect ownership.

Using the indirect ownership structure, the largest controlling owners were identified for each company. Companies with no controlling owner are classified as widely-held. Other companies are classified as ultimate-owned. Ultimate owners were further grouped into institutional, state, financial company, foreign company, individual/family and widely-held corporation. Table 4 depicts the classification of the largest ultimate owner at a 20% cut-off point. The table shows that about 85% of the sample companies have an ultimate controlling owner at the 20% cut-off point.

TABLE 3
DESCRIPTIVE STATISTICS OF DIRECT (IMMEDIATE) OWNERSHIP

	Mean	Median	SD	Min.	Max.
Number of blockholders	**2.44**	**2.00**	**1.25**	**0**	**7**
Shares owned by blockholders(in %)					
Institutions	5.93	0.00	11.29	0	75.72
Individual/Family	9.93	0.00	16.58	0	67.00
States	1.67	0.00	9.04	0	65.00
Financial institutions	0.33	0.00	3.47	0	59.00
Foreign corporations	6.52	0.00	18.45	0	85.00
Corporations	26.18	24.71	23.65	0	92.12
All blockholders	**50.56**	**52.62**	**20.05**	**0**	**92.12**

TABLE 4
CLASSIFICATION OF ULTIMATE OWNERS

Cut-off point	20%	
	Frequency	%
Widely-held	52	14.6
Ultimate-owned		
Institutional	26	7.3
State	17	4.8
Financial	6	1.7
Foreign company	43	12.1
Family/Individual	172	48.5
Widely-held corporation	39	11.0
Total	355	100.0

Shareholders' Rights

Table 5 shows the control (voting) rights and cash flow rights of the largest ultimate owner. The mean of cash flow rights (23.0%) is lower than the mean of control rights (33.1%), because of the dilutive effects of pyramid and crossholding ownership structures. The ratio of cash to control rights, with a mean of 0.71, indicates the degree of divergence between cash flow rights and control rights. The closer the ratio to zero, the larger is the divergence. The mean of control rights (33.1%) is high compared to the results obtained by Fan and Wong (2002) and Claessens et al. (2000), who report 30.7% and 28.3% respectively for Malaysian companies. As described before, these researchers economized on data collection by terminating the tracing of owners once the voting rights reached 50%. Thus, their statistics for control rights are expected to be lower than those reported in this study.

TABLE 5
CONTROL RIGHTS, CASH FLOW RIGHTS AND RATIO OF CASH TO
CONTROL RIGHTS OF THE LARGEST CONTROLLING OWNER

	Mean	Median	SD	Min.	Max.
Control rights (%)	33.10	29.40	20.20	0.00	141.30
Cash flow rights (%)	23.00	19.50	16.70	0.00	92.10
Ratio of cash to control rights	0.71	0.99	0.34	0.00	1.00

Diversification and Ownership

We measured the mean levels of diversification using the four different measurement bases set out above by reference to blockholding categories, types of ultimate controlling owners and presence or absence of group affiliation. We tested whether any differences between means were statistically significant by using the Kruskal-Wallis test (for more than two categories) and the Mann-Whitney test (for two categories). These non-parametric tests were chosen because the normality distribution and constant variance assumptions are violated for the diversification levels data. The results in Table 6 show that, irrespective of the measurement used for level of diversification, mean diversification levels differ significantly according to the types of controlling owner. Corporations controlled by financial institutions have the highest mean level for diversification (except when diversification is measured using the Herfindahl index for sales). In addition, 62.8% of the companies have a group affiliation (see Table 10), that is, they have the same controlling owner(s) as at least one other company in the sample or they have another PLC in the company's pyramid of ownership structure. As shown in Table 6, diversification levels are also higher in corporations without a group affiliation than in corporations with a group affiliation. This is consistent with the findings of Claessens et al. (1999c), who noted that single-segment (undiversified) corporations in Malaysia are marginally more likely to have a group affiliation than multisegment (diversified) corporations. Claessens et al. (1999c) argue that group affiliation complements diversification in creating internal markets.

TABLE 6
MEAN LEVELS OF DIVERSIFICATION BY OWNERSHIP DATA

Diversification levels		Number of segments reported	Number of related segments (2-digits SIC)	Herfindahl index – sales	Herfindahl index – assets
Categories of controlling owner					
No controlling owner	Mean	2.19	2.60	0.70	0.65
	Mean Rank	167.45	174.22	178.34	178.71
Institution	Mean	2.38	2.85	0.61	0.59
	Mean Rank	178.83	195.42	140.65	158.44
Financial institution	Mean	4.17	4.17	0.63	0.57
	Mean Rank	253.83	226.25	138.08	134.08
State	Mean	2.35	2.82	0.70	0.66
	Mean Rank	185.88	182.47	179.18	182.24
Foreign company	Mean	1.42	1.70	0.81	0.79
	Mean Rank	112.40	110.92	220.79	228.90
Family/ individual	Mean	2.59	2.90	0.70	0.63
	Mean Rank	192.79	190.30	173.90	170.09
Widely-held corporation	Mean	2.31	2.62	0.69	0.63
	Mean Rank	183.51	181.78	174.45	173.77
Kruskal-Wallis test	p value (chi square)	0.00***	0.00***	0.050**	0.029**
Group Affiliation					
Affiliation	Mean	2.22	2.53	0.72	0.67
	Mean Rank	167.15	167.39	184.58	184.20
No affiliation	Mean	2.60	2.94	0.68	0.61
	Mean Rank	196.33	195.92	165.45	167.52
Mann-Whitney test	p value (z-statistic)	0.007*** (2.711)	0.009*** (2.596)	0.086** (–1.718)	0.134 (–1.498)

*** significant at 0.01 level
** significant at 0.05 level
* significant at 0.10 level
The shaded cells are the highest diversification levels in the particular variable.

Corporate Value

We used Berger and Ofek's (1995) excess value approach to assess the impact of diversification on corporate value. The excess value is measured by taking the natural logarithm of the ratio of actual to imputed value using turnover and asset multipliers. As extreme cases (actual values either more or less than four times imputed) have been excluded, the total number of companies analyzed is 285 of the full sample of 355 companies. Table 7 summarizes descriptive statistics for excess value.

TABLE 7
DESCRIPTIVE STATISTICS FOR CORPORATE EXCESS VALUE

	N	Mean	Median	SD	Min.	Max.
Excess value (turnover multiplier)	285	–0.09	–0.11	0.62	–1.37	1.34

Table 8 reports the mean diversification level for each quartile of excess value. The levels of diversification for each quartile are significantly different. Interestingly, the highest level of diversification is found in the fourth quartile of excess value (the highest value category). The correlations between diversification levels and excess value show that excess value increases significantly as diversification level increases.

TABLE 8
DIVERSIFICATION AND EXCESS VALUE

Diversification levels		Number of segments reported	Number of related segments (2-digits SIC)	Herfindahl index – sales	Herfindahl index – assets
Panel A: Mean of diversification levels for each quartile of excess value					
1st quartile	Mean	2.02	2.50	0.72	0.65
(–1.37 to –0.59)	Mean Rank	131.13	141.00	142.67	144.26
2nd quartile	Mean	2.01	2.36	0.72	0.67
(–0.58 to –0.10)	Mean Rank	131.57	131.02	147.74	146.30
3rd quartile	Mean	2.28	2.47	0.74	0.69
(–0.09 to 0.49)	Mean Rank	141.58	134.37	154.52	154.46
4th quartile	Mean	3.08	3.59	0.62	0.57
(0.50 to 1.34)	Mean Rank	178.44	181.16	114.98	115.85
Kruskal-Wallis test	p value (chi square)	0.003[***] (13.641)	0.002[***] (14.572)	0.042[**] (8.217)	0.055[*] (7.620)
Panel B: Spearman correlation between diversification levels and excess value					
Excess value – turnover		0.20[***]	0.15[**]	–0.09	–0.09

[***]   significant at 0.01 level
[**]   significant at 0.05 level
[*]   significant at 0.10 level
The shaded cells are the highest diversification levels in the particular variable.

The relationship between excess value, ownership structure and diversification is analyzed further using ordinary least square regression, with excess value as the dependent variable (Denis et al., 1997; Lins & Servaes, 1999, 2002). The variables used are defined in Table 9, and descriptive statistics are shown in Table 10. The variables also include the control variables as used in previous studies, corporate size (Berger & Ofek, 1995; Lang & Stulz, 1994; Denis et al., 1997), leverage (Anderson et al., 2000) and corporate age (Denis et al., 1997).

TABLE 9
DEFINITION OF THE VARIABLES (MODEL 1 TO MODEL 4)

Variables	Definitions
EXCESSTR	Natural logarithm of ratio actual (book value of debt plus market capitalization) to imputed value (sum of segments' sales multiplied by industry median capital-to-sales ratio)
DIVER	Binary variable: 1 = diversified company, 0 = focused company
DIVERSIFICATION (NMSEG2D)	Diversification level measured as number of two-digit SIC segments
CONTROL	Percentage of control rights held by the largest owner
CASHCONT	Ratio of cash to control rights of the largest owner
HCONLCAS	Binary variable: 1 = company with the largest owner having control rights above median but cash flow rights below median, 0 = otherwise
SINGLE	Binary variable: 1 = company having single owner owned majority control (holding at least 50% of the total control rights of all owners), 0 = otherwise
GROUP	Binary variable: 1 = company having same ultimate controlling owners with other companies in the sample or has other PLCs in ownership structure, 0 = otherwise
RELATED	Binary variable: 1 = company with all two-digit SIC code segments falling in the same Campbell's (1996) classification as primary two-digit SIC segments
SIZE (LNASSET)	Natural logarithm of total assets
LEVERAGE (DBTASS)	Total debt-to-total asset ratio
AGE (LISTYR)	Corporate age since listed

TABLE 10
DESCRIPTIVE STATISTICS (N = 285) (MODEL 1 TO MODEL 4)

	Mean	Median	SD	Min.	Max.
EXCESSTR	–0.09	–0.11	0.62	–1.37	1.34
DIVER	0.54	1.00	0.50	0	1.00
DIVERSIFICATION	2.69	2.00	1.62	1.00	9.00
CONTROL	34.00	30.00	20.06	0	141.30
CASHCONT	0.72	1.00	0.33	0	1.00
HCONLCAS	0.14	0	0.35	0	1.00
SINGLE	0.39	0	0.49	0	1.00
GROUP	0.62	1.00	0.49	0	1.00
RELATED	0.39	0	0.49	0	1.00
SIZE	19.32	18.95	1.32	17.17	24.72
LEVERAGE	0 .28	0.28	0.35	0	3.34
AGE	9.93	6.57	6.96	9.52	40.20

We tested four models as stated in Table 11. Model 1 tests for a relationship between EXCESS value and DIVER (where 1 indicates a diversified company), controlling for SIZE, LEVERAGE and AGE of the corporations. In Model 2, DIVER is changed to diversification level (DIVERSIFICATION). Models 3 and 4 investigate whether owners' rights and group affiliation affect diversification value. In Model 3, the largest owner's control rights (CONTROL) and the ratio of cash flow rights to control rights (CASHCONT) are tested. In Model 4, the deviation of cash flow rights and control rights is measured using a dummy variable whereby companies with the largest controlling owner having high control rights but low cash flow rights (HCONLCAS) are coded as one. Another three new dummy variables, single owner controlled (SINGLE), group affiliation (GROUP) and secondary segment related to primary segment (RELATED) are added in Model 4. LEVERAGE and AGE are not included in Models 3 and 4 since they are not significant in Models 1 and 2. The results of the regressions are reported in Table 11.

The models are all significant at $p = 0.000$. The adjusted R^2 for the models are from 5% to 11%. However, since the purpose of this study is to examine the association between dependent and independent variables and not to derive a model to predict the dependent variable, the adjusted R^2 is not relevant.

TABLE 11
REGRESSION MODELS OF EXCESS VALUES ON DIVERSIFICATION
DUMMY AND CONTROL VARIABLES

Model 1: EXCESSTR = $\beta_0 + \beta_1$ (DIVER) + β_2 (SIZE) + β_3 (LEVERAGE) + β_4 (AGE) + e_i

Model 2: EXCESSTR = $\beta_0 + \beta_1$ (DIVERSIFICATION) + β_2 (SIZE) + β_3 (LEVERAGE) + β_4 (AGE) + e_i

Model 3: EXCESSTR = $\beta_0 + \beta_1$ (DIVERSIFICATION) + β_2 (CONTROL) + β_3 (CASH/CONTROL) + β_4 (SIZE) + e_i

Model 4: EXCESSTR = $\beta_0 + \beta_1$ (DIVERSIFICATION) + β_2 (RELATED) + β_3 (HCONLCAS) + β_4 (SINGLE) + β_5 (GROUP) + β_6 (SIZE) + e_i

The coefficient estimates from the regression (numbers in parenthesis are *t* statistics):

	Model 1	Model 2	Model 3	Model 4
INTERCEPT	0***	0***	0***	0***
	(–3.84)	(–3.85)	(–4.35)	(–4.67)
DIVER	0.03			
	(0.50)			
DIVERSIFICATION		0.19***	0.18***	0.21***
		(3.24)	(3.17)	(2.75)
CONTROL			–0.13**	
			(–2.24)	
CASHCONT			–0.04	
			(–0.72)	
HCONLCAS				–0.12**
				(–2.12)
SINGLE				–0.19***
				(3.13)
GROUP				–0.03
				(–0.48)
RELATED				0.04
				(0.49)
SIZE	0.22***	0.20***	0.23***	0.25***
	(3.50)	(3.22)	(3.56)	(4.11)
LEVERAGE	0.03	0.01		
	(0.54)	(0.09)		
AGE	0.03	0.02		
	(0.48)	(0.28)		
Adjusted R^2	0.05	0.09	0.11	0.11
N	285	285	285	285

*** significant at 0.01 level
** significant at 0.05 level
* significant at 0.10 level

standard deviation of residual value for all models are lower than the standard deviation of dependent variable (0.62), illustrating that there is no problem in the linearity of the relationships between the dependent variable and independent variables of the models. The Cook-Weisberg tests for heteroscedasticity show that this does not appear to be a problem in all models. Linktest and Ramset tests

show that none of the models has a specification error. The _hatsq for all models are not significant (p > 0.05), so Linktest has failed to reject the assumption that the model is specified correctly. Similarly, p > 0.05 in Ramsey tests illustrate that there are no omitted variables in the models. As the VIF of each independent variable is less than two in all models, multicollinearity is also not a problem for the models.

Model 1 shows that diversified corporations have excess value of more 3% compared with focused corporations, but it is not statistically significant. In Model 2, when DIVER dummy is changed to DIVERSIFICATION level, the coefficient shows significant positive relationship with excess value. This means that diversification gives more value to the corporations. Diversification level is measured as the number of two-digit segments (Claessens et al., 1999c, 2001). The coefficients for SIZE, LEVERAGE and AGE are positive in both models but only SIZE has significant effect on excess value.

The control rights of the largest ultimate owner (CONTROL) have a significant negative relationship with excess value (EXCESSTR) in Model 3. Therefore, the higher the control rights of the controlling owner, the lower the excess value. This supports the concern that expropriation might occur when the controlling owner has significant control rights (Shleifer & Vishny, 1997; Bukart, Gromb & Panunzi, 1997). The ratio of cash to control rights (CASHCONT) is not significant in the models, but the negative sign coefficient supports the argument that high divergence, where control rights are higher than cash flow rights, gives an incentive to controlling owners to expropriate minority interests because the controlling owners bear a smaller proportion of the cash effect (Bebchuk et al., 1999). Model 4 supports the idea that deviation of cash flow rights from control rights (HCONLCAS) has a significant relationship with excess value when the coefficient illustrates that companies with the largest owner having high control but low cash have excess value 12% lower than other companies. The results in Model 4 also show that single-owner-controlled companies (SINGLE) have less excess value, about 19%, compared with companies that are not controlled by a single owner. There is no significant relation between GROUP and RELATED variables with excess value tested in Model 4. All variables in Models 3 and 4 have estimation of positive and negative coefficient as expected.

CONCLUSIONS

Previous studies on the relationship between corporate ownership and the value of corporate diversification have included Malaysian corporations in their pooled samples, but do not examine the data of Malaysian corporations separately.

Using a sample of 355 PLCs in Malaysia (of which 55% were diversified), we found that the level of diversification varies significantly for different types of ultimate controlling owners. In addition, companies without a group affiliation diversify more than companies with a group affiliation.

Overall, our findings do not support the argument that diversification is a value-reducing strategy for Malaysian corporations. Although there is no statistical evidence that diversified corporations are valued differently from focused corporations, there is evidence that value increases when the level of diversification increases. This provides evidence that diversification does not necessarily reduce corporate value. Our finding is consistent with the work of Fauver et al. (2003), who suggest that the value of corporate diversification in different countries is related to the institutional framework in each country.

Due to pyramid and crossholding structures, control rights are higher than cash flow rights. The regression models show that control rights of controlling shareholders have a significant negative relationship with excess value. This is consistent with the view that corporate diversification may be a strategy for expropriating minority interests. The ratio of cash to control rights is not a significant variable, although the sign of the variable is consistent with the expropriation strategy (the greater the divergence between control and cash flow rights, the more likely it is that controlling shareholders will be interested in expropriation). Therefore, the evidence shows that ultimate owners' rights are related to diversification strategies.

In this paper, we demonstrated that, in a developing country, diversification is perceived as a mixed blessing. Given the inter-relatedness of many companies, it may still be more efficient for substantial investors to achieve the benefits of a diversified portfolio through firm-level diversification rather than capital market diversification. Hence, diversification may be regarded as positive. On the other hand, diversification may be used by controlling shareholders as a strategy for extracting value from companies at the expense of minority shareholders. Our evidence suggests that diversification is still, in Malaysia, perceived to be on balance a contributor to firm value rather than value reducing.

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