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Diversification Effects on Firm Value and Corporate Governance

Underlying Theories and Case Studies from Thailand

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ABSTRACT

Title: Diversification Effects on Firm Value and Corporate Governance – Underlying Theories and Case Studies from Thailand

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Purpose: The purpose is to find whether corporate governance can alleviate value-destroying diversification strategies. We construct a theoretical framework to demonstrate how different forms of corporate governance mitigate agency costs of diversification in the East Asia context, and conduct case studies from Thailand to present predominant agency conflicts between controlling and minority shareholders in East Asia corporations.

Conclusion: Agency cost of free cash flow is the most detrimental cost to a firm as it can engage firm in the misuse of capital or over-diversification, and could be so tremendous that deprives all the benefits of diversification, generates diversification discount, and destroys firm value. Corporate governance is a mechanism to safeguard the agency problems, hence, plays an important role to reduce value-destroying diversification strategies. However, corporate governance mechanisms in East Asia are different from those of developed countries due to the predominant agency conflicts between controlling and minority shareholders.

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I. INTRODUCTION

1.1 BACKGROUND INTRODUCTION

The interest of the importance of corporate governance has first produced by the collapse of several empire businesses in the United States, particularly Enron and WorldCom, during the 1992 to 2001 or about the same period as the Fifth wave of the merger and acquisition. Looking further back into the history of the failure of mergers and acquisitions which is the origination of corporate governance is merit for this study. The waves of mergers and acquisitions were classified into five periods. The first wave (1897-1904) was known as the creation of large monopolies (Gaughan P.A., 2007)[1]. In this period, many companies engaged in horizontal expansions and industry consolidations to benefit from the economy of scales. However, due to a lack of impactful antitrust laws were enforced, the pace of the acquisitions relentlessly continued, unethical takeover practices were difficult to prevent. Nonetheless, the end of the first wave was caused by financial factors rather than the lax legal restrictions. The second wave, during 1916 to 1929, was the period that companies merged into oligopolies and engaged in vertical expansions rather than monopolies and horizontal expansions occurred in the first wave. This was the first large-scale establishment of conglomerates with the widely use of debt to finance the large acquisitions, and the popular pyramid holding company. The second wave ended with the stock market crash in 1929, which is known to many as “Black Thursday”[2].The third wave (1965-1969) was the period of the conglomerate merger, featured the diversification into new lines of business. Since the main source of fund was low-rate convertible debentures, many conglomerates traded the hope for the future capital gains on the sale of the convertible debentures to investors. However, some of them were overpaid for the target companies and failed to realize the benefits; while, some entered into price-earnings games and accounting manipulations. Thereby, many acquisitions were followed by poor financial performance. The end of the wave was marked by the passage of the Tax Reform Act in 1969 to stop the manipulative accounting abuses. The fourth wave (1984-1989) was the megamerger characterized by hostile takeovers, aggressive role of investment bankers, more aggressive uses of debt, and international takeovers. The mild recession in 1990 and the collapse of the junk bond market ended this wave. The rise and fall of each wave was driven by different diversification strategies and management incentives. The lucid period that questioned the efficiency of diversification strategies is the third wave

as many conglomerate firms formed in this period were later destructed and became more focused firms. The misconduct of some CEOs in the U.S. that caused giant corporations to cease operation is one possible account for the failure of diversification strategies. The explanation of the incentive of management lies in the agency theory.

Even though diversification strategies have a lot of benefits to the firm, the benefits of diversification strategies may be depleted if firms are not safeguarded against the costs of complexity of managing a large firm. The important cost is based on the misallocation of capital assumption. Instead of increasing firm value due to the benefits of economies of scale and scope, the value of diversified firms may be dampen by transferring funds from the most profitable business segment to the least one. Another cost of complexity arises when the interests of shareholders and managers are not aligned. Managers may have an incentive to employ diversification strategies for their own benefits but at the expense of firm value. Both costs of diversification are inherited in the agency problems. To counter these dilemmas, one of the commonly used mechanisms is governance and control. Corporate governance can resolve the agency problems by aligning the interests between shareholders and managers. Therefore, if the interests of shareholders and managers are closely aligned, it is likely that diversification strategies create value to the firm. However, corporate governance mechanisms designed for developed countries to reduce the conflicts between shareholders and managers may not fully applicable to East Asia countries due to the differences in the ownership structure and institutional context. The dominant family ownership structure and weak legal environments are key determinants of the agency problems in East Asia corporations. The primary agency problems, thus, arise by the deviation of interests between founder's family shareholders who have controlling power and minority shareholders. This requires different corporate governance mechanisms to solve the agency problems in East Asia.

1.2 PROBLEM DISCUSSION

Corporate diversification has been believed as a value enhancement to a firm due to the benefits of coinsurance effect (Lewellen, 1971), economies of scale (Chandler, 1977), and the benefits of efficient resource allocation through internal capital markets (Weston, 1970; Stulz, 1990; Stein, 1997). However, after the golden era of corporate diversification in the U.S. or the third wave, firms that grew into conglomerates in the 1960s were disassembled through divestitures during the 1970s and 1980s. The

deconglomerization raises serious doubts as to value-creation diversification strategies. Recently, a lot of research studies show that corporate diversification results in a loss rather than generating firm value. Berger and Ofek (1995) study diversification effects of non-financial U.S. firms during 1986-1991 and find a value loss of averaged between 13 and 15 percent. Lins and Servaes (1999, 2002) find a diversification discount[3] in Japan, the United Kingdom, and seven emerging markets, including Hong Kong, India, Indonesia, Malaysia, Singapore, South Korea, and Thailand. Comment and Jarrell (1995), John and Ofek (1995), and Berger and Ofek (1996) cite the benefits of corporate refocus as opposed to corporate diversification. Lamont (1997), and Ozbas and Scharfstein (2008) demonstrate an inefficient allocation of capital among companies under the same conglomerate firms, resulting in under-funded in some businesses and over-funded in others.

Albeit several research studies provide evidences of negative consequences of corporate diversification, the question is why many firms remain diversified. Villalonga (2004a) argues that the diversification discount is as a consequence of artifact of data used to analyze, rather than the discount itself. After adjusting for the choices of industry segment reporting, Villalonga finds the diversification premium[3]. Other possible answers to the question are based upon managerial behavioral theories including the agency theory, managerial entrenchment, and managerial hubris. These theories provide explanations that diversification strategies are not often motivated by shareholders' value maximization purpose. In contrast, diversification strategies are motivated by private benefits of managers. According to Jensen (1986), and Jensen and Murphy (1990), diversification can provide benefits to managers in terms of higher compensation, more power and control, and prestige from managing larger firms. Shleifer and Vishny (1989) describes how managers can use diversification to entrench themselves by making them valuable to shareholders and costly to replace. Consequently, managers may have many different incentives to remain diversify despite reducing shareholders' wealth. Moreover, Richard Roll (1986) adds that the pride of managers induce them to make a mistake by paying a premium for a target firm, causing shareholders' value loss in merger deals. These findings suggest that the agency problems attribute to the value-destroying diversification strategies.

There are a few research studies focusing on the relation between corporate governance and corporate diversification, and the explanation of the simultaneous

effects of both factors on firm value. Research studies previously focus on corporate diversification and firm value, corporate governance and firm value, or corporate governance and the degree of diversification. Most of them were conducted in the U.S. or the European countries, where the ownership structure and institutional context, particularly legal and governance protections are different from East Asian countries. Moreover, the Asian Financial Crisis in 1997, which was the origination of interests of corporate governance in Asia, was known to partially produced by over-diversifying of firms into nonproductive lines of business (Tirapat, 2003; Dhnadirek and Tang, 2003), following by huge losses to many large diversified firms. This provides some hints that corporate governance is related to corporate diversification, and firm value, and thus arouses our interest in this area. The East Asia countries in our meanings are Hong Kong, India, Indonesia, Malaysia, Singapore, South Korea, and Thailand.

1.3 PURPOSE

The purpose is to find whether corporate governance can alleviate value-destroying diversification strategies. We construct a theoretical framework to demonstrate how different forms of corporate governance mitigate agency costs of diversification in the East Asia context, and conduct case studies from Thailand to present predominant agency conflicts between controlling and minority shareholders in East Asia corporations.

1.4 THESIS OUTLINE

The subsequent parts of this paper are structured as follow. Section 2 provides the methodology and approach employed in this paper, choices of selecting large diversified firms in Thailand as case studies, and approaches of data collection. Section 3 discusses previous research studies and underlying theories. This section is attempted to provide various views regarding diversification discounts and premiums, corporate governance, their effects on firm value, as well as their joint effects on firm value. Section 4 discusses the institutional context and corporate governance structure in East Asia. Later part illustrates a theoretical framework of how corporate governance relates to the value of diversified firms in the East Asia context. Final part presents five case studies of large diversified firms in Thailand to emphasize the dominant agency problems. Section 5 is a conclusion, comprising key findings and suggestions for the future research studies.

II. METHODOLOGY

2.1 RESEARCH METHODOLOGY AND APPROACH

Our first choice of research method was a multiple regression analysis. Our aim was to find the relation and correlation between the value of diversified firms in Thailand and a range of corporate governance indications. However, due to the small and thin capital market of Thailand, we can identify only 19 diversified firms. With this small number of observations, it was difficult to draw a legitimate conclusion. To overcome this problem we expanded our firm-years observation from one year (2009) to five years (2005-2009) to obtain more data points. Unfortunately, there were two structural transformations occurring during the studying period. The first structural change happened in 2008. The economy of Thailand was affected by the economic recession of the United States due to the subprime crisis. As a result, the value loss of diversified firms may cause by the impact of macroeconomic, rather than the diversification itself. The second structural change was related to the enforcement of corporate governance in Thailand. The regulator (the Stock Exchange of Thailand; SET) requests every listed company to include corporate governance information in its annual report, and Form 56-1 since 2007. Although the code of corporate governance of Thailand is not enforced by law, in order to comply with the SET's rule, every company listed on the SET has to adopt the code of corporate governance. Consequently, this casts doubt whether the significant improvement in corporate governance of many firms in 2007 was based upon their impetus to improve or just to comply with the code. Due to the limitation we have, we decided to change our research methodology. We, thus, chose qualitative and deductive method as they are not limited our study to the small number firm observations, and the structural changes in macroeconomic and corporate governance regulation.

We describe how we conduct this paper in detail as follows. In section 3, first part, we discuss the foundation and motivation of corporate diversification by reviewing and analyzing several research studies such as of Edwards (1955), Penrose (1959), Jensen (1986) which are building block theories of diversification strategies, and then integrating them into one substance which explaining why firms engage in corporate diversification. We apply this literature review method (reviewing literature, synthesizing, and integrating into one substance), as we named it, throughout this study. Later, we explain two main types of corporate diversification comprising related and

unrelated diversification and their differences. This knowledge is important as a basis to understand other research studies because some studies focus on one type of corporate diversification than the other, and the results of each type on firm value are not monotonic. However, we do not focus on diverse views of firms pursuing different types of diversification strategies; thus, the purpose is just to improve understanding of the contents. Then, we compare two competing models; one side supports corporate diversification as a source of value creation, while the other side disputes that corporate diversification can destroy firm value. This part is conducted by comparing benefits and costs of corporate diversification as written by Lawellen (1971) about benefits and Fama (1980) and Jensen (1986) about costs. Then, we expand our discussion to the effects of corporate diversification on firm value. In the second part, we continue with corporate governance which is believed to be a warrant mechanism to mitigate agency problems. We discuss extensively on the agency problems between principals and agents (established by Jensen and Meckling, 1976) since they are central to the motivation of managers in pursuing corporate diversification. We also summarize the extension of agency problems which include overinvestment problems (Jensen, 1986), managerial entrenchment (Shleifer and Vishny, 1989), and managerial hubris (Roll, 1986). The objective is to find the implication of these problems on the costs of diversification. Then, we investigate the impact of corporate governance on firm value. This part is also employed the literature review method but with horizontally focus to obtain evidences of the relation of corporate governance and firm value. In the last part of section 3, we develop deductive reasoning from the premises found in the previous parts, and construct a deductive argument about the relation of corporate diversification and corporate governance on firm value, and the joint effects of corporate diversification and corporate governance on firm value. The literature review of Yermack et al. (2009) is conducted to support our argument about the interrelation of the three factors. It is worth noted that this section is relevant in the international level and may not be fully applicable to the East Asia and Thailand context.

In section 4, we limit the scope of the study to only what is pertinent to East Asia. This is because there are numerous diversities in country-specific level and firm-specific level that produce impacts on the strength of corporate diversification and the validity of the conventional corporate governance systems[4] applied to East Asia corporations. In the first part, we summarize the study of Khanna and Palepu (1997)

regarding the key implication of the institutional environments in East Asia that encourages corporate diversification strategies. Later, we investigate the prevalence of diversification discount in East Asia to provide a premise that the benefits of the institutional setting alone do not guarantee valuable diversification strategies but there are some other complementarities. Next, we examine corporate governance structure in East Asia. Besides the literature review, we employ deductive reasoning to draw a conclusion that the conventional corporate governance systems are not appropriate in the East Asia context but the proposed new corporate governance framework, which is family-based system developed by Khan (2003b), is more justify. Then, we combine all of the findings from previous sections to develop a theoretical framework to illustrate how the agency problems are the nexus of corporate governance and diversification discount. More specifically, we model the framework in the East Asia setting by putting together the two arguments; first, the agency costs are among other costs pertinent to diversification strategies, and second, the agency costs can be so enormous that deprive all the benefits of corporate diversification, but can be lessen by different forms of corporate governance. The agency costs in East Asia differ from those in the U.S. mainly due to the different ownership structure and institutional context. Therefore, we indicate that different governance mechanisms are required in dealing with the agency conflicts in the East Asia context. The importance of the theoretical framework is that it can capture all elements of concerns in one picture and highlight the focused point of the issue. Our framework can be used as a tool or a frame of thought to perform analyses or generate new ideas within the relevant areas. The theoretical framework does not only stress the important cost of diversification that is the agency cost of free cash flow, but also illustrate other possible costs and benefits of diversification. Also, the framework makes ones think of what could be the right corporate governance tools to apply in the different ownership structure and institutional setting in order to reduce the agency problems. We also summarize key corporate governance mechanisms suitable for the family-based ownership structure of most firms in East Asia, comparing to governance mechanisms used in developed countries such as in the U.S. Lastly, we conduct case studies of five large diversified companies in Thailand to emphasize that different ownership structures incur different types of agency conflicts, thus, require different treatments. The process of conducting the theoretical framework and case studies is iterative and co-developed rather than one-stop self-dealing modeled. We use annual reports, Form 56-1, websites, and other document of the companies to explore

possible agency problems, evaluate existing corporate governance tools, and investigate the prevalence of other alternative governance mechanisms that firms voluntarily erect and apply. The case study is a good way to gain comprehensive views of business, ownership, and financial structures of the firms, and is especially useful to justify the validity of the governance policies written in the document of the companies. By investigating the ownership structure of the firms, it can imply types of agency problems, and by evaluating governance mechanisms, it can deduce whether the firms hit the nail of the head. If the agency problems are solved at its core, it is likely that the costs of agency conflicts are diminished or not so immense that disturb the decisions of firms in doing diversification.

2.2 SELECTION OF RESEARCH COMPANIES

The firms we selected are diversified firms which are publicly traded on the SET, and have sales revenue exceeding USD20 million throughout the past five year (2005-2009). We choose to study large diversified firms. The selected firms must operate in more than one business segments and not operate or report any segments' sales under the financial services industry. The words conglomerate firms and diversified firms are used interchangeably in this paper. The lists of five large diversified firms are as follows:

Table 1: Researched Companies

Company Name	Business Sector	Business Owner
The Siam Cement Plc. (SCC)	Construction Materials	State-owned
Central Pattana Plc. (CPN)	Property Development	Family-owned
PTT Plc. (PTT)	Energy & Utilities	State-owned
Berli Jucker Plc. (BJC)	Commerce	Family-owned
Thai Airways International Plc. (THAI)	Transportation & Logistics	State-owned

2.3 APPROACH OF DATA COLLECTION

The financial information and corporate governance data is primarily obtained from the annual reports, Form 56-1, websites, and other document of the individual company. The information of corporate governance regulations is collected from various sources, comprising the National Corporate Governance Committees, the Stock Exchange of Thailand, the Securities and Exchange Commission, etc.

III. DIVERSIFICATION AND CORPORATE GOVERNANCE IN THEORIES

3.1 CORPORATE DIVERSIFICATION

Diversification is a form of corporate strategy which companies used for expanding from their business into other product markets (Andrews 1980, Berry 1975, Chandler 1962, Gluck 1985). Diversification strategy allows firms to enter into new lines of businesses which are different from current operation. Rumelt (1986) finds that by the year 1974, 86 percent of Fortune 500 firms operated as diversified businesses. Some authors also show a continued increasing trend in diversified firms in 1990s (Bennett, 1989). However, the level of diversification declined between 1985 and 1989 mainly because of the conglomerates busts-up (Lichtenberg, 1992). Many arguments, thus, have been discussed for reason behind diversification strategy. According to Montgomery (1994), the motivations of corporate diversification stem from three perspectives; the market-power view, the resource view, and the agency view. Both of the market-power and resource views are supported by the profit maximization motives. Only the agency view is supported by the efficient use of corporate resources. The market-power perspective developed by Edwards (1955) describes two main benefits of diversification; firms may use one of the segment profits to support another, and firms may face less vigorous market competition as each competitor become interdependent in multiple markets (Bernheim and Whinston, 1990). The resource approach is based upon the work of Penrose (1959). From this view, firms have incentive to expand businesses, as long as an expansion could be a means of gaining higher profit from their unused resources. The agency approach views the separation of managers (agent) and owners (principals) as a conflict relationship. Managers might pursue strategies to their own interest rather than to the benefits of shareholders (Berle and Means, 1932; Mueller, 1969; Morck, Shleifer, and Vishny, 1988; Jensen, 1986, Shleifer and Vishny, 1989). Including, managerial entrenchment as describes by Shleifer and Vishny (1989) is one of the reasons for managers conducting corporate diversification because it is a way to increase firms' demands for managers-specific skills.

3.1.1 Type of Diversification

The diversification strategy can be classified into two main types, depending on the need for interdependence or resource-sharing of new businesses. The two types are related diversification and unrelated diversification. (Rumelt, 1974; Pitts, 1977; Song, 1982; Reed and Reed, 1989; Michel and Hambrick, 1992). Related diversification is a strategy of firms undertaking new operations at different stages of production which

related to existing operations. The procession of product goes through the transformation of raw materials to finish products. It can be either forward (downstream) or backward (upstream) in the value chain. On the contrary, unrelated diversification is a strategy of corporations entering into new unrelated business areas. A lot of research studies argue that diversifying into related product-markets give more returns than diversifying into unrelated businesses (Rumelt, 1974; Christensen and Montgomery, 1981; Michel and Shaked, 1984; Keats, 1990). However, unrelated diversification has been argued as a desirable strategy when firms' profits start to erode, particularly when firms entering into the mature stage or operating in lower profitability industry (Leontiades 1986). However, no consensus has been made on this issue.

3.1.2 Benefits and Costs of Diversification

After the rise and fall of the conglomerate era in the 1960s, finance researchers have been separated into two schools of thought; one side buttresses the diversification strategy as a value creation; while, the other side argues about the diversification discount. Benefits of diversification can be classified as operating and financial characters (Lewellen, 1971). Benefits of operating synergies are as follows:

(1) Cost saving or benefits from economies of scale (Chandler, 1990) – may be as a result of a reduction in per-unit costs deriving from an increase in size or scale of a firm (Gaughan, 2007);
(2) Benefits from economies of scope (Panzar and Willig 1981) – arise when firms are able to share some inputs with other business segments in order to offer a broader range of services and products
(3) Revenues enhancement – stems from the monopoly power or the advantage of the more complete product line. When firms encounter the mature stage of their market or industries, firms may need to find an alternative for continuing growth, new opportunity and/or more profitability; all of which can be achieved by pursuing corporate diversification (Gort, Grabowski, and McGuckin, 1985);

Benefits of diversification from financial synergies are described as follows:

(1) Co-insurance effects – firms could obtain a diminished variability of corporate earnings through the portfolio diversification to unrelated businesses (Lewellen, 1971). Diversification could reduce the chances of bankruptcy by going into new products or markets (Lewellen, 1971; Higgins and Schall, 1975) because

diversified firms pool unsystematic risk and reduce the voluntarily in operating cash flow. Firms could also be beneficial from unutilized debt capacity or reduced tax liabilities of an acquired firm subsequent to diversification by merger.

(2) Internal capital market – diversified firms can allocate resources to their best use by forming an internal capital market where the internally generated cash flows can be pooled (Weston, 1970; Williamson, 1975; Li and Li, 1996; Matsusaka and Nanda, 1997; Stein, 1997).

Nevertheless, diversification has costs as well. Costs of diversification are illustrated as follows:

(1) Misallocation of capital or cross-subsidization – firms may misallocate their capital from more profitable to less profitable segments (Rajan, Servaes, and Zingales, 2000). The inefficient resources allocation can also be explained by incentives and behaviors of division managers by the rent-seeking hypothesis (Scharfstein and Stein, 2000). Division managers could raise their bargaining power and negotiate for more compensation from CEO, which could not necessarily be done by cash wages but by the capital budget allocation; thereby, weaker divisions get subsidized by stronger ones. Put it another way, division managers may engage in wasteful or rent-seeking activities for enhancing their negotiating position rather than spending all their time on productive efforts.

(2) Agency problems (Jensen and Meckling, 1976; Fama, 1980; Jensen, 1986) – are costly to the diversification strategies. As firms' size and executive compensations are correlated, it could be that managers' motivation of diversification which provides benefits to managers that are unavailable to investors. Other researchers argue that managers engage in diversification due to self-interest to reduce their employment risk (Amihud and Lev, 1981). Including, decisions to diversify could be viewed as an attempt by the CEO to entrench herself (Shleifer and Vishny, 1989) or managerial hubris (Roll, 1986). The agency problems will be discussed extensively later in the corporate governance section;

(3) An ambiguity in the benefit of coinsurance effect – managers might pursue diversification strategies due to the benefits of coinsurance effect that reduce the cash flow volatility and make them manage company's portfolio easier. However, this benefit will be at the expense of shareholders (Gaughan 2007)

3.1.3 Diversification and Firm Value

In evaluating efficient investments, many researchers are based their methodology upon the internal capital market theory. This is because one way to know whether the diversification creates value or not is to measure how efficient firms allocate their capital resources to other business segments. In others word, if the internal capital markets lead to misallocation of capital, it is most likely that diversification destroys value of the firm. The misallocation is when a firm moves funds from profitable sectors in high Tobin's Q[5] industries to support investment in lower Tobin's Q sectors (Scharfstein and Stein, 2000). Scharfstein and Stein call it 'socialism' in internal capital allocation, referring to weaker divisions getting subsidized by stronger divisions. The principal of internal capital market, hence, has become a basis for measuring the value of diversified firms. The excess value, developed by Berger and Ofek (1995), is a method used to compare the firm value to its imputed value. The imputed value is the sum of the values of each segment of the firm if it was operated as stand-alone entities. If the imputed value is less than the firm value, it implies that diversification strategies destroy firm value.

The issue of diversification generates values to the firm or not is the issue that has not been settled. According to the research roundtable discussion on the diversification discount issue held by Harvard Business School in April 2003, the level of diversification discount can be labeled into three forms of market efficiency: strong, semistrong, and weak. Strong form refers to that diversified firms destroyed value by engaging in diversification strategies. Semistrong form means that firms could worth more or less by pursuing the diversification strategies. However, weak form suggests that diversified firms trade at discount when comparing to stand-alone or specialized firms in the same industries. Each of the forms has both supporters and protesters. The opponents of the diversification discount claim that firms might be traded at discount before they do diversify (Hyland, 1997; Campa and Kedia, 2002; Villalonga, 1999). Another argument made by Campa and Kedia (2002) and Villalonga (2004a) is that failing to take into account endogeneity between corporate diversification and the structure of corporate governance may lead to some errors or the detection of diversification discount. Moreover, COMPUSTAT[6], which is a main source of segment database, is controversial to the segment reporting bias; while, a new census database or BITS[7], which covers the whole U.S. economy at the establishment, is claimed to be a

better database. Villalonga (2004a, 2004b) finds a premium for the firms pursue related diversification when using BITS as the main data source. In addition, different time periods of the study and diverse countries provide mixed results when measuring the value of diversified firms. Servaes (1996) finds the diversification discount in the U.S. during the 1960s but disappears during the 1970s. Lins and Servaes (1999, 2002) find the diversification discount in the United Kingdom, Japan, and seven emerging markets, including Hong Kong, India, Indonesia, Malaysia, Singapore, South Korea, and Thailand, but not in Germany; while, Khanna and Palepu (2000) find a premium in Indian business group.

In terms of the diversity in countries, Khanna and Palepu (1997) argue that diversification strategies benefit emerging countries but not developed economies. Their finding shows that the highly diversified business groups or large conglomerate firms in emerging markets add value by imitating the functions of financial intermediates, government bodies, and other institutions that are present only in the advanced economies. This assertion is supported by Fauver, Houston, and Naranjo (2003)'s study of 35 countries[8]. They do not find the diversification discount for emerging but developed countries, after taking into consideration the capital market development, international integration, and legal systems. Khanna and Palepu (1997) conclude three main characteristics of the institutional context that make some economies enjoy more benefits than the others, that we will be discussed in detail in subsequent section. The characteristics comprise the capital, product, and labor markets, government regulation, and enforcement mechanisms. The summary of the institutional context of three countries, the United States, Japan, and India is provided in Appendix 1.

3.2 CORPORATE GOVERNANCE

Corporate Governance has been increasingly important issue after several corporate scandals, especially after the collapse of several empire businesses in the U.S., Enron and Worldcom, or during 2001 to 2002; and, has become the force to the Sarbanes–Oxley Act 2002. Corporate governance approaches have evolved in different social and economic contexts which include diversity among nations (Clarke, 2007); however, the diversity of corporate governance could be classified into two main systems. The first system is the outsider system found in Anglo-American countries, characterized by dispersed equity markets, the separation of ownership and control, and the disclosure-

based regulation. The other system is the insider system, so called the Continental European system, which predominates in the Europe, Asia Pacific, and other regions of the world. This system is characterized by the concentration of ownership, bank finance, and the representatives of majority shareholders on a board of directors (Coffee, 2001). Although many multinational corporations adopt corporate governance as the force of the globalization, many research studies show that corporate governance is associated with firm performance (Gompers, Ishii and Metrick, 2003; Bebchuk and Cohen, 2005; Bebchuk, Cohen and Ferrell, 2005; Cremers and Nair, 2005). Moreover, corporate governance can be viewed by internal and external governance mechanisms (Cremers and Nair, 2005). Blockholders and a board of directors are often seen as primary internal monitoring mechanisms; whereas, takeover defenses and the market for corporate control (e.g. law and regulation) are main external mechanisms. These different mechanisms work together in a system to affect governance in a firm. Although, the definition of corporate governance has been defied in many, one of the corporate governance definitions is the system by which companies are directed and controlled (Cadbury, 1992). Essentially, corporate governance is concerned with holding balance between economic and social goals, and between individual and communal goals. Nevertheless, the dominant theoretical framework for understanding corporate governance lies in agency theory (Clarke, 2007). Before we proceed to discuss the agency problems, we would like to define what we refer when talking about good corporate governance.

There is no single model of good corporate of governance, and it can be differed from regions to regions. In the region where the corporate governance structure is the Anglo-American type or equity-based, good corporate governance refers to measures to balance the conflicts between shareholders and managers. The regulation has been set in order to monitor managers and limit their power. In the region where the corporate governance structure is the Continental European or bank-based, good corporate governance refers to a means which help relieve the conflict of interest between majority and minority shareholders (or between creditors and shareholders). However, recently a lot of research bodies have been studied the corporate governance structure in emerging countries, and revealed a new structure. In East Asia, corporate structure is dominated by family owners, good corporate governance, thus, should be minority protection and large outside blockholders. Including, banks as outside monitoring

system could play an important role to mitigate agency problems between majority and minority shareholders (Berglof and Claessens, 2004). Although many factors contribute to good corporate governance and corporate governance guideline can be varied countries by countries, the Organization for Economic Co-operation and Development, McKinsey analysis provides 10 common areas of good corporate governance principles as table below.

Exhibit 1: McKinsey 10 Common Areas of Good Corporate Governance

Accountability	**Independence**
Transparent ownership: Identify major shareholders, director and management shareholdings, and cross-holdings. **Board size:** Establish an appropriate number of board seats; studies suggest that optimal number is 5 to 9. **Board accountability:** Define board's role and responsibilities in published guidelines, and make them basis for board compensation. **Ownership neutrality:** Eschew antitakeover defenses that shield management from accountability. Notify shareholders at least 28 days before shareholder meetings and allow them to participate on-line.	**Dispersed ownership:** Deny any single shareholder or group privileged access to or excessive influence over decision making. **Independent audits and oversight:** Perform annual audit using independent and reputable auditor. Insist that independent committees oversee auditing, internal controls, and top-management compensation and development. **Independent directors:** Allow no more than half of directors to be executives of company; at least half of nonexecutive directors should have no other ties to company.
Disclosure and transparency	**Shareholder equality**
Broad, timely, and accurate disclosure: Fully disclose information on financial and operating performance, competitive position, and relevant details (such as board member backgrounds) in timely manner. Offer multiple channels of access to information and full access to shareholders. **Accounting standards:** Use internationally recognized accounting standards[1] for both annual and quarterly reporting.	**One share, one vote:** Assign all shares equal voting rights and equal rights to distributed profit.

[1] *Generally accepted accounting principles (GAAP), such as US GAAP, UK GAAP, or International Accounting Standard (IAS).*

3.2.1 Agency Problems

Agency theory conceives of the firm as a nexus of constantly re-negotiated contracts by individuals, each aiming to maximize their own utility (Alchian and Demsetz, 1972). An essence of the agency problem is the separation of finance and management. The agency cost in firm is zero when the manager is the firm's sole shareholder, (Jensen and

Meckling 1976). Shareholders (principals) and managers (agents) have a contract specified duty and responsibility but the problem is that future contingencies cannot be anticipated, complete contracts are, hence, not feasible (Clarke 2007). Agency theory raises a fundamental problem in firm. The theory explains that shareholders have the right to residual claims; while, managers have the right to manage. As the basis of agency theory is the self-interested utility-maximizing motivation of individual actors, there is a single-minded focus on how the principal is able to prevent the agent from maximizing his own utility (Jensen 1994). The agency theory perspective influenced theoretical perspective of board and governance. This views board as a control mechanism to ensure match between managers and shareholders, and to reduce the potential divergence of interests between corporate management and shareholders. In addition, firms might face the agency problems in different ways depending on their ownership structure. A dispersed ownership structure likely faces the agency problem between managers and shareholders. While concentrated ownership structure has conflict between majority and minority interests. According to an article of Coffee (2005), the corporate scandals in the United States and Europe have been different. It shows that in dispersed ownership country like the U.S. mainly has earning management, and short-term stock manipulation problems. In contrast, in the countries where the concentrated ownership is dominant, the problem is mainly expropriations of private benefits of controlling shareholders.

3.2.1.1 Free Cash Flow Hypothesis

The agency costs of free cash flow of Jensen (1986) explain that managers have incentives to drive firms to grow beyond the optimal size because firms' growth increases managers' power by increasing the resources under their control. This problem refers to as an overinvestment problem. Jensen describes that conflicts of interest between managers and shareholders are more serious when firms have substantial free cash flows. Managers have incentives to invest excess cash flow at below the cost of capital or to waste it on inefficient investments. Shleifer and Vishny (1997) argue that this type of agency conflict is the most detrimental costs to the firm value associated with diversification strategies. Nevertheless, Jensen (1986) suggests that one of the solutions to decrease managers' overinvestment is debt creation. By issuing debt, managers are bonding to pay out future cash flows in a way that cannot be accomplished by increasing dividend payout. If managers do not maintain their promise

to make the interest and principle payments, firms may get into bankruptcy. Thus, debt creation mitigates the agency costs of free cash flows by reducing the available cash flows for spending at the managers' discretion.

3.2.1.2 Managerial Entrenchment

Managerial entrenchment is a theory developed by Shleifer and Vishny (1989). The theory explains how managers may make themselves valuable to shareholders and costly to replace. Their model describes by the choices of investments made by entrenched managers. Those choices include the manager-specific investments, the manager-specific contracts, the motivation behind the diversifications, and divestitures.

The first implication of managerial entrenchment related to firms' investments is excessive growth. Managers have an incentive to invest more, than invest less because the larger the company is, the higher wealth, fame, or consumption of perquisites the managers will gain. Put it another way, the resources that managers can extract from the shareholders when managing larger firm are higher than when managing smaller firm. Summarizing, the manager-specific investments create costs to shareholders in two ways: a social inefficiency (investments are not value-maximizing), and an expropriation of wealth from shareholders to managers through rent-seeking. Second, the manager-specific contract, this can be both explicitly and implicitly. Managers can sign such an explicit contract that is favorable to them or to make it very costly to replace them. In contrast, an implicit contract is for instances; if managers resign from the position, the firms may lose other valuable employees due to the loyalty of those employees towards managers. In sum, managers can entrench themselves by making the contracts contingent upon their continued employment. Managers, therefore, have more bargaining power over their compensation. Third and fourth implications are the motivation of managers behind diversifications and divestitures. The theory describes entrenched managers who pursue the business expansion excessively as they want to lock-in existing position in the firm. The motivation for diversification could be underlying on the firm's poor financial performance comparing to its peers or could be underlying on a change in industry conditions that makes managers' skill less valuable. In contrast to the impetus to invest, the impetus to divest is rather simple. Managers are willing to sell assets only at a price that reflects higher profits, and the divestiture must increase the market value of firms.

The implication of the theory is that managerial entrenchment is very costly to shareholders, especially manager-specific investments. For this reason, the diversification strategies as suggest by this theory might not create value to the firm. Shleifer and Vishny also present the mechanism to tackle the entrenchment problem; that is governance by the board of directors. First proposition is having the board of directors which are knowledgeable to evaluate the investment projects proposed by managers. Another way is selecting the right managers at the first place. This also implies the important of effective nominating committees. Last, the board may provide managers lucrative pay, and voting control of the firm. In this case, it implies granting managers the ownership stake in the firm. In sum, it can be deduced by the context of the theory that to overcome the value-reducing diversification strategies caused by managerial entrenchment problems, the firm has to establish a good corporate governance setting. The theory suggests three governance indications which are skillful and active board of directors, effective and transparent nominating committees, and the managerial ownership.

3.2.1.3 Managerial Hubris

Roll (1986) proposed the hubris hypothesis as an explanation of corporate takeovers. The hypothesis is that managers might seek to acquire firms for their own personal motives. This hypothesis explains why managers might pay a premium for a target firm that the efficient market has already corrected value. According to hubris hypothesis explanation, managers have superimposed their own target's valuation. The pride of management allows them to believe that their valuation is superior to that of the market (Gaughan, 2007). According to Hayward and Hambrick (1997), they found four indicators of CEO's hubris; a recent organizational success or a good acquiring company's recent performance, a media praise for the CEO, a CEO's self-importance, and the composite of these three indicators. They cite that these four indicators are highly associated with the size of premium paid. The better the recent performance, the greater the recent media praised for the CEO, the greater CEO's sense of potency, the higher the confidence the CEO believes he or she can bring to an acquired entity, and the higher the price paid. Furthermore, the relationship between CEO's hubris and premiums paid is strengthened when board vigilance is lacking; for instances, when CEO and the chairman of the board is the same person, and when the board's composition has a high proportion of inside directors. Malmendier and Tate (2005)

show that CEO's overconfidence can explain a significant portion of acquiring shareholder value lost in merger deals. Therefore, managers' motivations to involve firm diversification strategy may be driven by managerial hubris.

In summary, the hubris hypothesis explains the value destruction from firm diversification in the way that managers find corporate diversification as a rise in their power and prestige.

3.2.2 Corporate Governance and Firm Value

Corporate governance is a control mechanism to ensure match of interests between shareholders and managers. When the interests of managers become more aligned with shareholders, the firm value is suggested to be increased. Consequently, corporate governance is conjectured as a means to increase firm value. However, evidences of the relation between corporate governance and firm value are limited and provide mixed results. The problems could be that different researchers employ different proxies when testing for corporate governance and firm value, making it difficult to draw a concrete conclusion. Moreover, there are many factors influencing corporate governance such as legal framework, finance, and corporate performance. Coase (1960) and La Porta et al. (1998) find that law matters for corporate governance. The study of Durnev and Kim (2005) confirms Coase (1960) and La Porta et al. (1998)'s findings, and add that firms' choice of adopting corporate governance and disclosure is positively related to growth opportunities, need for external financing, and concentration of cash flow rights. In addition, ignoring dynamic endogeneity may lead to bias in estimating the relation between corporate governance and firm performance (Hermalin and Weisbach, 2004; Wintoki, Linck, and Netter, 2008). The dynamic endogeneity refers to that *current* firm performance affects *future* corporate governance and *future* firm performance.

Nevertheless, until research studies that are robust and provide comprehensive views on corporate governance and firm performance have produced, we will accept research studies that are thoughtfully constructed and concern about issues we have outlined prior. Gompers, Ishii and Metrick (2003) develop their own "governance index", comprising 24 governance rules to use as a proxy for the level shareholder rights or the balance of power between managers and shareholders. They find that stronger shareholder rights are associated with higher firm value, profits, sales growth, lower capital expenditures, and lower incidents of corporate acquisitions. Cremers and

Nair (2005) study governance mechanisms and equity prices and conclude that external (market for corporate control) and internal (shareholder activism) governance mechanisms are complementarily related to long-term abnormal returns and profitability of firms. Bebchuk and Cohen (2005) find that staggered board result in a reduction in the value of the firm. Brick and Chidambaran (2007) use the number of board meetings and the number of director-days devoted to board meetings as proxies of corporate governance. The result shows that an increase in board monitoring has led to an increase in firm value. Chi and Lee (2010) control for the diversities in the potential severity of agency costs across firms, and focus on the most detrimental case of agency problems that is the agency cost of free cash flow. Their finding reveals that the value of firms which maintain high free cash flow increases as corporate governance improves, but the benefits are lower in firms which have low free cash flow. Morck et al., (1988), McConnell and Servaes, (1990), and Lins (2003) discover that when managerial ownership increases, interests of managers and shareholders become more aligned. Taken together, evidences reveal that to certain extent corporate governance has an effect on firm performance.

3.3 INTERRELATION OF DIVERSIFICATION, FIRM VALUE, AND CORPORATE GOVERNANCE

As we have previously outlined, diversification strategies have a lot of benefits to the firm comprising both operating and financial synergies. Nevertheless, the complexity of management large diversified or conglomerate firms is not trivial. If diversified firms cannot overcome such complexity, the benefits of diversification strategies may be depleted. The important cost of managing a large firm lies in the misallocation of capital assumption. Instead of increasing firm value due to the benefits of economies of scale and scope, the value of a diversified firm may be dampened by transferring of funds from the most profitable business segment to the least one. The inefficient resources allocation can lend an explanation from the rent-seeking hypothesis inheriting in the agency theory. The hypothesis explains that division managers may have an incentive to raise their bargaining power by means of getting more capital budget allocation. In doing so, weaker division gets subsidized by stronger division. In addition, another source of complexity arises when the interests of shareholders and managers are not aligned. In a firm where internal capital resource is abundant or external capital market is not a constraint, managers who have a diverted incentive

from shareholders may engage in excessive investments which Jensen (1986) used to call the overinvestment problem. The distract interests of managers can also be explained by the managerial entrenchment and managerial hubris. The literature suggests that managers may have an incentive to employ diversification strategies for their own benefits such as making themselves costly to be replaced, enhancing rewards through managing a larger firm, and acquiring low-quality assets due to strong belief in own pride. From the above stand, it implies that the motivation of managers is a key determinant of value-creating or value-destroying diversification strategies, thereby the agency costs of observing and controlling manager behaviors can become massive costs of diversification.

Corporate governance was established to tackle the agency problems. A lot of research bodies discover that corporate governance is to some extent positively related to firm performance. The source of value creation of corporate governance is the alignment of interests between shareholders and managers. Therefore, if the interests of shareholders and managers are closely aligned, it is likely that diversification strategies create value to the firm. We twist and expand from this argument and posit that the agency costs of monitoring and observing behaviors of managers can be so tremendous that caused the diversification discount. Therefore, if different forms of corporate governance can mitigate the severity of agency costs, it can also alleviate value reduction caused by diversification strategies.

To strengthen our argument, we lend support from the studies of Yermack et al. (2009). The study buttresses the explanatory power of agency problems for the value reduction of diversified firms. The authors examine how much of the diversification discount can be attributed to poor corporate governance. Their sample consists of all non-financial U.S. firms which reported on both COMPUSTAT and Segment data files, testing for the period of 1992 to 2005. They construct a panel dataset including a wide range of corporate governance variables. To measure potential agency problems, they have concentrated on ownership variables by employing CEO ownership, institutional investor ownership, and outside blockholder ownership as proxies. Other explanatory variables include board size, the fraction of independent outside directors, independent nominating committee dummy, the fraction of directors whose tenure predates CEO, the powerful CEO dummy, the governance index developed by Gompers et.al (2003), and classified board dummy. In their study, they are successful to address potential

endogeneity problems of corporate diversification decision and of corporate governance attributes. They detect the negative value impact of diversification of approximately 25 to 30 percent, and the discount is amplified by adverse governance variables such as low CEO ownership, low board independence, and board classification. In sum, they find that firms with good corporate governance are less likely to implement value-destroying diversification strategies.

IV. DIVERSIFICATION AND CORPORATE GOVERNANCE IN EAST ASIA

4.1 AN IMPLICATION OF INSTITUTIONAL CONTEXT TO DIVERSIFICATION IN EAST ASIA

As discussed earlier in the part of diversification and firm value, the institutional context has influences on corporate diversification. The institutional context suggests that emerging countries, including East Asian countries be beneficial from group diversification. To demonstrate how the institutional context is advantaged to emerging markets, Khanna and Palepu (1997) explain as follows. First, since most emerging countries lacks of rigid control to monitor firms in *the capital market*, investors may be reluctant to provide funds to new enterprises as they may not be well-protected from unscrupulous entrepreneurs, especially when the enforcement of the securities litigation are unpredictable. As a result, only large diversified companies which maintain good track records can get access to the capital market. Moreover, they benefit from the internal capital market by internally raising funds to invest in new lines of business. This advantage is more pronounced when governments of emerging countries have a restriction on amount of funds to which banks can provide large diversified business group such as in India and Korea. Second, *the labor market*, the authors claim that most emerging markets suffer from a deficit of well-trained personnel. They site Thailand as an example of the country which managers are not enough to serve the economy needs. Therefore, business groups may be more cost-efficient to establish their own in-house training programs than standalone entities. In this case, business groups can put the man on the right position by allocating talented people to where it most used or needed. Moreover, group structure facilitates the flexibility in workforce by developing internal labor markets; employees from a declining company in a group can be transferred to other thriving or more stable companies. Last, *the product market*, they describe that under-developed communications infrastructure, inefficient information flows, limited

enforcement of liability laws, and a lack of activist consumers make firms in emerging markets have higher costs in building brands than counterparts in advanced economies. Hence, large conglomerate firms with good reputation in the product market have advantages when entering into new businesses. They are also advantaged in cost-sharing among affiliated firms. Besides the three market characteristics, there are two other specifications contributing to the institutional context of emerging markets: governmental regulation and enforcement mechanism. *Government intervention* is prominent in many emerging countries. Decisions in some businesses are needed to get permission from governments. Therefore, good relationships and connections with governments are important in doing some businesses such as commodities and important raw materials. As a result, large diversified groups add value to firms because they have capacity to carry costs of maintaining relationship with governments, and the uncertainty of regulatory systems. The authors explain the intricate relationship between businesses and governments as the norm throughout the developing countries. Bribes and corruptions are prevalence and may be part of working with the bureaucracy. In terms of *contract enforcement*, these countries do not have effective mechanism to enforce contracts. Companies in emerging markets cannot work together under arm's-length contractual arrangements because the judicial system is not so efficient and less likely to resolve disputes; thus, they have to rely on their honest and reputation. This reputation can also be seen as a source of competitive advantage.

In summary, the institutional setting in emerging countries encourages valuable diversification strategies due to weak investor protection, shortage of managerial personnel, asymmetry of information, government intervention, and ineffective contractual enforcement. However, the implication of the institutional context of emerging markets should be applied with caution. If the institutional context accounts for the whole story of corporate diversification in East Asia, we would not have seen the Asian Financial Crisis in 1997 caused by over-diversifying and expanding into new lines of business (Tirapat, 2003; Dhnadirek and Tang, 2003). There are also other aspects should be taken into consideration when evaluating the virtue of corporate diversification such as the development of firms, ownership structure, capital structure, etc.

4.2 INVESTIGATION THE EXISTENCE OF DIVERSIFICATION DISCOUNT IN EAST ASIA

In this section, we provide evidences of diversification discount in East Asia countries to serve two purposes; first, to emphasize that the imperfection of institutional environments in East Asia does not always guarantee the successes of corporate diversification, and second, to argue that diversification discounts detected in East Asia economies have a root cause from the agency problems associated with excessive diversification.

Lins and Servaes (2002), in their studies of corporate diversification in seven Asian countries (Hong Kong, India, Indonesia, Malaysia, Singapore, South Korea, and Thailand) find the diversification discounts in firms that are part of industrial groups[9] and for large diversified firms with management ownership concentration between 10 and 30 percent. The discount is most severe when management control rights substantially exceed their cash flow rights. In other words, expropriations of minority shareholders are central to the value-reducing diversification strategies. Their results do not support the benefits of the internal capital market of diversified firms and reveal the benefits of imperfections of the institutional context in East Asia. This implies that the severity of agency conflicts between controlling and minority shareholders exceed the benefits of the internal capital market and the institutional context that corporate diversification can offer. In addition, Isak and Napier (2006) find a support that corporate diversification in Malaysia is value-reducing strategy. They find that due to pyramid and cross-shareholding structures of the firms, the expropriation is most likely to occur when the controlling shareholders have significant control rights. In Thailand, Tirapat (2003) discovers the negative effect of corporate diversification on firm value. He also concludes that the managerial entrenchment is responsible for the value-reducing diversification of Thai firms. Claessens et al. (1998) discover the diversification discounts for South Korea and Malaysia by suggesting the misallocation of capital as a cause of the value loss. Chen and Ho (2000) from Singapore find significant value loss from diversification only for those firms with low managerial ownership. They conclude that value-reducing diversification stems from agency problems.

4.3 CORPORATE GOVERNANCE STRUCTURE IN EAST ASIA

In East Asia, the important of corporate governance has been increasingly pronounced after the Asian Financial Crisis in 1997 (World bank 1998, 67-68). There are several features determining the structure of corporate governance such as the ownership

structure, law and finance, levels of economic, social and political development, etc (La Porta et al., 1998; Claessens and Fans, 2003; Parades, 2005; Young et al., 2008; Peng and Jiang, 2010; Lόpez-de-Foronda, Forthcoming). Differences in these features attribute to differences in corporate governance structure of each region and country. There are two widely-accepted corporate governance systems which are the outsider (the Anglo-American system) and insider (the Continental European system) systems used to explain corporate governance structure of firms in the U.S., and the Europe, Asia Pacific, and other parts of the world, respectively. However, neither of them is fully applicable to East Asia firms. Essentially, the ownership structure and institutional context, particularly legal environments, are main determinants of corporate governance structure of East Asia (North, 1990; La Porta et al., 1998; Dharwadkar et al., 2000; Claessens and Fans, 2003; Ozcan and Cokgezen, 2003; Wright et al., 2005; Morck et al., 2005; Paredes, 2005; Young et al., 2008; Peng and Jiang, 2010). Claessens et al. (1999a, 2000) identify that two-thirds of the corporations in East Asia[10] are controlled by single ultimate shareholders, and more than half are controlled by large families' stakeholders. Their study also indicates that in 1996 the top ten families' ownership in Indonesia, Philippines, and Thailand account for 58, 53, 46 percent, respectively. In South Korea and Malaysia, the top 15 families' ownership accounts for 38 and 28 percent, respectively. Faccio et al. (2001) also find that family owners are the predominant controlling shareholders in Asia[10]. Lin (2000) investigates 22 emerging countries and finds that 58 percent of firms have at least on blockholders. Next, the question is how the institutional context has an impact on corporate governance structure in East Asia. North (1990) and Wright et al. (2005) mention that the institutional context of emerging economies makes the enforcement of governance mechanisms according to the conventional agency theory costly and problematic. Paredes (2005) state that the U.S. corporate governance is inappropriate in developing countries because these countries lack of three mechanisms (1) advanced market that essential for the Anglo-American governance system to work, (2) contracting system that firms can design the contracts as they see appropriate, and (3) stability in social, political, and economic policies. Young et al. (2008) explains that a lack of formal institutions, laws and regulations regarding accounting requirements, information disclosure, securities trading, and their enforcement makes conventional corporate governance mechanisms inefficient or not operative as intended. Thus, the creation of informal institutions such as business groups, family connections, and government

relationship is important for corporate governance in East Asian corporations. They also suggest that the family ownership and other informal mechanisms emerge to fill the vacuum for the corporate governance in East Asia.

As a consequence, the dominant family ownership structure in East Asia causes different agency problems from their counterparts in the U.S. and U.K. In East Asia, Claessens and Fan (2003) discover that the combination of family ownership structure and law and enforcement fundamentally delineates the incentive, policy, managers' performance, and firm profitability. They explain that the agency problems arise by deviations between control and cash flow rights of controlling shareholders. When controlling shareholders have power to control the firm beyond the cash flow rights provided by their shares' ownership, they have incentive to expropriations because the expropriations are easy to achieve with the high level of control of management. Also, controlling shareholders, who usually hold undiversified portfolios may want to reduce their own risks, are involved in corporate diversification. This can be comparable with the finding of Amihud and Lev (1981) that managers with more ownership in the company diversify more to reduce their own risks. The agency problems are even worse when the protection of minority rights is weak, and firms are formed into pyramid-holding or cross-shareholding structures because the complex structures make it difficult for investors to monitor excessive investments performed by controlling shareholders (La Porta et al., 1999; Claessens et al., 1999b; Claessens et al., 1999c; Fan and Wong, 2002).

Expropriations can be operated in many manners. La Porta et al. (2000) define the expropriations by that controlling shareholders sell output or assets to their related businesses at below or above market prices, set transfer price which benefits firms in their own groups, and put unqualified family members in managerial positions, or pay excessive salary to executives. Expropriations can also include engaging in excessive diversification strategies which enhance personal, family, or political agendas at the expense of firm performance (Backman, 1999).

Due to the different causes of agency conflicts in East Asia, it is implied that applying governance mechanisms designed for developed countries to firms in East Asia may not effective or even counterproductive (see Table 3 for corporate governance mechanisms for different types of agency conflicts). Young et al. (2008)

explain that increasing ownership concentration which is believed to resolve the agency problems between managers and shareholders would not work in the case of emerging markets because giving more control to already powerful controlling shareholders may increase the possibility of expropriations. Moreover, the same authors also question the effectiveness of the board monitoring role in family-owned firms because family owners who have control power of the company can decide who sits on the board. Therefore, the ability of the board of directors to oversee controlling shareholders may be nullified. There is also an interesting piece of literature discussing that corporate governance in three Asian countries, Thailand, Malaysia, and Singapore, is illusion. The authors, Chuanrommanee and Swierczek (2007), suggest that these countries improve their corporate governance in response to international financial demands. They also claim that the corporate governance presentation in the document of the companies does not reflect the real practices, and thereby does not have an impact on firm value. The formal acceptance of corporate governance does not mean the commitment to follow. The incident is prominent in Thailand and Malaysia where the regulatory standards are high but enforcement are weak. This could be that these countries adopt international corporate governance mechanisms that are meaningless or ineffective to use under the East Asia institutional context. Repeatedly, weak shareholder rights protection, inefficient law enforcement, lax transparency and information disclosure are effective deterrents to implement corporate governance mechanisms established in developed markets.

The apparent shortcomings of standard governance mechanisms and weak explanatory power of the conventional agency theory in emerging markets are extensively criticized by Khan (2003b). Khan introduces a new conceptual framework of corporate governance for East Asian countries, and named it as the family-based corporate governance system (FBS). Khan argues that common good approaches may be more suitable to serve the needs of multiple shareholders in East Asia firms than conventional corporate governance approaches designed for develop countries. The detail of FBS and the illustration of differences among family-based system (FBS), equity market-based system (EMS), and bank-led system (BLS) are exhibited in the table as follow:

Table 2: Types of Corporate Governance System

Summarized from Corporate Governance: The Limits of the Principal-Agent Approach in Light of the Family-Based Corporate Governance System in Asia by Khan (2003b)

Characteristics	**Equity Market-Based System : EMS** (Anglo-American)	**Bank-Led System : BLS** (the Continental European)	**Family-Based System : FBS** (East Asia)
Control by providers of finance	Low	High	High initially; but vary as family groups get external funds
Finance markets	Large and Highly liquid	Not necessarily small but Less liquid than EMS	Small and Less liquid
Share of all firms listed on exchanges	Large	Not necessarily small	Usually small
Investor orientation	Large	Concentrated	Concentrated
Investor orientation	Portfolio-oriented	Control-oriented	Control-oriented for family groups
Shareholder rights	Strong	Weak	Weak for outsiders
Creditor rights	Strong	Strong for close creditors	Strong for close creditors, but Weak for arm's length creditors
Dominant agency conflict	Shareholders vs Managers	Banks vs Shareholders	Controlling vs Minority Interests
Role of BoD	Important	Limited, but less than FBS	Limited
Role of hostile takeovers	Potentially important	Quite limited	Almost absent
Role of insolvency	Potentially important	Potentially important	Potentially important
Monitoring of non-financial enterprises (Monitoring by outsider investors)	Can be done through interlocking directorships, but equity market and threat of takeovers are the most important mechanisms	Mixed; adequate regulations are enforced, and stable intra-group shareholding monitoring can be effective	Mixed; in the presence of strong regulations and government vigilance, monitoring could be efficient. But the presence of moral hazard could lead to lax monitoring
Self-monitoring	Possible; but the mechanisms above apply for the most part	Possible; with oversight by government, and members of the group	Initially self-monitoring is effective. Later, a strong tendency of insiders to be predatory by outsiders, self-monitoring could still be efficient but depending on owner-managers' performance

Essential aspects of FBS that make it differs from EMS and BLS can be grouped into four main issues: (1) the extent of family controlled corporations in East Asia, (2) the financing modes, (3) the dominant agency conflicts, and (4) the problems of monitoring family businesses. In terms of the ownership and financing modes, East Asia corporations are initially highly controlled by the providers of funds which are usually founder's family groups, but the power of control can be varied if later firms get access to external funds. However, the small and less liquid financial markets together with weak outsider shareholders' protection suggest that the main source of fund be financed by large family shareholders and/or close-knit banks. In contrast, EMS, the control of providers of finance is low since the shares of ownership are dispersed among multiple stakeholders due to the large and liquid financial markets. Relatively strong shareholders' and creditors' protection also promote investments in the capital markets, making firms in developed economies gain easier access to the external funds. Third, since the firms grow as managing and supervising by founder's family owners, they maintain close monitoring in managers' behaviors, thus the agency problems between owners and managers are usually not severe. Also, because most family-owned firms in East Asia have management from the same family, the conflicts between members of the same family may not extreme. On the contrary, the problems arise between founder's family owners and financiers which are either banks or outside shareholders. The dominant agency problems in FBS countries arise between founder's family owners (controlling interests) and outside shareholders (minority interests). Fourth, the self-monitoring role of founder's family owners is initially strong but becomes weak as firms acquire large external financing and grow into large conglomerate firms because firms may expand into areas which they lack of expertise or experiences to manage. In addition, the demand of external capital arises in tandem with high leverages (equity finance is not a viable option due to inefficient capital markets of East Asia economies) and increased monitoring from financiers or banks. The bank-led structure suggests that the agency conflicts arise between banks and shareholders, thus firms in East Asia markets should follow BLS. However, the failure of bank monitoring role in East Asian countries evidenced by the Asian Financial Crisis (1997)[11] casts doubts upon the appropriateness of BLS to East Asia firms. EMS is impossible for East Asia economies since the role of hostile takeovers and the outsider rights' protection is almost absent. In summary, the key different of FBS from EMS and BLS is that the ultimate control resides with large family shareholders or groups of

shareholders, neither banks nor equity markets. Second, the source of finance largely comes from owners' family members, making them controlling shareholders of the firms, and hence inviting different agency problems from EMS and BLS. Lastly, the monitoring roles of outside investors and banks are limited due to weak legal environments. Therefore, the new developed FBS may be more suitable for firms in East Asia countries.

As a consequence of Khan's establishment of FBS, complex questions arise with regard to how effective of the existing governance mechanisms that East Asia firms adopt from EMS and BLS. Should alternative governance mechanisms more appropriate for FBS to work in East Asia corporations? Lins (2003) finds non-management control rights blockholdings as an external governance mechanism partially substitutes for the absent formal governance institutions in emerging markets. Klapper and Love (2004), and Durnev and Kim (2007) propose that voluntary firm mechanisms are used in emerging markets to partly compensate for poor legal protection and law enforcement. Moreover, of Claessens and Fan (2003), Parades (2005), and Young et.al (2008) propose several governance mechanisms to protect expropriations of minority shareholders or to prevent insiders' disloyalties. The proposed mechanisms include giving the rights to minority shareholders to nominate a certain number of representatives to the board even a small fraction of minority shares' ownership, allowing minority shareholders to have the cumulative voting, giving minority participation in determining dividend policy by letting them vote on how much they want to get paid. Also, there are other alternative policies that relevant to prevent expropriations such as CEO and important positions are not limit to only founder's family members or groups of controlling interests but elected from the most qualified person. Clearly, further studies in this area are required. With the new establishment of the family-based corporate governance system and corporate governance mechanisms tailored to East Asia firms, it is likely that they will reduce agency conflicts between controlling and minority interests which cause the diversification discount.

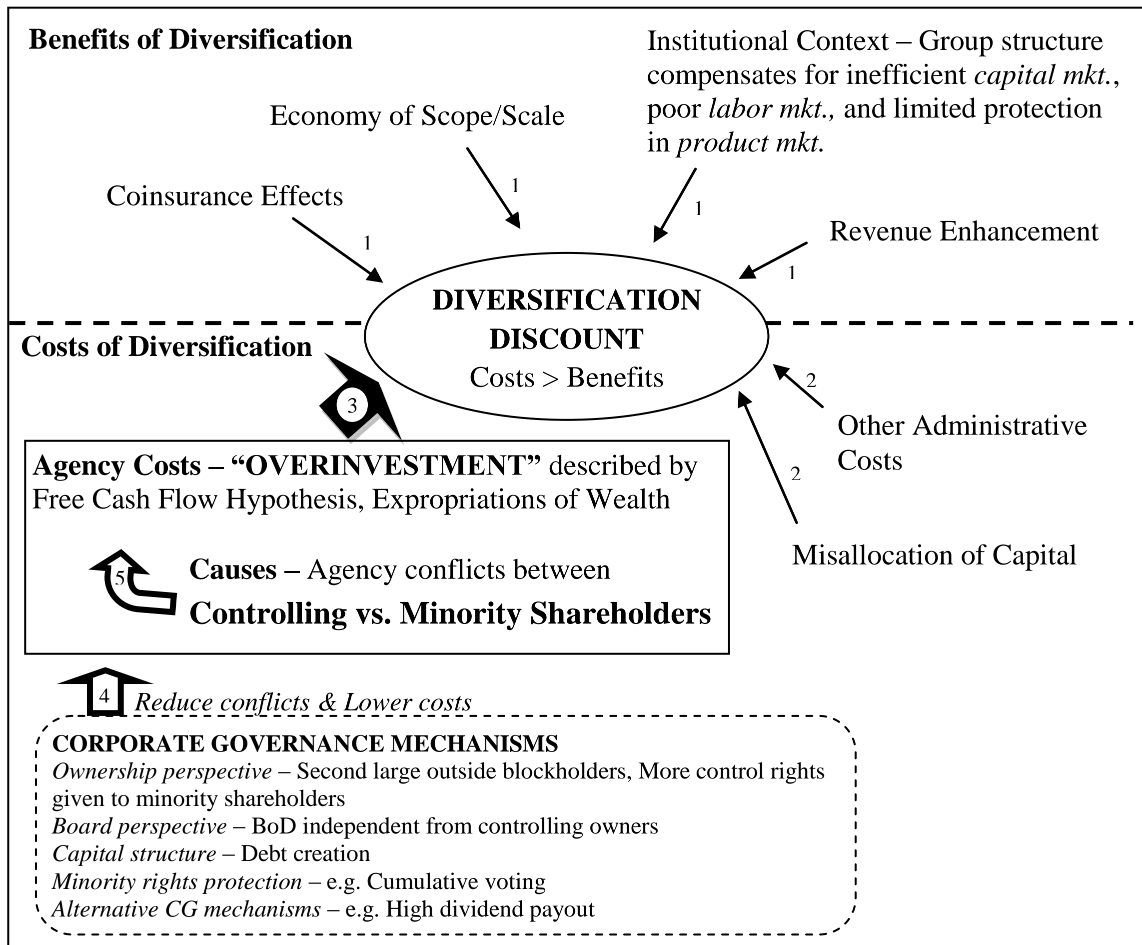
Last but not least, the conflicts between shareholders and managers are not entirely lacking in East Asia corporations, but not severe and may occur in different forms from the conventional agency problems. Young et al. (2008) mention different behaviors of agency conflicts in family-controlled firms that the conflicts can emerge

between controlling shareholders and managers who have the same family name as the controlling shareholders. However, in our view, the agency problems in family-owned businesses are more likely to arise in the conventional operation that is between controlling shareholders and outside professional managers rather than owner managers. This grey area requires future research studies to fill the voids.

4.4 THEORETICAL FRAMEWORK IN EAST ASIA SETTING

There are many complementarities in the firm-specific, market, and corporate governance contexts to justify the virtue of diversification strategies. We construct the theoretical framework to demonstrate how corporate governance mechanisms are relevant to diversification strategies, and consequently to firm value.

Exhibit 2: Theoretical Framework in East Asia Setting



1 – Refers to potential benefits when doing corporate diversification

2 – Refers to potential costs when doing corporate diversification

3 – The overinvestment problem is the detrimental costs of diversification.

4 – Corporate governance mechanisms can mitigate agency conflicts, as a consequence, lower agency costs or overinvestment problems by preventing expropriations. (Please refer to the detailed explanation of each corporate governance mechanism in Table 3)
5 – The primary cost of overinvestment problems in East Asia is due to the agency conflicts between controlling and minority shareholders.

The theoretical framework divides potential benefits from costs of diversifications and demonstrates that when costs exceed benefits, diversification discount appears and firm value is negatively affected. The detrimental costs of diversification is agency costs which generated by agency problems between controlling and minority shareholders (principal-principal conflicts) or shareholders and managers (principal-agent conflicts), but the former problem is more dominant in East Asia corporations. The agency conflicts between principals and principals arise when controlling shareholders expropriate wealth from minority shareholders. The agency conflicts have negative consequences to firm value as they drive firms into excessive investments because of substantial free cash flow to spend. However, the agency conflicts can be diminished by corporate governance. When the agency conflicts are kept in check by corporate governance mechanisms, misconducted diversification activities less prevail, corporate diversifications are operated for the purpose of firms' value maximization that benefits all shareholders. It is, therefore, highly likely that corporate diversification generates value to the firm. One important caveat of implementing corporate governance mechanisms in East Asia lies in the validity of the mechanisms firms put into practice. Therefore, different treatments to the principal-principal conflicts from the principal-agent conflicts may be more justify in defending agency costs of diversification in East Asia firms.

The following table exhibits the different forms of corporate governance that help diminish the conflicts of interest. The diagram highlights the different governance mechanisms in relaxing the agency conflicts between managers and shareholders, and between controlling and minority shareholders.

Table 3: Corporate Governance Mechanisms for Different Types of Agency Conflicts

	Types of Agency Conflicts	
	Managers vs Shareholders	**Controlling vs Minority Shareholders**
CG System	Equity Market-Based System (EMS)	Family-Based System (FBS)
CG Mechanisms		
Ownership Structure	Concentrated ownership [1] High managerial ownership [3] Institutional ownership [5]	Second outside blockholders [2] Low managerial ownership [4] More control rights given to minority shareholders, e.g. cumulative voting right [6]
Boards of Directors	Role separation of chairman and CEO[7] Independent outside boards of directors [8] Independent NC and Chairman is independent	Role separation of chairman and CEO[7] Board member not dominated by controlling shareholders [9]
Capital Structure	Use debts implying increasing monitoring from banks [10]	Use debts implying increasing monitoring from banks [10]
Capital Structure	Use debts implying increasing monitoring from banks [10]	Use debts implying increasing monitoring from banks [10]

[1] *Shleifer and Vishny (1986) find that the concentrated ownership benefits firms due to the benefits of monitoring activities by major shareholders. However, the degree of concentrated ownership should not exceed a certain limit. McConnell and Servaes (1990) and Weinstein and Yafeh (1995) argue that once the concentrated ownership exceeds a certain threshold, these owners can extract private benefits.*

[2] *Lins (2003) finds non-management control rights blockholdings as an external governance mechanism partially substitutes for the absent formal governance institutions in emerging markets. López-de-Foronda et al. (Forthcoming) discover that second large outside blockholders play an important role in reducing the expropriations of benefits of minority interests.*

[3] *Denis, Denis, and Sarin (1997) find that firms with higher managerial ownership are significantly less likely to be diversified as managers bear some risks which diversification strategies represent.*

[4] *Burkart, Panunzi, and Shleifer (2003) suggest that in weaker legal regimes, when controlling owners and professional managers share the same private benefits, they may collude to extract benefits at the expense of minority shareholders.*

[5] Bethel, Liebeskind, and Opler (1998) indicate that the company performance improves after an activist institutional investor purchases a block of shares, so the institutional ownership can be seen as external governance mechanism.

[6] Parades (2005) and Young et.al (2008) propose alternative governance mechanisms to protect expropriations of minority shareholders e.g. giving rights to minority shareholders to nominate a certain number of representatives to the board, allowing minority shareholders to have the cumulative voting, giving minority participation in determining dividend policy.

[7] Mallette and Fowler (1992) and Finkelstein and D'Aveni (1994) find that CEO duality (CEO is also the chairman of the board) can absolutely entrench a CEO at the top of an organization, challenging the board's ability to effectively monitor and discipline.

[8] Rosentein and Wyatt (1990) examine that outside director appointments have positive correlation with share-price and firm value.

[9] Filatotchev et al. (2005) find that board independency from founder's family owners has a positive impact on firm performance

[10] Jensen and Meckling (1976) and Jensen (1986) indicate that debts can represent a bonding commitment by managers to pay out cash-flows to debtholders, thus, helping to overcome the free cash-flow problem.

In conclusion, with the help of corporate governance mechanisms for FBS, the possibility that corporate diversification destroying firm value in East Asia is lessen because they prevent the controlling shareholders from expropriations of benefits from minority shareholders by excessive diversification. Thus, corporate diversification is operated for the purpose of maximizing firm value.

4.5 CASE STUDIES FROM THAILAND

This section provides comprehensive overviews of corporate governance structure of five large diversified firms which are publicly traded on the SET. These five selected companies are different in many characteristics, but we find that they have a commonality in that all of them have single dominant shareholder either founder's family shareholder or the government of Thailand. The main purpose of case studies is to indicate that the dominant concentrated ownership structure, especially the family-based ownership structure, can initiate different agency problems from the conventional agency theory. Thus, alternative corporate governance mechanisms may be more appropriate in operation to mitigate the agency conflicts in the East Asia context.

Although there are many dimensions (as discussed in Section 4.3) to be considered when studying the corporate governance structure of firms, we concentrate on four main dimensions which include the ownership structure, board structure, capital structure, and minority rights protection. The ownership structure can determine agency conflicts within the firms; while, board vigilance can examine the severity of agency conflicts. The capital structure suggests the allocation of powers between equity finance providers and creditors. In addition, we investigate whether the firms have any minority rights protection or voluntarily corporate governance mechanisms.

Research Company 1: The Siam Cement Public Company Limited (SCC)

SCC was established in 1913 following the Royal Decree of His Majesty King Rama VI to produce cement, which is a main building material for infrastructure projects, and hence is important to the fundamental development of Thai's economy. SCC was first diversified to new lines of business in 1938, and has become a conglomerate company in 1971. The reason of SCC's first diversification was driven by the government's intention to employ SCC as a government arm to serve as the fundamental development of Thailand. SCC was known to be a facilitator of many infrastructure projects/industries. However, later it is the SCC's own strategies to become the conglomerate firm. The SCC conglomerate comprises five business segments, encompassing chemical, paper, cement, building material, and distribution. The following table shows the summary of the ownership structure, board structure, capital structure, and minority rights protection.

Ownership Structure	2009	2008	2007	2006	2005
% Majority ownership	30%	30%	30%	30%	30%
% Second outside blockholder	11%	7%	9%	11%	9%
• Type	Non-voting right institutional shareholder				
% CEO, directors and management ownership	0.13%	0.14%	0.12%	0.12%	0.12%
Board Structure					
Role separation between chairman and CEO	Yes	Yes	Yes	Yes	Yes
% Independent outside directors	42%	42%	42%	42%	50%
Nominating committee					
• % Independent committee	60%	60%	60%	50%	60%
• Independent chairman	Yes	Yes	Yes	Yes	Yes
Capital Structure					
Debt ratio	53%	57%	49%	53%	59%
Minority Shareholders' Right	Yes	Yes	Yes	Yes	Yes

Ownership Structure

The major shareholder of SCC is the Crown Property Bureau (CPB) which is a state enterprise, owned by His Majesty the King of Thailand. The decisions or policies made

by the Thai government can have a direct influence on the CPB because the chairman of the CPB's board of directors is the Finance Minister. Moreover, many CPB's investment projects are cooperative with the Thai government. This could imply that SCC is a company which the majority ownership is concentrated on the government's hands. CPB maintains a constant ownership stake in SCC at 30 percent over the past five years. The second outside blockholders, which mainly are non-voting right institutional investors, also holds quite constant shares of averaged 9 percent. Due to the ownership composition of SCC that has the government as the majority interest and has CEO as an outsider, the agency conflicts can arise by two ways; between management and shareholders, and between controlling and minority interests.

First, the conflicts of interest between managers and shareholders might not be severe because SCC's management is indirectly monitored by the government through the chairman of CPB's board of directors. In our view, the government does not compromise the governing and controlling of SCC; otherwise, the government risks sabotaging the reputation of the His Majesty the King of Thailand. This force could help discipline SCC's management to act on the interests of CPB, to remain transparent, and not to pursue value-destroying activities. However, the low percentage of the managerial ownership and no policy of earning stock option may not motivate CEO and management to put the highest effort in managing the company.

Second, the conflicts between controlling and minority interests, the government through the CPB's arm could influence the board and extract benefits from SCC's minority shareholders to other affiliated companies under the government's umbrella portfolio. Especially, when the second blockholders are non-voting right institutional investors, they cannot hold balance of power for the minority protection. Conversely, the presence of the non-voting right shareholders implicitly increases the voting power to the government. However, in this case, the low percentage of the managerial ownership coupled with zero stock option are seen to be beneficial to minority interests because this could prevent a coalition between the controlling shareholders and professional managers from expropriations of benefits, as well as could moderate earning management and short-term stock manipulative problems since professional managers may not have an incentive to involve in pushing the stock price.

In the bright-line, we detect an alternate good governance mechanism voluntarily exercised by SCC. SCC gives rights to minority shareholders to report, suggest, and complain about inequitable treatments. The minority shareholders can directly contact independent directors through e-mail. This implies SCC's concern over the minority protection.

Board Structure

SCC has the separation of role between the chairman of the board and the CEO, implying a good check and balance between the decision control and the decision management. However, the SCC's chairman is also the managing director of the CPB. This implies CPB's arm in SCC. It can be interpreted by two competing perspectives. The government may want its representative through CPB to protect own interest and other shareholders' interests, that helps reduce the agency problems between shareholders and managers. On the other hand, the government may want to maintain influential power in SCC and exploit the resources of the firm for private benefits, which is costly to minority shareholders. However, the percentage of SCC's independent outside directors has been above that of required by the SEC regulation regarding corporate governance stated that independent directors of all companies listed on the SET shall constitute no less than one third of the board of directors and shall consist of at least three persons. The high fraction of independent board members could imply the impetus to maintain the transparency of the firm. Furthermore, the voluntarily establishment of the SCC's nominating committee (NC) demonstrates an effort to maintain good corporate governance. The more than half independent directors in NC and independent NC chairman also show the impetus to be transparent in electing appropriate board members for the benefit of shareholders.

Capital structure

SCC's capital structure comprises of equal debts and equity. The current capital structure could imply the shareholders' attempt to monitor management by means of debt creation. The debt creation induces owners of the money to put some restriction on management action which is seen as an outside governance mechanism.

Research Company 2: Central Pattana Public Company Limited (CPN)

CPN is a leading developer, manager and investor of retail and commercial properties in Thailand. CPN was established by a Thai wealthy family group, including the Chirathivat (Central) Group, Tejapaibul Group, and Saha Union Group. CPN has its

main business operation in developing and managing large-format and integrated shopping centers. The major owner of CPN is the Chirathivat family or also known as the Central Group. CPN has been in business for 30 years, having 15 shopping complexes, mainly in Bangkok. Besides, CPN has diversified their business to five business sectors, comprising office buildings, hotel, residential buildings, water parks and recreational parks, and food centers. The food centers business support the shopping complex business by optimizing the use of land, serving as an additional source of income, and drawing in more customers to the shopping complexes. Although CPN has enhanced revenues from diversified businesses, the shopping complex business generates the highest revenues.

Ownership Structure	2009	2008	2007	2006	2005
% Majority ownership	60%	60%	60%	61%	N/A
% Second outside blockholder	6%	5%	5%	5%	8%
• Type	Institutional investor				
% CEO, directors and management ownership	11%	11%	11%	13%	N/A
Board Structure					
Role separation between chairman and CEO	Yes	Yes	Yes	Yes	Yes
% Independent outside directors	31%	23%	23%	23%	23%
Nominating committee					
• % Independent committee	67%	67%	67%	67%	29%
• Independent chairman	Yes	Yes	Yes	Yes	Yes
Capital Structure					
Debt ratio	47%	50%	47%	47%	48%
Minority Shareholders' Right	No	No	No	No	No

Ownership Structure

Since more than half of CPN's ownership is hold by the Chirathivat family, it is undeniable that Chirathivat family has significant influence on CPN's business policies and operations. The shareholdings' structure of the major shareholders is characterized by two forms; first, a pyramid holding structure through the holding company named Central Holding Co., Ltd.; and second, individual member and its relative from the same family name holding a large percentage of shares in aggregation. In addition to the high ownership stake in CPN, members of the Chirathivat family maintain key positions in CPN such as CEO, the Chairman of the board of directors, and several other positions in the board and executive management. Thus, the dominant family ownership in CPN of the Chirathivat family suggests that the agency problems arise between controlling and minority shareholders. The high ownership concentration of the Chirathivat family is further observable in the high percentage of shares of 11 percent owned by managers who come from the same family or respond directly to the Chirathivat family. In this case, we see the high managerial ownership as an effective

deterrent to good corporate governance. This could imply the high possibility of expropriations of wealth from minority interests due to the ultimate control of both the board of director and management by the Chirathivat family. Then, we investigate the CPN's annual reports whether they specify any governance mechanisms to protect minority benefits. We find that CPN mentions about an equitable treatment to shareholders but it is not specific how minority shareholders can exercise rights. We further investigate the presence of second large outside blockholders who provide balance of power. We find that the second outside blockholders are the institutional investors with shares' ownership of 6 percent. Due to the mixed blessing results of the institutional ownership on firm performance associated with relatively low percentage of ownership, we predict that the institutional investors assume passive role and not act as a governance mechanism to protect the benefits of minority shareholders.

Board Structure

Even though the chairman of the board and the CEO are different person, they both are members of the Chirathivat family. Thus, we see this as no separation between decision control and decision management. This could imply the family owners' impetus to maintain influence and control in both the managing level and monitoring level. Moreover, the CPN's percentage of independent outside directors has been below one-third (23 percent) during the year 2005 to 2008, but the percentage improves to around one-third (31 percent) of the total board members in 2009. This is because the new regulation from SEC regarding corporate governance which was issued in 2008 required that since the fiscal year 2010 onwards at least one-third (33 percent) of the board of directors be independent. The genuine intention of CPN to improve the independence of the board of directors is difficult to predict. CPN might increase the independency due to the compliance with the SEC regulation or the transparency of the board. Nevertheless, 62 percent (8 of 13 members) of CPN's board of directors is representatives from the Chirathivat family. This intention is clear that the Chirathivat family would not give up control over the company. This can infer poor minority shareholders' protection, and severe agency problems between controlling and minority interests. In terms of NC, we find that CPN maintain 67 percent of independent directors during 2006 to 2009. However, we still doubt in the CPN's nomination process and the influence from the Chirathivat family in selecting board members

because the preponderance of board members comprises a significant number of the Chirathivat family for the past several years.

Capital structure

CPN's capital structure comprises a fairly equal proportion of debts and equity. The main source of borrowing is financial institutions and institutional investors who provide averaged 91 percent of total debts during 2005 to 2009. These groups of investors can be seen as an outside governance mechanism because they have an incentive to monitor the performance of management and balance the power of the controlling owners to make certain that they would receive the money back. Although the effectiveness of bank monitoring is contingent upon the close relationship between the owners and the banks and the level of development of the institutional context to accommodate the monitoring role of the banks, we believe that having banks as a monitoring arm is better than nothing.

Research Company 3: PTT Public Company Limited (PTT)

Petroleum Authority of Thailand was established by the Thai government in 1978, in parallel to the second World Oil crisis. The primary objective of PTT was to procure adequate oil to serve domestic demand. In 2001, following the privatization of the state enterprise, Petroleum Authority of Thailand has changed its name to PTT Public Company Limited (PTT) and has been listed on the SET since then. PTT has a vision to become a Thai premier multinational energy company. PTT has its main operation in four chains of business: natural gas business, oil business, petrochemical business, and new businesses, including coal mining and palm plantation. PTT has been extensively diversified into both upstream and downstream businesses for the past several years until it now has become the largest oil and gas conglomerate firm of Thailand.

Ownership Structure	2009	2008	2007	2006	2005
% Majority ownership	67%	67%	68%	68%	68%
% Second outside blockholder	2%	2%	2%	2%	1%
• Type	Non-voting right institutional shareholder and Nominee accounts				
% CEO, directors and management ownership	0.003%	0.003%	0.03%	0.05%	0.04%
Board Structure					
Role separation between chairman and CEO	Yes	Yes	Yes	Yes	Yes
% Independent outside directors	67%	64%	67%	60%	64%
Nominating committee					
• % Independent committee	100%	100%	67%	67%	67%
• Independent chairman	Yes	Yes	Yes	Yes	No
Capital Structure					
Debt ratio	42%	37%	36%	38%	44%
Minority Shareholders' Right	Yes	Yes	Yes	Yes	Yes

Ownership Structure

PTT is a state-owned enterprise which has the Ministry of Finance (MOF) as the major shareholder. Unlike SCC that the government indirectly owns 30 percent stake through the CPB, the government directly holds averaged 67 percent of total shares in PTT. The high ownership stake signals the clear intention of the government to direct and control PTT business strategies and operations. Moreover, the non-active role of second outside blockholders implicitly increases the control power to the government. The ownership composition of PTT is comparable to the CPN in which the founder's family shareholders maintain decisive control over the company like the government's control in PTT. The agency problems are, hence, more severe between the controlling interest which is the government and the minority interests, than between shareholders and managers because the government may act as self-governing body to protect its own and minority benefits. Although there is no firm evidence suggesting that having government representatives in the company is a sign of government intervention, the general wisdom tells us that the government uses these representatives as a means to resonate the voice. The agency problems are intense if the government influences PTT to pursue the strategies that do not benefit other shareholders. The government may conduct PTT for the purpose of increased its popularity and votes, or promoted country development and employment. In addition, since managers in PTT are outsiders and have low ownership stake in the company (less than 1 percent), they may not have incentive to answer every request from the government. Therefore, we see the low managerial ownership as a plus side for corporate control. PTT tries to demonstrate its concern about minority rights by organizing company visits and management team meetings for minority shareholders to gain comprehensive overviews over the business

operation and management. However, no specific statement has been mentioned to how minority interests can give voices in unequal practices.

Board Structure

PTT's board composition depicts a clear separation between the monitoring role and managing role. The high proportion of independent outside directors, both in the main board (averaged 67 percent during 2005 to 2009) and in the NC (100 percent throughout the past five years) implies strong corporate governance and control. However, after further examining into detail, we find that every chairman of the board has always been in the position of the Deputy Permanent Secretary, Ministry of Energy. Even though PTT's board composition has been shown in high percentage of independence, most of the independent directors have positions in one of the government-related bodies such as the Office of the Prime Minister, the Cabinet, and other government organizations. In others word, these directors are despite classified as independent by definition, they are not independent in reality. In addition, NCs' members who are classified as independent are also related to the government. All in all, 4 of 10 directors who are reported as independent are related to the government. Therefore, the number of independent directors who have no relationship with the government is 40 percent (6 of 15 directors). 40 percent of independent directors are seen as high board independence but we still doubt the effectiveness of the board in balancing the power of the controlling shareholders. The intention of government intervention is distinct in the case of PTT, thus, this gives rise to the severity in the minority wealth expropriations.

Capital structure

The capital structure of PTT composes of lower amount of debts than equity. According to free cash flow hypothesis, the low debt creation implies that PTT may not want to be monitored or intervened by creditors.

Research Company 4: Berli Jucker Public Company Limited (BJC)

Established for more than 125 years, BJC was first erected through a partnership between the Berli family and the Jucker family, a Swiss family in order to conduct merchandise trading business in Thailand. BJC has been among seven first companies publicly traded on the SET since the SET was first operated in 1975. BJC has turned to be public company limited in 1993. Thai Charoen Corporation Group (TCC Group or

TCC Holding), owned by a very wealthy family, the Sirivadhanabhakdi family, acquired BJC from the First Pacific Group of Hong Kong in 2001. TCC Holding is one of the largest conglomerate firms in Thailand, engaging in alcohol beverages and alcohol-related businesses, industrial production, commercial trading, and property and financial services. The company's flagship product is beer operated under the "Chang" brand. Originally, BJC operated rice milling, mining, timber, shipping, importing, and other activities that laid a fundamental foundation for Thailand's development towards industrialization. Later on, by carefully selecting and nurturing its local and international partners, BJC has continuously prospered over the years and become a major Thai import and export firm. After World War II, in 1945, BJC diversified its operations into manufacturing, packaging, and distribution with a vision to be a provider of integrated supply chain solutions of quality products and services that are involved in the everyday life of people in the region. Currently, the products and services of BJC are classified into four categories; industrial product group, consumer product group, healthcare product group, and technical service and product group.

Ownership Structure	2009	2008	2007	2006	2005
% Majority ownership	71%	75%	77%	83%	83%
% Second outside blockholder	12%	1%	0.1%	0.1%	0.1%
• Type	Institutional and individual shareholders				
% CEO, directors and management ownership	0%	0%	0%	0%	0%
Board Structure					
Role separation between chairman and CEO	Yes	Yes	Yes	Yes	Yes
% Independent outside directors	27%	20%	20%	20%	20%
Nominating committee (NC)					
• % Independent committee	67%	33%	33%	No NC	
• Independent chairman	Yes	Yes	Yes		
Capital Structure					
Debt ratio	35%	38%	34%	26%	27%
Minority Shareholders' Right	No	No	No	No	No

Note: The majority ownership comprises the ownership of TCC Holding and Nakornchuen Company Limited. Nakornchuen is one of the affiliated companies owned by the Sirivadhanabhakdi family. Nakornchuen is also a subsidiary of TCC Holding and used to hold substantial amount of shares in BJC (hold 83% of shares in BJC in 2005). Therefore, we view Narkornchuen as a company in the same group.

Ownership structure

Since TCC Group acquired BJC in 2001, it has become the largest major shareholder of the firm. The strong concentrated ownership was as high as 83 percent during 2001 to 2005, but gradually declined to 71 percent in 2009. With regard to TCC Group's ownership structure in 2009, TCC Group is 99 percent owned by two important

members of the Sirivadhanabhakdi family, the founder and his wife. Both of them are also the incumbent chairman and vice chairman of BJC. This demonstrates the dominant family business that the founder's family owner has high influence and ultimate control in business strategies and operations of BJC. It is also very distinct that control rights of the Sirivadhanabhakdi family largely exceed its cash flow rights. Assume that there are no deviations from one-share-one-vote and there are only two companies in the group, TCC Holding and BJC. We would say that the Sirivadhanabhakdi family, through TCC Holding owns about 70 percent (0.99*0.71)[12] of the cash flow rights in BJC in 2009, despite the control rights of 99 percent. The deviations between control and cash flow rights of 29 percent (0.99-0.70) suggest that the agency conflicts between the controlling and minority shareholders could be acute. Furthermore, even if there is no top executive management holding shares in BJC, the CEO of BJC and vice president can be seen as members of the Sirivadhanabhakdi family because the CEO is son-in law of the chairman and vice chairman and the vice president is their daughter. According to the complex ownership structures of TCC Holding and BJC (there are very much more complex than we described above, but for the purpose of this research, we would prefer not to investigate the cross-shareholding structure of TCC Holding), we could say that the policy, business strategy and operating decision would be strongly influenced and directed by the Sirivadhanabhakdi family. In addition, annual reports of BJC have not stated about minority rights protection in any particular manners. The second outside blockholders first prevailed in 2009 with the 12 percent ownership in BJC after TCC Holding relaxed its concentrated ownership. Before that the ownership of other shareholders seemed insignificant. However, the institutional investors usually assume passive role in the company.

Board Structure

Although the chairman of the board and the CEO have different family name, investigating in detail we find they are both related. Since 2007, the son-in-law of the chairman has taken the helm of BJC as the CEO. Thus, this is a clear lack of a role separation between the chairman and the CEO. Moreover, the high fraction of the controlling shareholders' representatives in the board (7 of 15 members are found to be related to the founder's family owners) could imply the intention of the controlling shareholders to maintain influential control over BJC by using the board of directors. In addition, the CEO and vice president both sit in the board committee. It seems that

BJC's board of directors could not perform check and balance function in this setting. However, BJC demonstrates an intention to improve the transparency of the board by increasing the number of independent NC.

Both the condensed family ownership and family-dominated board of director suggest a clear type agency conflict, which is between controlling and minority interests. The expropriations of wealth are easy to achieve by absolute control of the controlling shareholders.

Capital structure

BJC uses low debts. Since BJC has strongly concentrated ownership, BJC's major owners who are also the main provider of fund may want to conserve the power and control within the family members.

Research Company 5: Thai Airways International Public Company Limited (THAI)

THAI was founded in 1960 as a joint venture between the Thailand's domestic carrier, Thai Airways Company (TAC) and the Scandinavian carrier, Scandinavian Airlines System (SAS). SAS provided operating, managerial and marketing expertise, with training assistance aiming at building a fully independent national airline within the shortest possible time. After 17 successful years of partnership between TAC and SAS, SAS shares were sold back to the Thai Airways International which was currently entirely owned and managed by Thai Airways. THAI's main business operation covers both domestic and international airlines, but has been diversified into six main areas, all of which are related to the airline business and provide support services to commercial airline customers. The six business segments include cargo business, maintenance business, catering business, ground services, ground support equipment & services business, and aviation training business.

Ownership Structure	2009	2008	2007	2006	2005
% Majority ownership	68%	68%	69%	69%	71%
% Second outside blockholder	5%	3%	4%	3%	2%
• Type	Non-voting right institutional shareholder/ Government bank and Nominee accounts				
% CEO, directors and management ownership	0%	0%	0%	0%	0%
Board Structure					
Role separation between chairman and CEO	Yes	Yes	Yes	Yes	Yes
% Independent outside directors	53%	47%	40%	36%	47%
Nominating committee (NC)					
• % Independent committee	67%	43%	20%	33%	No NC
• Independent chairman	Yes	No	No	No	
Capital Structure					
Debt ratio	59%	61%	46%	49%	52%
Minority Shareholders' Right	No	No	No	No	No

Ownership structure

The majority of shares of THAI is held by the Ministry of Finance, thus, THAI is classified as a state-owned enterprise. Similar to PTT which the government maintains high ownership stake in the company (68 percent), the government have significant influences on THAI's business operations and strategies. Since the insignificant percentage of shares are held by a group of non-voting right institutional investors and government-related banks or nominees, THAI's shareholders cannot rely on second outside blockholders to balance the power of the controlling shareholders, conversely this implicitly increasing power to the controlling shareholders. The government and politicians may exercise their power to interfere the decisions of the management team, and that is likely to happen. Although, there are no precise evidences with regard to the government intervention in the management level, prior 2009, several top management executives used to have some positions in the government organizations or the Royal Thai Air Force. This suggests that the conflicts of interest between principal and agent may not be so strong in THAI but may be severe between principal and principal. Furthermore, THAI does not have any specific guidance to mitigate the conflicts of interest between controlling and minority shareholders.

Board Structure

THAI has a role separation between the chairman and the CEO. THAI tries to improve the independency of the board of directors by increasing the number of independent outside directors from only 36 percent in 2006 to 53 percent in 2009. The company also tries to improve the independency of the NC from only 20 percent of independent members in 2007 to 67 percent in 2009. Again, the impetus to increase the transparency

may be driven by the new SEC regulation fully applied to all listed companies on the SET in fiscal year 2010 to maintain at least one-third independent directors in the board. Nevertheless, before 2009, the three former chairmen of the board and most of the board members have some positions in the Cabinet, government organizations, or the Royal Thai Air Force. Currently in 2009, although the chairman is not related the government, but he used to be. Thus, the independency and transparency of the THAI's board are not clearly observed. The board's duty to provides good check and balance may not be well functioned.

Capital structure

THAI's capital structure contains more debts than equity. The debt creation induces the providers of fund to assume outside monitoring role, which should be beneficial to all shareholders of the company. However, after investigating in detail, we find that one of the main financiers is directly related to the Ministry of Finance, and several other creditors are also state-owned banks. This could imply that almost all funds of THAI are solicited by the government. The majority of voting rights, the major owner of finance (both debts and equity), and the skeptical function of the board infer that the government is the sole owner who has autonomously control over the company. Nonetheless, it is interesting that THAI announced an earning restatement in year 2007, making net profit reduced by 31 percent. The company reasoned that this was due to changing in accounting standard.

CONCLUSION OF CASE STUDIES

The results of our study reveal several interesting patterns. The prevalence of concentrated ownership is communal across five firms we study. Four of five companies have a very high concentration of ownership of more than 60 percent, and two-fifth of the companies are family-controlled firms while the other three is state-owned enterprises. In the companies where founder's family owners are present; we find that they try to maintain influential power and control in the company by putting family members into important positions. Family-owned companies in our study started its operation with small business and have developed into large successful conglomerate firms with more complex ownership structure such as cross-shareholding structure. For state-owned enterprises, we find that the government maintains many representatives in the board of directors. The level of control by the government increases with the increased percentage of ownership. We discover that the high control

in the corporation provides an incentive to controlling shareholders to expropriate benefits. Moreover, all of the companies we study have no specific policy to protect minority rights. Most of the boards of directors are filled with controlling shareholders' representatives; thus, the transparency and effectiveness of the board are questionable. The improved independency of the board of directors is witnessed in many firms we study but the trend keeps up with the requirement proposed by the regulator.

The following table summarized corporate governance mechanisms that each firm uses to reduce the agency conflicts by employing four perspectives (as outline in the theoretical framework), including the ownership structure, board structure, capital structure, and minority rights protection. The effectiveness of each governance mechanism is evaluated by plus or minus signs according to the criteria constructed in Table 3.

Table 4: Summary of Corporate Governance Mechanism Used by Each Researched Company

Types of agency conflicts	SCC 30% major ownership	CPN 60% major ownership	PTT 67% major ownership
Managers VS Shareholders			
• Ownership Structure	- Concentrated ownership (+) *Have a power to monitor managers' behavior* - Low managerial ownership (-) *No motivation to put the highest effort*	Less likely to happen	Less likely to happen
• Board Structure	- CEO and Chairman are different person (+) - More than 33% independent directors (+)		
• Capital Structure	- Equal debts & equity (+) *Outside monitoring by debt creation*		
Controlling VS Minority Shd.			
• Ownership Structure	- Concentrated ownership (-) *Too much control to major shd. may increase incentive to expropriate benefits* - Non-voting right second blockholders (-) - Low managerial ownership, professional mgrs.(+) *Less incentive to collude with major shd. to expropriate benefits*	- High concentrated ownership (-) *Too much control to major shd. may increase incentive to expropriate benefits* - Institutional second blockholders (-) *May not provide check & balance due to assuming passive role* - High managerial ownership, owner mgrs. (-) *Owner mgrs. may conduct company mainly for their private*	- High concentrated ownership (-) *Too much control to major shd. may increase incentive to expropriate benefits* - Non-voting right second blockholders (-) - Low managerial ownership, professional mgrs. (+) *Less incentive to collude with major shd. to expropriate benefits*
• Board Structure	- CEO & Chairman are different person (+) *Good check and balance system* - More than 33% independent directors (+)	- CEO & Chairman are members of the same family (-) *No good check and balance system* - Less than 33% independent directors (-) - 62% of directors related to major owner (-)	- CEO & Chairman are different person (+) *Good check and balance system* - More than 33% independent directors (+) *Despite 67% reported independent, only 40% independent in reality*
• Capital Structure	- Equal debts & equity (+) *Outside monitoring by debt creation*	- High debts (+) *Outside monitoring by debt creation*	- Low debts (-) *Low outside monitoring*
Alternative governance	Emailing complains from minority shd. directly to BoD is provided	N/A	Company visit and management meeting session

Table 4: Summary of Corporate Governance Mechanism Used by Each Researched Company (Continued)

Types of agency conflicts	**BJC** **71% major ownership**	**THAI** **68% major ownership**
Controlling VS Minority Shd.		
• Ownership Structure	- High concentrated ownership (-) *Too much control to major shd.* *may increase incentive to expropriate benefits* - Institutional second blockholders (-)	- High concentrated ownership (-) *Too much control to major shd.* *may increase incentive to expropriate benefits* - Non-voting right second blockholders (-)
• Board Structure	- CEO & Chairman are members of the same family (-) *No good check and balance system* - Less than 33% independent directors (-) - 47% of directors related to major owner (-)	- CEO & Chairman are different person but related to government (-) *Less good check and balance system* - Improved the percentage of ind.directors & NC (+) *Board ind. from 36% in 2006 to 53% in 2009* *Nc ind. from 33% in 2006 to 67% in 2009*
• Capital Structure	- Low debts (-) *Low outside monitoring*	- High debts, debts are funded by government (-) *Government assumes creditors' role /* *Low outside monitoring*
Alternative governance	N/A	N/A

For the ownership perspective, we see the high concentrated ownership of controlling shareholders in five companies except for SCC as a main predictor of expropriations. Besides non-active roles of institutional shareholders or non-voting right second blockholders cannot provide good check and balance function to protect the benefits of minority shareholders. We find low managerial ownership in every researched company except for CPN. The low managerial ownership can be viewed as good corporate governance since the low ownership may provide less incentive for professional/hired managers to collude with the controlling shareholder to expropriate benefits. CPN has high concentrated ownership and at the same time have owner managers; therefore, we conclude that high managerial ownership in CPN is not advantaged to minority shareholders. All in all, low managerial ownership can be seen as good governance mechanism no matter what managers are owner or hired managers. For the role of second outside blockholders to provide check and balance, since all firms we study have either non-voting rights blockholders or institutional blockholders who hold small fraction of shares in the firms, we conclude that this mechanism is not effective in the Thailand context. In terms of board mechanisms, the independence and transparency of the board of directors are questionable across five firms. Four of five companies have less than one-third of independent directors in reality. Although some companies declare some of their directors as independent, delving into detail we find that most of the directors are indirectly related to the controlling shareholders. Therefore, we conclude that the board function is fairly weak in Thailand. Third, for the capital structure, we find only CPN that uses high debts, while, SCC and CPF maintain equal amount of debts and equity. As the debt creation is seen as an outside corporate governance mechanism to induce the owners of money to supervise the company, we conclude that the relatively high level of debts found in CPN, SCC, and CPF are a proxy of good corporate governance. Finally, half of the companies we study have mentioned the protection of minority rights in the document of the companies. However, none of them provide a specific guidance of how minority shareholders can exercise their rights. SCC and PTT have implemented voluntarily governance mechanisms which are allowing minority shareholders to send emails complaint directly to the board of directors and organizing company visit and management meeting sessions for minority shareholders, respectively. Nevertheless, we conclude that all of the companies we study do not really have enforceable minority rights' protection.

Although our case studies present the agency problems of only five large diversified firms, we believe that characteristics of these firms reflect most large diversified firms in East Asia countries. Our finding is consistent with several other research studies in East Asia in many aspects. First, the prevalence of high concentrated ownership of either founders' families or the governance found in five companies is consistent with Claessens et. Al (1999a, 2000)'s finding that two-thirds of the firms in East Asia are controlled by single ultimate shareholders, and more than half are controlled by large families' owners. In addition, Polsiri and Wiwattanakantang (2004) in their study of 30 largest business groups in Thailand also conclude that the ownership and control of Thai business groups are concentrated in founder family owners. They also detect the disparity between control rights and cash flow rights in Thai large business groups on averaged seven percent during 1995 to 1997. Second, the five case studies answer our conjecture from the beginning whether existing governance mechanism in East Asia is appropriate. We find that the concentrated ownership, managerial ownership, and board monitoring role (which are conventional governance mechanisms used in developed countries) are not suitable for Thai firms, and may not be suitable for other East Asia corporations. This is because increasing ownership to already powerful family owners increases the possibility of expropriations. Most managers are members of family owners, thus, higher managerial ownership is equal to increased concentrated ownership to controlling shareholders. An inefficient board monitoring function can be explained by the same reason since a lot of family members sit in the board. This finding is in line with what Amran and Admad (2009) discovers in their study of 896 firms in Malaysia. They find that not all governance mechanisms (they use board independence, board size, separate or duality leadership dummy, and founders' families as CEO tenure dummy as proxies of governance mechanisms) are effective, and the effects differ between family and non-family businesses. They comment about the role of the board of directors that the presence of many family members on the board makes most family firms lack of independence and internal control. Moreover, the less independence of the board function is observed in the empirical study of Suehiro (1993). He studies characteristics of Thai large corporations and discovers that 60 percent of 153 firms have family members in top management positions including CEO, while 63 percent of 89 firms have family members as the chairmen of the board. 50 percent of 90 firms in his study have both the chairmen and the CEO come from the same families, presenting a lack of role separation between decision control and decision management. Last but not least, we discover the ultimate

control rights of single major owners and the web or cross-shareholdings structure. The notion that the combination of these two factors gives rise to an incentive of controlling shareholders to expropriate benefits is found in our study and also documented in the research studies of Claessens et al., (2000) and Bertrand et al. (2002). Consistently, LaPorta, Lopez-de-Silanes, and Shleifer (1999) indicate that in many economies the primary agency conflict is restricting expropriation of minority interests by controlling shareholders.

In conclusion, we find that the agency conflicts are more likely to occur between controlling and minority shareholders; and, family owners are the main predictor of the expropriation operation. The concentrated ownership, managerial ownership, and board function are not suitable for Thai firms, and may not be suitable for other East Asia corporations.

V. CONCLUSIONS

5.1 KEY FINDINGS

We find that the agency costs of free cash flow to some extent are responsible for the value loss from diversification strategies. The agency costs generated by agency conflicts between shareholders and managers (Principal-Agent conflict; PA) or between controlling shareholders and minority shareholders (Principal-Principal conflict; PP) can drive firms to engage in the misuse of capital or excessive diversification. In a firm where there is excessive free cash flow, managers or controlling shareholders who have the divert interest from shareholders or minority shareholders may choose to employ diversification strategies for their private benefits as described by the managerial entrenchment and expropriation of wealth hypotheses. The agency cost of free cash flow, hence, can be so tremendous that deprive all the benefits of diversification strategies, create diversification discount, and reduce firm value. Corporate governance is a mechanism to safeguard the agency conflicts. If the interests of principals and agents are closely aligned, diversification strategies will be operated by the intention to create value to the firm, therefore it is likely that the diversification benefits firm value.

The theoretical framework demonstrates how corporate governance links to corporate diversification and firm value, and how different forms of corporate governance can alleviate agency costs of free cash flow in the East Asia setting. The reason of designing the theoretical framework for the East Asia context is that firms in East Asia

countries often encounter different agency conflicts from firms in developed countries; the agency conflicts arise between controlling and minority shareholders rather than between all shareholders and managers. This is mainly because the dominant family-based ownership structure and weak legal environments of East Asia that drives firms to engage in different types of agency conflicts. Therefore, governance mechanisms that can protect minority shareholders from expropriations of controlling shareholders are more appropriate for East Asia countries than conventional governance mechanisms designed for developed countries. The theoretical framework does not only pan out the key contents of this study which are the agency problems, corporate diversification, corporate governance, and firm value, but also capture concerning areas of corporate diversification. It clearly and succinctly illustrates what benefits and costs are relevant when firms do diversification and can be used as a tool or a frame of thought to perform analyses or generate new ideas within the areas of corporate strategies and corporate governance in the East Asia setting. More importantly, the framework makes ones think of what could be the right corporate governance tools to apply in different ownership structures and institutional settings in order to reduce the agency problems.

In addition, the results of the case studies of firms in Thailand confirm that the family-based ownership structure and agency problems between controlling and minority shareholders are predominant in Thai corporations. The results reveal that the concentrated ownership, managerial ownership, and board of directors which are governance mechanisms used in developed countries are not effective governance mechanisms for Thai firms, and may not be appropriate to East Asia corporations. This finding corresponds to our conjecture at the beginning that different treatments for the agency conflicts in East Asia are needed, consistent with many the research studies of Paredes (2005) and Yermack et al. (2008) that demand for the development of corporate governance for East Asia. At last, the findings from case studies help improve the theoretical framework by suggesting which corporate governance mechanisms are relevant or not relevant in the East Asia setting.

5.2 SUGGESTIONS FOR THE FUTURE RESEARCH STUDIES

Since corporate governance is not single institution that can monopolistic evolve but it is embedded in a complex web of many institutions especially laws and regulations, changes in the corporate governance system require changes in various areas such as the ownerships structure and law and enforcement (Guillen, 2000b). Therefore, the

development of the corporate governance structure in East Asia is not just to adopt an ideal set of mechanisms and wait until the institutional context advance, and then see how well mechanisms can be enforced, but rather to enact the mechanisms that can be effectively enforced within the current institutional context. Otherwise, the existing mechanisms of corporate governance that corporations install into their business practices are mere illusion as Chuanrommanee and Swierczek (2007) find in Thailand, Malaysia, and Singapore. More importantly, it may be impossible to witness founder's family owners in East Asia to give up their ownership and control rights in the companies they have been built, even the capital market become more efficient and laws and regulations are more stringent. Family businesses have become deep-rootedness in many East Asia countries; and, play an important role in the development of economies in East Asia countries. One empirical study of Thailand by Bertrand et al. (2008) reveals that the decay of the performance family-owned firms is partly due to the dilution of ownership and control. Thus, the question is whether more dispersed ownership structure is appropriate to firms in East Asia countries. Until the convergence to the Anglo-American system has emerged or the new corporate governance standard for East Asia has been fully evolved and accepted, the agency problems in East Asia may need alternative corporate governance mechanisms different from those developed for the conventional agency problems to fill the voids. Clearly, more research studies in this field are warranted.

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ENDNOTES

[1] The following passages are excerpted from Gaughan A. Patrick, 2007, Mergers, Acquisitions, and Corporate Restructurings, Fourth Edition.
[2] "Black Thursday", 29 October 1929, was the Great Crash in the largest stock market, particularly, the New York Stock Exchange (NYSE).
[3] In the case that corporate diversification generates a loss to the companies, it is called diversification discount. In contrast, if corporate diversification creates value to the firms, then it is known as diversification premium.
[4] When we refer to the conventional corporate governance, we mean the Anglo-American corporate governance (outsider) system and the Continental European (insider) system.
[5] Tobin's Q is a ratio of market value of equity and book value of debt over book value of debt. Tobin's Q is a ratio widely used to measure the firm value.
[6] COMPUSTAT (Capital IQ Compustat) is a provider of financial information of approximately 98% of the world's market capitalization.

[7] BITS (Business Information Tracking Series) is a database that covers the whole US economy at the establish level.
[8] Australia, Austria, Brazil, Canada, Chile, China, Denmark, Finland, France, Germany, Hong Kong, India, Indonesia, Ireland, Italy, Japan, South Korea, Malaysia, Mexico, Netherlands, New Zealand, Norway, Pakistan, Philippines, Portugal, Singapore, South Africa, Spain, Sweden, Switzerland, Taiwan, Thailand, Turkey, the United Kingdom, the United States.
[9] Industrial groups refer to firms that belong to groups of company that have some level of cross-shareholdings and interlocking directorships.
[10] In both studies of Claessens et al. (1999a, 2000) and Faccio et al. (2001), Asia countries refer to Hong Kong, Indonesia, Japan, Malaysia, Philippines, Singapore, South Korea, Taiwan, and Thailand.
[11] There are extensive studies addressing the causes of the 1997 East Asian financial crisis such as International Monetary Fund, Krugman (1997), Corsetti, Pernti, and Roubini (1998), Radelet and Sachs (1998), Department of Foreign Affairs (2000), and Siamwalla (2001). There are several reasons are claimed to be responsible for the Crisis, comprising the financial liberalization without a comprehensive regulatory and supervisory framework, macroeconomic mismanagement by the government, large foreign short term debt, and inadequate corporate governance and prudential regulations in the private sector. *This summary is taken from Polsiri and Wiwattanakantang (2004).*
[12] We follow the calculation mode of Claessens et al. (2000) to calculate the disparity between control and cash flow rights.

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Appendix 1: How Institutional Context Drives Strategies by Khanna and Palepu (1997)

Institutional Feature	United States	Japan	India
Capital Market	equity-focused; monitoring by disclosure rules and the market for corporate control	bank-focused; monitoring by interlocking investments and directors	underdeveloped, illiquid equity markets and nationalized banks; weak monitoring by bureaucrats
Labor Market	many business schools and consulting firms offering talent; certified skills enhance mobility	few business schools; training internal to companies; firm-specific development of talent	few business schools and little training; management talent scarce, workers inflexible
Products Market	reliable enforcement of liability laws; efficient dissemination of information; activist consumers	reliable enforcement of liability laws; efficient dissemination of information; less activist consumers	limited enforcement of liability laws; little dissemination of information; no activist consumers
Governmental Regulation	low; relatively corruption free	moderate; relatively corruption free	high; corruption is common
Enforcement Mechanisms	predictable	predictable	unpredictable
Corporate Scope	focused; diversified groups have disadvantages	diversified groups may have some advantages	diversified groups have many advantages