A NOTE ON THE FINANCIAL PERFORMANCE OF CONGLOMERATE VERSUS NON-CONGLOMERATE

Fauzias Mat Nor
Hussin Dollah

ABSTRACT

The objective of this study is to look at the accounting based measure to draw an implication pertaining to the financial performance of conglomerate and non-conglomerate companies, which are listed on the Kuala Lumpur Stock Exchange. Market perception of a company's growth and profit opportunities as depicted by Tobin's q and price earnings ratio is higher for the conglomerate than the non-conglomerate. While there is evidence of size maximising activity for the years 1981 to 1985 as depicted by the low ROE, high growth and total assets, conglomerate activity in general, may also be regarded as an attempt to maximise the value of the shareholder's wealth.

1. INTRODUCTION

The diversification of firms has been commonly examined in finance literature. The argument is that firms following related diversification should outperform unrelated diversification. Levy and Sarnat (1970) showed that, under acceptable assumptions about financial markets, there are no economic motives for unrelated diversification. However, Lewellen (1971), Higgins and Schall (1975), and Galai and Masulis (1976) have shown that if one introduces some friction in the financial markets, such as bankruptcy costs and taxes, there may be financial motives for non-synergistic merger. The study of the financial performance of the conglomerate (versus non-conglomerate) which involves firms engaged in unrelated types of business activity is similar in nature to the study on performance effects of related or unrelated diversification. An early

The authors would like to acknowledge Mohd Mustapha Awang, Azian Mohd Noh, Ramli Zakaria for providing data.

**Dr. Fauzias Mat Nor is a lecturer and Head of Finance Department, Faculty of Business Management, Universiti Kebangsaan Malaysia.*
**Encik Hussin Dollah is a lecturer in ITM, Dungun, Terengganu.*

study on conglomerate merger was undertaken by Reid (1968). He concluded that conglomerate merger is a special case among the various merger types, with the firms using it displaying a unique performance pattern in comparison with firms using alternative growth strategies. While the profit to stockholders variable is stronger in this group than in the other merger type groups, size maximising appears to be a particularly strong factor in the conglomerate group

Later, Weston and Mansinghka (1971) reported in their study that the conglomerate firms outperformed samples of other firms of broader groups on all of the growth measures. They used arithmetic mean of growth rate for total assets, net income, earnings per share and market price based on the yearly high, the yearly low and the arithmetic mean of the annual high and low price. They also reported that the earnings performance measured by the ratio of net income to net worth (ROE) is somewhat higher for conglomerate firms compared to non conglomerate, but the difference is not statistically significant.

Mueller (1977) concluded in his survey of the empirical evidence that whatever the selected or unselected goals of a manager are, the mergers they have consummated (conglomerate firms) have, on average, not generated extra profits for the acquiring firms, and therefore have not resulted in increased economic efficiency

In the Malaysian experience, a related study by Fauzias and Shamsubaridah (1993) reported that the target firms experience a decline in earnings performance after the takeover. This could be explained by the fact that except for one, all targets are of the conglomerate type. The fact that they used only acquired firms as their sample of study, means that the evidence of the performance of conglomerate firms is not conclusive enough. In our study, we intend to use specific definition. Any firm is defined as a conglomerate if the majority of its activities consist of more than one line of business.

2. DATA AND METHODOLOGY

The data used for this study were collected from the Kuala Lumpur Stock Exchange Handbook using a table of random numbers, whereby 31 conglomerate and 26 non-conglomerate companies for the year 1981 to 1990 were chosen as shown in the appendix.

Data collected include:

a. Total Assets (TA)

b. Total Turnover (TO)

c. Earnings Before Interest and Tax (EBIT)

d. Net Income (NI)

e. Earnings Per Share (EPS B-ex)

f. Market Price – High (MPH) and Low (MPL)

g. Shareholders' Funds (SHF)

h. Market Capitalisation (MC)

i. Price Earnings Ratio (PER)

The growth rate (g) for each of the variables was calculated by using the following formula:

$$VF = VP\ (1 + g)^n$$

$$g = \left(\frac{VF}{VP}\right)^{1/n} - 1$$

where g = compound annual growth rate

V = the variables, i.e TA, TO, EBIT, NI, SHF, MPH, MPL, and MC

F = the future year.

P = the previous year.

n = number of years.

F-Test is used to test the significant-difference of the key financial items between the two groups.

The performance of the conglomerate versus non-conglomerate companies is also measured by the earnings before interest and tax to total asset (EBITTA) ratio, return on equity (ROE), price earnings ratio (PER) and Tobin's q, which is measured as the ratio of company's market value (debt plus equity) to its total asset. The ratio and growth measurements are used for the study so as to avoid the ambiguous indicators of economic performance because of the differences in accounting standards employed by companies.

3. FINDINGS

(i) Comparative Growth Rate

Tables IA and IB show the growth rates of key financial items for the years 1981 to 1985, and 1986 to 1990 respectively. For the years 1981 to 1985, the growth on total asset (GTA) for the conglomerate is significantly higher than for the non-conglomerate. Therefore, it appears that there is evidence of size maximising activity by the conglomerate firms.

However, the growth on turnover (GTO), growth on earnings before interest and tax (GEBIT), growth on net income (GNI), and growth on shareholders' fund (GSHF) for the conglomerate are not significantly higher than for the non-conglomerate. Likewise, the growth on market price – high (GMPH), growth on market price – low (GMPL) and growth on market capitalisation are lower than for the conglomerate, but are not significant either at the 10 percent or 5 percent level.

TABLE 1A

GROWTH RATES IN KEY FINANCIAL ITEMS, 1981 TO 1985 (%)

	Conglomerate	Non C'merate	F Stat.	Pr > F
GTA	13.9	9.3	3.74	0.0581**
GTO	9.3	7.1	0.45	0.5046
GEBIT	7.3	7.4	0.00	0.9771
GNI	10.4	9.4	0.10	0.7528
GSHF	11.7	9.4	0.81	0.3734
GMPH	-4.9	-2.5	1.92	0.1716
GMPL	-2.3	-0.2	1.65	0.2042
GMC	2.8	5.4	0.93	0.3387

** Significant at the 10 percent level

For the years 1986 to 1990, all items are not significant either at the 10 percent or 5 per cent level.

TABLE 1B

GROWTH RATES IN KEY FINANCIAL ITEMS, 1986 TO 1990 (%)

	Conglomerate	Non C'merate	F Stat.	Pr > F
GTA	8.0	9.8	0.34	0.5635
GTO	11.1	10.7	0.01	0.9401
GEBIT	11.0	15.1	0.44	0.5084
GNI	15.2	27.7	1.01	0.3194
GSHF	8.3	7.1	0.16	0.6865
GMPH	10.2	7.8	0.60	0.4406
GMPL	6.4	6.6	0.00	0.9473
GMC	12.6	6.9	1.80	0.1857

(ii) Comparative Performance Measures

Tables 2A and 2B show the differences in the financial performance of conglomerate and non-conglomerate companies for the period 1981 to 1985, and 1986 to 1990 respectively. The earnings performance is determined by EBITTA and ROE. The ROE of the non-conglomerate is significantly higher than for the conglomerate for the years 1981 to 1985, but it is not significantly different for the years 1986 to 1990. However, the market perception of company's growth and profit opportunities of the conglomerate as determined by PER is significantly higher than for the non-conglomerate for the years 1981 to 1985 and also for the years 1986 to 1990. Tobin's q of the conglomerate is also significantly higher than for the non conglomerate for the years 1981 to 1985, but slightly lower for the years 1986 to 1990.

TABLE 2A

COMPARISON OF THE EARNINGS PERFORMANCE, PRICE EARNINGS AND BOOK VALUE MULTIPLES 1981 TO 1985

	Conglomerate (%)	Non C'merate (%)	F Stat.	Pr > F
EBITTA	12.2	14.1	0.51	0.4773
ROE	5.4	17.4	6.60	0.0129*
PER	66X	32X	2.95	0.0917**
Tobin's q	3.55X	2.02X	3.67	0.0608**

* Significant at the 5 percent level.

** Significant at the 10 percent level.

TABLE 2B

COMPARISON OF THE EARNINGS PERFORMANCE, PRICE EARNINGS AND BOOK VALUE MULTIPLES 1986 TO 1990

	Conglomerate (%)	Non C'merate (%)	F Stat.	Pr > F
EBITTA	8.7	18.6	1.99	0.1635
ROE	11.3	15.9	1.84	0.1807
PER	42X	16X	3.84	0.0551**
Tobin's q	0.97X	1.36X	3.71	0.0592**

** Significant at the 10 percent level.

4. CONCLUSIONS

From our study, we found that the performance of non-conglomerate companies is slightly and significantly higher in terms of ROE as compared to conglomerate companies for the years 1981 to 1985. However, the difference is not significant for the years 1986 to 1990. Nevertheless, the growth on total asset of the conglomerate is significantly higher than for the non-conglomerate for the years 1981 to 1985, but not significantly for the years 1986 to 1990. Likewise, the market perception of company's growth and profit opportunities as depicted by the Tobin's q and PER for the conglomerate is significantly higher than for the non-conglomerate for the years 1981 to 1985 and also for the years 1986 to 1990.

Therefore, while there is evidence of size maximizing activity for the years 1981 to 1985 as depicted by low ROE and high growth on total assets, the conglomerate activity, in general, may also be regarded as an attempt to maximise the value of the shareholder's wealth. Nevertheless, we also do believe that the success of individual conglomerates will depend upon the relative abilities of their management for achieving operational efficiency and for making the shifts in their product markets required by the changing economic environment as professed by Weston and Mansinghka (1971).

APPENDIX

LIST OF CONGLOMERATE COMPANIES

1. Dunlop Estates (M) Bhd
2. Oriental Holdings
3. Malayan United Man. Bhd.
4. Timuran Hlds. (M) Berhad
5. Hong Leong Credit Bhd.
6. Hong Leong Ind. Bhd.
7. Setron (M) Bhd.
8. Selangor Prop. Bhd.
9. Magnum Corporation Bhd.
10. Malayan Uni. Ind. Bhd.
11. Malaysian Bld. Soc. Bhd.
12. Island and Peninsular
13. Leader Universal Hld. Bhd.
14. Highlands and Lowlands Bhd.
15. Multi Purpose Hld. (M) Bhd.
16. Lion Corporation (M) Bhd.
17. Genting Berhad
18. UMW Holdings (M) Bhd.
19. Hume Industries
20. Promet
21. Palmco (M) Bhd.
22. Batu Kawan
23. Boustead Holdings
24. ALCOM Bhd.
25. MBF Finance Bhd.
26. Sime Darby Berhad
27. MWE Holdings Bhd
28. DNP Holdings (M) Bhd.
29. Bandaraya Dev. Bhd.
30. Samanda Holdings Bhd.
31. IGB Corporation Bhd.

LIST OF NON-CONGLOMERATE COMPANIES

1. Ajinomoto (M) Bhd.
2. Carlsberg Brew (M) Bhd.
3. Chocolate Product (M) Bhd.
4. Khong Guan Holdings (M) Bhd.
5. The N. Borneo Timber (M) Bhd.
6. Cycle & Carriage (M) Bhd.
7. Cons. Plantation (M) Bhd.
8. Datuk Keramat Hld. (M) Bhd.
9. Dunlop M'sian Ind. (M) Bhd.
10. Malayan Flour Mills Bhd.
11. Malayan Tobacco Co. Berhad
12. Pan M'sian Cement Works Bhd.
13. U. Malayan Flour Mills Bhd.
14. Bata (M) Bhd.
15. Gold Coin (M) Bhd.
16. Shell (M) Bhd.
17. Sanyo (M) Bhd.
18. Tasek Cement Berhad
19. Esso (M) Bhd.
20. Tractor (M) Bhd.
21. Chem. Co. (M) Bhd.
22. Rothmans of Pall Mall (M) Bhd.

32. Berjaya Textiles Bhd.
24. KL Kepong Berhad
25. Malaysian Mosaic Bhd.
26. Malayan Banking Bhd.

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