Analysis of Diversification Driven by Restructure and EVA in China State-owned Key Enterprises

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Abstract

The restructuring of state-owned key enterprises is the major theme to comply the state sector's distribution and structure adjustment, and to enhance comprehensive national power. It is required for raising the core competitiveness of central enterprises and sustainable development. The restructuring of state-owned key enterprises drives the diversification. In this paper, an empirical analysis is given on relation between diversification and EVA in the state-owned key enterprises listed companies researching the effect of specialization ratio (sr), related ratio (rr) and EVA in 2007-2012.The empirical results show that the EVAs of related-diversification companies are the best, the ones of unification are the lowest, and RR is positively associated with EVA, while SR have an U relationship with EVA. In addition, the paper gives advices on restructuring state-owned key enterprises. The conclusions of this paper have great implications on improving state-owned key enterprises restructuring.

1 Introduction

The restructuring of state-owned key enterprises has been a priority since the establishment of the SASAC (State-owned Assets Supervision and Administration Commission of the State Council). 196 state-owned key enterprises was managed at the beginning of the

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establishment of the SASAC in 2003, but then the number reduced to 123 by the end of 2010.During the "12th Five-Year Plan" period, the goal of state-owned key enterprises' restructuring is to reduce the number to 30-50 .Horizontal merger is an important way of state-owned key enterprises' restructuring, and It accounts for 56.25%. With the restructuring becomes faster, it also accelerates the diversification of state-owned key enterprises: the average number of main business in each company was 2.44 in 2007, and then it increased to 2.75 in 2009; The Herfindahl index, which reflects the main business concentration of 177 listed companies controlled by state-owned key enterprises dropped from an average of 0.6197 in 2007 to 0.6025 in 2009.

SASAC implemented state-owned key enterprises' EVA assessment in 2010. EVA (Economic Value Added) refers to subtracting full cost of equity and debt from the net operating profit after tax, compared with traditional accounting index, it can reflect corporate's capital use efficiency and value creation ability more truly (Stewart, 1991).EVA assessment is designed to guide state-owned key enterprises to change the operating mode of development, improve the efficiency of capital use. However, in the background of state-owned key enterprises 'structure adjustment, can EVA assessment achieve its original purpose? Is diversification helpful in improving EVA? What are the implications of EVA for the restructuring of state-owned key enterprises? This is the starting point of this paper.

2   Theoretical Review and Research Hypothesis

2.1 Theoretical Review

Restructuring is specified to be a strategy for the enterprise to change its business portfolio or financial structure. Restructuring, mergers and acquisitions can either be within the same industry of development, namely horizontal integration, or can be into a new industry, namely vertical integration and diversification. Due to the intervention of the government at all levels, state-owned key enterprises mostly start their diversification by mergers and restructuring of companies not related with their own business scope.

Ansoff (1957) first put forward the concept of diversity, and the widely accepted view is Dundas and Richardos' (1980): Diversification is a management behavior to distinguish between the markets and pursue more than one target market . The commonly used method to classify diversification is Rumelt correlation method, which put forward Related Ratio(rr) on the basis of Wrigley's concept of Specialization Ratio(sr). This classification method is as follows: (1) unitary type: sr≥0.95; (2) dominating type: 0.70≤sr<0.95; (3) related diversification: sr<0.7; rr≥0.7; (4) unrelated diversification: sr<0.7; rr<0.7. This classification method distinguishes between related and unrelated business, and is accepted by most scholars (Singh and Gu, 1994). This paper also uses this classification method. Among them:

$$sr = \frac{b}{g} \tag{1}$$

$$rr = \frac{br}{g} \tag{2}$$

b is biggest project sales in enterprise; br is biggest group of somehow related business

project sales in the enterprise g is the gross sales in the enterprise.

Scholars have carried out extensive research in effects of diversity on business performance, and the results are not consistent (Lang and Stulz, 1994; Berger and Ofek, 1995; Linus and Servaes, 2002; Campa and Kedia, 2002; Zhu Jiang, 1999; Zhang Yi etc., 2005; Wei Xiaoke, 2007; Huang Shan, etc., 2008). some indexes are concluded from the existing literature to study the performance of diversification, and they are accounting index (Singh and Gu, 2004; Zhang Yi, 2005), stock returns index (Comment and Jarrell, 1995; Lang and stuzl, 1994), financial index (Begre and Ofk, 1995; Llody and Jahara, 1995; Li Ling, Zhao Yugang, 1998), excess value index (Givoyl and Hayn, 1999), total factor index (Schoar, 2002). Stock returns index lacks practicality because it's hard to choose the time; in other indexes, the cost of shareholders are not considered, so they can't reflect the shareholders' real income, let alone input and output value of shareholders, and these are exactly the advantages of EVA.

In conclusion, first, In the study of diversification and performance, no one has yet use EVA as a performance index; Second, most of the existing domestic research take listed companies as the research object and very few researches are about the state-owned key enterprises, which are the "eldest son" of the national economy, and carries the task of economic transformation; Third, there is almost no research about Specialization Ratio and Related Ratio's influence on the performance; Xie Huobao, Zhang Jun (2007) took research in listed companies' Specialization Ratio and Related Ratio, but they only chose 32 samples, and the indexes are used as business concentration evaluation, not for targeted analysis. The paper regards state-owned key enterprises as the object of research, regards EVA as the performance index, accurately reflects shareholder investment value, and study diversity under this background. All of these give this paper's research more practical significance.

2.2 Research Hypothesis

2.2.1 Diversification Type and Enterprise Performance

Unitary strategy is to focus enterprise management on its leading products, and provide relatively small number of products or services in a certain area. Although it's easy for unitary enterprise to realize economies of scale by specification, but because the products and services are relatively single it brings much more risks to management. Since the market conditions change rapidly, unitary strategy can't quickly meet customer needs; and under the background of customer demand diversification, it also can't meet the personalized requirements of customers. In addition, it is also unfavorable to use channels, technology, equipment and other assets to realize scale economy effect. State-owned key enterprises are mostly the backbone of national economy industry, with assets of large scale, great variety, widely involved in industries. Unitary strategy, compared with other diversification strategies, can't make technology and capacity transmit in the relevant range, so the scale economy effect is limited.

Dominating strategy, compared with unitary strategy, implements a small diversification, with slightly lower degree of products specialization, but it still focus on its main products, makes technology and production capacity implement partial extension.

Dominating enterprises limitedly develop other business, which takes a very low proportion, in addition to the core business, so it can't produce scale effect, and it's asset's potential has not been fully developed, so it also can't fully achieve synergy effect and scope effect compared with the related diversification strategy.

Unrelated diversification strategy refers that enterprises produce new products and services unrelated with its original ones. Unrelated diversification means entering multiple areas, although it scattered the empirical risk, but it will enlarge the management range, increase the management level, so it's easy to form "X-inefficiency"; unrelated diversification also caused the resources diversification and makes it unfavorable to intensive large-scale production. In efficient capital markets, unrelated diversification may also cause value discounts (Campa & Kedia, 2002; Huang Shan 2008);Compared with related diversification, it's also faced with multiple tests, such as management synergy, financial synergy, enterprise culture synergy and human resource synergy, and it's easy to produce the phenomenon of $1 + 1 < 2$.

Related diversification strategy creates value by establishing or expanding its resources, capabilities and core competencies . Singh and Gu think related diversification can extend their core competence and management resources to related fields. Relatedly diversified enterprises achieve economies of scope through activities of business level, technology of enterprise level, or transference of enterprise core competitiveness to create value   (Hitt, 2008).

As a special enterprise similar to government authority level, state-owned key enterprises have strong political ties(Lu Chuang,2010).This helps to improve the related technology transformation and the efficiency of the business integration across the country, also to make up for the original product life cycle fluctuation(He Biao,2008).A lot of research results at home and abroad have proved relatedly diversified enterprise easy to give better performance(Bettis and Hall,1981;Rumelt,1982;Sigh and Gu,1994;Myong,2007).

Through the analysis of the above comprehensive, we put forward the following hypothesis:
H1: EVA is lowest in the unitary state-owned key enterprises;
H2: EVA is highest in the relatedly diversified state-owned key enterprises.

2.2.2 Specialization Ratio, Related Ratio and Diversification

Academics on the explanation for enterprise diversification reasons can be divided into three categories:The first one is a competition point of view, which thinks diversified enterprises are to obtain scale economy, scope economy to gain competitive advantage; Second point is the proxy theory, which argues that diversification is not for increasing the economic benefit or shareholder interests, but for protecting or maintaining the business operators' current interests by expanding production. The third view is resource-based theory, which thinks enterprise implementing diversification not in order to obtain economies of scale and synergies effect, but to take maximum efficacy of the resources and capabilities.

From formula (1) and (2) we can see Specialization Ratio and Related Ratio explain the motivation of the diversification from the longitudinal and transverse. Specialization Ratio reflects the concentration of main business of the enterprise. When enterprise's Specialization Ratio is low, the business concentration is also very low; enterprise's resources are more scattered; investment directions and funding pressure increase; so enterprise was unable to achieve economies of scale. Improve Specialization Ratio can make the enterprise focus on particular product and service, help the enterprise focus on the long-term core ability to form the competitive advantage and improve performance. But when Specialization Ratio exceeds a certain limit, the enterprise's business will be too concentrated. With development direction bound in one point, resources investing direction very single, excess capacity lack of free space, enterprise resources' effectiveness limited,

marginal returns of scale economy and enterprise performance begin to decline.

Related Ratio reflects the correlation degree between the main products of the enterprise. When Related Ratio is low, the commonality of business areas is reduced, causing information asymmetry between managers and principals. Managers have more information to pursue private interests in diverse ways, such as job security and personal ascension, to protect self-interest (Shleifer & Vishny, 1989).With Related Ratio increasing, similarities between various business fields enhance; concealment of information is reduced. This will effectively reduce the phenomenon of information asymmetry use by managers for private gain, and helps to improve performance. At the same time, as Related Ratio increases, on enterprise level, the "menu cost" of enterprise ability and core competence transferring from one business to another will be reduced; on management level, developing economies of scope by sharing products or market competition will be much easier(Hitt,2008),and enterprise gains more.

Through the analysis of the above comprehensive, we put forward the following hypothesis:

H3: Specialization Ratio and EVA of state-owned key enterprises have a U relationship;

H4: Increasing Related Ratio will have a positive effect on EVA of state-owned key enterprises.

3   Research Design

SASAC began to implement EVA evaluation in state-owned key enterprises in 2010, so we choose EVA as a performance evaluation index. The calculation of EVA is based on the interim regulations, head of the central enterprise performance evaluation *Interim measures to evaluate business performance of state-owned key enterprises principle.*

In This paper, we selected 177 listed companies hold by state-owned key enterprises in Shanghai and Shenzhen stock market as the research object and there's a total of 146 listed companies, after eliminating ST, * ST companies. This paper collected three years' panel data of 2007-2012 a total of 438 effective observation points. The sample data mainly comes from Wind database and manual collection.

3.1 Diversification and EVA

In this paper, we take the *Industry classification guidelines for listed companies* released in 2001 by CSRC (China Securities Regulatory Commission) as the basis of industry classification of product. With reference to SIC (standard industry classification), and according to the actual situation in our country, we put the business with same first 4 digits of product code in listed company's main business income as a basic unit of enterprise diversification; and on this basis, put the products with same first 3 digits as associated businesses in some way.

3.1.1 The model

$$eva = \beta_0 + \beta_1 dive_{1i} + \beta_2 dive_{2i} + \beta_3 dive_{3i} + \sum_{4}^{9} \beta(others) + \beta_{10} year + \beta_{11} industry + \varepsilon \ (3)$$

The explained variables: annual EVA; The explanatory variables. We introduce 3 dummy variables: $dive_{1i}$、$dive_{2i}$、$dive_{3i}$ to distinguish four types of diversification:

$$dive_{1i} = \begin{cases} 1, & other\ diversifiation \\ 0, & unitary\ type \end{cases}$$

$$dive_{1i} = \begin{cases} 1, & other\ diversifiation \\ 0, & do\min ating\ type \end{cases}$$

$$dive_{1i} = \begin{cases} 1, & related\ diversifiation \\ 0, & unrelated\ diversifiation \end{cases}$$

(1) For a unitary enterprise, without considering other control variables:

$$E\{eva \perp dive_{1i} = 0, dive_{2i} = 0, dive_{3i} = 0\} = \beta_0 \tag{4}$$

(2) For a dominating enterprise, without considering other control variables:

$$E\{eva \perp dive_{1i} = 1, dive_{2i} = 0, dive_{3i} = 0\} = \beta_0 + \beta_1 \tag{5}$$

(3) For a relatedly diversified enterprise, without considering other control variables:

$$E\{eva \perp dive_{1i} = 1, dive_{2i} = 1, dive_{3i} = 1\} = \beta_0 + \beta_1 + \beta_2 + \beta_3 \tag{6}$$

(4) For an unrelatedly diversified enterprise, without considering other control variables:

$$E\{eva \perp dive_{1i} = 1, dive_{2i} = 1, dive_{3i} = 0\} = \beta_0 + \beta_1 + \beta_2 \tag{7}$$

According to the existing literature, we choose the following indicators as others control variables:

(1) The scale type of control variables.

In general, the larger the enterprise is, the more abundant its resources are, and more capable it is to carry on diversified management. Therefore, we choose assets (ln) to be control variables, and choose the natural logarithm of total assets to reflect the enterprise scale. In order to distinguish the difference between different-income state-owned key enterprises' demands for resources allocation, we select the total assets turnover index (zzc) at the same time.

(2) The income type control variables.

Zhang Yi (2005) have proved that companies' return on assets doesn't present a monotone increasing or monotone decreasing trend with the increasing of diversity degree, but the diversified enterprise' return on assets is smaller than unitary enterprise's. Inspired by this, we select return on equity (roe) as control variables. Considering the central enterprises have different capital structures and profit structures due to different industries, we add earnings before interest and tax profit share (xs) as control variables.

(3) The debt type control variables

Essentially speaking, enterprise diversification behavior is a kind of expansion (Zhang Min, Huang Jicheng, 2009), and debt can inhibit enterprise expansion (Jensen, 1986).So we select liquidity ratio (lb), which measures enterprise's short-term debt, and the ratio of financial costs in total liabilities to income (cw) as control variables.

Time and related industries are other control variables; Industry types are respectively labeled 1-13 according to the CSRC.

3.2 Specialization Ratio, Related Ratio and diversification

3.2.1 The model

$$eva = \beta_0 + \beta_1 sr + \beta_2 rr + \beta_3 sr^2 + \beta_4 rr^2 + \beta_5 sr \times rr + \sum_6^{11} \beta(others) + \beta_{12} year + \beta_{13} industry + \varepsilon \quad (8)$$

The explained variables: EVA. The explanatory variables. To test Specialization Ratio and Related Ratio's different effects on EVA, we choose Specialization Ratio (sr), Related Ratio (rr), square of Specialization Ratio (sr^2), square of Related Ratio (rr^2) and product of Specialization Ratio and Related Ratio ($sr \times rr$) as control variables. Others control variables, time and industry control variables, refer to the above.

Sections and subsections should be numbered as 1, 2, etc. and 1.1, 1.2, 2.1, 2.2 respectively. Capital letters should be used for the initial letter of each noun and adjective in the section titles, the section should be formatted as left, bold, times new roman, and 15pt font size. For subsection (left, bold, times new roman, and 14pt), the initial letter of first word should be capitalized. And also similarly for other sub-subsections (left, bold, times new roman, and 12pt).

4   Research results

1) Take annual EVA as an explanatory variable and plug the values into formula (3), then carry on a panel regression analysis with Stata11.0, and the calculation results are as shown in table 1.

Table 1: Different diversities' Impacts on EVA

	Model-1	Model-2	Model-3
cons	-0.0697*** (-10.16)	-0.0642*** (-9.85)	-0.0601*** (-9.58)
$dive_{1i}$	0.0133** (2.18)	-0.0138** (2.38)	0.0145** (2.38)
$dive_{2i}$	0.01932	0.01782	0.023328
$dive_{3i}$	0.0167* (1.73)	0.0169*** (1.76)	0.0175*** (1.82)
roe	0.0005** (2.5)	0.00054** (2.65)	0.00047** (2.25)
xs	0.0306*** (5.32)	0.0309*** (5.41)	0.0306*** (5.37)
zzc	0.0004* (2.71)	0.00039* (2.8)	0.00036* (2.51)
ln		-0.0083** (-2.53)	-0.0076** (-2.29)
lb			0.0021
cw			0.0622
year	control	control	control
industry	control	control	control
F	330.77***	300.32***	270.83***
adjusted R^2	0.8225	0.7601	0.7451
Hausman test	62.72***	76.91***	85.23***
model	fixed effects	fixed effects	fixed effects

Note: * * *, * *, *, respectively represent double tail significant at levels of 1%, 5%, 10%; and numbers in brackets are t values after white adjustment.

According to the inspection results in table1 and formula (4) ~ (7), E (Eva) can be calculated for each type and shown in table 2.

Table 2: EVA values of differently diversified state-owned key enterprises

model	unitary type	dominating type	related diversification	unrelated diversification
Model 1	-6.97%	-5.64%	-5.12%	-6.79%
Model 2	-6.42%	-5.04%	-4.45%	-6.14%
Model 3	-6.01%	-4.56%	-4.25%	-6%

After three models' tests, related diversified state-owned key enterprises have the highest EVA performance, which supports hypothesis H2.Zhu Tao (2009) found in his studies of domestic mergers and acquisitions of listed companies, that with the combination of capabilities and resources, diversified enterprises have good performance[29]; Related diversification makes resources and knowledge shared in state-owned key enterprises in management level, ability to facilitate combined with resources, to achieve better performance, and this makes it easy to combine ability with resources to achieve better performance.

After three models' tests, unitary state-owned key enterprises have the lowest EVA performance, which supports hypothesis H1.Although unitary strategy improves the efficiency of enterprise specialization and lays foundation for cost control, but its narrow business objective decreases the ability to respond to customer demand changes.

Table 3: Specialization Ratio and Related Ratio's impacts on EVA

	Model-1	Model-2	Model-3	Model-4	Model-5
cons	13.3288 (1.20)	14.823 (1.32)	13.522 (1.22)	15.347 (1.38)	13.8761***(1.25)
sr	2.5975 (1.56)				
rr		1.468* (1.76)			
sr^2			2.1461* (1.68)		
rr^2				0.9213 (0.69)	
sr×rr					1.9766 (1.40)
roe	0.3728*** (24.67)	0.3727*** (24.53)	0.3732*** (24.70)	0.3728*** (24.5)	0.3734*** (24.64)
xs	0.0266*** (2.68)	0.0272*** (2.73)	0.0261*** (2.63)	0.0272*** (2.82)	0.0262*** (2.62)
zzc	6.7735*** (7.68)	6.6452*** (7.55)	6.7849*** (7.70)	6.6480*** (7.75)	6.760*** (7.66)
ln	-1.091** (-2.22)	-1.1300** (-2.30)	-1.0698** (-2.17)	-1.1288** (-2.29)	-1.089** (-2.21)
lb	0.487** (-2.13)	0.49** (2.13)	0.4862** (2.13)	0.4912** (2.14)	0.4827** (2.11)
cw	0.2864** (2.05)	0.296** (2.11)	0.2837** (2.03)	0.2963** (2.11)	0.2911* (2.01)
year	control	control	control	control	control
industry	control	control	control	control	control
F	160.42***	160.69***	159.09***	159.02***	170.83***
Adjusted R^2	0.8021	0.8024	0.8007	0.8008	0.7451
Hausman test	932.42***	610.49***	419.61***	506.9***	485.23***
model	fixed effects	fixed effects	fixed effects	fixed effects	fixed effects

Note: * * *, * *, *, respectively represent double tail significant at levels of 1%, 5%, 10%; and numbers in brackets are t values after white adjustment.

2) The way Specialization Ratio (sr) and Related Ratio (rr) affect EVA

(1) Specialization Ratio (sr) has a U relationship with enterprise EVA.As can be seen from table 3, when we take EVA as an explanatory variable, Specialization Ratio (sr), and product of Specialization Ratio and Related Ratio($sr \times rr$)can't pass the significance test, but the square of Specialization Ratio (sr^2) can pass the significance test (coefficient is 2.1461, t value is 1.68, p < 10%). This means Specialization Ratio's influence on enterprises' EVA is u-shaped. Too high or too low Specialization Ratios are both unfavorable to EVA, and maintaining a moderate amount of Specialization Ratio can improve performance.

(2) Related Ratio (rr) has a positive correlation with enterprise EVA. As can be seen from table 3, when we take EVA as an explanatory variable, Related Ratio (rr) is significantly positive (coefficient is1.468, t value is 1.76, p < 10%).This illustrates that, if related products account for higher percentage in main business income, it will have greater positive impact on that year's EVA. That is to say, the higher Related Ratio, the greater scope economy effect.

5   Research Conclusion and Policy Advice

This paper selects the data of 146 listed companies hold by state-owned key enterprises in 2007-2012, and then researches on the relationship between diversification strategy and EVA. The research results show that: With SASAC promoting state-owned key enterprises restructuring, different types of diversification have great effects on enterprises' EVA. Relatedly diversified state-owned key enterprises have the highest EVA, while unitary state-owned key enterprises have the lowest EVA.

Specialization Ratio and Related Ratio have different impacts on EVA. Specialization Ratio (sr) has a U relationship with enterprise EVA while Related Ratio (rr) has a positive correlation with enterprise EVA.

As control variables, state-owned key enterprises' industries have influence on EVA. The empirical analyses of table 1 and table 3 have proved that, state-owned key enterprises' industries have different status in the national economy, so their Economic and social responsibilities, and the market environment they face is also different. And it's bound to form different internal resources allocation and different influences on EVA.

Based on the above research, this paper argues that in the process of SASAC promoting state-owned key enterprises restructuring, we should pay attention to the following questions:(1) In state-owned key enterprises restructuring, the correlation should be taken as the starting point. Li Baomin, director of SASAC, said in the "12th five-year economic outlook peak BBS" that during the"12th five-year" period, the number of state-owned key enterprises will be reduced to 30-50.From the current 123 to 30-50, state-owned key enterprises restructuring is a quite heavy task. According to the research in this paper, relatedly diversified state-owned key enterprises have the highest EVA performance, so in the process of state-owned key enterprises restructuring, Consideration should be given to related diversification as the starting point and avoid simply reducing the quantity. Whether the relevance is in management level or corporate level, the restructuring must insist on transferring or sharing some knowledge or assets as the foundation.(2) When determining or adjusting the state-owned key enterprises' main business, SASAC should take Specialization Ratio and Related Ratio into consideration. With state-owned key enterprises

restructuring speeding up, and SASAC proposing the requirements of "Refocusing strategy", separation of the auxiliary body from the main body, the state-owned key enterprises' main business scopes are also in the adjustment accordingly. According to the research, Specialization Ratio has a U relationship with EVA while Related Ratio has a positive correlation with EVA. This will help to improve EVA, if we maintain a certain concentration of main products and keep a correlation between different main products and services. When adjusting the state-owned key enterprises' main business, whether it's advantageous to improve Specialization Ratio and Related Ratio should be taken into consideration.in this way, On the one hand, it can Promote the state-owned key enterprises to carry out related diversification strategy, On the other hand, it can enhance enterprise EVA by improving Related Ratio.

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