

**INVESTMENT OPPORTUNITY SET ROLE AS MEDIATING THE EFFECT OF
DIVERSIFICATION TO COMPANIES VALUE IN INDONESIA
(EMPIRICAL STUDY OF GO PUBLIC SECONDARY SECTOR COMPANIES)**

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Abstract

Purpose - This study aims, first, to measure and to interpret the effect of diversification on company value, and second, to measure the role of Investment Opportunity Set (IOS) as the mediating effect of diversification to company value.

Design/methodology/approach - This study uses a quantitative approach with paradigm positivistme. This empirical research object is the go public secondary sector companies at Indonesia Stock Exchange (ISE). This study use sample 18 companies. Observation period is 2006-2010. The method of data analysis is Structural Equation Model (SmartPLS software) Ver 2.0 M3.

Findings - First, diversification has significant and positive effect on company value. Second, IOS acts as a partial mediating effect of diversification to company value.

Research limitations - The study is not concerned with the qualitative, eg management and customer service. The reason is lack of information qualitative data. This assessment is only a kind of financial portrait moment and, of course, contains many limitations. Moreover, the researchers did not check again whether the financial report is true, that in accordance with the conditions of the company, without engineering.

Practical implications - The research could be an important input to regulators such as the company's managers, board of directors, the board of commissioners in deciding investment opportunities and to explain the information disclosure or publication on Stock Exchange in the online media. For potential investors, this study describes the company prospects before buying shares at secondary sector.

Originality/value - This research fills opposition research results of previous studies, by including IOS as a mediating variable, the effect of diversification on company value. These variables can explain the emergence of the gap with the object of observation on go public secondary sector companies in Indonesia.

Keywords: Diversification, Investment Opportunity Set, Value Company.

Article Classification: Research Paper

INTRODUCTION

Revolution and globalization lead companies to choose diversification, when faced with a very tight competition and the market grow rapidly. Montgomery (1994) suggest that there are three perspectives to diversify motives, namely Market

Power View-MPW, Resources-Based View RBV, and Agency View. David (2003: 167-170) states that the development of new business is different from the existing business and involving a number of investment diversification. When a company chooses to diversify operations from

one to several industries, it mean the diversification strategy done at the enterprise level (Hitt et al., 2011: 158-159).

Ansoff (1965) states that diversification is the evolution of business growth. Rumelt (1974), Hoskisson & Hitt (1990) states that diversification is a corporate level strategy. Unlike Tecee et al. (1997), Matsusaka (2001) and Barney (2002) states that diversification can be used as a source of sustainable competitive advantage. Clarkson et al. (1983), Nayyar (1993) suggested diversification is the source of value creation. Rumelt (1974) states there is a correlation between the diversification of corporate diversification and company performance, including Strategic Management and Financial Management.

Studies of diversification and its impact on the company value is still debating, whether diversification can bring benefit or even a negative impact on company value. The studies suggesting that diversification increases the company value are: 1) On average, higher profitability relate to diversification companies than non-diversified company (Amit & Livnat, 1988; Rumelt, 1982; Aisjah, 2009). 2) Diversification does not reduce the

company's enterprise value (Gomes & Livdan, 2004; Sujoko, 2006). 3) Diversification associated with technology diversity (Miller, 2004, 2006). 4) International Diversification did not lower the company value (Santos et al., 2008). 5) Diversification has positive influence on the performance of companies in Indonesia (Chakrabarti et al., 2007).

However, research on the effect of diversification on company value find the opposite result. First, the value of diversified companies are smaller than companies that operate in a single segment. Value loss ranged from 13% -15%. Difference in value will be reduced if the company made related diversification (Berger & Ofek, 1995). Second, there is a negative relationship between Tobin's q ratio on diversification (Lang and Stulz, 1994; Campa & Kedia, 2002; Fukui and Ushijima, 2007). Third, no significant effect on diversification Excess Value and profitability (Harto, 2005; Kusmawati, 2005, Satoto, 2009, Yuliani, 2011). Four, diversified companies have asymmetric information problems than the company's focus (Clarke et al., 2004).

Various previous studies on the effects of diversification on companies value is still not consistent. This creates a gap, with variable

operationalize Investment Opportunity Set (IOS) as a mediation between the effect of diversification on companies value. Reason to include variables when a company is to diversify, namely there are a number of investments that will be involved. Diversification opportunities for the company will create investment opportunities that should be implemented. Investment opportunities in financial management in the context of investment decisions entry. Research Fama and French (1997) has shown that the only determinant of the company value is an investment decision.

Myers (1977) firstly introduced the Investment Opportunity Set (IOS) in relation to achieving the company's goals. Gaver and Gaver (1995) stated that IOS provides guidance a broader, enterprise value as the primary goal depends on corporate spending in the future, which is now the investment options that are expected to yield a greater return. IOS is a combination of assets in place and future investment choices with a Net Present Value (NPV) positive (Myers, 1977; Kallapur & Trombley, 1999). Adam and Goyal (2008) emphasizes that the IOS plays an important role in corporate finance related to the achievement of corporate goals. Smith & Watts (1992)

explains that the IOS is a component of the company's value results from the choices to make future investments.

Empirical studies The IOS influence on companies value outcome remains consistent. On the one hand, IOS influence on companies value [(Fama, 1977; MacKay, 2005; Hasnawati, 2005a, 2005b; Hossain et al., 2005; Yoon and Starks, 1995; Nopratiwi, 2004; Hidayat, 2010; Akhtaruddin & Hossain, , 2008; Efni, 2011)]. But on the other hand, Kallapur & Trombley (1999); Suharli (1997) and Bernadi (2008) found that IOS has no effect on companies value. IOS effect on companies value, which means that the investment opportunities that exist, if the company is able to choose from different investment companies will acquire surplus for a number of investments made. Surplus proceeds will be contributed to the cash inflow, and then accumulated in improving profitability. Conversely, if the IOS does not affect the company then the company has a deficit in the number of investments made, which will reduce the equity and will ultimately lower the company value.

The phenomenon of companies go public in Indonesia showed show most of them diversify through

divestment and organization restructuring. Examples are Bimantara Group, Texmaco Group, PT. Indomobil Sukses International Tbk, PT. Karwel Indonesia, Bunas Finance Indonesia. Sutrisno in Sujoko (2006) found evidence that merger and acquisition activity at corporate strategy level actions more emphasis on maintaining corporate sustainable advantage. Apparently, the results lowered the company's stock price. For example, the management of PT. Eastman Kodak diversify its business through the acquisition of PT. Sterling Drug. After the acquisition, the stock price PT. Eastman Kodak fell 15%, therefore, aggrieved shareholders.

This study develops a diversified variable relationships, IOS and the company value, as well as fill the research gap of Lang and Stulz (1994) and Fukui and Ushijima (2007). Research of Lang and Stulz (1994) in the United States and Fukui and Ushijima (2007) in Japan showed inconsistent results. In fact, the two researchers using the same performance indicators Tobin's Q. This study fills the gap by offering a single solution, which operate as a mediating influence between IOS diversification on companies value. IOS mediating variable will make an increasingly broad diversification, it

will lead to a variety of investment opportunities. Existing investment opportunities encourage companies to choose investments with a high rate of return. Therefore, the company earned surplus, which in turn increases the company value.

This study will answer the following problems: (1) Measuring and interpreting the effect of diversification on company value, (2) Measuring and examining the role of IOS as mediation the effect of diversification on company value. Benefits theoretically study: (1) Testing the theory of diversification with perspective of Montgomery (1994), (2) Expanding the study of signaling theory (Ross, 1977), namely company with variety of investment opportunities mean better corporate growth. (3) The study extends the research topics of the theory of Financial Management and Investment Management. While the practical benefits of this research can be input for management, investors and other practitioners about the impact of the interaction of each variable to increase the company value in order to obtain images and information about the financial performance of the company.

RESEARCH HYPOTHESIS

The study's findings are inconsistent regarding the relationship of diversification on company value. Hitt & Hokisson (1990) suggests, diversification relation with the performance of non-linear form, ie the higher the degree of diversification the lower performance. Palich et al. (2000) suggests, diversification and performance relationship can be linear and non-linear. The linear relationship between diversification and performance has been described by MBV approach. Diversification can enhance market power, facilitate the implementation of pricing practices, and cross-subsidies between businesses. Therefore, it exploits the synergy of economic diversification. In the non-linear forms, business diversification can lead to control difficulties. Therefore, high diversification will lead to greater marginal cost, so the high diversification causes a decrease in the company value.

Montgomery (1994) explains that the reason diversification company is looking to diversify the market. That is, the market share control will greater. Another reason is to optimize existing resources. Montgomery & Wernerfelt (1988) stated that the diversified company, it

will first try to use excess assets to the nearest market to enter. If there is still excess capacity, the company will enter the market more deeply. But if the assets used in the market too much with the current market, companies will lose their competitive edge and low profit. This indicates that the relationship between diversification and marginal profit is diminishing function. Several studies have also concluded that diversification is more profitable for companies in emerging economies (Khanna and Palepu, 1999). The reason is that in countries with developing economies, capital market intermediaries often run inefficiently or even absent. Based on explanation above, the hypotheses formulation of diversification effect on company value is:

Hypothesis 1: The more extensive secondary sector company to diversify, the higher company value

Investment Opportunity Set as an investment option depends on the value of future discretionary expenditure growth chosen by manager (Kole, 1991). Each choice is influenced by the growth of competitive advantage in business. Diversification can be done because the company has investment

opportunities set. Investment opportunities means the company will have a good value, reflected in the stock price as well as for other indicators. IOS plays an important role in corporate finance related to the achievement of corporate goals.

Singh et al (2003) and MacKay (2003) conduct empirical research on the effects of diversification to IOS. The results showed that company was not consistent because the opportunity to diversify their investments is differ. Investment Opportunity Set selected based on

resource considerations, strategic assets and market share. When companies implement diversification, they will contribute to the increased company value. IOS acts strengthen the company to diversify. Therefore the presented hypothesis as follows:

Hypothesis 2: IOS mediate the diversification effect to company value.

Based on explanation above, theoretically and empirically, the model hypotheses are follows:

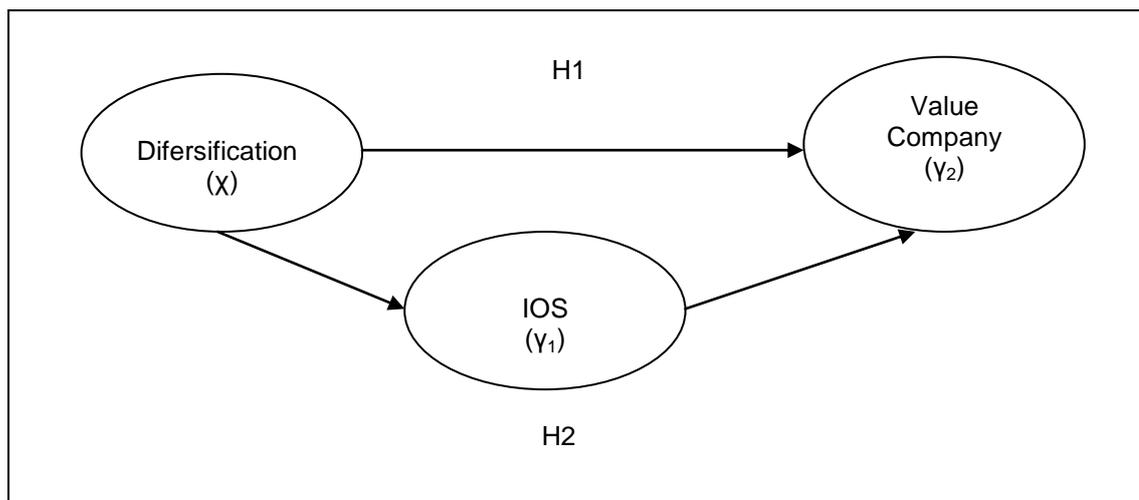


Figure 1. Research Hypothesis Model

RESEARCH METHODS

A. Approach and Type Research

The approach is a quantitative study with paradigm positivistme by empirical research on the go public secondary sector companies in IDX. While this type of research is explanatory (explanatory research),

the aim is to find an explanation of the relationship (causality) between variables through hypothesis testing.

B. Population and Research Sample

The study population was all companies included in the secondary

sector in IDX. This includes basic industry and chemicals (6 sub-sectors), miscellaneous industry (3 sub-sector), consumer goods industry (5 sub-sectors) during the observation period 2006-2010. Object of observation in the study is the annual report 2010 amounted to 136 issuers. Population criteria include: 1) The Company publishes audited financial statements 2006-2010. 2) The Company did not incur losses. 3) The Company has positive retained

earnings. 4) The Company has a positive equity balance, and 5) the Company has more than one type of business.

Based on these criteria, the amount eligible is 18 companies. This study used a sample saturated (census). The unit of analysis is the pooling of data with lag time during the observation period (t) by the number of observations 72 cases. Companies that entered the samples shown in Table 1:

Table 1. Sample Research

No	Emiten	Kode	Sub Sector
01	Indocement Tunggal P Tbk	INTP	Cement
02	Ekadharna International Tbk	EKAD	Chemicals
03	Charoen Pokphand Indonesia Tbk	CPIN	Animal Feed
04	Astra Otoparts	AUTO	Automotive and Comp.
05	Indo Kordsa Tbk	BRAM	Automotive and Comp.
06	Indospring Tbk	INDS	Automotive and Comp.
07	Selamat Sempurna Tbk	SMSM	Automotive and Comp.
08	Sumi Indo Kabel Tbk	IKBI	Cables
09	Indofood Sukses Makmur Tbk	INDF	Food and Beverages
10	Mayora Indah Tbk	MYOR	Food and Beverages
11	Siantar Top Tbk	STTP	Food and Beverages
12	Ultra Jaya Milk Tbk	ULTJ	Food and Beverages
13	Darya-Varia Laboratoria Tbk	DVLA	Pharmaceuticals
14	Merck Tbk	MERK	Pharmaceuticals
15	Pyridam Farma Tbk	PYFA	Pharmaceuticals
16	Mustika Ratu Tbk	MRAT	Cosmetics and Household
17	Unilever Indonesia Tbk	UNVR	Cosmetics and Household
18	Kedawung Setia Industrial Tbk	KDSI	Houseware

Sources: Companies Go Public Performance Summary, 2010

C. Sources and Data Collection Methods

The data used are secondary data, such as financial statements Year 2006-2010, obtained from the Annual Report Database Corner

Stock IDX-UB. Furthermore, financial statements are used to obtain data from each study variable.

D. Operational Definition of Research Variables

Table 2. Operational Definition of Research Variables

Variables	Indicators	Measurement
Difersification (χ_1) David (2003): The Company is developing several businesses led by a holding company that oversees couple of subsidiaries and scattered in various types of business	Market Share _{t-1}	Sales/sales industry
	Free Cash Flow _{t-1}	Δ Retained earning+depreciation+amortization
	Size _{t-1}	Δ TA
	Compensation _{t-1}	Δ Remuneration paid to the boards of commissioners and directors
IOS (γ_1) Myers (1977): The combination between assets in place and future investment opportunity with a positive NPV	MBA Ratio _{t-1}	(TA-TE)+(OSxSP)/BVA
	MBE Ratio _{t-1}	(OSxSP)/TE
	EP Ratio _{t-1}	EPS/SP
	CEFA/BVA Ratio _{t-1}	FA/BVA
Value Company (γ_2) Damodaran (2006): Companies value is a measure of management success in past operations and future prospects.	Tobin's Q _t	(OSxSP)+(D+I)-CA/TA
	ROIC _t	EBIT/EQUITY

Description: TA = Total Assets; TE = Total Equity; OS = Outstanding Share; SP = Share Price; BVA = Book Value of Assets; EPS = Earnings Per Share; FA = Fixed Assets; D = Total Debt; I = Inventory; CA = Current Assets; EBIT = Earnings Before Interest and Tax.

E. Method of Data Analysis

Inferential statistics are used to determine the relationship between variables simultaneously. This study uses Structural Equation Model (SEM) based on the variance, the Partial Least Square (PLS), using software SmartPLS Ver 2.0 M3. The reasons for using PLS is (1) The research variables are latent or unobservable,

(2) a relatively small number of observations namely 72 observations and (3) empirical models indicate causality tiered.

RESULTS AND DISCUSSION

Hypothesis Testing Results (H1)

This study has two hypotheses, the direct testing and mediating testing variable. The test results are presented in Table 3:

Table 3. Hypothesis Testing Results

Independent Variable	Dependent Variable	Path Coefficient	t-statistic	p-value	Explanation
Diversification	CV	0,316	2,428	0,018	Significant
Diversification	IOS	0,650	16,099	0,000	Significant
IOS	CV	0,267	4,221	0,000	Significant

Source: Adapted from secondary data

Description: CV = Company value; Significant at $\alpha = 5\%$

Table 3 shows that each of the independent variables have a positive and significant effect on the dependent variable. The direct effect of diversification on company value is significant and positive, the value of s path coefficient is 0.316 and p-value less than 0.05. The direct effect of diversification on IOS is significant and positive. Big path coefficient is 0.650 and p-value less than 0.05. The direct effect of IOS on company value is 0.267, p-value less than 0.05. Therefore, the effect is significant and positive.

Table 3 shows the results of a positive and significant effect of diversification on company value. The first hypothesis which states the more

extensive secondary sector companies to diversify, the higher company's value is received (H1 Accepted).

Hypothesis Testing Results (H2)

Testing mediating variables influence also called indirect effect testing, aims to determine the position of mediating variable (IOS) in this study. The process of examination the IOS variable in determining the type of mediation, whether partial or complete mediation steps are as follows:

Step 1: Calculate the path coefficients. The way is to enter the IOS variable in the model and the empirical test results, as shown in Table 4:

Table 4.
Mediation Test Results Analysis with Variable IOS

		<i>Original sampel estimate</i>	<i>t- statistic</i>	<i>p-value</i>	<i>Explanation</i>
Diver	→ CV ^(a)	0,316	2,253	0,027	Significant
Diver	→ IOS ^(c)	0,650	19797	0,000	Significant
IOS	→ CV ^(d)	0,267	4,417	0,000	Significant

Source: Adapted from secondary data

Step 2: Calculate the path coefficient without entering the IOS variable in empirical models. The test results are shown in Table 5 follows:

Table 5.
Result Analysis of Variable Test Mediation Without IOS

		<i>Original sample estima</i>	<i>t-statistic</i>	<i>p-value</i>	<i>Explanation</i>
Diver	→ CV ^(b)	0,568	19,880	0,000	Significant

Source: Adapted from secondary data

Table 4 and Table 5 shows the value of (c), (d) is significant, and (b) significant. Path coefficient (a) is smaller than the path coefficient (b). Therefore, the nature indirect effect of mediated diversification on company value through IOS is a partial mediation. That is, diversification can directly affect the company value and can also through IOS. It can be stated that hypothesis as a mediating influence of IOS diversification on company value received or (H2 Accepted).

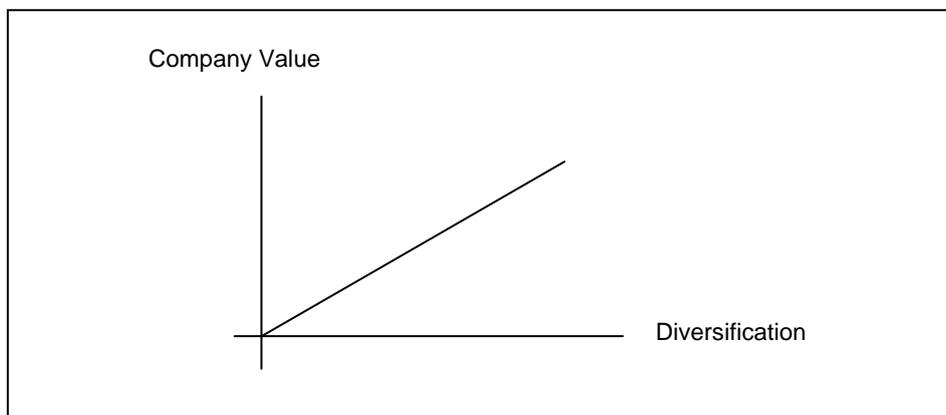
DISCUSSION

Diversification Effect on Company Value

Analysis results the influence of diversification on company value is significant and positive. Thus, hypothesis that the more extensive secondary sector companies to diversify, hence increasing the company's value, is acceptable.

These results suggest that diversification can explain the variation in the increased value of secondary sector company in Indonesia during the Year 2006-2010.

Palich et al. (2000) explains the diversification and performance relationship can take linear and non-linear form. This study proves that for the secondary sector in Indonesia relationship between diversification with company values are linear. The linearity assumption is tested by relationship between the value of corporate diversification. The test result significance at p-value 0.000 0.05, so it is said that the relationship between the two variables is linear. The findings of this study can be illustrated in linear curve pattern of diversification and performance relationship:



Source: Adapted from secondary data

Figure 2 **Linear relationships between Diversification and Company Value** **Findings Secondary Sector in Indonesia**

Linear relation model was developed from the market based view and transaction cost economies perspective. It is said that the company can create value through the exploitation of market power advantages. It is a positive linear relationship between diversification and performance. Internal market based view and transaction cost perspective, by Montgomery (1994), is proved in this study. Reason secondary sector companies in Indonesia to diversify created by the views and approach of market-based economic transaction costs.

Market-based view approach is actually referring to the power sources that affect industry competition that comes from thinking Porter (1980), in order to formulate the company's competitive strategy related to the environment. For Porter, Environment is the industry in which the company competes. The company's ability to cope with the industrial environment is being developed (Hitt et al., 2011) referred as managing the company's resources as an integrated input. Therefore, it create a potential source of Sustainable Competitive Advantage (SCA), the company is able to outperform its competitors, the

company finally can achieve superior return.

This study supports Barney (2002), which states that the rationality of the company to diversify with anticompetitive motivation is to exploit the market share. Some researchers such as Bourantas et al. (1987); Amit and Livnat (1988); Szymanski et al. (1993); Chakrabarti et al. (2002) has demonstrated significant and positive relationship between diversification on company value. Miller (2006) concluded that the relationship diversification on company value on the 192 companies in the United States is as significant and positive. While in Indonesia, the findings are consistent with research Aisjah (2009); Sujoko (2006), that diversification provides significant and positive effect for companies listed on the Indonesian stock market.

These results contrast with the results of Lang and Stulz (1994); Campa and Kedia (2002) and Fukui and Ushijima (2007). Fukui & Ushijima research manufacturing company in Japan. The results showed that the relationship of diversification and company value is significant but negative. That is, the wider number of businesses owned by companies in

Japan, the lower the company value. This means that the curve of the relationship of diversification and value of companies in Japan are non-linear (curvilinear linkage model), inverted-U-shaped model and the intermediate model. Both models happen to companies in Japan because of diversification that have been done have optimum limit. This means that the company did not generate diversification benefits in accordance with the increase in the degree of diversification or even lead to an increase in some costs such as the costs of coordination, due to the increasing complexity of the company's business structure. The condition is called inverted-U model or also occurs in organization's diminishing returns (Palich et al., 2000), called the intermediate linkage model.

This study is not in line with the findings of Berger and Ofek (1995), Li & Wang (2003); Sulastri (2006); Kusmawati (2005); Harto (2005, 2007). Research Berger and Ofek (1995) using a sample of 5233 companies. The results showed that the diversified company have difference value loss ranged from 13% -15%, smaller than the companies that operate in a single segment. In addition, the company's

operating profit was also smaller fungsi impulse respon diversified company than the focus company or operate with a single segment. Berger and Ofek (1995) argued the conditions of lower financial performance of diversified companies than focus company cause the company value as a whole will be lower, because the amount of excess investment performance of the company's financial results are not well diversified into the following year.

Financial performance condition of the secondary sector in Indonesia during the year 2006-2010 showed sales growth 16.94%, with average sales of Rp 88 trillion per year. This suggests the secondary sector diversified companies have better sales performance. Increased sales growth was followed by an increase in operating income and net income, ie 35% to 39% in operating profit and net income for development. Financial condition is a market share measure of secondary sector companies in Indonesia with a sizable percentage.

Mediating Role of IOS as Diversification Effect on Company Value

The results of path analysis, to measure the IOS as a mediating of variable diversification effect on company value, shows a significant

and positive coefficient (Table 4). This means that the diversification affect on company value, either directly or indirectly, through IOS. Based on the description of the steps to determine the nature of the variables IOS (Tables 4 and 5), it was found that the variable IOS affect value company (Table 5.7) increase the company value, initially only 0.316 in the absence of IOS, rising to 0.568 (Table 5) after including IOS.

This study was able to prove that the IOS is a partial intervening variables to enhance the role MBER and MBAR and in influencing the company value. The consequence of this finding is that companies need to pay attention to the book value of assets and the book value of equity. The book value of assets reflects the growth prospects of the company, used to see how much its assets for the company's operations. The higher the book value, the better the company growth prospects, because the company has a productive asset. The equity book value reflects the capitalization of shares on the stock market. The higher the equity book value, the better the prospects of the company in the eyes of investors and prospective investors. This condition will make funding decisions. Therefore, these two elements have a

(partial mediation). This is because the value of (c), (d) is significant, and (b) significant. Path coefficient (a) is smaller than the path coefficient (b). Positive direction of indirect effect demonstrates the ability MBAR and MBER

positive effect for increasing corporate value.

The study's findings are consistent and support Fama (1978) research. Direct and indirect influence of diversification on company value through IOS is obtained from the activities of the investment itself, through the selection of projects or other measures such as the creation of new products, the replacement of more efficient engines, the development of research & development, and mergers with other companies (Myers, 1976). Enterprise value represented by Tobin's Q is also influenced by investment opportunities and discretionary expenditure in the future (Myers, 1977; Myeong & Hyeon, 1998).

The findings in this study support the signaling theory. IOS shown by MBAR AND MBER essential enhance shareholder value. These types of investments will provide a signal about the company's growth prospects, the growth

prospects for assets and market capitalization value stocks, which is reflected in the expected future equity growth. This fact is based on the assumption that the maximum company value will be acquired through the selection of investments with a positive net present value. That is, the investment expenditures have been considered and analyzed with existing methods, the selected investments with positive NPV (Chan et al., 1990). Fama and French (1998) stated that the investment provides a positive signal about the company's growth and capitalization growth stocks in the future, resulting an increase of company value as a whole.

CONCLUSION AND RECOMMENDATIONS

This study resulted in two conclusions. First, the secondary sector of Indonesia diversified company that formed by market share were able to increase the company value, as reflected in the value of Tobin's Q. Second, IOS acts as a partial mediation between diversification and companies value.

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Some suggestions that may suggested are: first, still need to be developed and empirically examined the influence of diversification on the control systems at every level corporate and business unit level. This is because when companies diversify, the consequences faced was the change of organizational structure or the structure of the larger and comprehensive businesses. Therefore, it is necessary that the study looked at the business structure changes because it also have an impact on policy and strategy. This condition is seen in the phenomenon of several publicly traded companies that make quite aggressive business development for a relatively short period of time. Second, growth prospects and outlook for asset capitalization of growth stocks reflect IOS variables. Therefore, it is important for companies to maintain growth with positive development from year to year. Companies that have positive growth development give positive signal to investors that company performance has good prospects.

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