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OWNERSHIP AND DIVERSIFICATION: AGENCY THEORY OR STEWARDSHIP THEORY

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INTRODUCTION

Diversification is often seen as the opportunistic pursuit by incumbent management of their own self-interest at the expense of the shareholders who can, if they so desire, diversify their individual portfolios simply by buying shares in other companies. This reflects the influence of agency theory and managerialist theory as part of the growing organizational economics movement (see Barney, 1990). However, recently such views have been challenged by what its supporters have labelled stewardship theory (Donaldson, 1990a; Donaldson and Davis, 1991), a framework which presumes that managers are seeking to maximize organizational performance. This article will examine corporate diversification in a way which bears on these two contrasting theoretical frameworks. Specifically, we seek to establish why firms diversified when they did. The evidence lends more support to stewardship theory than it does to agency theory. In the next section we summarize the literature bearing on why firms diversify and set out the research questions which motivated the study. This leads into a discussion of the empirical data, particularly those concerned with the ownership type (or governance structure) of the companies concerned. We are then in a position to confront our research questions with new evidence from large New Zealand companies. The article ends with some general conclusions on what motivates diversification.

WHY DO FIRMS DIVERSIFY?

An earlier article in the *Journal of Management Studies* (Hamilton and Shergill, 1992) identified the primary role of diversification strategy in determining the financial performance of New Zealand companies through the contingency of structure, thus confirming the findings of, in particular, Donaldson (1987) and others. The further work reported here was undertaken to establish why firms diversified when they did. An answer to this question is of interest in its own right but gains greater significance when it is appreciated that at least some part of the frequently observed association between corporate-level

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strategy and performance may indeed be spurious. On the one hand there is evidence that ownership type influences diversification strategy (Ahimud and Lev, 1981; Chenhall, 1984; Lloyd et al., 1987) and on the other hand, that ownership can also have some bearing on financial performance (Chaganti and Damanpour, 1991; Larner, 1970; Monsen et al., 1968; Oswald and Jahera, 1991). Taken together, these dual influences of ownership could underlie any association we observe between diversity and performance. There has in fact been surprisingly little research undertaken to ascertain when and why firms diversify, with Ramanujam and Varadarajan (1989) in their major review of the corporate diversification literature concluding (at p. 545) that '... we need to learn more about the motives for, and implementation of, diversification as a strategy'. One major strand of the literature which seeks to answer this question uses agency theory (Eisenhardt, 1989; Jensen and Meckling, 1976). This tries to account for diversity in terms of the separation of owners from managers and, thence, the inability of the owners to control their agents, the managers effectively. While the upsurge of interest in agency theory is of fairly recent origin, for our purpose, the best concise statement we have found in the literature goes back to 1965:

> In firms whose owners are not also their managers there may be a divergence of interest between the managers and the owners in certain situations. Such a divergence can cause firms to deviate from profit-maximizing behaviour. ... Diffused-ownership firms will exhibit a strong prediliction for diversification of products, especially through merger, as a means of reducing risks taken on any one product or line of products. Since diversification through merger tends to reduce the rate of return on capital, owner-managers would be less likely to adopt such policies (Monsen and Downs, 1965, pp. 223, 232–33).

Several studies have provided support for this view that changes in ownership type lead to changes in diversification strategy. The general proposition then is that as share ownership becomes more diffuse – and, as a result, managers' discretion increases – the firms they manage will be observed to diversify in ways, e.g. as conglomerates, which are likely to be contrary to the owners' primary concern for profitability. Through diversity comes a reduction in managers' perceived 'employment risk' (Ahimud and Lev, 1981) and some increase in company size and hence managers' compensation (Gomez-Mejia et al., 1987). Further support for this association between ownership and strategy is in Hill and Snell (1988) and Lloyd et al. (1987).

Irrespective of governance structure, a second fundamental reason for diversifying, one consonant with stewardship theory, would be to enhance company profit and growth prospects by reducing dependence on static or declining markets. This motive was clearly manifest in Hassid's study of UK-based companies:

> The largest increases in diversified activity have ... been directed to industries where enterprises' profit rates have increased most and especially to

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those where such rates have been relatively more stable (Hassid, 1975, p.392).

Other studies which support a financial rationale for diversifying include those of Chenhall (1984), Devine et al. (1985, p. 188) and Gorecki (1975). The literature does of course contain several other reasons for diversifying, e.g. conglomerate building (Argenti, 1989, p. 276); earnings stability (Mueller, 1987, p. 34; Shephard, 1985, p. 301) and economies of scale (McGuigan and Moyer, 1975, p. 453). However, we regard such other motives as these as capable of being subsumed by either the ownership type (agency theory) or company financial performance (stewardship theory) rationales. The one distinctive basis for diversifying which is not covered explicitly in this study is that based on the notion of transaction costs, i.e., following Teece (1982), firms diversify in order to utilize excess resources which could not be otherwise sold or leased because of the high transaction costs that this would entail. This basis has been well researched in recent times (Chatterjee and Wernerfelt, 1991; Jones and Hill, 1988). We include this mention of the transaction cost approach in order to make plain that our research was not intended to either confirm or deny its role in the diversification moves which we have been able to study.

We can now set out in general terms the questions which we intend to address in the remainder of this article:

(1) How did the ownership of New Zealand companies change in the decade up to 1985?
(2) Over the cross-section of these companies, are the most diffusely-owned companies also the most diversified?
(3) On a diachronic basis, can diversification be linked to changes in ownership type or changes in financial performance?

DEFINITION AND MEASUREMENT OF OWNERSHIP TYPE

Definition

Control type is pivotal to this study and hence the need to spell out in some detail how this was made operational.[1] The specific objective is to classify firms according to the degree of control of those owning shares and hence to answer our first question. Previous attempts to define control types are summarized in Cubbin and Leech (1983, table I). What is rather apparent is the arbitrary manner in which this has been defined and the difficulties this creates for both replicating and extending the line of research. For example, McEachern and Romeo (1978) regard firms where less than 4 per cent of the voting shares are held by a controlling group as 'managerially controlled', whereas, in the classic Berle and Means (1932), up to 20 per cent of the voting shares could be held by a controlling group and yet the firm in question would still be deemed to be under 'management control'. Likewise, to qualify in the 'owner-controlled' group, Berle and Means would need to see almost 100 per cent of the voting capital held by a single controlling

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group; cf. Pedersen and Tabb (1976) where owner control is deemed to be present when more than 5 per cent of the votes are held by a controlling group.

There have been two previous New Zealand studies of ownership type: that of Fogelberg (1980) and Chandler and Henshall (1982). The later study used essentially the same definitions of ownership type as did Fogelberg so, partly in our own interests for local continuity and replication, we also intend to base our definitions of ownership on Fogelberg's. Moreover, it is also worth pointing out that Fogelberg's system appears to avoid some of the criticisms levelled at such classification schemes (see Nyman and Silberston, 1978). In terms of ownership, Fogelberg defines 'control' to be:

> . . . the ability to direct the affairs of the company, or to directly influence the policy decisions that are made . . . the ultimate control of any company is determined by the distribution of voting shares and the ability of any shareholder, or group of shareholders, to directly influence decisions which the board of directors make (Fogelberg, 1980, p. 55).

Fogelberg's four types of control represent different stages in the detachment of ownership from management control. These are set out and defined in table I. 'Majority control' is a situation where the firm's strategy is determined by those owning the largest proportion of the shares, whereas, and at the other extreme, 'management control' signifies no significant shareholder constraints on the activities of managers.

Table I. Classification of ownership types

Classification	*Deemed to exist when*:
Majority	Majority of capital (> 50%) held by one holder or a tightly-knit group.
Minority	Individual holder or small cohesive group of shareholders hold sufficient votes to be able to dominate the company through their interest. Exists where there is an important minority interest or family group accounting for between 15 to 50% of the votes, *where this minority interest is represented on the board.*
Joint	Minority interest strengthened by a close association with management, or management control is enhanced by a sizeable minority interest. One of two situations may apply. *Either*: (1) Owning of a minority interest of 10–15% coupled with board representation *or*: (2) Owning or controlling of a minority interest of more than 5% with board representation and active management involvement.
Management	Ownership is so widely distributed that no one individual or group has a minority interest which is large enough to allow them to exert a dominance over the company's affairs.

Based on Fogelberg (1980, pp. 61–4). Note that for Minority control, we have confirmed board representation whereas Fogelberg simply assumed this would be the case.

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Measurement

The project from which this article emerged focused on 103 public companies with shares traded on the New Zealand Stock Exchange over the period 1975 through 1985. The initial task here was to classify each of these companies to one of Fogelberg's control types as at the end of their 1985 financial year. The companies' Annual Reports were the main source of shareholder information, identity of directors, and whether they had some form of active management involvement in the firm. The *New Zealand Business Who's Who* (various years) was also useful in ascertaining the identify of final shareholdings and in linking shareholdings with individual directors. There were four cases in which adequate annual reports could not be sourced and here we worked instead from the *Directory of Shareholdings: New Zealand Public Listed Companies*, a source which also proved useful in yielding information on the holders of nominee and investment company interests. We were eventually able to map 96 of our 103 companies on to one or other of the four control types defined in table I. (In the seven cases which could not uniquely be mapped, the main problem we had concerned the ultimate ownership of shares held by nominee companies.)

With this new information to hand we were able to address the first of our three research questions: how did the ownership of large New Zealand companies change in the decade to 1985? In table II we set our findings for 1985 alongside those of Fogelberg for 1962 and 1974, and Chandler and Henshall for 1981.

This table tells a rather interesting story but before we turn to that, we need to confirm that the trends revealed are not due to major differences in firm size across the three studies with, *a priori*, smaller firms being more likely to be majority owned. In fact the opposite situation applies. The Fogelberg study was based on the 56 *largest* listed companies (in 1962) of which 43 survived through to 1974. In 1974, these 43 large companies represented 16 per cent of companies then listed and 57 per cent of the total assets of all companies listed in that year. Our 1985 sample also included the largest companies and represented, in 1985, some 44 per cent of those then listed and 71 per cent of their total assets. (Chandler and Henshall's data essentially cover all companies listed in 1981.)

Table II. Ownership types in New Zealand listed companies: 1962, 1974, 1981 and 1985

Ownership	1962*		1974*		1981**		1985***	
type	No.	%	No.	%	No.	%	No.	%
Majority	7	16.3	3	7.0	45	22.1	41	42.7
Minority	14	32.6	13	30.2	78	38.2	41	42.7
Joint	5	11.6	6	14.0	19	9.3	4	4.2
Management	17	39.5	21	48.8	62	30.4	10	10.4
Totals	43		43		204		96	

Sources: *Fogelberg (1980); **Chandler and Henshall (1982, p. 17); ***this study.

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The interesting story alluded to above can be given most emphasis if we return to Fogelberg's conclusion regarding the 1962–74 changes. He writes:

> ... by the early 1960s there had been a substantial movement towards management control. During the next 12 years this movement continued, 13 firms moved either directly to or more closely towards management control (Fogelberg, 1980, p. 69).

This movement subsequently reversed. By 1981 there had been a big rise in the proportion of majority owned companies and a roughly equivalent fall in the proportion of management controlled companies (as well as consistent if less marked shifts in the minority and joint categories). These changes continued on through to 1985. In short, over the extended period covered by these data, there has been a strong movement back towards majority ownership of New Zealand companies.

Given the importance of this finding, we wanted to be careful to ensure that it was not just a reflection of the membership of different samples (on aspects other than company size). To address this we conducted a separate exercise on changes in ownership type *between 1974 and 1985* in the subset of 19 companies[2] which were in both our sample and Fogelberg's. In six of these companies there was no change in control type classification between 1974 and 1985; three did change in the direction of management control; but the largest group, 10 in all, did indeed alter their control type in the direction of majority control. Thus we can point with confidence to a significant shift of corporate control in New Zealand over the decade to 1985, a shift which will have reduced managerial discretion and increased the control of the main shareholder(s). This development, previously overlooked, may also account for the fact (see Hamilton and Shergill, 1989; 1992) that, by international standards, large New Zealand companies have relatively low levels of diversity. However, confirmation of this requires comparative international data on company ownership and diversification strategies.

OWNERSHIP TYPE AND DIVERSITY

We now turn to the second of our three research questions: are the most diffusely-owned companies also the most diversified? Our measures of diversity were calculated using the product-count approach developed by Varadarajan and Ramanujam (1987) and validated on New Zealand companies in Hamilton and Shergill (1992). This enabled us to classify the companies into one of the following four levels of diversity as at the end of their 1985 financial years: very low diversity; related diversified; unrelated diversified; and very high diversity. In table III we bring together this classification of strategy with that of forms of control at the same point in time for the 96 companies discussed above.

If there is the expected agency theory association between ownership type and diversification strategy, this would evidence itself by disproportionate numbers of less diversified firms in or towards majority control and, likewise, a preponderance of the most diversified firms in or towards the management

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Table III. Ownership type and diversification strategy for 96 companies in 1985

Diversification strategy	*Ownership types*				
	MAJ	*MIN*	*JOINT*	*MANGT*	*TOTAL*
Very low diversity	12	14	0	4	30
Related diversified	12	11	1	3	27
Unrelated diversified	13	9	1	2	25
Very high diversity	4	7	2	1	14
Total	41	41	4	10	96

Note: MAJ = Majority; MIN = Minority; MANGT = Management

control end of the spectrum. Two Chi-square tests were performed to test for any association at all between control and diversification strategy. We did not include the joint or management categories on their own in either of these tests because the expected cell frequencies were less than five. Since 82 of our 96 control type observations are either majority or minority, we first tested for an association involving only this dichotomy of control and strategy. However, there was none – the calculated Chi-square statistic was far from being significant. The second test used the majority group and a composite of the other three control types but, once again, the Chi-square statistic was not significant. So, contrary to agency theory expectations based on overseas studies, there appears to be no association between ownership type and diversity in this sample of large New Zealand firms. Indeed, given that there have been contemporaneous moves towards increased diversity (see Hamilton and Shergill, 1989; 1992) and majority ownership, any association is likely to have been the converse of that identified elsewhere. We repeated these tests of association using organizational structure (functional, holding company, and multidivisional) in place of diversification strategy. Our expectation was that majority-owned companies, by resisting decentralization, would exhibit a tendency to retain the functional structure while, again following agency theory, those under management control would be divisionalized because managers want more control. However these tests again produced insignificant results (see Appendix for these data).

Cross-section evidence can only provide a static test of what is clearly a process that will take time to work itself out: if ownership and strategy are related, we should not expect the adaptation of one to the other to be instantaneous. It is also quite conceivable that omitted variables, e.g. financial performance, could be more influential than ownership in the determination of strategy. In other words, in this as in any cross-section, there will be distorting influences which we hope to mitigate in the next section where we revert to diachronic analysis.

OWNERSHIP, FINANCIAL PERFORMANCE AND DIVERSIFICATION

We now focus on those 13 companies which we know *increased* their diversity during the period 1980–85, having not changed their diversity at all in the

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preceding five-year period.[3] First we can again discount changes in ownership type as a causal influence: only six of the 13 companies changed ownership type in the period 1980–85 and, of these, five became majority owned and one shifted from being management controlled in 1980 to minority control in 1985.

The stewardship explanation for diversification moves, one captured in the earlier quotation from Hassid's paper, is that they represent, in fact, a considered response by managers to financial adversity and/or the need for improved financial performance for their company. Hassid's result, like others in the industrial economics literature (e.g. Gorecki, 1975; MacDonald, 1984), is based on a statistical analysis of aggregate (industry) data in which we can do no more than impute financial motives to individual firms. A necessary condition for this financial rationale to apply here is that the managers involved can indeed be shown to have recognized that they were experiencing financial hardship in the period *prior* to their diversifying. To test for this prerequisite we first calculated, for each of these 1980–85 diversifiers, their annual rates of return before interest and tax on total (tangible) assets (ROA) for the financial years 1975 through 1985 inclusive. The ROA measure was selected because it appears to be generally accepted as valid measure of overall company performance, one which is not too sensitive to differences in financial structures. It is also a measure which can be compared meaningfully with general inflation rates as is done in table IV for this group of companies.

The evidence here is quite clear: these companies, on average, earned no real return at all on their assets in the period 1975 through to 1981. Real returns only improved in 1983 and 1984 when a wage and price 'freeze' suppressed New Zealand's inflation rate. In other words, we conclude from this that those companies which diversified between 1980 and 1985 did indeed experience a degree of financial hardship (negative real profitability) in the period prior to this. This is only partial proof – necessary but not sufficient

Table IV. Nominal and real profitability of diversifying companies

Year	*Average company ROA (% nominal)*	*General rate of inflation*	*Average company ROA (% real)*
1975	11	17	−6
1976	14	17	−3
1977	13	15	−2
1978	10	12	−2
1979	12	13	−1
1980	14	18	−4
1981	15	15	0
1982	17	16	+1
1983	15	7	+8
1984	14	6	+8
1985	17	15	+2

Note: The general inflation rate refers to New Zealand's Consumer Price Index with data extracted from annual editions of the *New Zealand Official Yearbook*. Our final measure of real ROA is simply the nominal ROA *minus* the inflation rate.

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– of the financial rationale for these companies diversifying. To complete the case we need to establish that those involved were aware of the financial problems *and* perceived diversification to be a solution.

Our efforts to do this required us to screen carefully the annual reports of each the 13 companies for the period 1979 through 1985. From this it became quite clear that, prior to diversifying, the managers of these companies were very well aware of the need to improve performance and we can illustrate this by the following fairly typical extracts from different company annual reports for the 1980 financial year:

> Continually increasing costs of all kinds remain a cause of concern . . .
>
> Notwithstanding the difficulties experienced in containing and in recovering higher costs . . .
>
> One must, of course, view the final result in terms of the 18% inflation now prevailing in the national economy. Many of our costs have, in fact, risen far higher than 18% . . . substantially higher profits are needed.
>
> . . . the domestic trading situation has continued to be difficult.
>
> Inflation in New Zealand is at a higher rate than in many other countries. . . . Some increase in costs must be regarded as inevitable . . .
>
> The second half of our year under review saw a marked reduction in demand for our products. . . . These factors significantly affected group profitability in that second half.
>
> The trading results for the year are disappointing . . . with the result that substantial losses were suffered in the early part of the year.
>
> Domestic trading is presently reflecting low levels of demand, and follows the decline in residential building . . . prospects in the building industry continue to look bleak.

If we accept that these companies were aware of their financial straits, is there yet further evidence that it was this that prompted them to diversify? In fact these companies appeared disinclined to offer much in the way of explanation for their diversification moves, perhaps a reflection of the moves we have documented towards their majority control. However, there is some clear evidence of their subsequent resort to diversification:

> The decision to diversify was also made near the end of the period under review (from 1984).
>
> In order to improve our returns . . . we are becoming increasingly involved in the cutting, packaging, and manufacture of meat and meat products (from 1981).

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> It is expected there will be some reduction in margins due to the price freeze regulations but hopefully this will be offset by ... growing diversification ... (from 1982).
>
> The Group is searching for diversification opportunities outside the automotive industry in order to provide a sound basis for continued growth (from 1982).
>
> It will be the aim to continue with appropriate diversification to provide a source of increasing income in the shorter term (from 1983).

From this we reach the conclusion, albeit tentative, that the diversification moves of large New Zealand companies during 1980–85 were motivated by a perceived need on the part of senior managers to improve their company's financial performance and prospects. Unfortunately, and as was documented at length in the earlier article (Hamilton and Shergill, 1992), most of these companies – 10 of the 13 in fact – ended up with either unrelated or very high diversity strategies when related diversification would have been best in terms of their overall profitability and growth. In other words, in trying to act as good stewards in the interests of the company as a whole, some managers appeared to have erred but, as Donaldson (1990b, p. 398) is at pains to point out, such errors are understandable and not to be confused with the pursuit of narrow self-interest which lies at the heart of agency theory.

CONCLUSIONS

These firms diversified, and, contrary to agency theory, this was not because they came under more managerial control. The cause lay in attempts to deal with problem performance. Thus managerial behaviour in these corporations is more in keeping with the stewardship theory of management than with agency theory.

APPENDIX: OWNERSHIP TYPE AND ORGANIZATIONAL STRUCTURE

We provide here the mapping between ownership type and organizational structure in 1985 (cf. table III). As reported in the text, Chi-square tests of association were not significant.

Organizational structure	*Ownership types*				
	MAJ	*MIN*	*JOINT*	*MANGT*	*TOTAL*
Functional	17	19	0	5	41
Holding company	2	3	3	2	10
Multidivisional	22	19	1	3	45
Total	41	41	4	10	96

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NOTES

[1] The measures of diversification strategy and also organizational structure are not discussed here in any detail. For a full explanation see Hamilton and Shergill (1992).

[2] The 19 firms common to both studies were as follows: Alex Harvey Industries; Cable Price Downer; Carter Holt Harvey; Ceramco; D I C Ltd; Dominion Breweries; Farmers Trading Co; Feltex; Golden Bay Cement; Lane Walker Rudkin; L D Nathan; NZ Forest Products; NZ News; R & W Hellaby; Skellerup Industries; U E B Industries; Wattie Industries; Wilson and Horton; and Winstones Ltd.

[3] In fact, 14 companies changed their strategy in 1980–85 but one of these (NZ News) actually reduced its diversity (from unrelated to related diversified). Also, in contrast to all the other companies, NZ News diversified considerably during 1975–80. Since our focus here is on companies which diversified further during 1980–85, we had to omit NZ News from the sample. The 13 companies making up the sample are: Carter Holt Harvey; Christchurch Press Co; Hume Industries; Independent News; James Hardie Impey; John Burns & Co; McKechnie Brothers NZ; NZ Forest Products; Quill Humphreys; R & W Hellaby; REPCO NZ; Wilson and Horton; and Yates Corporation.

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