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DIVERSIFICATION AND FINANCIAL PERFORMANCE OF QUOTED COMPANIES IN NIGERIA.

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Abstract

The present research employed an ex-post facto research design. The study focused on a research population consisting of 169 publicly quoted companies listed on the Nigerian Stock Exchange (NSE, 2018) over a span of 6 years (2013-2018). To obtain a representative sample, approximately 119 companies were selected using Yaro Yamane's estimated formula (1967) and stratified sampling techniques were utilized due to population heterogeneity. However, due to limited data accessibility, a random subset of thirty (30) firms was selected from the initial pool of 119 companies.Descriptive statistics and multiple regression analysis, aided by the Statistical Package for Social Sciences (SPSS), were employed to analyze the collected data. The study's findings indicated a positive and significant relationship between highly diversified companies and the financial performance of quoted companies in Nigeria. In contrast, moderately diversified companies displayed a positive but insignificant relationship, while undiversified companies showed a negative and insignificant relationship. Based on these findings, the study recommends that firms engage in diversification strategies to enhance their market stability and reduce dependency on a single product. This approach, in turn, has the potential to improve future profitability, enhance predictive capabilities, and strengthen financial stability by facilitating sound investment decision-making

Keywords: Financial Performance, Diversification, Highly Diversified, Moderately Diversified and Undiversified
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Introduction

In the past few decades, the issue of whether or not diversification leads to financial performance have attracted much attention from an international perspective, different researches have been conducted on few advance countries and in context of less advance countries which are relatively scare (Nwakoby&Ihediwa, 2018). Mansi and Reeb (2002) define corporate diversification as the process by which an organization expands into different areas, such as industries and product lines. This strategy is often pursued by organizations to grow their business. Daud, Salamudin, and Ahmad (2009) explain that corporate diversification involves expanding the offerings of a business by entering new markets. Companies may pursue diversification when they reach market saturation with their existing products or if the demand for their primary product declines. In organizations with multiple divisions, managers can allocate capital between business units, creating internal capital markets and leveraging skills developed in one business to benefit

others (Santalo& Becerra, 2008). Yigit and Behram (2013) affirm that diversification can add organizational value through increased profitability, reduced operational risks, higher market share, improved creditworthiness, higher growth rates, extended business life cycle, and enhanced utilization of financial and human capital. Iqbal, Hameed, and Qadeer (2012) assert that diversification is a strategy used by management to capitalize on additional opportunities within the current market, spread business risks, and achieve higher profits.

According to Denis, Denis, and Yost (2002), theoretical arguments suggest that corporate diversification has both costs and benefits for organizations, which impact their financial performance. Potential costs of diversification include the allocation of larger discretionary resources toward value-decreasing investments, cross-subsidies that allow underperforming segments to drain resources from better-performing segments, and misalignment of incentives between corporate and divisional managers. On the other hand, the benefits of diversification include improved operating efficiency, reduced tendency to reject positive net present value projects, increased debt capacity, and lower taxes, all of which contribute to better financial performance. However, empirical studies on the relationship between diversification patterns and performance have yielded inconsistent results, with conflicting findings reported in different investigations (Johnson & Scholes, 2007). For instance, while Lei and Schmit (2009) found that more diversified insurers exhibit better financial performance, Dyer, Godfrey, Jensen, and Bryce (2016) observed that organizations competing in few related markets or industries perform better than those focused on a single industry. Afza, Slahudin, and Nazir (2008) identified small market size and low aggregate demand as factors contributing to reduced accounting returns and increased risk for diversified firms. Such firms may struggle to achieve economies of scale, resulting in higher transaction costs and lower accounting profits.

Previous studies, such as the one conducted by Mwangi (2015) in Kenya, have used the Herfindahi Hirschmann Index (HHI) to assess corporate diversification rather than the specialization ratio. However, the HHI fails to account for the complexities of various markets, limiting its accuracy in evaluating competitive or monopolistic market conditions. Despite various attempts, the implications of diversification on firm value remain mixed, as diversification can have both value-enhancing and value-destroying effects. Furthermore, the impact of diversification on the performance of companies in less developed economies like Nigeria has received limited attention, leaving room for further research, such as the current study. Thus, this study aims to address this research gap by examining the patterns of diversification and financial performance of quoted companies in Nigeria.

Review of Related Literature

Financial Performance

The concept of performance is challenging to define and quantify, as it represents the output of an activity and is measured using relevant criteria aligned with the organization's goals (Burca &Batrinca, 2014). In the field of strategic management, researchers have employed various models to evaluate the financial performance of organizations. However, there is no consensus on what constitutes a valid set of performance criteria (Ostroff & Schmidt, 1993).

Penman (2007) defines financial performance as the level of performance achieved by a business over a specified period, expressed in terms of overall profits and losses during that time. Assessing the financial performance of a business allows decision-makers to evaluate the outcomes of business strategies and activities in objective monetary terms. According to Penman (2007), there are multiple approaches to measure financial performance, but all measures should be considered collectively. Some common indicators of financial performance include return on

equity, liquidity ratios, asset management ratios, profitability ratios, leverage ratios, and market value ratios.

Financial performance serves as a blueprint for an organization's financial affairs, demonstrating how well a business has performed under the guidance of its management. It provides insights into the financial activities of an organization and serves as a reflection of its overall performance.

Measurement of Financial Performance

The performance of a company is a complex concept that requires careful definition and quantification. Various performance measures have been used in previous research, including Return on Equity (ROE), Return on Capital Employed (ROCE), Return on Assets (ROA), and Profit Margin (PM) (Palepu, 1985; Pandya & Rao, 1998; Hamilton & Shergill, 1993). However, in this study, the measurement of Return on Assets (ROA) was employed to assess the financial performance.

Diversification

Diversification, derived from the term "diverse," refers to introducing variety or differences in a company's activities (Salma & Hussain, 2018). It involves organizations engaging in distinct businesses with the aim of adding value to shareholders or stakeholders (Cretu, 2012). Faulkenberry (2011) defines diversification as a portfolio strategy that combines different assets to reduce overall investment risk. Firms embrace diversification as a corporate-level strategy to enhance competitiveness and profitability (Reza, Reza & Banafsheh, 2015). It is a deliberate action taken by organizations to achieve value creation through economies of scope, financial economies, or market power (Chen & Yu, 2012). The primary purpose of diversification is to enable organizations to enter new lines of businesses that differ from their current operations (Manyuru, Wachira & Amata, 2017). Ishak and Napier (2004) suggest that firms seeking success in diversification may need to spread out their business ventures and costs, which can sometimes limit investments in existing products or cash cow sectors.

Kheng (2017) asserts that diversification strategies can be approached in three ways: related or concentric diversification, unrelated or conglomerate diversification, and a hybrid strategy combining both. In related or concentric diversification, new pursuits are deliberately related to the existing product line, while unrelated or conglomerate strategy occurs when there is no common trend of strategic fit or relationship between the new and old lines of business or products. The hybrid strategy involves a company combining or operating on both strategies. When organizations choose to diversify, the primary decision they need to make is whether to diversify into related business, unrelated business, or a mixture of both strategies.The study presents the following null research hypothesis for investigation:

H_{01}: *There is no significant difference between diversification and the financial performance of quoted companies in Nigeria*.

Theoretical Framework

The relationship between diversification and financial performance in this study is supported by the resource-based view theory.

The Resource Based View

Wernerfelt proposed the resource-based theory (RBT) in 1984, which emphasizes that the competitive advantage of organizations is derived from their internal resources rather than their external positioning. According to Manyuru, Wachira, and Amata (2017), instead of solely evaluating external opportunities, it is more effective to explore how existing resources and

capabilities can be utilized in new and unique ways to gain a competitive advantage. Garcia, Hidalgo, and Rodriguez (2013) further elaborate that the resource-based theory provides insights into how organizations develop scarce, valuable, difficult-to-imitate, and non-substitutable resources, which serve as barriers to competition and enable economies of scale. The resource-based theory suggests that organizations possess untapped resources with potential that give them a superior position over competitors and contribute to enhanced performance when combined effectively. The management of scarce resources and the utilization of capabilities are key factors in achieving competitive advantage (Reza, Reza, & Banafsheh, 2015). By leveraging their resources and capabilities, organizations can enter different product markets (Su& Tsang, 2015).
Barney (1991) confirms that organizations need to focus on their internal capabilities and exploit their internal strengths in response to environmental opportunities to outperform competitors. The sustainable advantage lies in effectively applying strategic resources at their disposal. Therefore, the resource-based theory reinforces the diversification strategy as organizations diversify their resources and capabilities to produce unique/new products, identify new markets for expansion, and fully utilize rare, valuable, and non-substitutable resources. Diversified organizations can also increase their profit margin through the accumulation of diversified resources and knowledge over time (Nyaiangiri&Ogollah, 2015; Sulaimon, Ogunkoya, Lasis, &Shobayo, 2015).

Empirical Studies

Chen and Yu (2011) conducted a study on 98 firms listed on the Taiwan Stock Exchange to analyze the relationship between corporate diversification and financial performance. They utilized secondary data from 2001 to 2005 and employed a multiple regression model for data analysis. The results indicated a positive relationship between corporate diversification and the financial performance of the listed firms.
Turkey, Boz, Yigit, and Anil (2013) examined the interaction between corporate diversification and firm performance in Belgium and Turkey. They focused on 114 business groups in Belgium and 118 business groups in Turkey during the period 2007-2011. Their findings showed that diversified organizations achieved higher performance compared to undiversified organizations.

Santarelli and Tran (2015) conducted a study on the diversification strategies of Vietnamese firms and their impact on firm performance. They reported mixed findings regarding the influence of diversification on firm performance. Their study revealed a curvilinear effect, where diversification initially improves firms' profitability up to a certain point, but further increases in diversification are associated with a decline in performance. They advised firms to consider optimal levels of product diversification beyond their core business.

Mwangi (2015) investigated how corporate diversification influenced the financial performance of listed manufacturing firms in Kenya. The study included all 19 manufacturing firms listed at the Nairobi Securities Exchange. The results indicated a positive relationship between corporate diversification and the financial performance of the listed manufacturing firms.

Nyaingiri and Ogollah (2015) examined the influence of unrelated diversification strategy on corporate performance, focusing on the Semeer Group as the target population. Their findings highlighted the significant connection between the general economic environment, firm characteristics, co-insurance effect, and corporate diversification on performance. They suggested that firms should expand their product line and activities to different sectors with reduced environmental uncertainty to increase cash flow, profitability, and the benefits of diversification.

Odeleye and Olunkwa (2016) investigated the relationship between export diversification and economic growth in Nigeria using annual time series data from 1981 to 2015. They employed various statistical methods such as Ordinary Least Square (OLS), Error Correction Mechanism

(ECM), Co-Integration, and Over-Paramatization. The results indicated that export diversification had negative effects on Nigeria's economic growth, with the contributions of the agriculture and manufacturing sectors to exports being negative.
Krivokapic, Naldimir, and Stogic (2017) examined the effect of diversification strategy on the insurance industry in Siberia. They sampled 23 industries and utilized Entropy and Hausman tests to evaluate the relationship between dependent and independent variables. The findings revealed that diversified insurance companies performed better than undiversified insurance companies in Siberia.

Manyuru, Wachira, and Amata (2017) investigated the impact of corporate diversification on the value of firms listed at the Nairobi Securities Exchange (NSE). They employed panel regression techniques for estimation. The study found that industrial diversification reduced firm value, while geographical diversification did not have a significant impact on firm value.

Ayobola, Ekundayo, and Muibi (2018) examined the relationship between resource endowment, export diversification, and economic growth in Nigeria based on data from 1981 to 2015. The study concluded that, given the current circumstances, specialization was preferred over diversification for Nigeria.

Nwakoby and Ihediwa (2018) examined the effect of firm diversification on the financial performance of Nigerian firms. They employed an ex-post facto research design and collected data from the annual reports and accounts of Nigerian firms for a period of ten years, from 2008 to 2017. The collected data was analyzed using financial ratios, and the formulated hypotheses were tested using simple regression analysis with the assistance of the statistical package for social sciences (SPSS) version 20.0. The study concluded that the financial performance of Nigerian firms is significantly influenced by product diversification. There was a statistically significant correlation between financial performance and related diversification. However, the study found that business diversification did not have a statistically significant impact on financial performance.

Methodology

This study utilized an ex-post facto research design and focused on a research population comprising 169 quoted companies listed on the Nigerian Stock Exchange (NSE) in 2018.A sample size of approximately 119 companies was obtained using the Yaro Yamane's estimated formular (1967) and stratified sampling techniques was used since the population is not alike. 5% level of significance was employed. The estimated formular is stated as: $S=P/(1+P(e^2))$.

Where: S= Sample, P= Population and e= Level of significance desired. Therefore,
$S= 169/(1+169(0.05^2))=118.8=119$. However, a total of twenty (30) firms were randomly selected out 119 companies due to non-accessibility of data of some of the companies. The collected data wasanalysed through the utilization of descriptive statistics and multiple regression analysis, with the assistance of the Statistical Package for Social Sciences (SPSS).

Model Specification

The model specification for this studyis expressed infunctional and econometric form as:
Financial performance=F (Corporate diversification) -- (1)
FP= F (Highly diversified, Moderately diversified, Undiversified companies) ------------- (2)
$FP=\beta_0 + \beta_1 HD + \beta_2 MD + \beta_3 UND + \mu$ -- (3)
Where:
FP = Financial Performance proxied with Return on Assets
β_0 = Constant

$\beta_1$to β_3 Coefficients of the independent variables
HD= Highly diversified companiies portfolio
MD= Moderately diversified companiies portfolio
UND= Undiversified companies portfolio

Operational Measurement of Variables

Variable	Description	Measurement	Apriori Sign	Source
Dependent variable: Financial Performance				
Return on Assets	**ROA**	The ratio of net income (income available to common stockholders) to the book value of total assets.		Hamilton and Shergill (1993)
Independence variables: Diversification				
Highly diversified SR<70%	**HD**	Measuered with Specialisation Ratio (SR) i.e the proportion of the firm's annual revenues generated from its largest discrete product-market (core product-market) activity compared to its total revenues.	+	Pandya and Rao (1998)
Moderately diversified 95%<SR≤70 %	**MD**	Measuered with Specialisation Ratio (SR) i.e the ratio of the firm's annual revenues derived from its primary product-market activity (core product-market) to its total revenues.	+	Pandya and Rao (1998)
Undiversified SR ≥95%	**UD**	Measuered with Specialisation Ratio (SR) i.e the proportion of the firm's total annual revenues generated by its primary and most significant product-market activity compared to its overall revenue.	_	Pandya and Rao (1998)

Source: Author Compilation, (2019).

4. Analyses and Interpretation of Data

The results of the analyses are interpreted below.

Results of the Descriptive Statistics

Descriptive statistics					
		N	Mean	Std. Deviation	Std. Error
ROA	Highly Diversified	78	11.5513	24.58732	2.78397
	Moderately Diversified	30	10.3000	28.30030	5.16690
	Undiversified	42	36.0714	143.67433	22.16943
	Total	150	18.1667	79.20938	6.46742

Source: Author Compilation, (2019).

Table shows the results of the descriptive statistics. Thirty quoted companies were studied for the period of 5 years (2013-2017) making a total Observation (Obs*) of 150. Comparing the specialization ratio with the return on asset of the 150 Observations, 52% of the 150 observations

were found to be highly diversified, reporting a robust mean of 11.11, standard deviation of 24.58 and a positive standard error of 2.78. Meanwhile, 20% of the 150 observations were reported to be moderately diversified, exhibiting a mean value of 10.30, robust standard deviation of 28.30 and a standard error of 5.16. The remaining 28% observations reported a mean value of 36.07, standard deviation and standard error of 143.67 and 22.16 respectively. Evidentially, the comparison of return on asset and the specialization ratios of the sample reported an average mean, standard deviation and standard error of 18.16, 79.20 and 6.46 respectively.

Multiple Regression Analysis (ROA)

Model	Unstandardized Coefficients		Standardized Coefficients		Sig.
	B	Std. Error	Beta	T	P
(Constant)	9,635	4.634		7.247	0.000
Highly Diversified	0.482	0.183	1.285	2.564	0.004
Moderately	0.825	0.921	1.622	1.903	0.743
Undiversified	-0.213	-1.072	0.723	-1.132	1.211

Source: Author Compilation, (2019).

a. Dependent Variable: ROA
b. Independent Variable: Highly Diversified, Moderately Diversified, Undiversified

To validate the aforementioned results, an Analysis of Variance (ANOVA) test was conducted to determine if there were any differences in financial performance among highly diversified, moderately diversified, and undiversified firms included in the study. The results indicated significant variations in financial performance across the three categories of firms, as all variables yielded p-values lower than the critical value of 0.05 at a 5% level of significance.

Discussion of the findings

The study’s findings revealed that highly diversified companies exhibited a positive and significant relationship with financial performance. Moderately diversified companies, on the other hand, showed a positive but insignificant relationship, while undiversified companies demonstrated a negative and insignificant relationship with financial performance. These findings align with Mwangi's (2015) study, which examined the impact of corporate diversification on the financial performance of listed manufacturing firms in Kenya and found a positive relationship between diversification and financial performance. They also support the findings of Faccio, Marchica, and Mura (2011), who emphasized that diversification does not necessarily guarantee improved firm performance, as previous results have indicated that it reduces uncertainty and holds potential for better performance.

Furthermore, the findings are in line with the research conducted by Santarelli and Tran (2015), who presented a mixed perspective on the influence of diversification on firm performance. They suggested that diversification has a curvilinear effect on profitability, whereby an increase in diversification initially enhances profit, but further diversification beyond a certain point is associated with a decline in performance. They advised firms to carefully consider optimal levels of product diversification when expanding their product offerings beyond their core business.

Conclusion

The corporate sector has gained significant attention in recent years due to its direct impact on a country's economic growth. It is crucial to continuously monitor and assess the performance of business organizations, industries, and firms, as investors rely on research findings before

making investment decisions (Salma & Hussain, 2018). Therefore, comparing different organizations to identify the most profitable ones becomes essential.

This study aimed to evaluate how different patterns of diversification influence the financial performance of quoted companies in Nigeria. The results indicated that firms engaged in diversification into related businesses performed better than those that remained undiversified. This finding aligns with expectations, as diversifying into other businesses allows firms to leverage their strengths and accumulate valuable experience, enabling them to make crucial decisions.

Moreover, diversification facilitates the growth of firms in terms of both tangible and intangible assets. For instance, a company that diversifies across multiple sectors can mitigate the negative impact of one failing sector by relying on the success of another, thereby maintaining balance and ensuring efficient operations. In this way, diversification can be used as a risk reduction strategy and contribute to overall business performance.

The study recommends that firms consider diversification as a means to enhance market stability and avoid over-reliance on a single product. By diversifying, firms can improve their future profitability, enhance their ability to predict future trends, and strengthen their financial position by making profitable investment decisions.

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