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The Effect of Executive and Ownership Structure on Diversification Behavior: A Research about Businesses Listed In Istanbul Stock Exchange

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Abstract

There are studies in developed countries about the influence of ownership percentage in board of management on diversification strategy preferences. It is concluded that there is a negative relation between diversification strategy behavior and the ownership percentage of management or other elements of management structure in most of these studies. In this study, it is aimed to test whether there is a relation between executive structure and diversification strategy preferences in our country in light of the means of evidence of agency theory. Herfindahl Index used widely in the literature was used for diversification measure in the study. The data of businesses listed in Istanbul Stock Exchange was used to understand the relation between diversification behavior and executive structure. The data of these businesses were obtained from www.kap.gov.tr and www.imkb.gov.tr.

Keywords: Diversification strategies, diversification degree, ownership structure, agency theory, stewardship theory, Herfindahl index

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1. Introduction

While there aren't any studies about the relationship of diversification strategy preference with agency theory propositions in Turkish literature, there are lots of studies in this field in foreign literature. The study of Hoskisson and others (1991) named "Managerial Risk Taking In Diversified Firms: An Evolutionary Perspective", the study of Lane and others (1998) named "Agency Problems As Antecedents To Unrelated Mergers And Diversification: Amihud And Lev Reconsidered", the study of Denis and others (1999) named "Agency Theory And The Influence Of Equity Ownership Structure On Corporate Diversification Strategies", the study of Eisenmann (2002) named "The Effects Of Ceo Equity Ownership And Firm Diversification Risk Taking", the study of Amihud and Lev (1999) named "Does Corporate Ownership Structure Affect Its Strategy Towards Diversification?", the study of Goronava and others (2007) named "Managerial Ownership And Corporate Diversification: A Longitudinal View", the study of Jiraporn and others (2008) named "Multiple Directorships And Corporate Diversification" and the study of Ducassy and Prevot (2010) named "The Effects Of Family Dynamics On Diversification Strategy: Empirical Evidence From French Companies" contribute to this field.

Hoskisson and others told in their theoretical study that limiting diversification reduces executive risk-taking (Hoskisson and others, 1991, p.296). Lane and others' finding doesn't refuse the relation between diversification strategy and agency theory and it shows that the effect is more limited (Lane and others, 1998). Denis and others' findings show that there are strong findings between diversification strategy and executive structure. In other words,

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when the ownership ratio increases in business management, business diversification is negatively affected according to Denis and others' findings (Denis and others, 1999).

Like Amihud and Lev's study, it is expressed that there is a positive relation between risk taking and increase in the ownership ratio in business management according to Eisenman's study about cable industry in America. Accordingly, while agent CEO focuses on internal output, owner CEO gives more importance to the output for expansion (Eisenman, 2002). The results of Ducassy and Prevot's study made in France concludes that family businesses diversify more than non-family businesses; there is no significant difference between family businesses and diversification types based on Rumelt's measure and the ownership of the main shareholder is more in single businesses (Ducassy and Prevot, 2010).

As mentioned in the indicated studies, the relation between diversification strategy and executive structure is complex. In this study having a goal to understand this relation; types, reasons, advantages and risks of diversification strategy will be explained first. Then reasons, advantages and problems of agency theory will be studied. After that, the relation between diversification strategy and agency theory will be explained with reference to Turkey and the hypotheses will be suggested. An empirical study will be made in Istanbul Stock Exchange in order to test the hypotheses suggested for understanding the relation between diversification strategy and executive structure.

2. Diversification Strategy

Each of the probable economic benefits of related and unrelated diversification will be examined under the name of this title.

2.1. Unrelated Diversification

As mentioned above in unrelated diversification, there is not any relationship between the company's strategic business units in terms of technological or market relations. So why do companies prefer an unrelated growth? Can a company create any value by unrelated diversification (Craig and Grant, 1993)? There are five basic factors that can be regarded as answers to such questions:

Risk Reduction: Companies whose products are threatened by the environmental uncertainty or in decline phase of their life curve can prefer to engage in an unrelated diversification to overcome the risk arising from current industries. Expanding its product line and activities to different sectors where the environmental uncertainty is reduced and, profitability is higher, a company may confirm its survival thus will make its cash flow more reliable (Hitt and Ireland, 2007). *Decrease in Transaction Costs:* Considering each strategic business units of unrelated diversified businesses as profit centers, and the fact that top executives monitor each strategic unit, the top executives will have the opportunity to access all the available information regarding each independent business unit and the whole of the company at the lowest transaction cost (Craig and Grant, 1993). *Decrease in Costs of Service:* Some activities such as legal services, public relations, the company's case security, internal audit, investment decisions can be performed centrally at company level for all strategic business units. Although there may not be a relation in operational sense, such activities can be cost-saving benefits on behalf of the unrelated diversification strategy (Craig and Grant, 1993). *Accessing management skills:* Based on the claim, which needs a scientific support, that the executives have skills hard to achieve promotes the idea that the successful executives of companies engaged in unrelated diversification will be successful in new investments (Miller and Dess, 1996). *Exploiting inefficiencies in the market's valuation of companies:* Opportunities may arise for companies from time to time. These opportunities in some cases, are detected with rationale while in some cases may be based on intuition. An executive that feels he has enough knowledge may capture the opportunity of high profitability by investing in a new field by intuition (Craig and Grant, 1993).

2.2. Related Diversification

According to Craig and Grant, a competitive advantage of related diversification will be possible only by sharing of non-physical and physical resources, proliferation of some management skills into the strategic business units (Craig and Grant, 1993).

2.2.1. *Sharing Physical Resources*

There are two factors which affect performance based on physical resources. Firstly, the potential relationship of strategic business units can be identified and the utility of the resource can be enhanced so as to be utilized collectively by all the strategic units. Secondly, especially during the production process, already existing products which are complementary to each other can be commonly used. In both cases, the collective use of physical resources can help to provide cost savings for strategic business units (Farjoun, 1998).

2.2.2. *The effect of Sharing Intangible Resources and Transfer of Skills*

Brand and Reputation: The company's well-known brand value contributes positively to the performance of strategic business units. Reputation, independent of brand, refers to people's awareness of the firm's quality, etc. (Cohen, 2005; Craig and Grant, 1993). *Technology:* It refers to the evaluation of the company's existing technological capabilities so as to contribute to its growth and competitive advantage. The companies aware of their technological superiority can invest in new areas after analyzing where and how to use their superiority (Chiu and others, 2008). *Operational Capability:* It refers to the transfer of the capability of production of strategic business units to some other diversified business areas; more precisely that is the ability that one of the strategic business units has can be used by other units where the production process is similar (Craig and Grant, 1993). *Sharing General Management Skills:* In case of transfer or share of resources and capabilities among strategic business units of diversified companies some technical or market relatedness is needed. The capabilities transferred are not only functional skills but also are in relation to general management skills (Helfat and Eisenheart, 2004).

2.2. *Risks And Disadvantages Of Diversification Strategy*

One of the reasons for the failure of corporate diversification strategies stands out as the bureaucratic costs. It is possible to examine bureaucratic costs under two main headings (Hill and Jones, 1998). *Number of businesses:* Increases in the number of businesses in the company's portfolio may result in top executives' loss of control over the whole of the company thus deteriorations in performance happen. The main reason for the loss of this control appears to be the concept of limited rationality which refers to not having all the data required for rational decision-making (Hoskisson and others, 1991). *Coherence between Businesses:* Transfer of resources among the strategic business units requires an effective coordination system. Since the processes will be filled with bureaucratic procedures, increasing number of businesses in company's portfolio has an obstructive effect on determination, transfer and share of resources required by the units (Hill and Jones, 1998). Other routine activities are also encountered as a cost element in the bureaucratic processes and procedures. Routine activities and procedures in a growing majority of organizations appear as an element of cost, and the difficulty of changing these processes can result in deteriorated business performance. For instance, in case that changes in the processes, strategy, product, innovation, creativity and structure require alterations in the basic level of operational activities of strategic business units; a unique coordination problem will occur (Hoskisson and others, 1991).

Stock Return Risk: The findings of the prior research suggest that related diversification yields significant performance advantages and that related investments are relatively less risky and highly profitable to unrelated diversification (Chang and Thomas, 1989). In each diversification strategy regardless of being related or unrelated diversified, there is the problem of return risk despite different rates. Differences in risk-return rates will vary depending on the sector, the company size, the number of businesses within the company and the degree of related diversification (Hill and Jones, 1998).

3. **The Relation Between Diversification Strategy And Ownership Structure, Executive Structure And The Hypotheses Of The Study**

3.2. *Stakeholder Control and Diversification*

It is possible to say that there are three main approaches about this field. The relationship between diversification and these three approaches named agency theory, strategy and stewardship theory is as stated below. It is possible to see this relation in Table 1 (Ducassy and Prevot, 2010).

3.2.2. Agency Theory Approach

Agency theory viewing agent-principal relationship in organizations was mentioned first by Eisenhardt (Kim and others, 2005; Eisenhardt , 1989). This theory deals with the relations of two people whose aims and interests are different from each other (Koçel, 2005). The theory focuses on that the agent will not always make an effort for enhancing the organization's interests because of different aims (Wright and others, 2001). This is because human beings are inherently selfish and willing to enhance their own interests (Cohen and Baruch, 2010).

According to opportunism based economic approach, the agent will make an effort for enhancing his personal interests. Thus, the economic actors can keep their own interests superior by wrong information, hiding the existing situation or deflecting it. In order to minimize these opportunism based risks that can be because of agents, the principles want to detail this relation by obtaining a contract which is for following and controlling the agent's actions (Wright and others, 2001).

This approach focused on economy is based on agency theory. According to the results of the studies (Amihud and Lev, 1999; Eisenman, 2002) based on agency theory, the existence of stakeholder control in management effects diversification level negatively. This approach states that the increase in diversification level decreases the managers' individual risks, brings them prestige and opportunities to increase their power (Ducassy and Prevot, 2010).

Table 1. Agency theory, strategic approach and stewardship theory.

	Agency theory	Strategic approach	Stewardship theory
Foundations	Economy	Strategy	Sociology and psychology
Model of human behavior	Individual interests	Interests of the organization	Collective interest
Incentives to motivate managers	Financial incentives Share ownership	Performance maximizing	Commitment
Relationships between shareholder and managers	Divergence of interests	Shareholders do not have enough information to evaluate the strategic decisions	Convergence of interests
Organization of the relationship	Control	Delegation	Confidence
Control mechanisms	Financial incentives Governance founded on an external control	Autonomy of the manager Demand of maximizing share value	Participation of the managers in governance
Reasons for diversification	Reduction of the personal risk of the managers Prestige and power Remuneration, Entrenchment	Leveraging of the resources Economies of variety Synergies Power over the market	Financial performance Interests for the business
Connection between shareholder control and diversification	Negative	Negligible	Negligible

Isabella Ducassy and Frederic Prevot, The Effects Of Family Dynamics On Diversification Strategy: Empirical Evidence From French Companies, Journal of Family Business Strategy, 2010, pp.224-235.

3.2.3. Stewardship Theory

The management based theory claims that the social environment and institutional ethical values will shape the behaviors of agents (Quinn and Jones, 1995; Donaldson and Preston, 1995). According to this approach, agents can give more attention to their corporation's interests instead of being selfish because of the factors mentioned in order to enhance their own interests. As a result, according to stewardship theory, agents will make their decisions on enhancing corporation interests unlike the approach which indicates managers have a economic-oriented view about diversification strategy. In other words, if it is admitted that diversification has an organizational performance-enhancing effect, the corporate will diversify (Ducassy and Prevot, 2010).

3.2.4. *Strategic approach*

Another approach that explains the reason why businesses prefer diversification strategy as stakeholder control is strategic approach. According to this approach, organizations prefer diversification if it increases organizational performance. Diversification will increase organizational performance by organizational skills, synergy due to common usage of sources (Craig and Grant, 1993) and the distribution of risk as a result of investing in different fields (Hitt and Ireland, 2007). According to the study of Lane and others (1998), there is not a relationship between ownership structure and diversification. However, there is a relationship between ownership structure and diversification strategies according to the studies of Amihud-Lev and Dennis (Ducassy and Prevot, 2010). When the percentage of ownership increases, companies prefer less diversification. Therefore, they can have more control over all of the companies owned by them. Thus, we develop and test the following hypothesis 1,

H₁: There is a significant difference between percentage of ownership and diversification measure.

3.3. *Turkey, A Developing Country, and Diversification Strategies-Executive Structure Relation*

Unlike large US and UK corporations with their dispersed ownership structures, many of the largest corporations in Germany show concentrated ownership structures. It is reported that out of 171 large corporations, 85% have a shareholder with at least 25%, and 57% have a shareholder owning more than 50% of the equity (Yurtoğlu and Haid, 2006). It is understood that ownership structure is concentrated in Turkey (Yurtoğlu, 2000).

It was stated that the Turkish corporations have a centralist and ownership concentrated structure in Yurtoğlu's study about the Turkish corporations' ownership structure. It is stated that the institutional executive structure in Turkey is a system based on in-house management. Families have got most of the shares of corporations directly or indirectly and protect the majority of control. Ownership and separation of control are created by using pyramid capital structures or coalitions with other families and foreign firms. Also, it is known that the government has been the founder and executive of large and medium-sized firms in banking and industry field since 1930s (Yurtoğlu, 2000). Hypothesis 2;

H₂: There is a significant difference between ownership structure and diversification.

According to Khanna and Palepu, unlike in developed countries, corporate environmental factors such as gaps in developing country markets, business government relations, production, markets and labor market can be effectual for companies that have engaged in diversification strategy (Khanna and Palepu, 1997). There are findings about that there is a negative relationship between organizational performance and executive ownership in developing countries (Ünlü, 2011) and diversification- organizational performance relation and intensity of diversification in Turkey have the similar results as in developing countries and different results from developed countries (Yiğit and Anıl, 2011). The reasons of diversification and executive structure in Turkey differ from developed countries, so it is quite possible that the relationship between diversification structure and ownership structure is different in Turkey. As a result, hypothesis 3 is as below along with other possible factors:

H₃: There is a significant difference between executive ownership and the degree of diversification.

4. **A research About The Businesses Listed In Istanbul Exchange Stock**

4.2. *The Aim Of The Research*

The aim of the research is to see if there is a correlation between Herfindahl Index diversification measure and the ownership percentage of the businesses included in the research universe and if it is so to identify the possible effects of ownership percentage on diversification behavior. The research also aims to identify the existence of a significant difference between ownership/executive structure and diversification degree.

4.3. The Research Universe

The research universe is the 359 companies listed on the Istanbul Stock Exchange Market and whose shares got traded in period of 2005-2009. A sample group is not selected for the analysis; but full counting is carried out. Although shares of 359 companies were traded as of 2009, total data of 342 companies listed on ISE were analyzed since the 17 of them are excluded because of their fund traits.

4.4. The variables and measurement methods of the research

The independent variable of the research is ownership structure and the dependent variable is diversification.

4.4.2. Diversification Measure

In this study diversification measure is Herfindahl Index; *perhaps the most widely used measure of economic concentration. Thus, our first proposed index is*

$$DI(I) = 1 - HI = \sum_{i=1}^N W_i^2$$

Where: *DI = diversification index, HI = Herfindahl Index, W_i = the proportion of portfolio market value invested in security i (in decimal form), and N = the number of securities in the portfolio. Our use of the complement of this index is for the stylistic purpose of altering the index value so that zero represents a portfolio with absolutely no diversification (a one security portfolio) and 1.0 would represent the ultimate in diversification (Woerheide and Persson, 1993).*

4.3.2. Ownership Structure

We measure executive ownership as the percentage of shares outstanding owned by the CEO (Denis et al, 1997; Grant, Jamine, and Thomas, 1988). Ownership structure and executive structure in Turkey were classified as below. Ownership structure has four subgroups named single family, multifamily, public enterprise, and foundation. Executive structure has four subgroups named owner controlled, owner concentrated, manager concentrated and management controlled.

4.4. Analysis

Herfindahl diversification measure based analysis was used in the research to see the percentage of ownership - diversification relationship of the businesses listed in Istanbul Exchange Stock. First of all, correlation analysis is utilized for the dependent and the independent variables and then regression analysis is used to see the probable affect of percentage of ownership on diversification degree. Secondly, we will analyze if there is a significant difference between diversification strategies and executive structure, ownership structure or the percentage of ownership. Finally, if there is a significant difference, Mann Whitney U test will be used to understand the relation between ownership and subgroups of executive structure.

4.4.1. Degree Of Diversification, Percentage Of Ownership Correlation Analysis

In order to understand the relationship, the percentage of ownership and degree of diversification are subjected to correlation analysis separately. Table 2 demonstrates that there is correlation between percentage of ownership and diversification. Thus, hypothesis 1 is accepted. Accordingly, there is a negative weak relation between percentage of ownership and diversification. ($p=0,046$).

Table 2. Diversification, Percentage Of Ownership Correlation (Pearson) Analysis

Diversification (Herfindahl)	HERFINDAHL	Percentage of Ownership
Correlation Coefficient	1,000	-,181(*)
Percentage of Ownership	Sig. (2-tailed)	,046
N	124	122

* Correlation is significant at the 0.05 level (2-tailed). ** Correlation is significant at the 0.01 level (2-tailed).

4.4.2. Degree Of Diversification, Percentage Of Ownership Regression Analysis

Table 3 demonstrates the linear regression analysis results intended for understanding how diversification strategy is explained by percentage of ownership. The research model identifies diversification value, as the dependent variable and percentage of ownership, as the independent variable as; It is understood that Diversification (Herfindahl) equals to 0,215- 0,002 Percentage Of Ownership. According to the research model, % 0,002 of the diversification value is explained by percentage of ownership.

Table 3. Degree Of Diversification, Percentage Of Ownership Regression Analysis

Model	R	R Square	Adjusted R Square	F
	,181(a)	,033	,025	4,052
	B	Beta	T	Sig
(Constant)	,215		4,087	,000
HERFINDAHL	-,002	-,181	-2,013	,046

Dependent Variable: Herfindahl Independent Variable: Percentage Of Ownership

4.4.3. Degree Of Diversification, Ownership Structure

Kruskall Wallis” analysis, a nonparametric test, was used to test Hypothesis 2 which claims that there is a significant difference between diversification strategy and ownership structure. “Mann-Whitney U” test was used in order to test whether there is a significant difference between the two sub-variables in ownership structure group or not. The results of the analysis are below:

Table 4. Degree of Diversification, Ownership Structure (Kruskall Wallis)

The Measure of Ownership	Frequency	Percentage	Mean Rank	Kruskall Wallis
Single (or Family) Ownership	44	36,06	68,78	Test Statistics ^{a,b}
Multi Ownership	58	47,54	54,76	Chi-Square 11,765
Public	9	7,37	49,44	Df 3
Foundation	11	9,01	77,77	Asymp. Sig. 0,008
Total	122	100		a. Kruskal Wallis Test b. Grouping Variable: ownership

Hypothesis H₂ is accepted

As seen in Table 4, the results of Kruskal Wallis analysis applied to test Hypothesis 2 show that there is a statistically significant difference between ownership structure and diversification with a %5 error margin (Chi-Square=11.765, p=0.008). According to the results of the research, Hypotheses 2 was partially confirmed. Accordingly, the foundation ownership has the highest diversification, and public ownership has the lowest diversification. Dual comparisons of ownership structure were analyzed by Mann-Whitney test to understand which subcategories have differences.

Table 5. Single Family and Multifamily (Mann-Whitney U)

Ownership Structure	N	Mean Rank	Sum Of Rank	Mann-Whitney U	987,000
Single Family	44	58,07	2555	Wilcoxon W	2698,00
Multifamily	58	46,52	2698	Z	-2,516
Total	102	-	-	Asymp. Sig. (2-tailed)	0,012
-	-	-	-	a.Grouping Variable: Sermaye	

As shown in Table 5, according to the result of this analysis used for testing H_{2a}, the sub hypothesis of H₂, there is a significant difference between the diversification degree-single family ownership relationship and the diversification degree- multifamily ownership relationship with %5 error margin (p=0,012) and Hypothesis 2a was accepted. Accordingly, the diversification degree of businesses in which ownership concentrated on a single family is higher than the businesses in which ownership concentrated on multi-families.

Table 6. Multifamily and Foundations (Mann-Whitney U)

Ownership Structure	N	Mean Rank	Sum Of Rank	Mann-Whitney U	196,000
Multifamily	58	32,88	1907,00	Wilcoxon W	1907,00
Foundation	11	46,18	508,00	Z	-2,726
Total	69	-	-	Asymp. Sig. (2-tailed)	0,006
-	-	-	-	a.Grouping Variable: Ownership Structure	

Analyses were performed to correct Benfoni. Accordingly, While we use p=0,005 for Kruskal Wallis analysis, used p=0,05/4=0,0125 for Mann-Whitney U test (Field, 2005).

As shown in Table 6, according to the result of this analysis used for testing H_{2e}, the sub hypothesis of H₂, there is a significant difference between the diversification degree- multifamily ownership relation and the diversification degree- foundation ownership relation with %5 error margin (p=0,006) and Hypothesis 2e was accepted. Accordingly, the diversification degree of businesses in which foundation ownership concentrated is higher than the businesses in which ownership concentrated on multi-families.

H_{2b}, H_{2c}, H_{2d} and H_{2e}, the sub hypotheses of H2 were tested by the means of Mann-Whitney U test. There is not a significant difference with %5 error margin between diversification degree-single family ownership relationship and diversification degree – public enterprise relationship (p=0,012), between diversification degree – single family ownership relationship and diversification degree–foundation ownership relationship (p=0,46), between diversification degree-multifamily ownership relationship and diversification–foundation ownership relationship (p=0,549) and between diversification degree- public ownership relationship and diversification degree–foundation ownership relationship (p=0,029).

4.4.4. Diversification Strategies and Executive Structure

As seen in Table 7, the results of Kruskal Wallis analysis applied to test Hypothesis 3 show that there isn't a statistically significant difference between executive structure and diversification with a %5 error margin (Chi-

Square=0.445, $p=0.931$). According to the results of the research, Hypotheses 3 was rejected. However, it is understood that the diversification value of foundation managers is bigger than the others in terms of Median values. Accordingly, it can be thought that these managers are more eager to diversify in businesses.

Table 7. Diversification Strategies and Executive Structure (Kruskall Wallis)

Executive Structure	Frequency	Percentage	Mean Rank	Kruskall Wallis	
Owner Controlled	19	15,57	60,05	Test Statistics ^{a,b}	
Owner Concentrated,	61	50,00	60,76	Chi-Square	0,445
Manager Concentrated	28	22,95	61,89	Df	3
Management Controlled	14	11,47	65,89	Asymp. Sig.	0,931
Total	122	100		a. Kruskall Wallis Test b. Grouping Variable: management	

5. Conclusion

If the findings are evaluated in terms of diversification degree and ownership percentage in the diversified corporations, it is understood that ownership percentage effects diversification behavior. This result shows that more attention is given to the percentage of control in the corporation instead of diversifying when ownership percentage increases in the businesses researched.

The difference between holding company ownership structure and diversification was analyzed and when evaluated in terms of averages, it is understood that diversification degree is the highest in foundations and the lowest in public enterprises. This result indicates that investing in different fields, taking risks and turning environmental opportunities into advantages are more possible in foundation ownership. On the other hand, why diversification degree is the lowest in public enterprises can be associated with neo-liberal policies in Turkey. Then, some institutions have been privatized or liquidated by the government in Turkey. Also, the reasons of high diversification degree in single family ownership can be the difficulty of having agreed decisions in case of the existence of different individuals, unwillingness to get risks, possible diversification reasons not on strong footings and different aims of individuals.

There can be a lot of reasons of why there isn't a statistically significant difference between diversification degree and executive structure in Turkey such as dominance of owners on managers. Then, the owners get obliged to appoint some people as managers because of laws or other intuitional pressures. It is possible that such managers behave according to the owners' wishes instead of professional preferences.

The researchers interested in this field can make studies about the reasons of high diversification degree in single family businesses and the reasons of low diversification degree in multifamily businesses in Turkey. Also some other studies can be made about the relationship between organizational performance and ownership structure, ownership percentage or executive structure and about the relation of diversification strategy, organizational performance and agency theory.

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