CHAPTER I

INTRODUCTION

The first chapter would discuss about the underlying concept and studies of the topic. This will give a preview and the general knowledge of the study on why this idea arises in the market. Afterwards, this chapter will also discuss about the arising main problems of the paper. This will then lead to the research questions that will be explored throughout the paper. Next, this chapter elaborates about the purpose and contribution of the study and the chapter outline.

1.1 Background of Study

Symptoms suggest that most firms expands its scope and market reach in building their empire by diversifying into different segments (Jensen, 1989). Diversed segment reach is conducted to reallocate resources for better efficiency and productivity. However, reallocation of resources seldom happens within firms, not within markets, and is not captive to a single industry (Matvos and Seru, 2014). Matvos, Seru, and Silva (2017) identifies the benefit of diversification in providing a wider market scope. This strategy allow firms to reallocate resources more efficiently.

Given the aim of diversifying to different segments are to build empire, diversification is expected to happen and dominate mostly in good times. Under this condition, firms are believed to be oversupplied with cash and capital market are loose at the same time. However, recent study by Matvos, Seru and Silva in 2017, suggest that firms diversification aligned closely with the increase of external market frictions. The increasing situation of external market frictions implies a tightening capital market. This idea is strongly supported by Hovakimian (2010), Matvos and Seru (2014) and Ševčík (2015) from the previous researchers.

External market frictions are believed to be the frictions undergone in the market. These frictions often include the asymmetric information and the agency problems (Houston, James, and Marcus, 1997). It also causes the access to the external financing market become more costly. Matvos and Seru (2014) elaborate financial frictions as the shocks that are transmitted to the broader economy, where funds may not flow to the highest value use without incurring additional significant cost. Under Hovakimian (2010) explanation, market frictions are also considered as constraints in the market. Hovakimian explains it as the restriction of the amount of capital under the manager's discretion. This restrains the potential of good investment, as the capital allocation could not be maximized.

It is believed that firms do not change its scope in isolation (Matvos, Seru and Silva, 2017). Yet, firms tend to react to evolvement of scope in times of high external market frictions (i.e. global financial crisis). Evidences prove that large scope of publicly traded firms tends to widen their scope during these times (Matvos, et. all (2017), Matvos and Seru (2014), Ševčík (2015), and Hovaikimian (2010)) . Matvos and Seru (2014) predicts that the behavior of firms in altering the financial shocks may include the reallocation of resources internally. Hovaikimian (2010) believes that the internal capital within firms allows the firm to gain the opportunity in transferring capital between segments.

It is to be said that internally diversified firms may be highly able to phase out financial shocks in the market (Ševčík, 2015). The ability of firms to escape from the potential market freezes are through internal reallocations. Ševčík (2015) believes that internal capital market plays an important part in a diversified firm. Hence, diversification behaviour are emerging enormously as firms create internal capital market, thus reducing the reliance of funds from external market. The lesser reliance on external funds allow firms to avoid credit market imperfections. Instead of paying more, firms could channel the higher cost of external capital to strengthening the firm's internal capital. Therefore, internally diversified firms can focus mainly to the reallocation process.

Internal resource allocation allows the firms to withdraw from the external market's additional cost (Ševčík, 2015). Matvos and Seru (2014) study further qualifies that the performance of the diversified conglomerates investments improves when external capital market is distressed, relatively to the stand-alone firms. It is so because the cost of the reallocation of resources internally becomes more beneficial and effective compared to the additional cost incurred in the external market within the time. They also proves that there are a strong non-linearity in the effect of time-varying external capital market conditions.

Based on Matvos, Seru, and Silva's research in 2017, Ševčík (2015), Hovakaimian (2010), well-diversified firms can easily benefit highly during times of financial market freezes. As external market friction increases, financial market clash and eventually will freeze. These market freezes tends to lead financial markets to bearish. However, firm's diversification brings benefit and can potentially dampen the effect of financial market freezes.

Diversification allows firms to avoid those underperforming, costly and freezing market section and focus on those with high potential productivity internally to outperform market freezes (Ševčík, 2015). Moreover, with diversification conglomerates are able to reallocate investments from one less productive sector to other more productive sector, as firms diversify (Matvos, Seru, and Silva, 2017). With this intention, reallocating internal capital resources became more attractive compared to external. Thus, eager conglomerates to diversify companies to better survive in financial market freezes that eventually result in outperforming their competitors.

Increased diversification promotes better allocation of the internal financing. This strategy intuitively purges the likelihood of a low investment opportunity to a better investment opportunity. Therefore, diversification benefit should be at highest when conglomerates are more diversified in times of high external financial market frictions (Matvos, Seru and Silva, 2017). Although Hovakimian (2010) argues that the diversification causes by financial pressure may lead to an overinvestment, it may also cost other firms of underinvestment. Nonetheless of the cost of the investments, it will still be more effective than entering into the external capital market.

With the characteristic of market frictions in the financial market and potential firm's diversification benefits, firms show a positive attitude towards diversification strategy. As external market clashes, internal capital market became an interesting area to develop (Matvos and Seru, 2014). With this idea, it is predicted that firm's diversification attitude are affected by the level of frictions in the financial market. This study aims to test the relationship between the effect of financial market frictions to firm's diversification behavior in Indonesia.

1.2 Statement of Problem

Based on the background of the study previously, the problem in this research is as follow:

1. Does financial market frictions have influence on firm's diversification behavior?

1.3 Objectives of Research

The objectives of this research is to find check the previous stated problem, which is:

1. To test whether financial market frictions influences firm's diversification behavior.

1.4 Use of The Study

This research is hopefully useful for:

1. Investors

As external market frictions may potentially happen in the economy, this research can provide new knowledge and understanding for investors about the diversification level in respond to the financial market frictions.

2. Conglomerates

As financial market frictions correlate with the level of diversification of firms, this research can adequate conglomerates with new ideas and knowledge about the diversification level over market frictions.

3. Academic

With all hope, this research can provide new ideas, knowledge and understanding for finance specific field. Furthermore, this research can create a base and be useful for further research.

1.5 Systematic of The Study

The writer arranges the research with sub and sub-chapters systematically to ease readers for understanding the flow and purpose of the study. In addition, the writer uses an APA citation formats to ease the readers to correlate the references.

Chapter One

This section will identify the background of the case, problem, research question, and the use of the study

Chapter Two

This section will define the definition of each literature review, financial market frictions, and diversification. It will also discuss about the previous studies, results, and theories about the correlation between the diversification pattern of firms in response to the financial friction. Alas, it will end with the hypothesis development of this case

Chapter Three

This chapter shows how the data is collected and the empirical formula. It includes the definition of each variable, method of data calculation, determination of data requirement, the empirical models and diagnostic tests.

Chapter Four

This chapter discusses about the result and analysis of the data. This includes the implication and interpretation of the result on how it correlates with the given formulated hypothesis.

Chapter Five

The last chapter is closed by the conclusion and limitations of the study.