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POLITICAL CONNECTIONS OF CONGLOMERATES: EVIDENCE FORM INDONESIA STOCK EXCHANGE

This study aims to examine the effect between global crisis and political connections and conglomerates performance listed at Indonesia Stock Exchange. The sample of this research consists of the conglomerates listed at Indonesia Stock Exchange since 2006 and publishing financial reports every year and also never delisted from the capital market. We use multiple regression analysis and Wilcoxon signed test and found that the crisis has negative and significant effect on Tobin's Q but not significant for return on assets. The conglomerate performance during non-crisis is greater than at time of crisis while political connections have negative but not significant effect on Tobin's Q, with positive and significant effect on return on assets.
Keywords: conglomerate; global crisis; political connection; Indonesia Stock Exchange.
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ПОЛІТИЧНІ ЗВ'ЯЗКИ КОНГЛОМЕРАТІВ: ЗА ДАНИМИ ФОНДОВОЇ БІРЖІ ІНДОНЕЗІЇ

У статті оцінено вплив світових криз та політичних зв'язків на показники конгломератів на фондовій біржі Індонезії. Вибірка дослідження складалась з усіх конгломератів, що котирувались на фондовій біржі Індонезії з 2006 р., при цьому важливим умовами були наявність щорічної прозорої фінансової звітності та відсутність фактів делістингу. В аналізі використано множинну регресію та тест Вількоксона. Доведено, що криза негативно та суттєво впливає на коефіцієнт Тобіна, але несуттєво — на рентабельність активів. У той же час політичні зв'язки негативно, але несуттєво впливають на коефіцієнт Тобіна, однак позитивно та суттєво — на рентабельність активів.
Ключові слова: конгломерат; світова криза; політичні зв'язки; фондова біржа Індонезії.
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ПОЛИТИЧЕСКИЕ СВЯЗИ КОНГЛОМЕРАТОВ: ПО ДАННЫМ ФОНДОВОЙ БИРЖИ ИНДОНЕЗИИ

В статье оценено влияние мировых кризисов и политических связей на показатели конгломератов на фондовой бирже Индонезии. Выборка исследования состояла из всех конгломератов, котировавшихся на фондовой бирже Индонезии с 2006 г., при этом важными условиями были наличие ежегодной прозрачной финансовой отчётности и отсутствие фактов делистинга. В анализе использованы множественная регрессия и тест Вилькоксона. Доказано, что кризис негативно и существенно влияет на коэффициент Тобина, но несущественно — на рентабельность активов. В то же время политические связи отрицательно, но несущественно влияют на коэффициент Тобина, однако положительно и существенно — на рентабельность активов.
Ключевые слова: конгломерат; мировой кризис; политические связи; фондовая биржа Индонезии.

Introduction. Various studies and opinions on conglomerates are debated worldwide, mostly whether conglomerate can increase firm's value or actually reduces it. On the one hand, a lot of empirical research, starting with S.R. Reid (1968) and also

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a breakthrough R.P. Rumelt (1974) were dedicated to strategy, structure and economic performance of conglomerates, R.W. Melicher and D.F. Rush (1973), S.P. Ferris et al. (2003), M.D. Walker (2003), A. Yan (2006) and some other studies that followed up, commonly found poor performance and conglomerate value. But, on the other hand, a number of multi-industry companies, such as General Electric and 3M, are often used as examples of better management (Kerr and Darroch, 2004). J.F. Weston and S.K. Mansinghka (1971) proved that not all conglomerates have poor performance, and that companies called conglomerates are often efficient and rational organizations. This is supported by L. Keister (1998) who documented that group affiliation in China is linked to performance and better productivity. Other evidence was provided by (Hoshi et al., 1991; Kerr and Darroch, 2004). G. Kerr and J. Darroch (2004) who clearly identified superior performance in medians, means, measurements of upper quartile, and average market-to-book ratio.

Conglomerates positioning in developing countries is very strong, which is explained by the concentration of economic power in the hands of a small group of large conglomerates (Claessens et al., 1999). Same is happening in Indonesia, where conglomerates' contribution to GDP is huge. With a small number (only 0.01%) of the total companies in Indonesia, conglomerates contribute enormously to GDP of Indonesia, at about 44.4% (BPS, 2009). In fact, of the total 510 companies listed at Stock Exchange in 2014, 116 companies were conglomerates controlling more than 70% of the total market capitalization (IDX, 2015).

In 2005, from 339 listed companies at Indonesia Stock Exchange 70 were conglomerates which control 74.43% of the total market capitalization. In 2006–2014 conglomerates dominated market capitalization consecutively amounting to 76.25%, 77.25%, 77.62%, 76.10%, 78.88%, 68.46%, 74.45%, 72.35% and 71.61%. In 2008, the total market capitalization and conglomerate capitalization in Indonesia decreased very significantly as a result of the global crisis (sub-prime mortgages crisis) which also had impact on Indonesian economy. Market capitalization of conglomerates dropped from 1,543 trln Rp in 2007 to 819 trln Rp in 2008, down by 46.9% (IDX, 2015). The phenomenon of declining capitalization in 2008 with the global crisis was also confirmed by S. Claessens et al. (2001).

The 1997 financial crisis and the 2008 global crisis made many conglomerates rather unsteady. This is supported by M. Hanazaki and Q. Liu (2003), who examined the impact of crises on the performance of diversified companies. During the financial crisis companies are experiencing performance degradation. M.L. Lemmon and K.V. Lins (2003) states that the crisis negatively impacts on company's investment opportunities, and also incentives for controlling shareholders to expropriate minority shareholders rights increased.

In 2009, conglomerate capitalization increase to 1,593 trln, or by 94.5%. The increment of conglomerate capitalization in 2009 was attributed to economic recovery after the global crisis, also caused by the presidential elections in Indonesia. Entrepreneurs and corporate leaders in developing countries such as Indonesia (where the level of corruption is still high), believe that political connections provide support to achieve objectives of a company, so they make significant efforts to foster political connections in order to achieve company's growth, once they realize that political connection is a valuable resource for any company (Fisman, 2001; Li et al., 2012).

Indonesia and President Soeharto has become popular in political connections literature. There is strong evidence that Soeharto sought to protect companies that have political connection with his regime, conglomerates especially. R. Fisman (2001) showed that at the end of the Soeharto government and bad news about the health of President Soeharto hit Indonesian stock market, and companies close to Soeharto suffered negative returns. Likewise the performance of companies closely connected to Soeharto experienced deteriorating performance during the financial crisis (Leuz and Gee, 2006).

In the countries with weak legal system and high corruption level, political connections are very valuable to any company, even though political connections are not least important in the countries with strong legal systems such as the USA (Goldman et al., 2009). E. Goldman et al. found that political connections have broad effects on the value of a firm in the US Presidential election of 2000. M. Faccio (2006) supported the findings of E. Goldman et al. (2009). Using a sample of 47 countries, Faccio documented that political connections are very common in the countries with high levels of perceived corruption, companies in Indonesia ranked high as usually have extensive political connections with the members of parliament (DPR), ministers, president, sometimes even relative relations.

The rest of this paper is structured as follows. In Section 2 we describe literature, including that on conglomerate performance, global crisis and political connection, and an overview of the events is provided. Section 3 presents our research method and data, section 4 presents the results, and section 5 concludes.

Literature. According to J.F. Weston and S.M. Mansinghka (1971: 921), conglomerates are companies that perform broadly diversified program, achieving more through external mergers and acquisitions as compared to internal development of companies. F. Kerr and J. Darroch (2004: 21) defined conglomerates or multi-industry companies as companies which consists of businesses that do not have a relationship with each other.

S. Claessens et al. (2001) conducted a study on 3000 corporations in 9 East Asian countries to look at costs and benefits of diversification in the periods before and during the financial crisis. They found that internal market provides many benefits for the company before the crisis and diversification is undertaken to reduce business risks. But whenever a financial crisis occurred, a diversified company actually has worse performance. M. Hanazaki and G. Liu (2003) examined the impact of diversification on performance. During the financial crisis, companies are experiencing performance degradation which is very high.

Based on the theory and previous studies, the authors formulate the hypotheses as follows:

H1: There is a significant impact of global crisis on conglomerates' performance.
H2: Conglomerates' performance during non-crisis is greater than under crisis.

Company has political connection if one of shareholders or top managers of the company is a member of parliament, minister or heads of state, or has a close relationship with a political party or officials (Faccio, 2006: 370).

Political connections proved capable of providing preferential treatment and services in a variety of access, namely: access to funding (Khawaja and Mian, 2005; Leuz and Gee, 2006; Faccio, 2006; Claessens et al., 2006; Yeh et al., 2010; Boubakri

et al., 2012; Tian and Cheung, 2013), access to government procurement contracts (Goldman et al., 2009), public policy change (Bunkanwanicha and Wiwattanakantang, 2009), trade and licensing (Mobaraq and Purbasari; 2005), as well as better access to IPO (Francis et al., 2009). Literature shows that political connections affect performance and value of companies (Faccio, 2006; Leuz and Gee, 2006; Fisman, 2001; Goldman et al., 2006; Boubakri et al., 2008; Fan and Wong, 2007; Wong, 2010; Do et al., 2013; Ang et al., 2013).

Political connections would be more valuable under high level of corruption and weak regulation, both for small companies and large companies (Faccio, 2006; Do et al., 2013). S.H.W. Wong (2010) proved that company experiences an increase in ROE and MBV ratio after joining a Selection Committee. This means that political connections are able to improve company's performance as measured by ROE and MBV. Q.A. Do et al. (2013) supports S.H.W. Wong (2010), also stating political connections are able to increase the value of a company at the state level.

Besides various profits, political connections may have a negative impact on the company, namely, high leverage, followed by overinvestment (Wu et al., 2012), decline in stock prices and stock returns (Fisman, 2001; Fan et al., 2004), decline in performance (Leuz and Gee, 2006; Xu and Zhou, 2008; Li and Xia, 2013), lower quality of financial reporting (Chaney et al., 2011).

X. Deng et al. (2012) examined the effect from diversification for companies that have political connection and its influence on such companies in China. They found that political connections have a positive and significant impact on performance. The influence of political connections on conglomerate (unrelated diversification) is stronger than in the case of related diversification. But its negative impact on the performance of a company in the future (long-term) can damage the company. The company which has a market value due to political connections tends to diversify into unrelated fields (unrelated diversification).

X. Deng et al. (2012), J.S. Ang et al. (2013) examined the companies connected to politics in Singapore. Ang et al. found that within 3 years after the IPO, companies are mostly independent from political connections. But after the sample is breakdown into several categories by industries, they found the director of the company which has political connections can have positive and significant impact on the value of a firm.

X. Deng et al. (2012) supported the findings of W. Li et al. (2012) that the performance of conglomerate (unrelated diversification) with political connections is greater than the performance of a company which has political connection but also is involved in related diversification. These results show that political connections of a conglomerate are more valuable than that of a non-conglomerate.

Based on all these empirical explanations we put forward the Hypothesis 3 as follows:

H3: There is a significant impact of political connections on conglomerate performance.

Research methods and data analysis. This study used secondary data from the 2007—2014 annual reports. The study population consists of all publicly traded conglomerates at IDX for the period January 1, 2006 — 31 December 2014. This is as many as 127 companies all published financial reports every year and have never been

delisted from the capital market. Based on these criteria, the total sample of conglomerate in IDX were 77 companies (2007−2014), so that the total observation sample in this study is 616.

Variables used in this research are conglomerate performance, global crisis and political connection. Performance of conglomerates in this paper is considered through the market-based approach (market performance) and profit-based approach (accounting performance) (Niessen and Ruenzi, 2007; Deng et al., 2012). Accounting performance is a calculation of effectiveness and efficiency of a company within a certain time. If performance is good, it means company runs its operations effectively and efficiently, while market performance indicators reflect company's expectations and manifestation of long-term performance (Siegel and Shim, 1987; Deng et al., 2012). Market performance indicators (market performance) use proxy Tobin's Q and profit-based approach (accounting performance) use proxy Return on Assets (Niessen and Ruenzi, 2007; Deng et al., 2012).

Political connection criteria are according to (Fisman, 2001; Leuz dan Gee, 2006; Faccio, 2006). If one of the shareholders of the company or a top manager of this company is a member of parliament, minister or head of state, or has close relationship with political party officials, army and police officials − then there is a political connection.

To ensure that the model used to test the hypotheses mentioned previously applies to all the conglomerates, we use the variable of firm size, age and growth as a control variable. The following table explains all the variables applied.

To test the hypotheses 1 and 3 we used the multiple regression model as follows:

$$Tobin'sQ = \alpha 1 + \beta 1 Crisis + \beta 2 Pol + \beta 3 Size + \beta 4 Growth + \beta 5 Age + \varepsilon 1; \quad (1)$$

$$ROA = \alpha 2 + \beta 6 Crisis + \beta 7 Pol + \beta 8 Size + \beta 9 Growth + \beta 10 Age + \varepsilon 2. \quad (2)$$

To test the hypothesis 2 we used the Wilcoxon test by using the means of firm size, growth, Tobin's Q, ROA and ROE. The 2008−2009 period is referred to as the crisis period, while non-crisis period is the years 2007, 2010 to 2014.

Results analysis and discussion.

Descriptive statistics analysis. An overview of the research data (2007− 2014) is provided in Table 2.

According to Table 2, conglomerates politically connected are fluctuating in number, since 2008 until 2012 they increased significantly from 35 to 45. Firm size shows significant growth during the observation period. This shows that the total assets of conglomerates at Indonesia Stock Exchange continues to increase. Company's sales growth fluctuated, a sharp decline occurred in 2008−2009, this declining is explained by the global crisis which has reduced firms' value in many countries in the world. In 2010 firms' growth began to increase again, but in 2011 it again decreased. The average sales growth for 8 years was at 0.05, or 5%.

Conglomerates' value in this study has two proxies, namely Tobins Q which is market performance and Return on Assets which is accounting performance. Table 2 above shows that Tobin's Q of conglomerates at Indonesia Stock Exchange fluctuated, a sharp decline occurred in 2008−2009. Tobin's Q lowest value of 1.19 was recorded for 2008 and Tobins Q highest value of 1.96 was in 2007. The average value of conglomerates Tobin's Q for 8 years was 1.67.

Table 1. **Research variables,** *compiled by the authors*

No.	Variable	Subvariable	Indicator	Sources
1.	Conglomerate performance	Tobin's Q	$Tobins\ Q = \dfrac{Market\ Value\ of\ All\ Ots.\ Share + Debt}{Total\ Assets}$	Lindenberg and Ross, 1981; Wolfe and Sauaia, 2003; Villalonga and Amit, 2006; King and Santor, 2008; Kerr and Darcoch, 2004; Li et al., 2012; Li and Xia, 2013
		ROA	$ROA = \dfrac{EAT}{Total\ Assets}$	
2.	Global crisis (Crisis)		Dummy variable: 1 = crisis 0 = non crisis	Hanazaki and Liu, 2003
3.	Political connection (Pol)		Shareholders of the company (ownership 10%) or a top manager is a member of parliament, minister or head of state, or has close relationship with political party officials, army or police officials. 1 = political connected 0 = not connected politically	Fisman, 2001; Leuz dan Gee, 2006; Faccio, 2006
4.	*Firm size*		Log asset	Wiwattanakantang, 2001; Lins and Sarveas, 2002; Lins et al, 2011; Li et al., 2012; Cheng, 2013
5.	*Growth*		$Growth = \dfrac{\Delta (Total\ Sales)}{Total\ Sales}$	
6.	*Firm age*		Calculated from the date of IPO until the date of the annual report	

Table 2. **Descriptive analysis,** *authors'*

Variable	Proxy	Average								Means
		Year								
		2007	2008	2009	2010	2011	2012	2013	2014	
Pol	Politic connect	37	35	39	39	43	45	45	45	41
Size	Log assets	6.69	6.77	6.78	6.86	6.92	6.97	7.05	7.07	6.89
Growth	Growth of sales	0.14	0.10	-0.14	0.13	-0.09	0.14	0.11	0.04	0.05
Firm performance	Tobins Q	1.96	1.19	1.51	1.79	1.68	1.75	1.69	1.78	1.67
	ROA	0.054	0.033	0.065	0.075	0.062	0.051	0.076	0.063	0.060

Return on Assets of conglomerates also fluctuated a sharp declining occurred in 2008. The highest value was in 2012 amounting to 7.%. On average, ROA for 8 years was 6%.

Hypothesis testing analysis (Table 3).

Table 3. **Research model,** *authors'*

Research model	Constanta	Global crisis (Crisis)	Political connection (Pol)	Firm size (Size)	Firm growth (Growth)	Firm age (Age)
Model 1: Tobin's Q	1.502	-0.437 -3.521***	-0,163 -1.484	0,065 0.857	-0.090 -0,361	-0.005 -0.444
Model 2: Return on Assets	0.068	-0.001 -0.119	0.022 2.638***	-0.011 -1.784*	0.053 2.758***	0,004 4.637***

Notes: *** Significance 1%, ** 5%, * 10% levels.

For the first and third hypotheses the research models are as follows:

$$Tobins'Q = 1.502 - 0.437Crisis - 0.163Pol + 0.065Size$$
$$- 0.09Growth - 0.005Age + e1; \tag{3}$$

$$ROA = 0.068 - 0.001Crisis + 0.022Pol - 0.011Size$$
$$+ 0.053Growth + 0.004Age + e2. \tag{4}$$

Based on the above results, the crisis had negative and significant effect on Tobin's Q but not significant for Return on Assets. This shows that the global crisis that occurred in 2008 significantly influenced the declining market performance (firm value), but had no significant effect on accounting performance (firm performance). This result supports the previous research carried out by M.L. Lemmon and K.V. Lins (2003) who stated that the crisis had negative impact on company's investment opportunities.

Political connections have negative but not significant effect on Tobin's Q, but positive and significant effect on Return on Assets. This indicates that political connections have positive effect on company's profitability (firm performance), thus, if a conglomerate has political connections, its profits will increase. This is in accordance with X. Deng et al. (2012) who examined the effects from company's diversification and its influence on politically connected enterprises in China. They found that political connections have positive and significant impact on performance. The influence of political connections on conglomerate (unrelated diversification) is stronger than in the case of related diversification. But unrelated diversification connected with

politics will have a negative impact on the performance in the future (long-term one), it can even damage the company. The company which has market value due to political connection tend to diversify into the unrelated fields (unrelated diversification).

Table 4. **Wilcoxon ranks test,** *authors'*

		N	Mean rank	Sum of ranks		NON_CRISIS – CRISIS
NON_CRISIS – CRISIS	Negative ranks	0[a]	.00	.00	Z	-2.023[b]
	Positive ranks	5[b]	3.00	15.00	Asymp. Sig. (2-tailed)	.043
	Ties	0[c]				NON_CRISIS – CRISIS
	Total	5			Z	-2.023[b]

[a] NON_CRISIS < CRISIS. [b] NON_CRISIS > CRISIS. [c] NON_CRISIS = CRISIS.

From Table 4: Asymp. Sig (2-tailed) is 0.043, which means that for testing one side is 0.043 / 2 = 0.0215, so the hypothesis that conglomerate performance during non-crisis is greater than at time of crisis is correct. This means that the crisis affects conglomerate performance. This is consistent with S. Claessens et al. (2001) who stated that when a crisis occurs, a diversified company has poorer performance. Likewise in M. Hanazaki and Q. Liu (2003) who found that during the financial crisis diversified companies decreased their performance significally.

Conclusion. Conglomerates in Indonesia are always identified with some political connections. There is strong evidence that Soeharto sought to protect companies that have political connection with his regime, this especially refers to conglomerates. R. Fisman (2001) showed that at the end of the Soeharto government regime and bad news about the health of President Soeharto hit Indonesian stock market, and companies close to Soeharto suffered negative returns.

Our results support theories and the previous research, in which the crisis has negative and significant effect on Tobin's Q but not significant – on Return on Assets. This shows that the global crisis that occurred in 2008 significantly influence the declining market performance (firm value), but no significant effect on accounting performance (firm performance). The results support the previous research carried out by M.L. Lemmon and K.V. Lins (2003). The conglomerate performance during non-crisis is greater than at time of crisis, which means that the crisis affects conglomerate performance. This is consistent with S. Claessens et al. (2001), likewise with M. Hanazaki and Q. Liu (2003).

Political connections have negative but not significant effect on Tobin's Q, and also positive and significant effect on Return on Assets. This indicates that political connections effect positively company's profitability (firm performance), if the conglomerate has political connections, profits will increase. The results support the research carried out by X. Deng et al. (2012) who found that political connections have positive and significant impact on performance. The influence of political connections on conglomerate (unrelated diversification) is stronger that with the related diversification. But conglomerate's (unrelated diversification) political connections have a negative impact on the performance of a company in the future (long-term).

The company which has a market value due to political connection tends to diversify into the unrelated fields, that is becomes a conglomerate.

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