



## Does Diversification Strengthen Or Weaken A Firm's Performance On Stock Price?

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**Abstract:** This study examines the impact of diversification on a firm's performance, specifically in relation to its stock price. The primary aim is to assess whether diversification strengthens or weakens the effect of financial performance on stock prices. The research uses Price-to-Book Value (PBV) as a measure of stock price and Return on Assets (ROA) as a measure of financial performance. The sample consists of 292 companies, with data analyzed through descriptive statistics, regression analysis, and ANOVA. The findings suggest that financial performance, as measured by ROA, has a significant positive effect on PBV, indicating that better financial performance tends to enhance a company's stock price. However, the study also explored whether diversification both international and industrial moderates this relationship. The results showed that while diversification strategies were prevalent in the sample, they did not significantly weaken or strengthen the relationship between ROA and PBV. These findings imply that while financial performance plays a crucial role in determining stock prices, diversification, in this context, does not have a notable moderating effect. This study contributes to the ongoing debate regarding the impact of diversification on firm performance, suggesting that, although diversification may reduce risk, it does not necessarily amplify the financial performance's impact on stock prices. Further research could explore other factors influencing this relationship and test these findings across different industries and time periods.

**Keyword:** Diversification, Firm Performance, Stock Price, Financial Performance, ROA, PBV.

### INTRODUCTION

In the dynamic and competitive landscape of modern business, firms continuously seek strategies to enhance their performance and maximize shareholder value. Performance is a concept that varies depending on context and has become a critical focus for business organizations, drawing significant attention in academic literature. Effective performance requires strategic decision-making by management to drive improvement (Wegwu, 2020). Consequently, every organization strives to achieve optimal performance. According to Matar

and Eneizan (2018), performance serves as a method for evaluating progress toward organizational goals while identifying and addressing obstacles within the broader business environment.

Fundamental factors, often referred to as financials, play a crucial role in determining a company's intrinsic value through Fundamental Analysis (FA). This methodology entails a thorough examination of pertinent economic and financial variables. A company's financial performance is paramount among these factors, significantly influencing stock prices. Elevated profits, surpassing those of previous periods, typically attract investors, resulting in increased stock prices (Lee, 2014). Conversely, inadequate profits or losses dissuade investment, prompting existing shareholders to divest due to loss aversion. This behavior often leads to a decline in stock prices for companies with poor financial performance.

Consequently, investors engage in fundamental analysis to guide their investment decisions. Return on Assets (ROA) serves as an essential measure of a company's ability to generate profit from its assets. It highlights how effectively management utilizes available resources to produce earnings. A high ROA indicates robust financial and operational performance, whereas a low ROA signals potential growth issues. A higher ROA is desirable as it denotes higher earnings from relatively lower investments. Apart from ROA, stock prices are also affected by a company's debt policy and its profit-generating capacity, which is measured through the Net Profit Margin (NPM). The Net Profit Margin (NPM) indicates the proportion of net income or profit earned as a percentage of revenue. Larger companies, with substantial profit-making capabilities, tend to enhance firm value through elevated NPMs.

Diversification has emerged as a widely adopted strategy in the manufacturing sector for gaining a competitive edge (Haug & Pidun, 2013). Whether related or unrelated, it serves as a strategic approach for managers to enhance organizational performance. The efficacy of diversification as a strategic approach, however, remains a contentious issue among academics and industry practitioners. Proponents argue that diversification can lead to enhanced firm performance and elevated stock prices by leveraging synergies and diminishing volatility. Expanding into international and product markets strengthens a firm's resource base while reducing agency costs linked to domestic lobbying. Research by Shirodkar et al. (2022) suggests that lobbying positively impacts the performance of firms that are diversified across both international markets and product lines. In contrast, it tends to be counterproductive for firms that are purely domestic and lack diversification. For firms operating in diverse industries, negative events within a specific business segment are less likely to cause extreme outcomes for the entire organization, such as sharp declines in stock market prices (Wang et al., 2023). Conversely, critics contend that diversification may dilute a company's focus, resulting in inefficiencies and suboptimal performance.

Some studies regarding stock prices have been carried out by many researchers. Benkraiem et al., (2023), An examination of how stock price crash risk affects the capital structure dynamics of GCC firms reveals that greater exposure to crash risk is linked to slower adjustments in leverage towards the target level. This effect is particularly significant for over-leveraged firms compared to their under-leveraged counterparts. The studies conducted by Ramlawati et al., (2011) conducted empirical research on the factors that influence stock prices. The study focuses on textile and garment companies listed on the IDX during the 2005–2009 period, examining the influence of variables such as Debt to Equity Ratio (DER), Earnings Per Share (EPS), Return on Investment (ROI), and Price to Book Value (PBV) on stock prices. The findings indicate that EPS and PBV have a significant impact on stock prices, while DER and ROI do not. Additionally, research on diversification strategies and business performance highlights a positive and significant relationship, suggesting that firms should adopt diversification strategies to achieve growth and profitability—key indicators of business performance (Wegwu, 2020).

This research aims to explain the complex relationship between diversification, firm performance, with a particular emphasis on its impact on stock prices. By examining various dimensions of diversification-such as industry and international diversification-this study aims to provide a comprehensive analysis of how diversification strategies moderate firm performance on stock prices.

Employing a combination of quantitative analysis and case studies, this research will investigate whether diversification strengthens or weakens firm performance and how it is perceived by investors of stock prices. The findings are expected to offer valuable insights for corporate managers, investors, and policymakers, facilitating informed decision-making regarding diversification strategies.

## **THEORETICAL REVIEW**

### **Signaling Theory**

Signal theory, introduced by Spence in 1973 through his book “Job Market Signaling”. Signaling theory suggests the importance of an information or signal issued by the company's internal parties, namely management. Information issued by the management is very useful for external parties of the company as a tool for consideration in investment decisions. One form of signal issued by the company's internal parties is the annual report. There are two types of annual reports issued by companies, the first is a non-accounting annual report in the form of information that is not related to financial reports, the second is an annual report in the form of information related to the company's financial statements. All information issued by company management will have an influence on volume changes in stock trading, because investors first analyze and interpret all information issued by company management whether the information is classified as a good signal or a bad signal (Hartono, 2022).

### **Stock Prices**

Stock prices, often viewed as the firm present value's future cash flows that influenced by exchange rate fluctuations. These changes create a connection between future income, interest rate shifts, and current decisions regarding investment and consumption (Zhao et al., 2010). A stock price refers to the current market value at which a company's stock is being traded. It reflects the value that buyers and sellers are willing to exchange for that share at a given moment. Stock prices fluctuate based on various factors, including demand and supply, firm performance, market sentiment, and external factors. Understanding stock prices helps investors make informed decisions about buying or selling shares.

### **Firm Performance**

Firm performance refers to how well a company achieves its financial and non-financial goals. Generally, organisations are considered to have achieved high performance if they can effectively utilise their resources, ultimately increasing sales, market share and profits. Assessment of company performance is done based on financial data through a process called financial analysis which can be measured through the company's accounting information (Mukhopadhyay & Chakraborty, 2017).

### **Diversification Strategy**

Diversification strategies can generally be divided into two primary categories.: industrial diversification and international diversification. Jafarinejad et al., (2018) both play a crucial role in strategic decision-making within a company. This research focuses on international and industrial diversification. Diversification can help companies reduce risk and enhance competitiveness. However, it is important to note that diversification can also add complexity to the company, which may increase tax aggressiveness (Balakrishnan et al., 2019).

### The Influence of Financial Performance on Stock Prices

The better a company's management, the more capable it is of managing business development, thus improving financial performance on a larger scale and increasing stock returns (Salindeho et al., 2018). Therefore, the hypothesis in this study can be formulated as follows:

**H1: Financial Performance has a positive effect on Stock Prices.**

### The Influence of Financial Performance on Stock Prices moderated by Diversification Strategy

According to the analysis results obtained by Salindeho et al., (2018), business diversification does not significantly affect financial performance, nor does it significantly impact stock returns. Industrial diversification significantly enhances performance, whereas international diversification does not show the same impact (Wegwu, 2020) Additionally, research by Wang et al., (2023), indicates that diversification substantially reduces the risk of stock price crashes, whether the diversification is related or unrelated. Therefore, the second hypothesis in this study is:

**H2: Diversification Strategy weakens the Influence of Financial Performance on Stock Prices.**

### Conceptual Framework

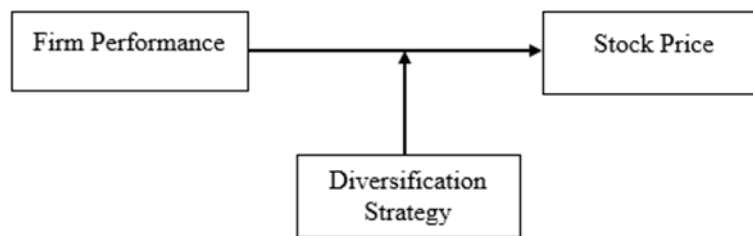


Figure 1. Research Framework

### METHOD

This study employs a quantitative approach to test the proposed hypotheses. The dependent variable is Stock Price, measured using Price to Book Value (PBV). The independent variable is Company Performance, assessed through Return on Assets (ROA). The moderating variable is Diversification Strategy, represented as a dummy variable categorized into international and industrial diversification (Gyan et al., 2017). The variables are defined as follows:

$$PBV = \frac{Marketpricepershare}{BookValuePerShare}$$

$$ROA = \frac{NetIncome}{TotalAsset}$$

Dint = 1 if the company's international sales > 10% 0 if the company's international sales < 10% Dcog= 1 if the company's industry segment > 1 segment 0 if the company's industry segment 1 segment.

The hypotheses are tested using the following models, with the diversification strategy serving as the models 2's moderating variable.

$$PBV = \alpha_0 + \beta_1ROA + \varepsilon \dots (1)$$

$$PBV = \alpha_0 + \beta_1ROA + (2ROA \times \beta_3DINT) + (4ROA \times \beta_5DINT) + \varepsilon \dots (2)$$

Where:

$\alpha$  = Constant

$\beta$  = Koefisien

PBV = Price to Book Value

ROA = Return On Asset

DINT = International Diversification

DIND = Industry Diversification

$\varepsilon$  = Standar Error

This study investigates manufacturing companies registered on the Indonesia Stock Exchange (IDX) from 2020 to 2023. Data spanning four years were utilized to explore the connection between corporate performance and stock prices of publicly traded companies in Indonesia. The study applied a purposive sampling method, omitting firms with negative Return on Assets (ROA). Following these criteria, 73 firms were selected annually, resulting in 292 observations over the four-year timeframe.

## RESULTS AND DISCUSSION

### Descriptive Statistics

**Table 1. Descriptive Statistics**

	N	Minimum	Maximum	Mean	Std. Deviation
PBV	292	0.11	8.46	1.7855	1.54665
ROA	292	-0.10	0.47	0.0978	0.07478
DINT	292	0.00	1.00	0.3562	0.47969
DIND	292	0.00	1.00	0.6164	0.48709
Valid N (listwise)	292				

The analysis includes 292 valid observations where all variables have non-missing values. This indicates a slight reduction in the sample size due to missing data in some variables. The study calculates the median, mean, minimum, standard deviation, and maximum values for each variable to facilitate straightforward comparative analysis.

Based on the descriptive statistics table, Price-to-Book Value (PBV) average of 1.7855 indicates the market, on average, values the company's shares 1.79 times its book value, with a value variation from 0.11 to 8.46 and a standard deviation of 1.54665. The average ROA (Return on Assets) of 0.0978 or 9.78% indicates the profitability of the company against its assets, with a range from -0.10 to 0.47 and a standard deviation of 0.07478, indicating most companies have near-average profitability. Diversification strategies, the average DINT

(International Diversification) of 0.3562 means that 35.62% of firms implement international diversification, while the average DIND (Industry Diversification) of 0.6164 indicates 61.64% of firms use industry diversification. These two variables are binary, reflecting variation between firms.

The positive mean ROA and variation in PBV support the potential positive influence of financial performance on stock prices (H1). However, the uneven application of diversification (DINT and DIND) requires further regression analysis to test whether diversification weakens the relationship between stock price and financial performance (H2).

### Regression Model

**Table 2. Variables Entered/Removed<sup>a</sup>**

Model	Variables Entered	Variables Removed	Method
1	ROAb		Enter

a. Dependent Variable: PBV  
 b. All requested variables entered.

The regression model presented in the table uses Return on Assets (ROA) as the independent variable, with no variables excluded. The analysis applies the Enter method, meaning all specified variables, including ROA, are included in the model simultaneously without selection or reduction. This model is designed to test the first hypothesis (H1) that financial performance represented by ROA has a positive influence on stock price represented by PBV. Further analysis results, such as regression coefficients and significance levels, will provide information on the extent to which ROA affects PBV.

### Simple Linear Regression Analysis

**Table 3. Model Summary**

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.473a	0.223	0.221	1.36530

a. Predictors: (Constant), ROA

The regression model shows that ROA has a moderate influence on PBV, with a moderate correlation and a contribution of 22.3%. Even so, other factors that not included can still influenced most of PBV variations in this model. These results support the first hypothesis (H1) that financial performance has a positive influence on share price, but it is necessary to look at the significance and regression coefficients for further validation.

**Table 4. ANOVAa**

Model	Sum of Squares	df	Mean Square	F	Sig.
1 Regression	155.538	1	155.538	83.441	<.001 <sup>b</sup>
Residual	540.573	290	1.864		
Total	696.112	291			

a. Dependent Variable: PBV

b. Predictors: (Constant), ROA

The regression model that tests the effect of ROA on PBV is overall significant ( $p < 0.001$ ). This means that ROA has a significant influence on PBV, and the regression model used can explain the variation in PBV quite well. The overall regression model is significant, which means ROA has a significant influence on PBV. These findings confirm the first hypothesis (H1), indicating that financial performance, as measured by ROA, positively affects share prices (PBV).

### Regression Model 2

**Table 5. Variables Entered/Removed<sup>a</sup>**

Model	Variables Entered	Variables Removed	Method
1	ROAXDIND, ROAXDINT, ROAb		Enter

a. Dependent Variable: PBV

b. All requested variables entered.

The independent variables included are ROA (Return on Assets) as the main predictor, as well as two interaction variables, namely ROAXDINT (interaction of ROA with International Diversification) and ROAXDIND (interaction of ROA with Industry Diversification). There are no deleted variables in this model, and the method used is Enter, which means all variables are entered simultaneously into the regression analysis without any selection process.

**Table 6. Model Summary**

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.479a	0.230	0.222	1.36439

a. Predictors: (Constant), ROAXDIND, ROAXDINT, ROA

An R value of 0.479 suggests a moderate positive relationship between the combination of independent variables (ROA, ROAXDINT, and ROAXDIND) and the dependent variable (PBV). The R Square value of 0.230 indicates that the model explains 23% of the variation in PBV, with the remaining 77% attributed to factors outside the model. After accounting for the number of predictors, the Adjusted R Square value of 0.222 confirms the model's relevance, with a slight reduction in explanatory power. The standard error of the estimate, measured at 1.36439, reflects the average deviation of the model's predictions from the actual PBV values.

**Table 7. ANOVA<sup>a</sup>**

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	159.984	3	53.328	28.647	<.001b
	Residual	536.127	288	1.862		
	Total	696.112	291			

a. Dependent Variable: PBV

b. Predictors: (Constant), ROAXDIND, ROAXDINT, ROA

The ANOVA test results indicate that the overall regression model is statistically significant, with an F-statistic value of 28.647 and a significance level (Sig.) of less than 0.001. This suggests that the independent variables (ROA, ROAXDINT, and ROAXDIND) collectively have a significant impact on PBV. The PBV variation explained by the model (Sum of Squares Regression) is 159,984, while the remaining (Sum of Squares Residual) of 536,127 is a variation that cannot be explained by the model.

**Table 8. Coefficients<sup>a</sup>**

Model		Unstandardized Coefficients		Standardized Coefficients		Sig.
		B	Std. Error	Beta	t	
1	(Constant)	0.823	0.132		6.246	0.000
	ROA	10.325	1.445	0.499	7.144	0.000
	ROAXDINT	1.409	1.352	0.060	1.042	0.298
	ROAXDIN	-1.662	1.344	-0.083	-1.236	0.217
	D					

a. Dependent Variable: PBV

The coefficient analysis results show that ROA has a significant positive effect on PBV, with a coefficient value of B = 10.325 and a significance level (Sig.) of 0.000. Every 1 unit increase in ROA is estimated to increase PBV by 10.325. In contrast, the interaction variables ROAXDINT (B = 1.409, Sig. = 0.298) and ROAXDIND (B = -1.662, Sig. = 0.217) are not significant. This means that diversification strategies, both international and industry, do not moderate the relationship between ROA and PBV in a statistically significant manner.

**Discussion**

**Effect of ROA on PBV**

Return on Assets (ROA) evaluates a company's efficiency in using its assets to generate profits, while Price to Book Value (PBV) serves as a metric reflecting the market's valuation of a company compared to its book value. A positive correlation between ROA and PBV implies that a higher ROA indicates improved asset management and profitability, which boosts investor confidence. Companies with a high ROA are often seen as financially strong, demonstrating efficient resource utilization to generate earnings.

Regression Model 1 reveals that ROA significantly impacts PBV, with an F-value of 83.441 and a significance level of less than 0.001. This result highlights a strong and meaningful connection between financial performance (ROA) and the market valuation of the company (PBV). Consequently, the first hypothesis (H1), which posits that financial

performance positively influences stock prices, is confirmed. Companies with stronger financial performance are generally valued higher by the market. This result aligns with the study by Prasetyo et al. (2021) discovered that financial performance indicators, including return on assets (ROA), book value, and net profit margin, have a significant impact on stock prices in Indonesia. Similarly, Velte et al. (2020) highlighted that ROA is a crucial indicator of financial health used by investors in emerging markets to guide their valuation decisions.

### **Effect of Diversification on ROA and PBV Relationship**

The impact of diversification on the relationship between ROA and PBV examines whether diversification strategies enhance or diminish the effect of financial performance on market valuation. In this context, diversification can take forms such as international diversification, where a company expands its operations within its industry, or industry diversification, where it ventures into multiple industries. Empirical findings often show mixed results. Diversification may not always enhance the ROA-PBV relationship due to challenges like operational inefficiencies or managerial complexity. For instance, poorly integrated diversified units can dilute the benefits of strong financial performance, limiting their impact on market valuation.

In Regression Model 2, the variables ROAXDINT (interaction of ROA and International Diversification) and ROAXDIND (interaction of ROA and Industry Diversification) are included to test whether diversification moderates the relationship between financial performance and stock price. The findings show that ROAXDINT and ROAXDIND have no significant effect, with significance values greater than 0.05 (0.298 and 0.217). This indicates that international and industry diversification have no significant effect in moderating the relationship between ROA and PBV in this model.

Research conducted by Capital Group, (2023) shows that the success of diversification may vary depending on how the company manages and integrates the diversified business units. Therefore, although industry diversification is more commonly applied by companies, The influence of diversification as a moderating factor on the relationship between financial performance and stock price may require more in-depth analysis or more complex model testing. Additionally, Kuppuswamy & Villalonga, (2016) found that diversification outcomes depend on external financing constraints, managerial focus, and market structure, which might explain the lack of moderating effects in this study. However, when managed effectively, diversification can create synergies that strengthen market perception. This potential depends on factors such as the company's strategic focus, industry characteristics, and governance quality. Thus, while diversification has theoretical potential to amplify ROA's impact on PBV, its effectiveness is context-dependent and varies across firms and industries.

### **Model Significance Test**

The significance test of a regression model evaluates whether the independent variables, taken together, adequately explain the variability in the dependent variable. This is typically assessed through the **F-test** in an ANOVA (Analysis of Variance) framework. a significant F-value ( $p < 0.05$ ) indicates that the model is statistically valid and that the predictors play a meaningful role in explaining the dependent variable.

Based on the ANOVA results in Model 1 and Model 2, both models show significant results, with F values of 83.441 (Model 1) and 28.647 (Model 2), each of which has a significance value  $< 0.001$ . This indicates that these regression models are overall significant in explaining variations in PBV. This finding supports the first hypothesis (H1), which indicates that financial performance as measured by ROA has an effect on the company's share price. This validates that the independent variables in both models jointly account for the variations in PBV. Although diversification does not significantly moderate the ROA-PBV relationship,

the results still support the first hypothesis, affirming that financial performance affects market valuation.

These findings highlight the robustness of the models in explaining PBV variations, even if individual moderating effects are not statistically confirmed. It also emphasizes the critical role of financial performance in shaping market valuations, while moderation through diversification may require further exploration using more complex models or additional variables.

## CONCLUSION

The analysis confirms the first hypothesis (H1), which posits that financial performance positively impacts stock prices, as the ROA variable significantly affects PBV. However, the second hypothesis (H2), suggesting that a diversification strategy weakens the relationship between financial performance and stock prices, is not supported by the results, because diversification (both international and industry) has no significant effect as moderation in the relationship. For companies, improving financial performance through efficient asset management and increasing profitability will have more influence on market valuation than diversification strategies. Therefore, companies need to focus more on strengthening financial performance to increase their share price, although diversification remains a strategy that can help reduce long-term risk.

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