

Research on the Effects of Real Estate Enterprises Diversification on Their Financial Risks

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Abstract. In recent years, under the dual influence of national policies and market fluctuations, the development of the real estate industry has shown an obvious downward trend. Up against this background, real estate enterprises have begun to try the diversified operation. However, their results of diversification are different. Some enterprises have found new profit growth points, while others are facing huge financial risks and even debt crises. With the data of Shanghai and Shenzhen A-share real estate listed companies in China from 2010 to 2020 as research samples, this paper constructs a two-way fixed effects model, tests the diversification effects on financial risks, and compares the real estate enterprises that adopt different diversification strategies. The findings are as follows. (1) Real estate enterprise diversification aggravates the financial risks of enterprises. (2) The degree of unrelated diversification has a significant negative correlation with the financial performance of real estate enterprises, while the degree of related diversification has no significant impact on financial risks.

Keywords: Financial Risk; Diversification; Real Estate Enterprise; Financing Constraint; Equity.

1. Introduction

Affected by various internal and external factors, the growth of China's real estate industry gradually slowed down after 2010 with the declining industrial profit rate, and the overall demand for commercial housing gradually get saturated. All signs show that the days for real estate enterprises to expand by relying on the dividends of the times have gone. In order to cope with the following challenges, major real estate enterprises began to try diversification and find new profit growth points. According to the CRIC, 97% of China's top 100 real estate enterprises have diversified businesses in 2018, and Jing Xinxin et al. (2018) also said that all kinds of small and medium-sized real estate enterprises are implementing diversification strategies except large ones. So compared with the diversification strategy and specialization strategy, which business model is more conducive to the development of enterprises in the transition period? What risks do real estate enterprises face when implementing a diversification strategy?

One of the keys to the success of diversification is to effectively control financial risks. On the one hand, a diversification strategy can disperse enterprise risks, improve the efficiency of capital allocation, and produce a synergy effect, thus improving the business performance and reducing financial risks. For example, Vanke's diversification strategy from "focusing on real estate development" to "paying equal attention to real estate development, operation, and service" has greatly enhanced its counter-cyclicality and continuously expanded its income sources. On the other hand, real estate is a capital-intensive and high-risk industry with debt financing as its main financing channel. Financially leveraging the business expansion of real estate enterprises will increase their financial risks such as narrow financing channels, tight cash flow, high asset-liability ratio, and even bankruptcy. For example, Evergrande Group, the leading real estate enterprise in China, is facing bankruptcy and reorganization because of its blind diversification, which greatly aggravates its internal financial risks. We should also note that our enterprises generally expand blindly but ignore internal risks, among which financial risks are the most prominent. For real estate whose debt financing occupies an absolutely dominant position, the huge financial leverage brought by the blind capital expansion will inevitably make enterprises encounter huge financial risks. Based on the above background, this paper will discuss the financial risks brought by diversification to real estate enterprises and analyze its influence mechanism in depth.

At present, most of the research on the impact of enterprise diversification focuses on business performance, while those on financial risks of diversification strategy are relatively uncommon and are mainly based on case analysis at the theoretical level lacking the support of empirical test. This paper taking real estate listed enterprises as the research object uses the two-way fixed effects model to empirically analyze the impact of diversification strategy on financial risks of real estate enterprises, which enriches its empirical evidence. At the same time, the research results of this paper will guide real estate enterprises that intend to implement or have implemented diversification strategies to diversify timely and moderately as well as prevent and control financial risks. In addition, the real estate industry is one of the pillar industries of the national economy. Research on the real estate enterprises in the implementation of diversified financial risks and the corresponding mechanisms is also significant for the stability of the national economy.

2. Literature Review

2.1 Total Diversification and Financial Risks of Real Estate Enterprises

Internal capital market theory, risk dispersion theory, and synergy theory all think that enterprise diversification can disperse financial risks. Jing Xinxin (2018) believes that enterprises form internal capital markets through diversified operations, thus reducing transaction costs, generating financial synergy, and enhancing the ability of enterprises to resist risks to a certain extent[38]. Meanwhile, Fu Yumei and Zhang Liping (2018) pointed out according to Markowitz's portfolio theory that enterprise diversification can reduce operational risks by realizing the portfolio[39]. At this time, the risk compensation obtained by investors, that is, the cost of financing capital will also decrease accordingly, which is conducive to reducing the financial risks of enterprises. In addition, Chen Tianzhi and Zhou Hong (2020) believed that when enterprises have surplus economic resources and management capabilities, they will take the initiative to invest these resources in other businesses, thus maximizing the efficiency of resource utilization. Improving capital allocation effect and producing synergy effect like this will enhance the profitability of enterprises, thus improving the financial situation of enterprises[40].

However, many scholars negate the above views and think that diversification will increase the financial risks of enterprises. First of all, from the perspective of cash flow, the real estate industry has the characteristics of a long construction period, large capital demand, and high risked returns, which leads to its average leverage ratio which is far higher than other industries. However, abundant funds are often needed in the initial stage of entering new industries. It is obvious that real estate enterprises cannot meet the investment of affiliated industries only by the operating cash flow generated by real estate business, so they have to obtain capital through high borrowing[5]. At the same time, the huge debt repayment pressure brought by diversification also raises the capital cost of real estate enterprises[41]. Double pressure undoubtedly increases the liquidity risk of enterprises. Secondly, from the applicable conditions of portfolio theory, Wu Dingguo (2015) believes that the development of the market economy and capital market in China, a developing country, is still immature, with enterprises lacking tools and mechanisms to avoid financial risks. In this case, the portfolio theory is not applicable, that is, the diversification of Chinese enterprises aggravates financial risks[29]. Gao Hui (2021) also believes that not only the expansion of the company's scale and level will increase the difficulty of management and operation when launching the diversification strategy, but also lead to low resource utilization efficiency and failure to risk dispersion and scale effect if the company cannot effectively reconfigure the existing resources[42]. Finally, from the perspective of agency cost and information asymmetry, the diversification strategy complicates the organizational structure, which virtually increases the degree of financial information asymmetry. Each subsidiary will inevitably optimize financial information, thus aggravating the financial risk and leading to "inefficient cross-subsidization". Yang Xingquan et al. (2019) criticized the principal-agent theory that the senior management team is prone to overheated investment in the diversification to seek its own interests (such as obtaining higher remuneration by managing larger enterprises, etc.),

thus increasing the financing cost and financial risk[11]. Based on this, this paper puts forward the following assumptions:

Hypothesis 1: The deeper the real estate enterprise diversification, the greater the financial risks faced by enterprises.

2.2 Diversification Types and Financial Risks of Real Estate Enterprises

According to the correlation between new business and original business, diversification strategy can be divided into unrelated diversification and related diversification.

(1) Related Diversification and Financial Risks of Real Estate Enterprises

From the perspective of resource utilization, because of the strong correlation among various departments compared with the implementation of unrelated diversification, related diversification does not require a high ability of enterprises to learn, integrate, and reconstruct resources, which is conducive to the sharing of enterprise management resources, market channels, R&D strength, etc., and gives full play to synergy and economies of scope[43], thus reducing liquidity risk, investment cost, and operational risk of enterprises with less overall financial risk.

From the perspective of the internal capital market, Zhang Yunlai (2016) believes that the resource allocation function of the internal capital market depends on the degree of an industry association to a certain extent[44]. On the one hand, if the industry correlation is higher, the parent company needs less external information with a smaller possibility of information asymmetry when allocating resources. At the same time, the interoperability of resources among related industries alleviates the demand for scarce or irreplaceable resources within the group. On the other hand, according to the differences in cash flow demand and production capacity of each subsidiary, the group can centrally manage and redistribute funds to improve the utilization rate of internal funds and the ability to resist risks of cash flow. Good financial information will ease the overall financing constraints of the company and improve the ability to obtain external funds.

From the perspective of business risks, the research of Naren Gerile (2021) shows that engaging in related production and operation activities for a long time will greatly reduce the uncertainty of business management, keep profitability in a relatively stable state, promote enterprise innovation, and thus reduce financial risks[45].

(2) Unrelated Diversification and Financial Risk of Real Estate Enterprises

From the perspective of liquidity risk, real estate enterprises enter a completely unfamiliar industry when implementing an unrelated diversification strategy. In order to eliminate industry barriers, carry out technological innovation, and open up new markets, a great initial investment is inevitably required and the new business cannot generate positive cash flow in a short time, which brings a lot of pressure on the capital chain of real estate enterprises. Besides, enterprises can't play a synergistic role when they are not familiar with the industry. Various expenses such as management expenses, production costs, and scientific research expenses will increase accordingly[46]. To sum up, the limited resources of real estate enterprises are difficult to concentrate on the main business and the affiliated businesses also face multiple challenges, which leads to a sudden increase in debt repayment pressure, declines in profit quality of enterprises, and the efficiency of capital use as well as the intensity of financial risks.

From the perspective of investment risk, Ma Wenli (2019) found that the more unrelated fields companies entered, the more obvious the information asymmetry. The more factors that are difficult for enterprises to predict and master, the more impacts on the investment decisions of managers and the larger investment risks of enterprises[47]. Yuan Bo (2017) studied the impact of industrial policies on the non-diversified business behavior of enterprises, his empirical results show that private enterprises are more susceptible to the government industrial policies and carry out blind unrelated diversification. If managers misjudge the new industry, it will cause a major blow to the real estate enterprises, which will not only affect the performance of other businesses and generate operational risks but also lead to capital operational risks and debt risks due to insufficient funds and high leverage[48].

From the perspective of information asymmetry and agency costs, the cash flow status of their subsidiaries is obviously different for an unrelated diversified group with few internal cross-subsidization. Enterprises involved in industries with low relevance may intensify the competition of subsidiaries for limited resources, resulting in serious rent-seeking problems, distorted resource allocation, and low efficiency within the group.

Furthermore, it is difficult to use the differences between various businesses to disperse the risks of enterprises in the business practice enterprises.[29] It is also easy to increase other risks when enterprises implement diversification to resolve some risks. For example, when the macroeconomic environment changes, the more enterprises involved in non-related industries, the greater the impact and the higher the risk.

Based on this, this paper puts forward the following assumptions:

Hypothesis 2a: Related diversification of real estate enterprises can effectively reduce their financial risks.

Hypothesis 2b: Unrelated diversification of real estate enterprises can increase their financial risks.

3. Empirical Analysis

3.1 Variable Definition

3.1.1 Predicted Variables

Financial risk. Considering the immaturity of China's capital market, this paper draws lessons from the research of Wu Dingguo (2015) and chooses the revised Altman Z Index to measure the financial risks of enterprises[29]. The specific calculation formula is as follows:

$$Z = 1.2 \times \frac{\text{Working Capital}}{\text{Total Assets}} + 1.4 \times \frac{\text{Retained Earnings}}{\text{Total Assets}} + 3.3 \times \frac{\text{Earnings Before Interest and Tax}}{\text{Total Assets}} + 0.999 \times \frac{\text{Sales}}{\text{Total Assets}} \quad (1)$$

The larger the index, the smaller the financial risk, and the less likely the enterprise is to fall into financial difficulties.

3.1.2 Explanatory Variables

Combined with the existing empirical research, there are three main methods to measure the degree of diversification, that is, the number of industries, the Herfindahl-Hirschman Index (HHI), and the Income Entropy Index (EI). Although both HHI and EI are calculated by the ratio of industry income to total income, HHI ignores the correlation between industries. Therefore, referring to Su Xin (2017)[8], this paper uses the income entropy index to measure the diversification degree of the real estate industry. The specific calculation formula is as follows:

$$EI = \sum_{i=1}^n P_i \ln\left(\frac{1}{P_i}\right) \quad (2)$$

Where P_i is the percentage of the i -th industry in total revenue, and n is the number of industries entered by enterprises. The greater the value of the income entropy index, the higher the degree of diversification of enterprises. The index can divide the total diversification into related diversification and unrelated diversification according to the Industrial Classification and Code For National Economic Activities (GB/T 4754-2017). When P_i and n are divided according to the four digits of the standard industrial classification, EI stands for "total diversification index DT"; When P_i and n are divided according to the two digits of the standard industrial classification, EI stands for "unrelated diversification index DU"; Subtract the two to get the "related diversification index DR".

3.1.3 Control Variables

In order to better reveal the relationship between diversification and corporate financial risks, this paper based on the research of Yang Jun (2020) selects company size, asset-liability ratio, profitability, number of directors, Tobin Q, and duality of CEO and COB as control variables[5]. The definition and specific calculation formula of related variables are shown in the following table:

Table 1. Variable Definitions

Variable Type	Variable Name	Symbol	Definition
Predicted Variable	Financial Risk	Z	Calculate the enterprise financial risk through formula 3-1, and the larger the Z value, the lower the enterprise financial risk.
Explanatory Variable	Total Diversification	DT	All three are calculated by formula 3-3. The larger the income entropy index, the higher the diversification degree of enterprises.
	Related Diversification	DR	
	Unrelated Diversification	DU	
Control Variable	Company Size	Size	Natural logarithm of total assets of a company
	Asset-liability Ratio	Lev	Year-end total liabilities divided by year-end total assets
	Profitability	ROA	The average balance of net profit/total assets
	Number of Directors	Board	The number of the board of directors takes natural logarithm
	Growth Ability	Tobinq	(Market value of tradable shares + number of non-tradable shares × net assets per share + carrying amount of liabilities) / total assets
	Duality of CEO and CBO	Dual	It is 1 as the COB and CEO are the same people, otherwise, it is 0

3.2 Sample Selection and Model Construction

This paper selects the real estate companies listed in Shanghai and Shenzhen A shares from 2010 to 2020 as samples. In order to ensure the validity and continuity of the data, this paper deals with the initial data as follows. (1) Eliminate ST and * ST enterprises; (2) Eliminate the enterprises with missing explanatory variables and predicted variables; (3) Rejecting real estate enterprises that have not carried out diversified operations; (4) The continuous variables are reduced by 1% to reduce the influence of extreme values. The data comes from CSMAR and the wind database. This paper will use Stata15 to analyze the sample data empirically.

On this basis, this paper applies the two-way fixed effects model to verify the relationship between diversification and financial risks of Shanghai and Shenzhen A-share real estate listed companies. On the basis of defining the above indicators, the two-way fixed effects model constructed in this paper is as follows:

$$Z_{it} = \beta_0 + \beta_1 DT_{it} + \beta_2 Size_{it} + \beta_3 Lev_{it} + \beta_4 ROA_{it} + \beta_5 Board_{it} + \beta_6 Tobinq_{it} + \beta_7 Dual_{it} + \lambda_t + u_i + Res_{it} \quad (3)$$

where it represents the i-th small and medium-sized enterprise in t year, λ_t is a time-fixed effect, u_i is an individual-fixed effect, and Res_{it} is a random interference term. When we examine the relationship between related diversification, unrelated diversification, and enterprise financial risk, we use DR and DU to replace DT for regression.

3.3 Descriptive Statistics

Table 2 shows the mean, median, standard deviation, minimum, and maximum values of all variables. From the descriptive statistical results, we can see that the maximum value of the financial risk index Z-score is 2.366, and the minimum value is -1.033, and the standard deviation reaches 0.487. The financial risks of real estate listed companies vary greatly from 2010 to 2020. The maximum value of total diversification DT is 2.801, the minimum value is 0, and the standard deviation is 0.492, which shows that the diversification of different real estate companies is quite different; The maximum value of related diversification of sample companies is 2.413, the minimum value is -0.590, and the average value is 0.299; Compared with related diversification, the unrelated diversification of listed real estate companies is higher, with an average of 0.403.

Table 2. Descriptive Statistics

variable	N	mean	p50	sd	min	max
Z	1196	0.941	0.935	0.487	-1.033	2.366
DT	1196	0.702	0.683	0.492	0.000	2.801
DR	1196	0.299	0.116	0.408	-0.590	2.413
DU	1196	0.403	0.296	0.374	0.000	1.518
Size	1196	23.310	23.200	1.528	17.500	28.260
Lev	1196	0.645	0.669	0.281	0.0165	7.995
ROA	1196	0.028	0.026	0.050	-0.593	0.481
Board	1196	2.137	2.197	0.195	1.386	2.708
Tobinq	1196	1.430	1.147	0.946	0.794	7.755
Dual	1196	0.160	0.000	0.366	0.000	1.000

Table 3 reports the correlation coefficients between the main variables in this study. It can be seen from this table that the correlation coefficient between the total diversification DT, unrelated diversification DU, and financial risk Z-score is significant at 1%, indicating that both total diversification and unrelated diversification will increase the financial risk of enterprises. However, related diversification will reduce the financial risks of enterprises, but its impact is very small. Meanwhile, profitability, the number of directors, and financial risk have a significant positive correlation (significant at 1%), which shows that when the company’s profitability is stronger and the number of directors is more, the financial risk of the enterprise is smaller. However, company size, debt, and Tobin Q are negatively correlated with financial risk. In addition, there is a significant negative correlation between the duality of CEO and COB and financial risks, which means that when the CEO and the COB are the same people, the greater the financial risks of real estate enterprises. The above correlation analysis initially proves that the control variables set in this paper are reasonable.

Table 3. Correlation Analysis

	Z	DT	DR	DU	Size	Lev	Roa	Board	Tobinq	Dual
Z	1									
DT	-0.120***	1								
DR	0.0190	0.713***	1							
DU	-0.191***	0.571***	-0.170***	1						
Size	-0.159***	-0.0400	-0.078**	0.0350	1					
Lev	-0.367***	-0.081**	-0.061*	-0.042	0.620***	1				
Roa	0.726***	-0.129***	-0.015	-0.163***	0.001	-0.214***	1			
Board	0.080**	-0.069**	-0.035	-0.056*	0.160***	0.064**	0.0460	1		
Tobinq	-0.207***	-0.050	0.004	-0.075**	-0.532***	-0.419***	-0.130***	-0.067**	1	
Dual	-0.078**	-0.016	0	-0.0230	0.128***	0.143***	-0.0410	-0.039	-0.084***	1

3.4 Overall Regression Analysis

Table 4 reports the regression results between diversification and enterprise financial risk. The coefficient of total diversification is significantly negative at 1%, which indicates that the higher the total diversification level, the greater the financial risk. Hypothesis 1 is verified. This shows that the diversification strategy implemented by real estate enterprises does not disperse but significantly increases the financial risks of enterprises. The main reason is that real estate enterprises already have problems such as narrow financing channels, weak liquidity, and a long collection period. However, diversified investment requires a large number of initial funds, so a large number of real estate enterprises have to raise funds through debt financing, which further increases the financing cost, debt repayment pressure, and liquidity risk of the company[49]. Secondly, with the expansion of business scope, managers of real estate enterprises are inexperienced, which is prone to investment risks such as inaccurate market positioning and unclear development goals, failing to play the role of risk dispersion and resulting in waste of enterprise resources and decline in profitability. Thirdly, with

the deepening of diversification, the financial risk early warning mechanism of real estate enterprises is imperfect, the financial information is opaque, and the agency cost is high, which leads to the corresponding increase in financial risks.

Table 4. Regression Results of Diversification and Financial Risks of Real Estate Enterprises

	(1)	(2)	(3)
DT	-0.093*** (0.019)		
DR		-0.032 (0.022)	
DU			-0.168*** (0.030)
Size	0.006 (0.016)	0.001 (0.016)	0.010 (0.016)
Lev	-1.193*** (0.076)	-1.180*** (0.076)	-1.206*** (0.075)
ROA	4.273*** (0.157)	4.384*** (0.157)	4.279*** (0.156)
Board	-0.040 (0.058)	-0.042 (0.059)	-0.042 (0.058)
Tobinq	-0.034** (0.016)	-0.032* (0.017)	-0.032** (0.016)
Dual	-0.039* (0.021)	-0.034 (0.021)	-0.048** (0.021)
_ cons	1.607*** (0.390)	1.703*** (0.394)	1.509*** (0.389)
Time Effect	Yes	Yes	Yes
Individual Effect	Yes	Yes	Yes
R2	0.884	0.881	0.885

Column (2) shows that the regression coefficient of the related diversification entropy index is -0.032, that is, related diversification is positively correlated with financial risk, but the correlation is not significant, and hypothesis 2a is not valid. This shows that the diversification of real estate enterprises has no significant impact on financial risks. The reasons are as follows. On the one hand, due to the strong correlation between industries, real estate enterprises can effectively integrate internal redundant resources, and exert synergy and economies of scope, which is not only conducive to enhancing profitability, but also increases the capital utilization rate, cash flow anti-risk ability, and overall counter-cyclicality. But on the other hand, the real estate industry already has financial risks of high turnover and high leverage. Most of the related industries (such as long-term rental, pension, cultural tourism, hotel operation, etc.) also belong to the business cultivation mode of heavy assets and long periods, which will exert continuous pressure on the cash flow of real estate enterprises. Moreover, it is difficult to release short-term profits, which will also aggravate its capital shortage and increase financial risks. As a result, the two impacts of real estate-related diversification on financial risks offset each other, resulting in no significant impact.

Column (3) shows that unrelated diversification is negatively correlated with financial risk at 1%, which shows that an unrelated diversification strategy will increase the financial risk of real estate enterprises. Thus, hypothesis 2b is tenable. The reason is that companies with a high degree of unrelated diversification need more funds to maintain the normal business activities of various industries because of many types of cross-industry businesses. In addition, real estate enterprises need to borrow a lot of money, which further improves the asset-liability ratio and puts forward higher requirements for cash flow, thus increasing the financial risks. Lun Shujuan (2018) studied Evergrande's financial risks and found that unrelated diversification made Evergrande's debt ratio continuously increase, with increasing operational risks and financial dangers hidden in its later debt repayment[49].

In addition, the debt level, the number of directors, Tobin Q, and the coefficients of the duality of CEO and COB are all significantly negative at 1%, which shows that when the enterprise has a higher debt level under other conditions unchanged, more directors, better growth, or integrated roles of CEO and COB, the smaller the revised Z value and the greater the financial risk of the enterprise. Similarly, the larger the enterprise scale and the stronger the profitability, the smaller the financial risk.

4. Conclusions and Suggestions

4.1 Research Conclusions

Using the data of Shanghai and Shenzhen A-share real estate listed companies from 2011 to 2020, this paper selects the modified Altman Z index to measure the financial risk of enterprises and constructs a two-way fixed effect model to explore the impact of diversification of real estate listed companies on financial risk. Secondly, considering the heterogeneity of different diversity types, this paper discusses the different effects of implementing related diversity and unrelated diversity on the relationship between them. The empirical analysis results show that the diversification of real estate enterprises has a significant role in promoting financial risks, that is, the higher the total diversification level of real estate enterprises, the greater their financial risks. The total diversification is further decomposed into related diversification and unrelated diversification. It is found that related diversification has no significant impact on the financial risks of real estate enterprises, while unrelated diversification will significantly raise the financial risks of enterprises.

4.2 Countermeasures and Suggestions

Reasonable planning of investment is needed to prevent blind diversification. Before diversification, real estate enterprises need to conduct strict and comprehensive market research in the investment field, make clear the market operation risks and have a good financial budget to rationally judge whether they can play the synergy effect and scale effect to prevent blind diversification. Enterprises should also establish corresponding business exit mechanisms. If the market changes, real estate enterprises can stop losses in time, adjust diversified development strategies, and reduce financial risks. Under the current environment, real estate enterprises are faced with tightening financing, strengthening supervision, disappearing demographic dividends, and COVID-19 pandemic, etc. For the sake of safety, more consideration should be given to the related diversification, so as to form a new development model of “development + operation + service”, reduce the financial pressure brought by real estate enterprises’ heavy asset business, find new profit points and enhance the overall counter-cyclicality. At the same time, pay attention to guarding against the financial risks brought by unrelated diversification and heavy asset-related diversification, which has high requirements on management, operation, and capital with difficulty in operation.

Financing channels should be expanded and capital control should be strengthened. Diversification of real estate needs a lot of funds. However, the previous financing structure based on bank loans will deteriorate the financial risks of real estate enterprises. Therefore, enterprises should establish a multi-level and multi-channel financing system to match the debt maturity structure and obtain more equity and long-term funds. Besides, the current development environment of the industry has changed. It is with extremely high financial risk to meet the cash flow demand by taking the makeshift methods. Real estate enterprises should play a diversified synergy to improve profitability and capital turnover speed. Meanwhile, according to the actual situation of enterprises, they should formulate scientific and feasible financial budgets and reasonably predict the cash flow in the enterprise development to prevent liquidity crises and debt crises. In addition, considering that diversified operations are involved in a wide range of fields, real estate enterprises should also establish a comprehensive financial risk early warning system to control the potential financial risks and effectively isolate the risks among subsidiaries.

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