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Ain Shams University
Faculty of Business
Business Administration

A Proposed Model to Examine the Effect of Unsystematic risk on Company's Value: An Empirical Study

نموذج مقترح لاختبار تأثير المخاطر غير المنتظمة على قيمة الشركة: دراسة تطبيقية

A Dissertation

Submitted in Fulfillment of the Requirements for the degree

Doctor of Philosophy in **Business Administration**

Prepared by

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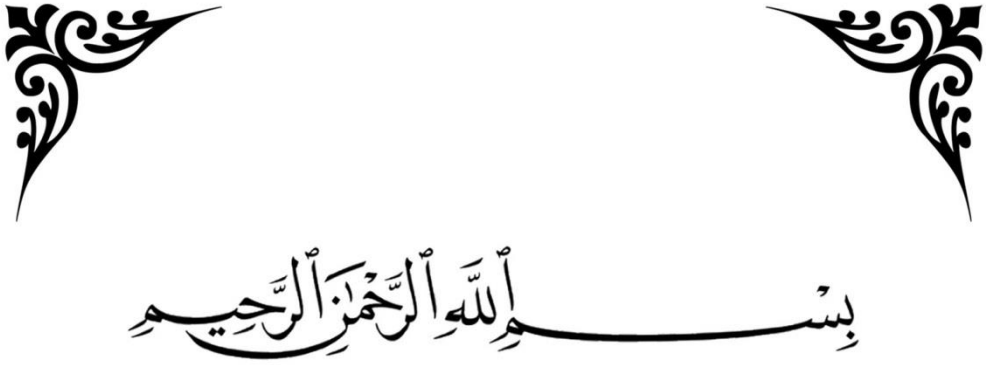
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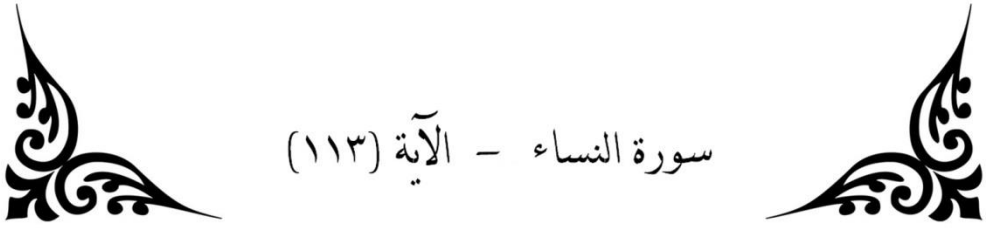
صدق الله العظيم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SUMMARY

The Capital Asset Pricing Model (CAPM), developed by Sharpe (1964), and Lintner, (1965), signed the beginning of asset pricing theory and points out that the systematic risk which is also called market risk, beta or non-specific risk, and refers to the risk that affect the entire market or segment-is the only risk that should be rewarded through higher return rates.

On the other hand, unsystematic risk which also refers to (company specific risk, idiosyncratic volatility, and investment-specific risk), and is defined as a function of characteristics of the individual company, the industry and the type of investment interest, must be ignored since investors are expected to hold proportions of the well diversified market portfolio.

However, CAPM failed in its practical application in real world due to its oversimplified assumptions. In fact, investors do not hold fully diversified portfolios, especially in the emerging markets. This is mainly because of the limited knowledge of investors, market inefficiency, restricted diversification opportunities, and liquidity problems. This has actually encouraged further research to look beyond the conventional model of the classical Capital asset pricing model and led to the development of various models to capture other explanatory factors about expected stock return than the single market factor that the CAPM is basically based on.

Due to the fact that the results of the studies executed by authors such as Campbell, Lettau, Malkiel and Xu (2001), Malkiel and Xu, (2003) and Wei and Zhang, (2004) assumed that idiosyncratic volatility increases over time, estimating the role of idiosyncratic volatility in the market has become a necessity. The important implication is that for investors to maintain the same level of diversification they need, they have to increase the number of stocks held in their portfolios and this is mainly due to the increased

idiosyncratic volatility. Nevertheless, it is still unclear what factors drive idiosyncratic volatility over time. The research goal of the dissertation is to find the factors of unsystematic risk for valuation of the companies in the Egyptian market, which is not a theme traditionally focused inside corporate finance literature especially in Egypt.

Analyst are usually perplexed with regards to the specific factors they should consider in evaluating unsystematic risk and which factors they should exclude. In practice, it depends merely on analyst's opinion and judgment where they basically do it randomly or through using rating system to indicate the company factor that will be included in the assessment.

This research was devoted to analyze the factors that affect the Egyptian company's value in the Egyptian market. The analysis was mainly based on financial factors only. After reviewing lots of existing literature, and identifying the factors that most of previous authors agreed on of having an effect on firm's value. I have decided to choose some of them which are: Revenue Growth (RG), Operational Performance (OP), Liquidity (LIQ), Financial Leverage (FL), Profitability (PROF), Size (SIZE), Board size (BS), Board composition (BC) and Duality (DUAL).

After testing the hypothesis of whether there is an effect of unsystematic risk on firms value, and testing the significance effect of ratios that represent different side of companies financial performance, it was figured out that the Operational Performance (Asset turnover ratio), Liquidity (Current ratio) and Duality (Dummy variable) are the most powerful variables in explaining the value of the firm. While the other factors that include Size, Revenue Growth, Financial Leverage, Profitability, Board size and Board composition do not have any significance effect on the Economic Value Added of the firm. Thus, it can be argued that managers should not consider these factors while valuating any business.

Name : Hanan Amin Barakat Mohamed Zaki Barakat

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Abstract:

Finance theory implies that there is a direct relationship between risk and return because when investors bear high risk they require a higher rate of return to compensate them. Previous literature suggests that CAPM is based on unrealistic assumptions. In fact not every investor holds fully diversified portfolios, instead Individual investors are likely to hold undiversified portfolios due to a number of reasons, and some of them are transaction costs, information costs and choice of investment style. As such, many authors have recently proclaimed that investors must require higher rates of return for holding under-diversified portfolios in order to compensate the existing of idiosyncratic volatility in their portfolios. In other words, many authors have recently demanded the necessity to price unsystematic risk. Therefore, this has triggered the researcher to investigate the effect of unsystematic risk on firm's value. The data consist of 28 non-financial publicly listed companies in Egyptian Stock Exchange (EGX100) during the period of 2010-2016. By using Panel Data regressions model, the Effect of Unsystematic risk is determined on the company's value by identifying the effect of company specific factors on EVA. The EVA serving as a proxy for firm's value has been used as the dependent value. On the other hand, the independent variables used to present the Company specific risk factors in the study include: Revenue Growth, Financial leverage, Operational Performance, Profitability, Liquidity, Size, and Corporate Governance (board size, board composition and duality). The results reveal that there is a relationship between each of the Operational

Performance (OP), Liquidity (LIQ), and Duality (DUAL) with the EVA, and all the variables are holding a positive sign, which indicates that they all have a positive effect in determining the value of EVA.

Key words: Unsystematic risk, Value of the firm, Company specific risk, idiosyncratic volatility, Company specific risk premium, Valuation, Corporate Governance.

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