Diversification Strategy in Corporate Enterprises: An Evaluation

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Abstract

This deals with the relationship between diversification strategy and corporate financial performance. An attempt has been made to find out impact of diversification strategy on corporate financial performance, Strategy wise one way Anova has been applied to analyze the performance of companies in major diversification strategies. The pairwise comparison of major diversification strategies and diversification sub strategies has also been done. The analysis has been done on the basis of five performance indicators, viz., ROE, ROA, GIS, GID, GNA for a period of about 10 years for the 94 sample companies. The composite index of performance has also been constructed to know the impact of strategy on overall profitability and growth. For statistical analysis various techniques used are One Way Anova, t-Test, Regression Analysis and Factor Analysis. All the analysis have been done on computer. Tables and figures have been used to present the analysis in analytical and simple mode for quick grasp.

Keywords: Diversification, Strategy, Comparison, Impact.

Introduction

Meaning of Diversification

The term diversification has its root in the world 'diverse'. The literary meaning of which is "Difference", "Unlike", "Distinct", "Separate", and when applied to business enterprise it signifies difference among aspects of firm's activities. In a wider and functional sense every business enterprise is diversified because all of the enterprises display some sub-activity diversity. For example, virtually all business firms contain different functional sub units, viz., manufacturing, marketing, finance etc. The researchers have not used it in this very sense but in a very restrictive sense. From researchers point of view, a firm is considered diversified if it is concurrently active in more than one business.

Forms of Diversification

Basically there are three forms of diversification:

a) Vertical Diversification
b) Horizontal Diversification
c) Global Diversification

(a) VERTICAL DIVERSIFICATION

When a firm performs more than one step of the process involved in converting raw materials into a product delivered and ready for consumption, it is considered to be a vertically diversified firm. A vertically diversified firm integrates its businesses so that one efficiently "feeds" other.Vertical integration is the way in which a firm may increase its range of operations. It involves an increase in the number of intermediate products that a firm produces for its own use. Simply stating, integration is an act of combining two or more separate stages of production under common ownership. A firm integrates "backwards" and thus produces products which it has normally purchased from others before. Similarly, a firm integrates "forwards" and extend its range of operations towards final consumers. Vertical integration often eliminates or at least reduces the costs of buying and selling. Marketing and sales efforts are reduced. Their operations are smooth and better coordinated.

(b) Horizontal Diversification

Horizontal diversification involves moving into more than one industry. Horizontally diversified firms serve two distinct markets with two very different products. In such cases the main issue is to determine how closely related the new business should be to the old business. Firms may diversify into related business or unrelated businesses. If a producer of iron and steel start producing cement or enters into textile industry it will be a case of horizontal diversification. In vertical integration the producer of iron and steel may integrate backwards and acquire its own source of iron ore and also integrate forwards by acquiring ship building yards and engineering firms.

(c) **Global Diversification**

International diversification is another form of diversification. Its importance rose sharply since late 80s. The firms now serve not only domestic market places but also serve complex world markets. Expansion into international operations offer various strategies advantages, one of which is lower operational costs. Cost of production also vary from country to country. Economies of scale are also available. There are some problems also like changes in currency exchange rates, different ways of competition, cultures and managerial practices.

Means of Diversification

The vertical diversification, horizontal diversification and international diversification can be achieved in different ways. The most commonly used means of diversification are :

(a) mergers and acquisitions

(b) strategic alliance

(c) internal development.

Mergers and Acquisitions

Mergers and acquisitions are frequently used means of diversification. Where a big firm acquires the

controlling interest of another firm, it is called acquisition. When two firms combine themselves for forming a third firm to operate and control their combined assets it is called merger. Merger refers to a fusion of two or more companies into one company.Mergers can take place in two different ways:

(i) Two companies belonging to one corporate group/parent combine to form a new company.

(ii) Two companies totally stranger to each other come together and merge into a new company.

In both of the above cases one company merges into another. The company which is liquidated and absorbed by other company is called the merging company and the company that absorbs is called acquiring company. Acquisition is a transaction through which one firm buys up a part of whole of the assets of another firm by paying compensation. By acquisition a firm secures an instant increase in its capacity/competence in the desired area of operation. It helps in achieving quick expansion. Through this route firms can intensify the activities in an existing business or readily enter into new business without the limits of the gestation period.

The track record of success with mergers and acquisitions is not very encouraging. A study conducted by MC Kinsey and company found that only 23 percent of merges examined over a 10 year period generated returns in excess of the costs incurred by the deal (Fisher, 1994). Yet many of mergers and acquisitions have been tremendously successful. Success or failures in

Diversification Strategy and Financial Performance

This section deals with the analysis of the empirical results of performance differences for the various diversification strategies. The findings are based on 10 years' observations of five performance indicators out of which two, viz., ROE, ROA are profitability indicators and three, viz., GIS, GID, GNA are growth indicators.The strategy performance relationship has been analyzed in three stages. At the first stage, one way Anova has been used to study the performance differences among different strategies and to test the level of significance. At the second stage, the industry wise performance has been analyzed to know whether strategy wise difference in performance, if any, has been affected by the nature of industry or not ? At the third stage, the information on five variables has been condensed with the help of Factor Analysis and a composite index of performance is constructed. The analysis conducted at the first stage is repeated on the condensed information. Analysis of empirical data in Chapter V shows that 69.40% variation in profitability and 57.95% variation in growth of the sample companies is because of the control variables, viz., size, age, leverage, capital intensity, market share and risk. The remaining 30.60% variation in profitability and 42.05% variation in growth is because of other factors i.e. Diversification strategy. Here, an attempt has been made to analyze the impact of diversification strategy on financial performance.

Strategy wise One Way Anova

Its shows the results of Anova for the five performance indicators separately. The F ratio depicted in the table provide a test of strength of significance of inter strategy differentials within the sample companies. Analysis of profitability indicators shows that the RB strategy scores the highest among

all the four major diversification strategies. Both ROE and ROA are the highest in this case. In case of UB strategy the mean ROE and ROA are 14.50 and 6.95. As far as profitability is concerned UB strategy stands next to RB strategy. In case of SB companies both ROE and ROA are the lowest. The analysis of growth indicators shows that DB companies are the poorest performers. On all the three indicators of growth, viz., GIS, GID and GNA, the mean values of respective growth indicators are the lowest. These are even lower than the average mean values of all the companies. The GID of RB companies is the highest. In this regard the RB companies are followed by UB companies and SB companies. The SB companies have the highest GNA. The UB and RB companies stand second and third as for as GNA is concerned. In case of RB companies, the mean values of all the performance indicators except GNA are higher than the overall respective mean values. For UB companies the mean values of all the performance indicators except ROA are higher than the overall respective mean values. However, the RB companies scored the highest scores on three performance indicators, viz., ROE, ROA and GID. The mean GIS of these companies is the second highest. The DB companies stand second last on profitability indicators and stand last on growth indicators. The mean values of all indicators except ROE are below the corresponding overall mean values in case of DB companies. The SB companies have the poorest ROE and ROA but the highest GNA. The UB companies have the highest level on GIS indicator and stand next to the highest levels on other two growth indicators, viz., GID and GNA. On profitability indicators mean scores of ROE and ROA of these companies are the second highest The F ratios indicate that the null hypothesis of inter strategy performance differences is accepted on only GIS at 1% level of significance and rejected on all other performance indicators. This implies that companies do not differ significantly with respect to growth in sales, whereas, the companies differ significantly (at 1% level of significance) as far as diversification strategy and other performance indicators (viz., ROE, ROA, GID and GNA) are concerned. The DB companies are the poorest performers and RB companies are the highest performers.

Inter Industry Performance Differences, Diversification Strategy and Financial Performance

The relationship among inter industry performance differences, diversification strategy and financial performance has been analyzed for 89 companies for five performance indicators over a period of 10 years. This is done to see whether inter industry performance differences have any influence on the impact of diversification strategy on financial performance. The sample companies have been put into 15 industry categories. Table 6.4 to Table 6.10 contain statistical results relating to the relationship between inter industry performance differences, diversification strategy and financial performance. It is clear from Table 6.5 that all the industry categories have significant performance differences amongst themselves for all the performance indicators except GIS.

The industry categories differ significantly with respect to ROE. The pairwise comparison between industries (Table 6.6) shows that Textile/Yarn and Cement companies have significantly lower mean ROE than Engineering, Pharmaceutical, Metals and Chemicals and Fertilizers companies. The Cement companies have also significantly lower mean ROE than Rubber and Footwear companies. The Textile/Yarn companies have significantly lower mean ROE than the companies in Electronics industry category. The Electricity manufacturing companies have significantly lower mean ROE than

the companies in Engineering, Pharmaceuticals and Metal based industries. The Tea companies have significantly lower mean ROE from all the sample companies except Textile/Yarn, Cement and Electricity producing companies.

The three major findings in relation to the impact of diversification strategy on corporate financial performance are as follows:

1. Diversification strategy explains only a small proportion of its relationship with profitability and growth. 69.40% of variation in profitability and 57.95% of variation in growth is because of other factors considered in the study.
2. The profitability and growth indicators individually have some impact on the relationship of strategy and performance. RB companies have significantly higher ROA than SB, DB and UB companies. Their ROE is also higher though statistically non significant. RC companies have significantly higher ROE and ROA than RL companies. On this basis it may by concluded that RC companies are better performers for profitability than others.
3. The strategy does not have any significant impact on overall profitability and overall growth.

From these observations, it can be said that the profitability and growth indicators individually explain a small proportion of influence on financial performance. On the whole, the impact of diversification strategy on financial performance is not significant.

Objectives of the Study

The major objective of the present study is to examine empirically the interface between diversification strategy and financial performance in listed large private sector manufacturing companies in India. However, following are more specific objectives :

1. To study the type of diversification in the Indian corporate sector. To study the extent of diversification in the Indian corporate sector.
2. To find out the relationship between the diversification strategy and corporate financial performance.
3. To make a suggestive framework on the basis of the study conducted.

Hypothesis

A hypothesis is an assumption about relations between variables. It is a tentative explanation of the research problem or a guess about the research outcome. According to Theodorson "a hypothesis is a tentative statement asserting a relationship between certain facts." According to Goode and Hatt

"Hypothesis is a preposition which can be put to test to determine its validity."

The following hypothesis has been developed and tested in this study:

1. Diversification strategy has significant impact on financial performance.
2. Higher degree of diversification of the firm is expected to have better effect on the performance of the firms.

Future Scope of Study

1. Make inter-sectoral and inter-temporal comparison of results. This may reveal new relationships between strategy and performance or may confirm the present findings,
2. Analyze the relationship between strategy, structure and performance,
3. Identify and involve more explanatory variables such as advertising intensity, research and development expenditure, skill, capacity utilization etc, and
4. Study the relationship between diversification, restructuring and financial performance. study the relationship between diversification strategy and performance in
5. Case of public sector companies.
6. Analyze the relationship between product diversification and market value of the firm.
7. Analyze the combined effect of international diversification and product diversification on the performance.
8. Analyze and establish linkage between CEO's perceptions and strategy adoption by the companies.

Limitation of Study

1. The sample size is a small one. He examined only 28 companies.
2. He has not done the detailed categorization of the companies. He classified the companies into only two main categories, viz. related diversifiers and unrelated diversifiers. Further he classified unrelated diversifiers into three categories :
   (a) Companies with one dominant and one unrelated business.
   (b) Companies with two unrelated businesses.
   (c) Companies with many unrelated business.
3. The diversification is not the only determinant of performance.

Conclusion

The impact of diversification strategy on corporate financial performance has been analyzed in three stages. For this One Way Anova, t - Test and Factor Analysis have been used. Tables, graphs and figures have been used for elucidation and concise presentation of results.The first two phases of present study show that RB companies, in general and RC companies, in particular are better performers with reference to profitability indicators, individually. The extreme strategies have significantly higher GNA than the companies following DB strategy. The constrained and linked strategies do not differ significantly for growth indicators. The diversification strategy explains only a small proportion of its relationship with profitability. The relationship between diversification

strategy and performance is curvilinear. The results of first two phases of analysis reveals that the diversification helps to some extent in improving profitability but upto a point only. Also, excessive diversification may hit the profits. In the third phase of analysis, the impact of diversification strategy on the basis of composite index of performance has been studied. The finding is that the diversification strategy do not have any significant impact on overall profitability and overall growth.

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