CHAPTER - I

INTRODUCTION DESIGN AND EXECUTION OF THE STUDY

1.1 INTRODUCTION

1.2 NEED FOR THE STUDY ON DIVERSIFICATION STRATEGIES OF CORPORATE GROUPS

1.3 STATEMENT OF THE PROBLEM

1.4 REVIEW OF LITERATURE

1.5 OBJECTIVES OF THE STUDY

1.6 HYPOTHESES

1.7 PERIOD COVERED BY THE STUDY

1.8 SCOPE OF THE STUDY

1.9 LIMITATIONS OF THE STUDY

1.10 CHAPTER SCHEME

******
CHAPTER - I

INTRODUCTION DESIGN AND EXECUTION OF THE STUDY

1.1 INTRODUCTION

Of the four decades of planned economic development, the '80s were the age of optimism for Indian business, since the Indian industry broke new ground, growing at an average rate of about 7% a year, far above the crawling 3% rates of the previous decades on account of liberalised economic policies. In particular, the private sector played an important role over the public sector, which was evidenced by its contribution to NDP around 76% in 1982-83. Further, within the private sector, the contribution of large and medium scale industries alone to the NDP were 78% in 1982-83. Besides, the stock market also boomed during 1980s. In fact, the total market capitalisation leaped from ₹.6,500 crore in 1980 to ₹.55,000 crore in 1989.

However, the private sector has become highly competitive, and a business firm even to retain its
relative position must go through continuous growth and change. There are four basic alternatives open to a business, namely, it can grow through increased market penetration, through market development, through product development, or through diversification. Of these, diversification has been increasingly used by large corporations as a strategy for adapting to the resilient economic environment, and has been claimed that it was the hallmark of their success.

At the same time, when the individual corporate giants and corporate groups take a recourse to the strategy of diversification, it requires them to raise huge financial resources, which are tapped in the form of both the loan finance, and from the booming stock market. Therefore, it is imperative to know the financial prowess of the leading corporate groups backed by the diversification strategy to find out their contribution towards further promotion of capital market and as well to the future growth of the Indian industry.
1.2 NEED FOR THE STUDY ON DIVERSIFICATION STRATEGIES OF CORPORATE GROUPS

From the beginning of 1980s, "Economic Rehabilitation Programme" has become the major challenge confronting India, in order to come out of the economic cripple. In the context of economic reformation, though several strategic approaches are involved, still 'privatisation' has gained ground. This is because, the Indian private sector has gained from strength to strength to takeup even the 'commanding heights', especially in eighties, while the public sector slid into the red, posing itself a stodgy performer.

The most interesting scene on the private corporate sector during 1980s was the relentless march of several entrepreneurs to build business empires adding to the existing ones, with the strategy of diversification, and jump into the first ten positions, inspite of the fierce competition. In fact, all successful corporate groups claim that diversification is the source of all their success, and it will continue to govern their progress in future too. But the degree of success varies
from group to group, for the reason that different groups adopt different modes of diversification strategies. Consequently, those at the top do not consistently remain to be so from year to year. Thus, diversification strategy, though one of the four alternatives to growth, however, plays a significant role.

1.3 STATEMENT OF THE PROBLEM

Every business unit is quite legitimately interested in maximising its profits and the value of its assets. If this cannot be achieved within its existing business, then it tends to diversify into other industries, whether they are technically allied fields or not, by setting up new projects either within the existing company itself, or under new companies with separate legal entities, but falling within the same group. The latter approach has gained much momentum, especially during 1980s, since several business empires were cropping up, despite the split in the old big business houses, in order to improve their position twice as fast as that. At the same time, those at the top do not stay there except as they keep ahead in the race of innovation and competition.
Therefore, when corporate groups procure huge funds to adopt diversification strategies over other three growth alternatives, namely, through increased market penetration, through market development, or through product development, the following questions arise:

i) In what manner the funds procured have been employed by the corporate groups to meet diversification?

ii) To what extent the corporate groups have grown to make an upbeat trend on investing funds in various industrial categories of their proliferation?

iii) What level of financial efficiency the corporate groups have achieved on adopting a particular form of diversification strategy to satisfy and gain the confidence of their investors?

iv) What are the specific financial factors that make or break a flagship company of the corporate groups, and what is the impact of the flagship on others within each group?
v) What is the impact of a particular form of diversification strategy adopted by the corporate groups on the financial performance of their portfolio?

1.4 REVIEW OF LITERATURE

Several studies have been made both in India and abroad on 'corporate Diversification'. Hence, a review is made of such past studies to know the objectives and findings of the early researchers.

i) Chandler in his organisational research (1962) asserts that for effective implementation of diversification strategy, organisational structure of the diversifying company should be skillfully adapted. When companies diversify, failure to adopt suitable organisational structures would cause serious administrative problems that would result in inferior performance.
ii) R.K. Hazari in his work "The structure of the corporate private sector" (1964) has analysed the diversification pattern in several large industrial houses in India. His major findings were:

a) Indian corporate scene reveals three forms of diversification, namely, horizontal, vertical, and unrelated.

b) Historical accident or deliberate choice and convenience were the only reasons for the industrial groups in selecting between diversification of industrial companies (i.e. setting up of every new plant within an existing company itself) and diversification by setting up of new projects under new companies, but within the same group.

c) Diversification of industrial companies strengthen the earning capacity of the company and simultaneously reduce the tax liability as a whole on the one hand and raises the value of the company's shares on the other hand.
d) In case of diversification by setting up of new projects under new companies, but within the same group, the capital value of the shareholdings appreciates less than it would be in case of diversification of individual companies, and also do not lead to a wider dispersion of economic power.

iii) Reid (1968), and Weston and Mansinghka (1971), while analysing the advantages and disadvantages of related and unrelated diversification, have concluded that unrelated diversification does not lead to higher corporate returns.

iv) Norman A. Berg in his research article, "what's Different About conglomerate Management?" (1969) has distinguished between 'conglomerates' and 'Diversified Majors' and concludes the following on conglomerates:

a) The conglomerates invest their resources beyond the confines of their original businesses in seeking greater growth, profits and stability.

b) A conglomerate may well be better at acquiring and running truly separate businesses than a diversified major.
v) J.Fred Weston and Surenda K. Manisingha in their empirical study, "Tests of the Efficiency Performance of Conglomerate Firms" (1971)\(^1\) place the following empirical findings:

a) The conglomerate firms outperformed other firms on all of the growth measures.

b) The earning performance measured by the ratio of net income to net worth was somewhat higher for conglomerate firms on account of employing larger and increasing percentage of leverage during the decade of the 1960s.

vi) J.Fred Weston et all in their study "Conglomerate performance using the capital Asset pricing Model" (1972)\(^1\) have concluded that, on the average the conglomerate firms were successful in improving Return/Systematic Risk Ratios, whereby the investors on including conglomerate firms in their investment portfolios, could reduce the remaining degree of unsystematic risk.

evidence of the relationship between diversification as an element of industry structure and the industry price-cost margins, and hence, diversification raises barriers to entry into an industry.

viii) Amir Barnea and Dennis E.Logue in their paper "Stock Market Based Measures of Corporate Diversification" (1973) have made an attempt to identify an easily computed measure of diversification embodying both product and market diversification, especially when the objective behind adoption of diversification strategies by business firms is to reduce the probability of risk (i.e., bankruptcy or ruin). In their attempt they have concluded the following:

a) The stock market based measures of corporate diversification were conceptually superior to physical measures of diversification, especially, to examine the extent to which a firm has engaged in risk reducing activity.

b) Of the two stock market based measures, namely, $R^2$ (Co-efficient of determination) and $\sigma(\varepsilon)$ (Standard error of the estimate), the $R^2$ measure of diversification was better than the other.
ix) Rumelt in his study "Financial Performance and Different categories of Diversification" (1974) found that the related diversified companies which expanded, based on some central strengths and competence, were the overall best performers, compared to the unrelated diversifiers.

x) Galbraith and Nethanson in their organisational research (1978) have observed that -

a) The strategies characterised by diversity and uncertainty, such as, UUD (Unrestricted unrelated diversification) would require greater decentralisation and self containment of divisions. When autonomy is not given poor performance would result.

b) In case of vertical integration leading to inter-divisional and inter dependence, more corporate integrity efforts are required. When too little effort is given, poor performance would result.

xi) Shekhar Chaudhuri et all in their study "Patterns of Diversification in Larger Indian Enterprises" (1982) have concluded the following:
a) In both the private and public sectors, larger enterprises have rapidly diversified at roughly equal rates.

b) While the private sector enterprises have diversified into unrelated businesses, the public sector enterprises have diversified into related businesses.

xii) Peters and Waterman in their empirical study (1982) have observed the following:

a) The excellent American companies are found to be pursuing a policy of related diversification as against the unrelated form of diversification.

b) The most successful diversifiers are those who diversified around a single skill, and the second best performers are those who branch out to some related fields.

xiii) C.W.L. Hill in his study "Conglomerate Performance over the Economic Cycle" (1983), has examined the hypothesis that the performance of conglomerate firms may be more volatile than that of non-conglomerate firms over the economic cycle. His analysis through financial
variables of 60 firms comprising 20 conglomerates, 20 concentric diversifiers and 20 single industry and closely Related Firms over a period from 1970 to 1976 (the period during which the British economy went through a well defined economic cycle) has shown that the hypothesis was correct, in so far as the performance of the conglomerates was found to have improved more significantly during the upswing, and on contrary deteriorated significantly more rapidly during the downswing than that of the two non-conglomerate categories. Besides, it was the concentric diversifiers which registered the more consistent performance.

xiv) Allen Michel and Israel Shaked in their article "Does Business Diversification Affect performance?" (1984) have concluded that the unrelated diversification generates superior risk-return profiles than related diversification.

xv) George Paul in his study "Corporate Diversification and a set of performance propositions" (1985) asserts the following:
a) In terms of growth, profitability, capital market performance and risk reduction, the diversified companies were most likely to outperform the non-diversified companies.

b) Among the diversified companies, related diversifiers were most likely to outperform the unrelated diversifiers.

c) In terms of risk reduction, the unrelated diversifiers would outperform the related diversifiers.

d) The restricted unrelated diversifiers were likely to outperform the unrestricted unrelated diversifiers in terms of growth, profitability, capital market performance and risk reduction.

e) In general, the related diversifiers were likely to be the high performers and the unrestricted unrelated diversifiers were likely to be the low performers.

xvi) George Paul in his article "Financial Performance of Diversified companies in India: A comparative study of Diversified and Non-Diversified Companies" (1985) has analysed the financial performance of 32 relatively matched pairs of diversifying and nondiversifying companies in five Indian industries, and found that -
a) Diversified companies had shown higher growth rates only marginally on most of the measures than the non-diversified companies.

b) Diversified companies had also experienced significantly higher gross profitability than the non-diversified, though not at the net profitability level.

c) Diversified companies experience lower risk at the gross profitability level, but was amplified at the net profitability level.

d) Diversified companies had also experienced significantly higher performance in terms of the market based measures of performance.

xvii) George Paul in his article "Corporate Diversification - Its Increasing Importance in India" (1985)\textsuperscript{22} has discovered the following:

a) The widely unrelated diversifiers or unrestricted unrelated diversifiers (UUDS) were the lowest performers in all parameters of performance relevant for the company as a whole and share holders.
b) Enormous difficulties in balancing the need for decentralisation of decision making with co-ordination and control on the one hand and difficulties in formulating optimal wage policies were the major organisational problems for the poor performance of UUDS.

c) What was required of the relatively poor performing conglomerates abroad and the UUDs in India was not merely making a structural reorganisation, but company reorganisation.

xviii) George Paul in his research paper "Corporate Diversification in India: A study of strategic categories and performance" (1985) has analysed the patterns of diversification strategies followed by 36 large Indian companies including a brief examination of the financial performance of different strategic categories. His main findings were:

a) 10 out of the 36 large diversified companies have followed related diversification strategy, while the remaining 26 companies have opted for unrelated mode of diversification as a strategy for growth.
b) Out of the 26 unrelated diversifiers, 11 were dominant unrelated diversifiers (DUD), 8 were restricted unrelated diversifiers (RUD) and the remaining 7 followed unrestricted mode of unrelated diversification (UUD).

c) Related diversification strategy was found more among synthetic textile and cement based companies.

d) From the financial performance point of view, the highest performers were the DUDs. The next high performers, while the RUDs, fell in between the RDs and the UUDs.

xxix) George Paul in his article "Does Diversification Always Improve Financial Performance?" (1986) has examined whether or not companies classified on their diversification strategies differ in their long-term financial performance and concluded the following:

a) Companies, especially MRTP Companies following different types of diversification strategies distinctly differed in long term performance.
b) Companies with many unrelated businesses showed the poorest performance on all the four profiles of performance, namely, growth, profitability, risk, and market value.

xx) S. Gopalakrishna Pillai in his study, "Growth and Profitability of Diversified Companies" (1986) has concluded that the growth rates of diversified group of companies were higher, and further that the profitability parameters of non-diversified group was substantially below those of the diversified group. Therefore, diversification, strategy certainly helps a company to attain its goals of profitability and as such it is a recommendable policy for a growth strategy.

xxi) George E. Hall in his article "Reflections on Running a Diversified company" (1987) asserts that conglomerates have proved to be difficult to manage, mainly due to an additional level of complexity for top management to deal with in trying to understand the variety of industries in which the business operate; and, secondly, the impossibility of imposing uniform business policies across all components of the group.
Mohinder N. Kaura in his work "Diversification: profile of Indian Industries" a result of ASCI seed research (1987) has ascertained the following:

a) Unrelated diversification has been practiced by the Indian industries in a bigger way than the related diversification.

b) The diversification phenomenon, especially, related diversification, has been relatively more pronounced among the Indian subsidiaries of multinational corporations, than the industry as a whole.

c) On the industry-wise, the shipping industry remained altogether undiversified, while the Electrical, paper, and cement showed a high degree of absence of diversification. Besides, when the maximum amount of related diversification occurred in the pharmaceutical industry, followed by chemicals, and tyres and tubes, the least amount of related diversification occurred in the case of cement. On the other hand, unrelated diversification was commonly practiced by units engaged in automobile and cement, and least resorted to by units belonging to pharmaceutical and chemicals industry.
xxiii) Michael R. Porter in his research work "Competitive Advantage to Corporate Strategy" (1987) has studied the diversification records of 33 large companies in U.S.A., from 1950 to 1986, and concludes that the companies undertaking diversification often fail in one or two of the three key tests, namely, the attractiveness test, the cost-of-entry test, and the better-off test, and consequently the strategic results were disastrous.

xxiv) Charles W.L.Hill in his paper "Internal Capital Market Controls and Financial Performance in Multidivisional Firms" (1988) has investigated the impact of internal control systems on performance within multidivisional firms pursuing either of the main strategies of diversification, namely, related diversification and unrelated diversification. His major findings were:

a) The M-form (multidivisionals characterised by a separation of strategic and operating functions) seems to be best suited to unrelated diversified firms, since, there are no inter-relationships between divisions.
b) The CM-form (centralised multidivisionals characterised by head office involvement in operating decisions) seems to be best suited to firms attempting to exploit inter-relationships through related diversification.

xxv) Winson B. Lee and Elizabeth S. Cooperman in their study "Conglomerates in the 1980s: A performance Appraisal" (1989) have examined the financial performance for a six year period including both an economic downswing (1980-'82) and an upswing (1983-'85) of conglomerates comprising 43 diversified firms operating in at least three distinct industries. The major findings of their study were:

a) Conglomerates operating in three industries had superior performance in terms of ROE and ROA and performance was found to deteriorate as more industries were added.

b) Conglomerates were found to have inferior performance in terms of ROE and ROA during the recessionary period and superior performance during the expansion.
c) Conglomerates operating in five industries tended to have higher GPM, OPM & NPM than firms with fewer industries, which however, was off-set by the lowest FAT, ATO and CAT for each year.

xxvi) S. Easwaran in his article, "Why Companies Diversify?" (1990)\textsuperscript{31} has examined all the related aspects of why and when so many companies diversify so furiously? Also comes under his examination, Into what kind of a venture the companies prefer to diversify? What is the success rate of such ventures? and has brought to fore the following:

a) The needs that motivate and influence the companies' growth decision by means of diversification are manifold, namely, Product-Related needs, Market-Related needs, Technology-Related needs, and competition-Related needs.

b) When the product-line improvements/extensions do not deliver corporate objectives, then diversification emerges as the optimal solution for growth.
c) Market conditions often determine the suitable area to diversify into for the intending companies.

d) The factors of risk, return, time and technology of the markets under consideration would determine the decisions concerned with the mode of diversification-merger/acquisition, or internal development.

Though a number of studies have been made on 'Corporate Diversification', and in particular on 'Conglomerates' in abroad; similarly several studies have been made in India, of which five such studies alone have been brought to fore by George Paul during 1985 and 1986, has concluded that -

Corporate Diversification in India is not a well researched subject.

Hence, in this present study researcher has taken a diversion from that of the earlier studies, since unlike the earlier studies, where the sample units comprised of only individual large concerns, whose
performance was analysed based on either the Accounting Measures or the Market Measures, the present study has been made to financially analyse the diversification strategies of large business houses in the Indian private sector, based on both the market measures and accounting measures of performance. Besides, the present study is a pioneering one, since, so far no study has been made to probe into the impact of different form of diversification strategies of corporate groups on their return on security, and especially, the impact of flagship on the rest of the companies in each corporate group.

1.5 OBJECTIVES OF THE STUDY

The objectives of the study are as follows:

i) To study the form of diversification strategy pursued by the corporate groups and to measure their growth rate under various forms of diversification strategies.

ii) To analyse the financial efficiency of the corporate groups under various forms of diversification strategies, and finally determine the financial factors making or breaking a particular company as the flagship of the corporate groups.
iii) To measure the impact of the flagship on the stock market of the other companies in each of the selected corporate groups.

iv) To determine the relationship between the financial performance of the portfolio and the degree of business diversification pursued by the corporate groups.

v) To offer suggestions to improve the financial prowess of the corporate groups, especially, in maintaining the companies of flagship to consistently remain so, and ultimately to promote their stand in the stock market through an appropriate adoption of a particular form of diversification strategy.

1.6 HYPOTHESES

In conformity with the third and fourth objectives, the following null hypotheses have been formulated and tested.

1. Flagship company does not influence the stock market of other companies in the corporate group.
2. There is no inverse relation between SBF and financial performance.

3. There is no inverse relation between non-conglomerates and financial performance.

1.7 PERIOD COVERED BY THE STUDY

The study covers a period of 11 years from 1979-80 to 1989-90, so as to include the entire decade of 1980s. The decade of 1980s has been deliberately chosen, because it was during this decade, the Indian private sector gained momentum by registering a higher share in the NDP; paved the way for building several business empires adding to the existing ones; in general the Indian stock market was in a buoyant mood; and the Indian industry was in a scenario marked with rapid growth and fierce competition.

1.8 SCOPE OF THE STUDY

The study basically aims to identify the pattern
of diversification through which the wealth maximisation could be achieved by any corporate unit. The study also aims to find out how well the top business houses on adopting the diversification strategies have performed in gaining and retaining the confidence of the investors by analysing the relationship between business diversification and performance. The study further makes an attempt to bring out the financial causes for the top performers and the poor performers within and as well between the selected corporate groups.

To sum up, the study aims at being a guideline to -

a) The investors in selecting their portfolio, especially, when they choose among corporate groups.

b) the corporate groups in adopting the best of various diversification strategies.

1.9 LIMITATIONS OF THE STUDY

The study is subject to following limitations.
1. The application of financial ratios to judge the financial efficiency of the corporate groups under various modes of diversification strategies is subject to certain inherent limitations of that financial tool.

2. The determination of the diversification ratios or otherwise the degree of business diversification based on business segments with or without the technological link typically required the judgemental input from the researcher. However, to reduce this judgement bias sincere efforts were taken to consult the specialists in various fields.

3. In case of RUD and UUD, though the diversification ratios were separately computed for each of the unrelated business segments in case of each of such companies, and the associated return on market portfolio was also available in respect of each of the unrelated business segments, however, the return on individual stock could be computed only for the company as a whole.

1.10 CHAPTER SCHEME

The study consists of SEVEN chapters.
The First Chapter deals with the Introduction, Design, and Execution of the study.

The Second Chapter exclusively deals with the methodology of the study covering the sample design, data source, and framework of analysis including the tools of analysis in conformity with the respective objectives.

The Third Chapter discusses the various forms of diversification strategies adopted by the selected ten top business houses and also attempts to measure their growth rate accordingly.

The Fourth Chapter analyses the financial efficiency of the corporate groups under various forms of diversification strategies, and finally the financial factors making or breaking a particular company as the flagship of the corporate groups has also been highlighted.
Chapter is devoted to measure the impact of flagship company on the stock market of other companies in each of the selected ten corporate groups.

Chapter brings out the relationship between the financial performance of the portfolio and the business diversification pursued by the corporate groups.

Chapter recapitulates the key findings of the study and offers suggestions to improve the financial efficiency, especially to maintain the flagship ever in the same status and to pursue the best diversification strategy for the corporate groups.
REFERENCES


3. Idem.


24. George Paul: "Does Diversification Always Improve Financial performance?" Vikalpa, April - June 1986, PP. 129 to 130


