CHAPTER 1
Introduction

In this chapter we introduce the reader to the background of the research area and its development in the past few decades. We also attempt to present the different paradigms in explaining diversification strategies not only in the developed markets, but also in the case of emerging markets. The centrality of the research problem surrounds our basic observation that despite offering a plethora of views and approaches, the findings are fraught with contradictions. We intend to combine multiple theoretical lenses; cutting across disciplines, to put in place a unified theoretical framework that attempts explains these dichotomies.

1.1 Research Context

The history of the U.S. economy has witnessed major shifts in the pattern of diversification. There was an increase in incidence of conglomerate form of diversification during 1960's. It was observed that two-thirds of the Fortune 500 firms in the U.S. were highly diversified and similar patterns of diversification were found to exist in Western Europe and Japan (Rumelt, 1974). As a consequence, interest in diversification has grown among practitioners, academics, and public-policy makers. Studies of diversification have long been a mainstay of Strategic Management research. They constitute a unique core of growing literature in this discipline. It began with the pioneering work of Ansoff (1957). The most researched phenomenon in this extensive body of literature is that involving diversification and performance (Chatterjee and Wernerfelt, 1991). Beginning with the seminal work of Gort (1962), Industrial-Organisation (I/O) Economics spawned decades of research based on the premise that diversification and performance are positively related. This position rests upon several assumptions, including those derived from market power theory and internal market efficiency arguments, among others (Scherer, 1980; Grant, 1998).

Another major shift in the patterns of diversification was witnessed with the onset of the 1980’s in the U.S. economy. Core competencies and focus became the new guidelines of conglomerates in most Western economies. Subsequently, there was a spurt in research activity to explain this new phenomenon. In a tacit rejection of the earlier linear model, Denis, Denis and Sarin (1997) concluded that recent empirical evidence suggested that the costs of high levels of diversification outweigh the benefits, that focused firms outperform
their more diversified counterparts. Palich, Cardinal and Miller (2000) in turn proposed a curvilinear model, based on their findings that moderate levels of diversification yield higher levels of performance than either limited or extensive diversification.

While U.S. conglomerates started focusing on their diversification strategies, it was also observed that there was an increasing trend to dismantle the large conglomerates formed in the 1960's into individual firms. Corporate managers argued that the unwieldy conglomerate form of structure was no longer responsive to environmental change, which was fast becoming the order of the day. Also the cost of maintaining a diversified conglomerate structure was slowly outperforming the benefits. To explain these phenomenon researchers tried to estimate the relative importance of firm, industry and group differences in the determination of performance of a business unit. In support Schmalensee (1985) observed that over a time, effects related to industry structure and group slowly gave way to firm effects.

But while managers in the West have dismantled many conglomerates assembled in the 1960’s, diversified business group remains a dominant form of enterprise throughout most emerging markets. Some groups operate as holding companies with full ownership in many enterprises, others are collections of public traded companies, but all have some degree of central control and coordination. In the midst of such controversy Khanna and Palepu (1997) advocated that Western companies take for granted a range of institutions that support their business activities, but many of these institutions are absent in most emerging markets. Therefore, focus may be good advice for firms in the West, but groups operating in emerging markets can add value by imitating the functions of several institutions that are present only in advanced economies. In support, it was observed that firm performance would initially decline with increases in a business group’s diversification, until group diversification reaches a threshold. Beyond this threshold, marginal increases in group’s diversification will yield marginal increases in firm performance. Further, the threshold above which marginal increases in unrelated group diversification result in marginal increases in firm performance will rise as market institutions evolve over time (Khanna and Palepu, 2000). Therefore, it will be become increasingly difficult for business groups to retain the positive effects of diversification. Hence, in the long run the pattern of performance of business groups in emerging markets will match with those of its Western counterparts. But the pace at which
group effects are likely to atrophy is dependent on the pace of economic liberalization pursued by the local government.

The authors also observed that after group diversification was controlled for, group affiliation was associated with positive performance effects. The study by Khanna and Rivkin (2001) that spanned across fourteen emerging markets concluded that group affiliation appears to have as profound an effect on profitability as industry membership. Also the performance effects of group membership will decrease as market institutions evolve over time. In support Chang and Hong (2002) had also observed that group effects decrease over time. However, the pace at which group effects will sublime is likely to depend on the particular institutional setting. While the outcome of this research phenomenon was uniformly observed across developed markets, they have evoked mixed reactions, particularly in the Indian context. While economic liberalisation has opened up a plethora of business opportunities, relatively newer business groups have continued to diversify during the last fifteen years of economic liberalisation; older business groups have by and large consolidated their business portfolio with some minor diversifications, while focused business groups still continue to perform unabated. Empirical findings in the same context remain equally confusing (Kakani, 2000; Mohanty, 2000). We intend to put in place a theoretical framework that integrates across these cross-findings.

1.2 Research Problem

Research on diversification and performance has long ignored managerial explanations in favour of explanations based on purely economic forces. Starting with the pioneering work of Gort (1962), followed by works of Leff (1976, 1978) and subsequent works of Khanna and Palepu (1997, 2000) all have based their work, which has its foundations in I/O Economics. While not opposed to the economic approach, it was felt that the balance between economic and managerial explanations was becoming dramatically skewed (Prahalad and Bettis, 1995). This did not square with their personal observations or theoretical biases. An earlier paper (Bettis, Hall and Prahalad, 1978) began to address this issue. They continued to observe problems that the top management had in coping with major diversification moves. Our own case studies revealed how several business groups found it increasingly difficult thinking about strategically unrelated businesses, or about businesses with different characteristics from their core businesses or when industry structures changed radically.
The problem becomes even more complicated on account of economic liberalisation, as the rules of business changed significantly. Business groups, which were used to perform in a protected environment, now faced challenges against international competition. While researchers were focusing exclusively on diversification – performance relationship, they were at the same time ignoring the extraneous influences of diversification on performance outcomes. This has been facilitated because most of existing research has looked into the relationship from the point of view of single theoretical lens. Prahalad and Bettis (1995) felt that research on diversification and performance was setting into a pattern of regressing a set of economic and/or accounting variables and a measure of diversification on a performance measure. This research trend was built on earlier research studies of Wrigley (1970), Rumelt (1974) and continues till recent times (Khanna and Palepu, 2000; Khanna and Rivkin, 2001). While new insights were found, it was felt that the marginal value of such studies was declining. There was also a need to shift focus from macro to micro level of analysis; from overall profiles of diversification to individual diversification projects and cumulative diversification experiences (Ramanujam and Varadarajan, 1989; Prahalad and Bettis, 1995).

Following this research tradition we made an attempt to study the diversifications patterns of Indian business groups and its outcome on performance from the point of view of a multiple theoretical lens by adopting a micro point of view. We also take a cue from the comments of Prahalad and Bettis (1995:6) “strategic management often ignored managerial explanations in favour of explanations based on purely economic forces and untenured faculty should not hesitate to strike out new directions, if it is firmly believed that the views are justified”. This study combines perspectives from Strategic Management, Organisation Theory, and I/O Economics to explain the above dichotomies. This would help us achieve three major objectives. First, it would enable us to identify factors that moderate the relationship between diversification and performance. Second, it would help us in assessing the nature and extent of moderating effect of these factors on the diversification – performance relationship. Third, it would enable us to increase the significance and explanatory power of diversification on performance.

1.3 Outline of the Thesis

The first chapter of the thesis introduces the research context and also provides an overview of the research problem. A critical review of major relevant literature on the subject is
presented in the second chapter. This chapter serves two purposes – one, giving a critical exposition of the extant literature and two, identify major research gaps. An elaborate discussion on the variables used in the course of the research is made in the third chapter. The fourth chapter presents a detailed account of research design and methodology adopted in the study. The fifth chapter analyses the cases relevant to the framework, the details of which are provided in the annexure. In the sixth chapter we build on the various hypotheses developed from existing literature and case studies; this forms the backbone of our conceptual framework. The seventh chapter integrates across the various hypotheses and proposes a unified theoretical framework on antecedents of diversification and its outcomes on performance. The eighth chapter reports the results and findings of various statistical analyses. The discussion and interpretation of results is presented in the ninth chapter. Finally in chapter ten, the final chapter of the thesis, we have summarised the major findings, discuss their implication for practicing managers and delineates the contribution of the study to Strategic Management and Organisational Theory, presents the limitations of the study, and raises some major issues for future research.