Corporate Diversification and Firm Performance: an Empirical Study

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Abstract: *The importance of diversification and performance in the strategic management literature is widely accepted among academics and practitioners. However, the proxies for performance and diversification that have been employed in past strategy research has not been unanimously agreed upon. Given the current state of confusion that exists with regard to the impact of corporate diversification on firm performance, the present paper seeks to add to this body of knowledge and help resolved some discrepancies. This study examines the impact of corporate diversification on firm performance in selected Nigerian companies. The reason for increased interest in diversification has always been on the possibility that diversification is related to corporate performance. However, while this topic is rich in studies, empirical evidences emerging from various studies about the effect of diversification on performance have so far yield mixed results that are inconclusive and contradictory. In addition, despite the existence of these studies, very little attention has been given to the companies in developing countries including Nigeria. This means that there is a major gap in the relevant literature on developing countries which has to be covered by research. This research attempts to fill this gap by studying the situation of the Nigerian companies and providing more empirical evidence on the effects of corporate diversification on firm performance based on individual company-level data. Survey research design was adopted in this study with the application of simple random sampling technique in selecting our case study companies as well as our respondents. Primary data were collected through questionnaire. Data were analysed through descriptive statistics and correlation and coefficient of determination were used to test our hypotheses. It was discovered that diversification impacted performance of these companies positively and we recommend that these companies should engage in geographical diversification in addition to other forms of diversification they are currently involved in for maximum performance.*

Keywords: Business Organisations, Corporate Diversification, Firm Performance, Strategic Management.

Introduction

Business organizations are operating in environments that are increasingly uncertain, complex, competitive, dynamic and unpredictable. The changes in environments are not only rapid and bewildering; they also appear to be in a state of constant flux. Development arising from these forces and the need for organizations to survive in today's fiercely competitive market are causing many organizations to rethink the way they are doing business in order to remain relevant to their stakeholders in the unfolding dispensations. These contextual influences not only present organizations with critical challenges, they also present new opportunities for growth and development. Companies are adopting various strategies to respond to these forces in order to survive and grow.

It is important to add that competitive pressures are forcing many organizations to react to these changes with improved quality services and/or products. In the light of these new challenges, many organizations have played out the logical restructuring paths through the adoption of various performance improvement methodologies ranging from Business Process Reengineering (BPR), Corporate Restructuring (CR), Organization Development (OD), Business Process Management (BPM), Mergers and Acquisitions (M&A), and Total Quality Management (TQM) to mention a few.

Despite the adoption and implementation of these strategic recipes in the past, organizations still find themselves in need of reinvigoration by way of strategic shifting of the organization structure from what it is now to what it has to be, in order to maintain competitive edge and satisfy customers needs at a profit. The desire for this repositioning has prompted many Nigerian business organizations to adopt diversification as a corporate strategy. Thus, the focus of this research is to assess the impact of diversification on corporate performance in selected Nigerian companies.

Statement of the Research Problem

The issue of diversification has assumed a position of centrality and universality in the management process. Diversification has become an increasingly important aspect of doing business in the world today (Elango and Ma, 2003). Academic interest in the topic of diversification is evident by the level of attention it has received over the last few decades. The relationship between diversification and firm performance has been the subject of abundant research in several fields. However, many researchers concurred on the fact that there is no agreement on the precise nature of the relationship between diversification and performance (Hoskisson and Hitt 1990; Markides and Williamson, 1994; Palich, Cardinal and Miller 2000). Some studies have shown that diversification improves profitability over time (Chang & Thomas, 1989; Lubatkin & Rogers, 1989) whereas others have demonstrated that diversification decreases performance (Michel & Shaked, 1984). Still other studies have shown that the diversification-performance link depends on business cycles (Hill, 1985). Santalo and Becerra (2004) explain conceptually and provide empirical evidence that no relationship (positive, negative or even quadratic) exist between diversification and performance. The empirical evidences emerging from various studies about the effect of diversification on performance have so far yielded mixed results that are inconclusive and contradictory.

Because of these contradictory results (Ramanujam & Varadarajan, 1989), the relationship between diversification and performance is controversial. Thus, the question of whether diversification improves or worsens firm performance is still worthy of further research such as the one being undertaken in this study. In addition, despite the existence of these studies, very little attention has been given to the developing countries. Besides, the impact of diversification on firm performance has not received adequate research attention in Nigeria. This means that there is a major gap in the relevant literature on developing countries including Nigeria, which has to be covered by research. This research attempts to fill this gap by studying the situation of the Nigerian companies and provide more empirical evidence on the effects of diversification on firm performance based on individual company-level data.

Significance of the study

A review of academic literature on the subject of corporate diversification and firm performance reveals that there is a dearth of literature on it in the developing countries including Nigeria. Besides, it is important to add the fact that in the industrialized countries where most of the studies on corporate diversification and firm performance were reported, little attention has been paid to the process of planning and execution of diversification to ensure a successful corporate diversification. Thus, it is hoped that this study will fill the existing gap in the literature especially in the less developed countries in general and Nigeria in particular.

This study will also provide a fresh and multidimensional framework for understanding the relationship between corporate diversification and firm performance. It is expected to, as much as possible, erase mental doubt and bring the empirical cum professional principles as well as standard practices concerning diversification strategy. In addition, this study will be of immense benefit to a number of people. These include academics who are interested in furthering their knowledge on corporate diversification as the results to be obtained are capable of adding new insight to the present state of knowledge in the field and may therefore be found useful for teaching and for developing a body of management theory. Equally important is the fact that this study will also be of great benefit to practicing managers who might be willing to consider the usefulness of diversification in managing and strengthening their organizations.

Objectives of the Study

The general objective of this study is to evaluate the relationship that exists between corporate diversification and firm performance in selected Nigerian companies. While the specific objectives of the study are to: 1) Examine the intents and/or objectives necessitating corporate diversification by Nigerian companies; 2) Investigate the diversification strategies of these companies; 3) Appraise empirically the relationship between corporate diversification and firm performance of the companies under study; and 4) To formulate recommendation regarding corporate diversification and firm performance.

Research Questions

The primary purpose of this study is the systematic discovery of the relationship between corporate diversification and firm performance in selected Nigerian companies. The following research questions are employed to guide this study:

1) What specific intents and/or objectives necessitate the adoption of diversification by Nigerian companies?
2) What are the diversification approaches or strategies used by these companies?
3) Is there any association between corporate diversification and firm performance of Nigerian companies that use diversification as a corporate strategy?

Literature review

The purpose of this section is to provide a review of the literature on diversification and to develop conceptual as well as theoretical framework for this study. Following a review of the research that has examined the impact of diversification on performance; the concepts of diversification as used by previous researchers are reviewed. The major common elements of corporate diversification are then modeled in order to provide a conceptual framework for judging and classifying the companies studied according to its levels of diversification.

Conceptual Framework

The concept of diversification is yet to be clearly defined and there is no consensus on its precise definition among researchers. Definitions of diversification are many. What is needed, therefore, is a comprehensive definition which is both theoretically valid and managerially meaningful. Reed and Luffman (1986) pointed out that the term "diversification" has different meanings when research interest varied. Earlier definitions of diversification, such as Gort (1962) and Berry (1975), approached the subject from products or services across industry or market boundaries. Later definition extended to the means, particularly investment or partnership that enables a focal organization to achieve growth or reduce overall risk (Hoskisson and Hitt 1990; Remanunam and Varadarajan 1989).

In general, diversification refers to a firm's entry into a new market. It means the increase by a firm in the kinds of businesses which it operates, being that diversity either related to products, geographical markets or knowledge (Penrose, 1995).

The grand strategy involving diversification represent distinctive departure from the firm's existing base of operations, basically from acquisition and internal generation (spin-of) of a separate business with possibilities counter balancing the strengths and weaknesses of the two business. However, diversifications occasionally are undertaken as unrelated investments, because of the high profit potential and their otherwise minimal resource demands (St. John, and Harrison, 1999).

Motives for Diversification

There are many possible motives behind diversification strategies (Jung, 2003) and due to the nature of this research problems, the researcher intends to discuss the motives related to competitiveness and performance.

1. Synergistic Motive: The first and obvious motive is shown in cases where synergy exists when individual units are operated as a single organization. Synergy occurs when the sum of all businesses together equals more than the sum separately (Hitt, Ireland, and Hoskisson, 2001). Amit and Livnat (1988) argue that diversification into related businesses may augment the market power of the diversified company which in turn may help the company enhance its long-term strategic position. Additionally, synergy may be created if operations of the individual units complement one another, so there are benefits from offering consumers a complete line of products. The size and reputation of such a firm might deter entry to the industry.

2. Financial Motive: This motive is based on the fundamental premise of portfolio theory that "one should not put all one's eggs in one basket". It may also he argued that a firm should diversify and not depend on a single operation. As shown in finance theory, whenever the cash flows of the individual units are not perfectly correlated, the total risk, as measured by variability of consolidated cash flows, is reduced by diversification (Amit and Livnat, 1988).

3. The Market Power Motive: Diversified firms have conglomerate power which makes them thrive on their diversity (Hill, 1985). In his own view, Gribbin (1976) says a firm will not have conglomerate power if it does not hold significant positions in a number of markets.

Montgomery (1994) explains three possible sources for the market power view:

- Cross-subsidization, a firm may use its excess profit from one business to enter in another, and hence give this new venture an advantage.
- Mutual forbearance, companies can meet on another market to compete less severely.
- Reciprocal buying, large and diverse firms can also buy reciprocally in other markets to seal competition from smaller competitors.

Lindstrom (2005) highlights the anti-competitive actions often associated with motives for diversification. The diversified companies are able to exploit, extend, or defend their power by strategies and tactics. In conclusion, the market power motive is not thought of as to increase efficiency, companies diversify to gain market power, and thereby earn profits.

4. The Agency Motive: There are a number of motives behind diversification from an agency perspective that will not benefit the principal. The reason for this is the separation between the owner and manager, where the manager does not own any equity. This is in agreement with Sambharya's (2000) motive for diversification that it may reflect top management aspirations and goals. Four main reasons for managers to diversify the company are:

- Empire building, the managers diversify in order to create their own empire (Montgomery, 1994).
- Managerial entrenchment, managers will diversify into markets or products in a way that increases the demand for their skills and abilities (Schleifer and Vishny, 1989).
- Risk reduction, managers try to reduce their employment risk by diversifying into different markets and products

and thereby make the organization less dependent on a single market or product. The basis of portfolio theory that states that a firm should not put all her egg in one basket (Amit and Livnat, 1988).

- Free cash flow theory, instead of paying stake owners the managers spend the excess cash flow on acquisitions (Jensen, 1986).The reason for this is that in the beginning of the firms life cycle there are lot of profitable opportunities for reinvestments, however, when the firm becomes mature these opportunities become more scarce and hence the cash flow from earlier innovations are being used for opportunistic diversification (Mueler, 1972).

5. The Resource Motive: Conventional wisdom suggests that the bigger the company the more resources it controls, hence it should perform above average in an industry. This wisdom is the resource- based motive which states that bundled resources and capabilities that are aggregated over time also underpin a company's competitive advantage (Barney, 1991). When a firm has underused resources that can be profitably employed, it also has an incentive to expand. Furthermore, diversification is driven by the need to use these excess resources (Caves, 1980). In order to grow the firm needs to specialize and the profit or resources from the successful growth will be underused and eventually used to growth by diversification.

Diversification Strategies

There are three general types of diversification strategies discussed in the literature:

a) growth into a new non-competing product/market which is related to the firm's technological and marketing skills base often termed related or concentric diversification;
b) growth into a new product that will appeal to current customers often called horizontal diversification; and c) growth into a new product/market which is unrelated to the firm's present technological or marketing skills base commonly called conglomerate diversification. Each of these diversification strategies has its own set of issues, benefits, and drawbacks.

Theoretical Framework

1. The Linear Model

Beginning with Gort (1962), industrial organization economics spawned decades of research based on the premise that diversification and performance are linearly and positively related. This position rest upon several assumptions, including those derived from market power theory and internal market efficiency arguments, among others (Grant, 1998).

Integrating the argument outlined above, a linear and positive linkage is suggested and presentations of theory continue to mention these arguments as part of diversification-performance puzzle. But dose the evidence support this position? In the recent review of relevant research, Denis, Denis and Sarin (1997) conclude that empirical evidence suggests the cost of high level of diversification outweigh the benefits, that focused firm out perform their diversified counterparts. However, it should be noted that these findings are not universal across or within studies (Servaes, 1996). These inconsistencies have lead to researchers using alternative models, particularly those that are curvilinear in orientation.

2. Curvilinear Models

In contrast to the argument presented above, a number of researchers have developed theory positing a curvilinear diversification-performance relationship. This theory recognizes that increasing diversification may not be associated with concomitant increases in performance, at least not through the entire relevant continuum. Two alternatives have surfaced in the literature; the Inverted-U Model and the Intermediate Model. Each of these posits that some diversification (i.e., moderate level or related diversification) is better than none; however they differ in their predictions of the performance trend as firm move toward even greater (usually unrelated) diversification. These curvilinear models are presented below.

The Inverted-U Model

Limited diversification presents a strategy of restricted business where the firm focuses on a single industry, thus limiting opportunities to leverage resources and capabilities across divisions. The argument outlined above (i.e. linear model) indicates that limited diversifiers as a group are unlikely to generate above average profits. Lubatkin and Chatterjee (1994) observe that single business firm do not have the opportunity to exploit between unit synergies or the portfolio effect that are available only to moderately and highly diversified firms. That is, focused enterprises do not have multiple businesses, so they do not enjoy scope economics. Also, these firms bear greater risk since they have not "diversified away" that risk by combining less than perfectly correlated financial streams from multiple businesses. This has negative implication for the debt capacity, cost of capital, and market performance of single business entities (Shleifer and Vishny, 1991).

The Intermediate Model

Few people have questioned the superiority of related over limited diversification. However, the relative performance contribution of related versus unrelated diversification is often debated. It may be that related and unrelated diversification is somewhat equal in their contribution to performance. The primary issue in this controversy arises from concerns that related firms may not be able to exploit fully the relatedness designed into the portfolio business. It was argued that related diversifiers will outperform their unrelated counterparts only to the degree that they are able to exploit relatedness "to create and accumulate new strategic assets more quickly and cheaply than competitors" (Markides and Williamson, 1994). Simply amortizing existing assets through economies of scope will yield short-term benefits at best.

In general, the Intermediate Model can be tied to the notion that diversification yields positive but diminishing returns beyond some point of optimization. Markides (1992) provides a helpful review of the argument supporting this view. He pointed out that has a firm increases in diversification, its moves further and further away from its core business, and the benefit of diversification *at the margin* decline.

Empirical Studies on Diversification and Performance

A large number of empirical studies from the perspectives of a number of business disciplines such as industrial economics, strategic management, and finance tried to hypothesize and test empirically the question, which type of company or diversification strategy has led to better performance. Rumelt (1974, 1982) propounded that related diversification will lead to superior levels of performance while unrelated diversification will recognise inferior levels of performance. On the empirical side, Salter and Weinhold (1979) note that "unrelated diver - sification does not lead to higher corporate returns". Other scholars such as Nathanson and Cassano (1982) concluded that diversity can hurt profits but appropriate organisational structures and strategies can help mitigate the damage, Gort (1962) also imputed that the premise that diversification and performance are linearly and positively related. Finally Lubatkin and Chatterjee (1994) also recognize the fact that increasing diversification may not be associated with concomitant increases in performance.

The empirical evidence on performance and diversification can be divided into three different groups:

a) Related performs better than unrelated.
b) No differences between related and unrelated.
c) Unrelated outperforms related.

Sambharya (2000) addresses that the contradictory results is related to: different time periods, various measures on profitability, and different measures on diversification.

Research Hypotheses

In order to answer the research questions and achieve the objectives of the study, the following hypotheses are advanced and will be tested in the course of this study.

1) H_0: That a high level of diversification is not widely practiced among Nigerian banks.
   H_1: That a high level of diversification is widely practiced among Nigerian banks.

2) H_0: Diversification is not needed and unimportant to companies' growth and survival.
   H_1: Diversification is needed and important for companies' growth and survival.

3) H_0: Diversification is not a reliable corporate strategy and does not relate to performance of Nigerian companies.
   H_1: Diversification is a reliable corporate strategy and relate to performance of Nigerian companies.

Research methodology

This section deals with the specific procedures utilized in the conduct of this study. The term methodology is a system of explicit rules and procedures in which research is based and against which claims of knowledge are evaluated (Ojo, 2003). Therefore, this section focuses on the research techniques adopted and used for this study with the aim of achieving the research objectives. For the purpose of this study, survey research design is adopted. The research design chosen is perceived as a good method because it helps identify changes in corporate performance due to diversification. The theoretical population of the study consisted of the entire manufacturing companies in the South Western Nigeria. This choice stems from the fact that the Headquarter Offices of these companies were located in this region of the country. For effective coverage and lower cost, this study was restricted to Lagos State, the commercial centre of Nigeria. Primary method of data collection was used in the study. The close-ended questions were used in order to simplify the coding and analytical procedure. The questionnaire is titled "Strategic Corporate Diversification Questionnaire."

To ensure the validity and reliability of the questionnaire used for the study, even number of experts were consulted to look at the questionnaire items in relation to its ability to achieve the stated objectives of the research, level of coverage, comprehensibility, logicality and suitability for prospective respondents.

Data collected from the questionnaire were analysed with the aid of descriptive statistical techniques such as total score, and percentage while inferential statistics such as correlation coefficients was used to proof the level of significance in testing stated hypotheses.

Verification of hypotheses

1) H_0: That a high level of diversification is not widely practiced among Nigerian companies.

   H_1: That a high level of diversification is widely practiced among Nigerian companies.

Correlations

		Do you think that a high level of diversification is being practiced by Nigerian companies?	Does diversification have any impact on organization's performance?
Do you think that a high level of diversification is being practiced by Nigerian companies?	Pearson Correlation	1	.851(**)
	Sig. (2-tailed)		.000
	N	44	44
Does diversification have any impact on organization's performance?	Pearson Correlation	.851(**)	1
	Sig. (2-tailed)	.000	
	N	44	44

*** Correlation is significant at the 0.01 level (2-tailed).*

Coefficient of Determination (C.O.D)

The coefficient of determination is given by the formula

C.O.D = r^2 x 100 where r = Pearson Correlation = 0.851

= $(0.851)^2$ x 100 Correlation is significant at the level 0.01(2-tailed)

= 0.724201 x100

= 72.42%

The correlation of r = 0.851, means that there is 72.42% shared variable between diversification and performance. This means that diversification has 72.42% relationship with performance.

Interpretation: The relationship between diversification and performance using Pearson's Correlation coefficient. There is a positive correlation between the two variables [r =0.851**, N = 44, p < 0.01]

Decision: the correlation (r =0.851**) gives a 72.42% relationship between diversification and performance and it is significant at the 0.01 level which is less than 0.05 level, thus we reject the null hypothesis (H_0) and accept the alternative hypothesis (H_1). This implies that there is nigh level of diversification being practiced by Nigerian companies.

2) H_0: Diversification is not needed and unimportant for companies' growth and survival.
   H_1: Diversification is needed and important for companies' growth and survival.

Correlations

		In your opinion is diversification important to your organization	Is diversification needed in the modern business
In your opinion is diversification important to your organization	Pearson Correlation	1	.823(**)
	Sig. (2-tailed)		.000
	N	44	44
Is diversification needed in the modern business	Pearson Correlation	.823(**)	1
	Sig. (2-tailed)	.000	
	N	44	44

*** Correlation is significant at the 0.01 level (2-tailed).*

Coefficient of Determination (C.O.D)

The coefficient of determination is given by the formula

C.O.D = r^2 x 100 where r = Pearson Correlation = 0.823

= $(0.823)^2$ x 100 Correlation is significant at the level 0.01(2-tailed)

=0.677329 x100 =67.73%

The correlation of r = 0.823 means 67.73% shared variable between diversification and the organization. This means that diversification is 67.73% important to organization growth and survival.

Interpretation: There is a positive relationship between diversification companies growth and survival using Pearson's Correlation coefficient. There is a positive correlation between the two variables [r =0.823**, N = 44, p < 0.01]

Decision: The correlation (r =0.823**) shows a 67.73% correlation between diversification and the organization growth and survival is significant at the 0.01 level which is less than 0.05 level, thus we reject the null hypothesis (H_0) and accept the alternative hypothesis (H_1). This implies that Diversification is needed and important for corporate growth and survival.

3) H_0: Diversification is not a reliable corporate strategy and does not relate to performance of Nigerian companies.
H_1: Diversification is a reliable corporate strategy and relate to performance of Nigerian companies.

Correlations

		In your opinion do you think diversification is a wise corporate strategy to adopt	Do you advise other organizations to adopt diversification
In your opinion do you think diversification is a wise corporate strategy to adopt	Pearson Correlation	1	1.000(**)
	Sig. (2-tailed)		.000
	N	44	44
Do you advise other organizations to adopt diversification	Pearson Correlation	1.000(**)	1
	Sig. (2-tailed)	.000	
	N	44	44

*** Correlation is significant at the 0.01 level (2-tailed).*

Coefficient of Determination (C.O.D)

The coefficient of determination is given by the formula

C.O.D = r^2 x 100 where r = Pearson Correlation = 1.000

= $(1.000)^2$ x 100 Correlation is significant at the level 0.01(2-tailed)

=1.000 x100 =100%

The correlation of r = 1.000 means 100% shared variable between diversification and reliable corporate strategy. This means that diversification is 100% important and related to corporate performance.

Interpretation: The relationship between diversification as a reliable corporate strategy and performance using Pearson's Correlation coefficient is [r =1.000**, N = 44, p < 0.01]

Decision: The correlation (r =1.000**) between diversification and corporate performance is significant at the 0.01 level which is less than 0.05 level, thus we reject the null hypothesis (H_0) and accept the alternative hypothesis (H_1). This implies that diversification is a reliable corporate strategy for enhancing firms' performance.

Discussion of main results

The study investigated the relationship between corporate diversification and firm performance in Nigerian companies From the data generated, analysed and interpreted, the major results of the Pearson's product moment correlation are: 1) r=0.851; 2) r=0.823; and 3) r=0.100. These suggest, among other things, that: 1) That a high level of diversification is widely practiced among Nigerian companies, 2) Diversification is needed and important for companies' growth and survival, and 3) Diversification is a reliable cor - porate strategy and relate to performance of Nigerian companies.

The reason why these companies made use of diversification strategy is varied. They include synergistic, financial, market power, resource based as well as agency motive. These companies have adopted a number of diversification strategies ranging from related to unrelated diversification, and product diversification among others in their efforts to improve performance.

Recommendations and conclusion

In the light of this study, the following recommendations of the researcher were given to effectively maximize the dividends of corporate diversification on firm performance.

First, the companies should engage in more feasibilities studies and improve the management of both the human and material resources. Second, the organization should understand that diversification and performance are linearly and positively related. Third, these companies should also embark on geographic diversification in addition to other diversification strategies they are used to.. This means that they need to extend their businesses to other countries as well as other continents of the world. Finally, prudent management of diversification strategies is very important in any business as it is said that diversification enhances the well-being of the business and it effective and efficient management will contribute to sound performance and profitability of the business.

Various reasons, models and explanations have been given in this research to enlighten people about the positive impact of diversification on the organization's performance and the reason why Nigerian managers should welcome diversification in their business and avail themselves of the prevailing benefits of adopting diversification.

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