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Rationale for Unrelated Product Diversification for Indian Firms

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Abstract

Diversification has been a popular strategy adopted by firms to achieve growth and create competitive advantage. There are empirical evidences to show that related product diversification improves performance of the firms. The related diversification creates synergy, which creates competitive advantage for firms. But, same is not true for unrelated diversifications. Researches find negative relationship between unrelated product diversification and corporate performance. Majority of researches are conducted in developed countries. The economic, social, and political environment of developing countries are different from those of developed countries. In India, before the liberalization of 1991, unrelated diversification was a popular practice to achieve growth. After licenses and quotas were abolished, firms were exposed to competition from domestic and international companies. In such competitive environment, companies needed to focus on creation of competitive advantage. In Post-liberalization era also, Indian companies continued to enter into unrelated businesses. This trend was more prominent among large firms. The present paper endeavors to find rationale for unrelated diversification by Indian firms. This paper used stratified random sampling technique to select a sample of top five firms in terms of revenue from top five industries in terms of revenue who diversified into unrelated business during the period of 2000-2010. The unrelated business is identified based on SIC code. This paper uses different market theories to explain possible motivations of unrelated diversification for Indian firms. Researcher believes that the current paper provides useful information to understand rationale for unrelated diversification by Indian firms, and can be used by firms who want to diversify into unrelated businesses.

Keywords: Unrelated Diversification, Conglomerate Diversification, Motivation for Diversification, Diversification Theories, Rationale for Diversification

1. Introduction

Diversification is a corporate strategy which is characterized by business interest in different industries and multi-unit organizational structure controlled by single firm. A firm can be called diversified if it reports sales in two or more industry segments. The industries segments are defined at the two digits SIC code level. The vertically integrated firms, who are integrated between manufacturing and distribution, are classified as single segment firms. Diversification can be expanded into a new segment of same industry that the firm is operating in, or in a new industry outside the scope of existing business. Diversification also occurs when a firm expands into a new market with existing product portfolio.

In unrelated diversification, a firm enters in a business unrelated to current operation. It means, in unrelated diversification, a firm enters a new business who's third, fourth, and fifth digits of SIC code are different from existing businesses. The new business has no connection with current technologies, markets, distribution channels, and products.

While there are empirical evidences to show that related diversification creates synergy, and hence improves corporate performance, majority of researches established that unrelated product diversification is negative for corporate performance. This paper explores the rationale for unrelated product diversification by Indian firms.

2. Literature Review

2.1 Theories of Diversification

There are four theories that can explain motivation for diversification:

1. Transaction cost economic theory
2. Resource based view
3. Market power theory
4. Agency theory

2.1.1 Transaction cost economic theory

Transaction cost is the cost incurred in making an economic exchange. Transaction cost includes cost incurred in finding best suppliers, customers, and business partners; cost of drawing a tamper proof contract, and cost of monitoring and implementing these contracts. According to transaction cost economic theory, all economic activities are economic behavior. All firms are indulged in an economic exchange. The behavior of the agent is confined by opportunism and bounded rationality. Since the firm is a contract structure that supplants imperfect exchange, the boundary of a firm is the logical result of cost-effective choice between organizational manipulate and market process. Firms try to lower the transaction cost to lower cost and improve competitiveness.

The transaction cost theory explains how vertical integration deals with ex-post contract cost. Firm's rent generating resources are exchanged through market process. The transaction incurs high contractual hazards like license loyalty, secrecy, learning curve advantage problems. A firm can avoid such hazards through vertical integration. (Silverman, 1999) Internalization (through vertical integration) reduces transaction cost, but organization incurs economic cost in managing hierarchies. The transaction cost theory explains why firms do not market. If diversification is an efficient alternative to the market contracting, firms choose to diversify.

When firm has to decide – "make or buy", firms prefer to "make" if it wants to avoid contractual hazards and reduce transaction cost. This explains why firms diversify through vertical integration. However, transaction cost theory fails to explain diversification when diversification is not done through vertical integration. For example, if firm has excess resources, transaction cost theory fails to explain why firm should not specialize to exploit the excess resources.

2.1.2 Resource-based Theory

Resources are scarce. Firms compete with each other to acquire and control scarce resources. The internal and external resources enable a firm to compete in competitive market. (Wernerfelt, 1984; Barney et. al., 2001). The resource based theory explains how a firm can exploit its resources to achieve its goals and create sustainable competitive advantage over competitors. The resource based theory can explain diversification strategy of a firm as an attempt to profitably deploy and exploit its scarce resources.

Penrose (1959) in her "theory of the growth of the firm", argues that firms diversify because of excess capacity in productive factors or resources. Early theories identified that firms adopted diversification strategy to exploit economic scope of excess resources. Later, researchers expanded the scope of resources and included intangible resources like services, human resources, knowledge etc. (Teece, 1980; Nelson & Winter, 1982; Lippman & Rumelt, 1982) Firms adopt the strategy of merger and acquisition to buy or sell resources in bundle

A firm's resource base affects the choice of industry firm diversifies into. Firms may either choose to diversify in related business or in unrelated business. Firms having excess resources tend to diversify into industries having similar R&D, marketing, production pattern etc, and the resource requirement in that industry matches with the resource capabilities of the firm. (Silverman, 1999) Diversification in related industry creates synergy and benefits the firm. The resource based theory helps to understand why a firm diversifies in a particular industry.

2.1.3 Market Power Theory

Market power refers to the ability of a firm to influence price by influencing demand and/or supply of a product. The market power theory also explains why firms diversify. A firm having market power is able to influence the price to its benefit. In general, market power also measures the amount of influence firm has in the industry.

A large firm, especially conglomerate, has power to influence demand and supply of a product. The conglomerate mergers and acquisitions enhance the market power of the firms. The conglomerates diversify in new industry to have market power in that industry as well. As Hill (1985) argues, greater the number of markets a diversified firm has dominant position in, greater the market power a firm enjoys. Greater market power allows the firm to raise price in industries where it has dominant position, and earn higher profit. With this profit, firm can subsidize the cost of activities in competitive industries.

The researchers argue that diversification can increase the market power of a firm. But, there is no consensus on how diversification can increase market power. According to market power theory, there should be a positive relationship between diversification and corporate performance as firm may improve its market power in an industry and influence price to its benefit. However, Montgomery (1985) argues that market power theory has put unnecessary emphasis on general market power and underemphasized specific market power that gives an undiversified firm competitive advantage in market.

2.1.4 Agency Theory

Agency theory explains the relationship between principal and agents. In any organization, shareholders are the principals and managers are agents. The principals (shareholders) hire the agents (managers) to perform the services on principal's behalf. The Agency theory was given by Berle &Gardiner (1932), which explains the conflict of interest between shareholders and managers. According to this theory, both principals and agents are opportunists who try to maximize their own benefits. The managers may not always act in the best interest of shareholders. The agents (managers) tend to take decisions which can benefit the managers, even at the cost of interest of shareholders.

If diversification generates benefit for managers, the managers may take the decision of diversification even though it does not benefit the organization. If a firm diversifies into new business, more managers get opportunities to hold higher positions. They also get challenging role and opportunity to earn higher bonus. So, managers are motivated to diversify the firm.

Mueller (1972) in his studies found that the managers have lower marginal cost of capital curve than that of stockholders. So, managers tend to overinvest to make the corporation bigger in term of revenue and physical assets, even though it is not maximizing profit of organization and shareholder's wealth. This growth maximization motivation encourages a manager to diversify the firm to maximize growth, even at the expense of shareholders. The managers take pleasure in building an empire even at the cost of the interest of shareholders.

Managers also like to have control over more resources. Diversification allows the managers to have more resources under their control. Managers get more control over cash flows (Jensen, 1986). Managers also get more compensation as manager's compensation is directly linked to growth in revenues (Ueng & Wells, 2001), or managers reduce their human capital risk (Denis & Denis, 1997).

3. Sampling And Data Collection

3.1 Sources of Data

For the purpose of this study, secondary source of data are used. Annual report of the companies act as major source of data. The financial data and annual reports are obtained from public domain. The financial data are also be obtained from database maintained by

Center for Monitoring the Indian Economy (CMIE). Other important sources of information are: SEBI website, Exchange (NSE/BSE) website, moneycontrol.com, Press releases issued by company, and exchange information published in leading financial newspapers.

3.2 Criteria for Selection of a Company for Study

The companies chosen for study must satisfy all of the following criteria:

1. Turnover of company should be at least 500 Crores in the reporting year company is diversifying.
2. Firm should report sales in two or more unrelated businesses.
3. The company must be listed on NSE/BSE.
4. The event of diversification must have been occurred between FY 2000-01 to FY 2009-10.
5. Company should have been remaining listed at least for 4 years after diversification.

3.3 Sample and Size

For the purpose of this study, stratified sampling technique is used. The population is divided into various industries. According to resource based theory, firms can deploy resources and exploit its resources to achieve its goals and create sustainable competitive advantage over competitors. (Wernerfelt, 1984; Barney et. al., 2001) Large companies have access to large resources that enable them to deploy resources in new businesses to achieve competitive advantage. So, this study is limited to large companies from leading industries. Top 5 industries in terms of turnover are chosen for study. From each chosen industry, five largest diversified firms in terms of turnover fulfilling set criteria who have unrelated business interests are chosen for study.

4. Analysis of Diversification Decision of Sample Firms

4.1 Sector: Oil and Gas

Indian Oil Corporation is the largest firm operating in refining and marketing of petroleum products. In 2004, company diversified into manufacturing of petrochemical products. This diversification can be explained through resource-based theory. Indian Oil already has facility to produce petrochemicals at refineries. Indian Oil can leverage existing distribution network, brand image, and human resources in petrochemical business. Bharat Petroleum, another refiner and marketer of oil and gas diversified into E&P business in 2003. The E&P business is entirely new line of business where Bharat Petroleum cannot leverage its tangible or intangible resources. However, this diversification can be seen as backward integration. Diversification of Bharat Petroleum in E&P business can be seen as an attempt to mitigate risk by having more control on supply chain. Essar Oil was in oil exploration business. Company diversified in refining and marketing of oil business. This diversification decision also can be seen as an attempt to mitigate risk through forward integration. Similarly, GAIL, a dominant player in oil and gas transportation, and manufacturing of petrochemicals, diversified into extraction of crude petroleum and natural gas. This diversification decision can be seen as an attempt to mitigate risk through backward integration. The transaction cost theory explains why firms diversify through vertical integration.

Reliance Industries, the largest private company in India, was a dominant player in oil exploration and refining. Company diversified into a number of unrelated businesses including oil marketing, retail trade, and telecommunication. The diversification decision of Reliance Industries is unlikely to find cognitive relatedness, or seen as an attempt to mitigate risk. This diversification decision may be a part of management's vision to create a conglomerate where different clusters of related businesses are controlled and operated by different divisions. In future, Reliance Industries can spin off different divisions into independent companies. The diversification decision of Reliance Industries can be explained through market power theory.

4.2 Sector: Steel

SAIL is a leading company in production of iron and steel. SAIL has diversified into cement business through joint ventures with Jaypee Associates. SAIL manufactures cement using slag generated by blast furnace during the process of manufacturing of steel. This diversification decision can be explained through resource-based theory and transaction theory. SAIL has scarce resources. Company can profitably deploy and exploit its scarce resources by entering in cement business. Through diversification, SAIL can lower transaction cost. Another steel manufacturer, Tata Steel, diversified into coal mining and mining of lignite. The diversification decision of Tata Steel can be explained through transaction cost theory and seen as an attempt to mitigate risk through backward integration. Backward integration ensures supply of inputs, and reduces dependency on suppliers. Jindal Steel & Power Ltd, a leading company in manufacturing of steel and steel products, diversified into generation of power. Jindal Steel was already generating power for own consumption through captive power plant. Company used existing tangible and intangible resources, including technology, human resources, and know-how to enter in power generation business. This diversification decision can be explained through resource-based view. There is relatedness based on cross-business transfer of competences and knowledge between the businesses. Similarly, diversification of Jindal Stainless into architectural and design solutions for stainless steel companies can be explained through resource-based view.

4.3 Sector: Automobile

Maruti Suzuki India Ltd., the largest manufacturer of passenger vehicles in India, diversified into selling motor insurance under Maruti Insurance brand name. Though there is no tangible relatedness between two businesses, both businesses have cognitive relationship. Motor vehicles and motor insurance are complementary products. The buyers who buy motor vehicle also purchase motor insurance. Maruti Suzuki can sell motor vehicle and vehicle insurance as a bundle, and cross subsidize products to sell more vehicles. Mahindra & Mahindra was a leading player in agricultural equipment and SUVs. Company leveraged its tangible and intangible resources to enter in manufacturing of passenger cars. This diversification decision can be explained through resource-based view. Tata Motors entered into the business of pre-owned vehicles through "Tata Motor Assured" in 2008. Tata Motors can leverage its existing distribution network to sell pre-owned vehicles. This diversification decision can be explained through resource-based view as Tata Motors aims to leverage its resources to achieve higher growth.

Diversification of Ashok Leyland, a leading truck manufacturer, in development of defence system through JV Ashok Leyland Defence System Ltd. In March 2008, and diversification of Amtek Auto into manufacturing of railway wagon in 2009 cannot be explained through resource-based view or transaction cost theory. There are no visible cognitive relationship between the businesses these companies operate in and diversified into. These diversification decisions can be explained either through agency theory or market power theory.

4.4 Sector: Engineering

Larsen & Turbo Ltd is a conglomerate having business interest in engineering, construction, consultancy, and information technology. In 2007, L&T diversified into power generation and distribution. There is no direct tangible relatedness between the businesses L&T operate in. Another similar diversification decision is by Crompton Greaves Ltd, an engineering company, into power distribution in 2007-08. The rationale of these diversification decisions is to create a new line of business, which can be explained through market power theory or agency theory. Punj Loyd Limited, another leading engineering company, diversified into petrochemicals, and development of urban infrastructure projects such as airports, jetties, mass rapid transit, light rail transit system, and developments of hotels and resorts. Diversification decision of Punj Loyd into development of urban infrastructure projects can be explained through market power theory and resource-based view as company can leverage its existing resources in new

business. But, diversification of Punj Loyd in petrochemical business does not seem to have any cognitive relatedness. This diversification decision can be explained through Agency theory. Another example of diversification of engineering company in unrelated business is by Apar Industries into manufacturing of automotive lubricants under license agreement with ENI, Italy in 2007. While ENI is the world's eighth largest automotive lubricant manufacturer, Apar Industries does not have any tangible or intangible relatedness with lubricant manufacturing business. Thermax Limited diversified into construction and maintenance of power plants. There is cognitive relatedness between existing line of business of Tehrmax and the new business firm entered in. Termax can leverage its know-how and talent pool in new business.

4.5 Sector: Power Generation and Transmission

NTPC is the largest power generation company in India. In 2002-03, NTPC diversified into power trading and consultancy business. Tata Power, another power generation company, also diversified into power trading business in 2004-05. These diversification decision can be explained through transaction cost theory. Through diversification, NTPC and Tata Power aim to reduce transaction cost and have more control on distribution network. Reliance Infra diversified into construction and maintenance of power plants business in 2004-05. Reliance Infra has entered into a business where it can leverage its know-how and intangible resources.

Power Grid, the largest owner of electric grid, entered into wired telecommunication activities through its telecom venture PowerTel in 2001. While there is no direct relationship between two businesses, Power Grid leverages its existing infrastructure in new business. Power Trading Corporation, a leading provider of power trading solutions, diversified into financial services in 2006 through its arm PTC India Financial Services Ltd. Though in first glance there seems to be no relatedness between two businesses, close examination of business of PTC India Financial Services Ltd. reveals that company provides total financial services to the entities in energy value chain. The activities of the new business of PTC include extending debt to power projects in generation, transmission, distribution, and fuel related infrastructure. So, there is cognitive relatedness between the existing business and new business of PTC. However, this diversification decision can be seen as creation of a new line of business which can be explained through market power theory.

Table-1 lists the companies, its existing line of business, diversification into new business, year of diversification, possible rationale for diversification, and appropriate theories that can explain the diversification decision.

Table-1: List of companies, diversification area, year of diversification, and applicable theory

Company	Existing Businesses	Diversified Into	Year of Diversification	Remarks	Theory used to Explain Diversification Decision
Sector: Oil & Gas					
Indian Oil Corporation Limited	Crude refining, oil and gas marketing, and oil and gas transportation	Petrochemicals	2004-05	Forward Integration	Transaction Cost Theory, Resource-based Theory
Reliance Industries Limited	Oil Exploration, Refining, and Marketing	Retail Network	2006-07	Creation of new line of business	Market Power Theory
Bharat Petroleum Corporation Limited	Oil and gas refining and marketing	Oil exploration	2006-07	Backward Integration	Transaction Cost Theory, Resource-based Theory
Essar Oil Limited	Oil Exploration, Refining, and Marketing	Oil refining, oil marketing	2008-09	Forward Integration	Transaction Cost Theory, Resource-based Theory
G A I L (India) Limited	Gas transportation, petrochemicals	Oil Exploration	2006-07	Backward Integration	Transaction Cost Theory, Resource-based Theory
Sector: Steel					
Steel Authority Of India Limited	Iron and Steel manufacturing	Cement manufacturing	2007-08	Forward Integration	Transaction Cost Theory, Resource-based Theory
Tata Steel Limited	Iron and Steel manufacturing	Mining of hard coal, Mining of lignite	2007-08	Backward Integration	Transaction Cost Theory, Resource-based Theory

Jindal Steel & Power Limited	Iron and Steel manufacturing	Power Generation	2007-08	Leverage of tangible and intangible resources	Resource-based Theory
Jindal Stainless	Iron and Steel manufacturing	Architectural and design solutions for stainless steel companies	2006-07	Leverage of intangible resources	Resource-based Theory
Bhushan Steel Limited	Iron and Steel manufacturing	Power Generation	2005-06	Leverage of tangible and intangible resources	Resource-based Theory
Sector: Automobile					
Maruti Suzuki India Limited	Manufacturing of motor vehicles	Selling motor insurance	2002-03	Selling complimentary product, cross-subsidizing	Market Power Theory
Mahindra & Mahindra Limited	Manufacturing of agriculture equipment, Manufacturing of commercial vehicles	Manufacturing of passenger vehicles	2007-08	Leverage of tangible and intangible resources	Resource-based Theory
Tata Motors Limited	Manufacturing of commercial vehicles, utility vehicles, and motor parts	Selling pre-owned vehicles	2008-09	Leverage of tangible and intangible resources	Resource-based Theory
Ashok Leyland	Manufacturing of heavy vehicles	Manufacturing of tanks, reservoir, and defense products	2007-08	Creation of new line of business	Market Power Theory, Agency Theory
Amtek Auto	Manufacturing parts and accessories for motor vehicle	Manufacturing of railway locomotives	2009-10	Creation of new line of business	Market Power Theory, Agency Theory
Sector: Engineering					

Larsen & Toubro Limited	Construction of building, construction of rail, roads and bridges	Power generation and distribution	2007-08	Creation of new line of business	Market Power Theory, Agency Theory
Punj Lloyd Limited	Construction of roads and railways, Manufacturing of electric equipment	Construction of urban infrastructure	2006-07	Creation of new line of business	Market Power Theory, Agency Theory
Crompton Greaves Limited	Manufacturing of electric equipment, Manufacturing of domestic appliances, Electrical and other construction activities	Electric power generation, transmission, and distribution	2007-08	Creation of new line of business	Market Power Theory, Agency Theory
Apar Industries Limited	Manufacturing of electric equipment	manufacturing of automotive lubricants	2007-08	Creation of new line of business	Market Power Theory, Agency Theory
Thermax Limited	Manufacturing of fabricated metal products	Construction and maintenance of power plants	2003-04	Leverage of tangible and intangible resources	Resource-based Theory
Sector: Power Generation and Transmission					
NTPC	Electric Power Generation	Power trading, Consultancy	2002-03	More control on distribution network	Transaction Cost Theory
Power Grid	Electric Power Transmission	Wired Telecommunication	2001-02	Leverage of tangible resources	Resource-based Theory
Reliance Infra	Electric Power Generation	Construction and maintenance of power plants	2004-05	Leverage of tangible and intangible resources	Resource-based Theory
PTC India Ltd	Power Trading Solution	Financial Services	2006-07	Creation of new line of business	Market Power Theory
TATA Power	Electric Power Generation	Power trading	2004-05	More control on distribution network	Transaction Cost Theory

6. Conclusion

Out of the sample of 30 companies, 6 companies took diversification decision driven by vertical integration. Diversification decisions of 8 companies were driven by creation of new line of business to have more market power. Diversification decision of 8 companies were driven by leveraging tangible and intangible resources. In power sector, two companies diversified to have more control over distribution network. The diversification decision of Maruti Suzuki was to sell complimentary product and create opportunities for cross subsidizing. In oil and gas sector, vertical integration has been major rationale behind unrelated diversification. Creation of new line of business has been a motivation for unrelated diversification mostly for private sector companies, especially in engineering sector. There is no single dominant rationale for unrelated diversification among Indian firms. The unrelated diversification decisions of Indian firms are mainly driven by vertical integration, leveraging tangible and intangible resources, and having more market power through creation of new line of business.

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