

Indian Conglomerates Diversification & Performance

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Strategic management literature is flooded with the notion of diversification strategy. Some researchers point out that diversification enhances corporate performance while there has been an antagonistic school which held that diversification destroyed corporate value and led to poor performance of conglomerates. The author examines the impact of diversification on performance of seven Indian conglomerates on different parameters such as profitability, market share and growth. Totally these seven conglomerates represented data of 324 companies coming from 80 different industries. Data was collected for the year 2013-2014. This study indicated that there was a very moderate effect on conglomerate performance.

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Introduction

Strategic management literature seeks to explore methods of firms to attain sustainable competitive advantage (Porter, 1980; Porter, 1985). Strategic management literature basket is filled with methods for firms to attain sustainable competitive advantage by means like developing core competencies (Prahalad & Hamel, 2006) internationalization (Verbeke, 2013), Mergers & Acquisition (Kusewitt, 1985) and many others. In the basket of strategies that a firm can pursue diversification occupies a large territory. Emerging economies has been characterized by high growth (Bhattacharyya, 2011). Firms in emerging economies have often grown substantially over a period of few decades because of high domestic demand. After witnessing growth in single line of business with cash and slack resources emerging economy firms undertook diversification to related and unrelated businesses to register further growth as a next strategy (George & Kabir, 2012; Coad, 2009; Das & Kapil, 2015; Tan & Peng, 2003). In the context of emerging economies the path of diversification led to higher performance and in some cases

weaker performance results (Das & Kapil, 2015; Tan & Peng, 2003). The question of diversification in emerging economies is still unsettled (Khanna & Palepu, 2000; Yiu, Lau & Bruton, 2007). In this article the author analyses data of 7 Indian conglomerates representing 324 companies and 80 industries so as to secure a better understanding of their performance while employing diversification strategy in the emerging economy context.

Literature Review

The world of business strategy gained momentum in 1960s but the question of firms to diversify or not has been as old as the history of business (Rumelt, 1982). For strategy managers when, how and what to diversify from their current business line has always been a dilemma (Palepu, 1985). Firms are positioned to contemplate on the question of diversification when they have attained a substantial scale advantage in its defined market with sufficient utilization of management bandwidth (Christensen & Montgomery, 1981; Rumelt, 1982; Palepu, 1985). The work of Khanna (2005) had deliberated on whether it was prudent to diversify in developed economies or in developing economies with presence of more institutional voids.

There has been substantial work on diversification literature documenting the reasons and need for diversification, the circumstances and factors required for successful diversification, the constraining factors in unsuccessful diversification (Montgomery, 1994; Palich, Cardi-

nal & Miller, 2000; Varadarajan & Ramanujam, 1989). Palich, Cardinal and Miller (2000) had mentioned that the diversification has been a central concept of enquiry in strategic management literature. According to the author diversification encompasses both strategic planning and implementation towards entering in to new product categories with expansion of value chain activities (Bausch & Krist, 2007). When a firm gets into a product line with distinct value chain activities it can further expand into newer market segments and geographic locations (Yiu, Lau & Bruton, 2007; Bausch & Krist, 2007).

Diversification strategies can be classified into different types as given by Rawley and Simcoe (2008). Diversification strategy can be horizontal or vertical (Rawley and Somcoe, 2008). Vertical diversification means that a firm extends its value chain (Porter, 1985) either upstream or downstream or both (Montgomery & Singh, 1984; Reed & Luffman, 1986). Upstream vertical integration means a firm getting into the business of its suppliers like a steel manufacturing firm getting into the business of iron ore mining. Vertical integration by diversification can also be towards the customer or seller side (Montgomery & Singh, 1984; Reed & Luffman, 1986). This is diversification downstream. Example of this kind of diversification is of a coal mining firm into becoming a thermal power plant or an iron ore plant becoming a steel plant. Vertical diversification entails a firm in getting into production life cycle or associated activities either for an earlier or later stage (Por-

ter, 1985; 1980; Rumelt, 1982). Vertical diversification helps firms in upstream integration to get better access to raw materials in desired quality and lower cost in right time (Rumelt, 1982; Palepu, 1985; Geringer, Beamish & DaCosta, 1989). Diversification by vertical integration in downstream helps a firm to control retail market better by understanding retail market better, reducing the bargaining power of retailers and reaching closer to the consumer (Rumelt, 1982; Palepu, 1985; Geringer, Beamish, & DaCosta, 1989).

In horizontal diversification, a firm having a set of resource and capabilities, with a focus on a particular line of business with a defined value chain gets into a new line of business with requirement of newer resource and capabilities and a different set of value chain activities (Aoki, 1986; Ensign, 1998). Thus, in horizontal diversification the extant value chain is added on with a very different value chain altogether (Li, 2014). Example of horizontal diversification could be that of a fruit farm producer becoming a logistics truck owner. The focus in horizontal diversification is to acquire new sets of customers whereas the focus of vertical diversification is on primarily the existing base of customers (Li, 2014; Aoki, 1986; Ensign, 1998).

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Diversification strategies can be further classified as defensive or offensive (Njuguna, 2013). The author pointed out that in offensive diversification a firm has more cash or slacks than its need of incremental expansion then the firm acquires business lines in new products or markets more with an attacking instinct. Defensive diversification strategy, on the other hand, is motivated to avert risk (Park, 2002). A firm undertakes defensive diversification when it is attacked by other firms substantially (Park, 2002). In defensive diversification a firm diversifies to increase its portfolio of businesses so that it can avoid the risk of being hit by other competing firms in a particular line of business (Park, 2002; Njuguna, 2013).

The literature on diversification strategy also dwells on related and unrelated diversification (Park, 2002). According to Varadrajam and Ramanujam (1989), if a firm enters a new line of business that requires changes in the organizational management process systems and administrative structures substantially then it is termed as unrelated diversifications. According to Hoskisson, Hill and Hitt (1992), if the diversification is very different from the extant product lines of the organization then it is classified as unrelated diversification. Otherwise it is related diversification. Chang (2003) had classified diversification in terms of geographical expansion; if diversification leads to expansion into international market then it becomes international diversification. Otherwise it is domestic diversification.

From the beginning of business firms worldwide have applied diversification as

a strategy for growth (Zahra, Ireland & Hitt, 2000). The prominent logical reasons for diversification has been to increase firm profitability, increased market share, inducing higher growth, reduction of business risks, extension of business value chain, more efficient utilization of resources and increase financing capacity (Zahra, Ireland & Hitt, 2000). Adner and Zemsky (2015) categorised diversification decisions into three key components depending upon the relative degree of industry association nature. These are the fixed cost related to diversification strategy, firm growth opportunity because of diversification and the extent of home market competitiveness (Adner & Zemsky, 2015). Adner and Zemsky (2015) advocated that diversification initiatives affect both the firm competitiveness as well as the structure of the market in which the firm enters. Their research also indicated that enhanced relatedness in diversification increased firm competitiveness. The work of Stopford and Wells (1972) identified two critical factors which affected the success of a firm's growth as the extent of product diversification and international diversification. However Kim, Hwang and Burgers (1989) indicated that the different types of related and unrelated product diversification and its impact on financial performance of a firm were dependent upon the extent of international diversification. Berger and

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Ofek (1995) found that diversifying and operating different line of business helped firms to attain higher operational efficiency increased debt capacity, moderation of tax levels and incentive choices to focus on projects with higher net-present value. There is also literature on the downside of diversification because of increased costs (Brouthers & Brouthers, 2000; Jensen, 1986). There are often expenditure of increased discretionary resources to justify investments, cross subsidies draining cash earned from better performing firms and increased administrative cost because of misalignment between the diversified firms (Walter, 2003; Brouthers & Brouthers, 2000). Lewellen (1971) remarked that the potential advantage of the diversification emerged from combining business firms having imperfectly co-related earning streams. This can be thought of co-insurance effect and thus providing the firm overall a greater debt capacity. The enhancement of increased debt capacity (with respect to single line firms of similar size), create value by increasing tax shields (Devos, Kadapakkam & Krishnamurthy, 2009; Lubatkin & Chatterjee, 1994).

One can thus argue that diversified firms as compared to other firms would possess higher leverage and lower tax payment outflows (Smith & Stulz, 1985; Lubatkin & Chatterjee, 1994). On similar lines Majd and Myers (1987) reported that undiversified firms faced tax disadvantage. In diversified firms the non-profit firms reduce the tax burden of the firms. Diversification adds value because it increases economy of scope. Economy of

scope is enhanced because firm can re-deploy resources and capabilities across related product market (Anand & Singh, 1997; Døving & Gooderham, 2008; Helfat & Eisenhardt, 2004). Tanriverdi and Lee (2008) explained that firms could leverage its familiarity with consumer insights to enhanced product quality for introducing related products in similar markets. Li and Greenwood, (2004) stated that redeployment of resource and capabilities is possible when either the factor inputs or the catered customer segments are similar. Khanna and Palepu (1997) advocated that for the success of diversification depended on the degree of the market development and institutional development. Chakrabarti, Singh & Ishtiyad (2007) pointed out that potential returns from diversification decreased with market and institutional development. It is important to note that in emerging economies like India and China where there is lack of well-established regulatory framework and poorer markets for products, finance and labour there is better probability of diversification giving better performance (Hennart, 2012). Kock and Guillen (2001) found that in emerging economies where there is more protectionism and other trade barriers present, resource value for firms get distorted and hence diversification helps. Chakrabarti, Singh & Ishtiyad (2007) further mentioned that while di-

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versifying firms utilize scale and scope advantages by internalizing firm's resources and capabilities with external institution framework in advanced economies. Because external frameworks are not as good in emerging economies internalization by diversification becomes more viable and profitable. The work of Gatzer, Hoang and Ruckes (2014) indicated that firms with internal capital markets have better resource allocation than those having external capital markets. On these lines it can be argued that diversified firms possessing a larger internal capital market better allocated resources. Stulz and Bailey (1990) further wrote that because of the presence of this large capital market firms in diversified organizations reduce the underinvestment problem as proposed by Myers (1997). These scholars of internal capital markets univocally argue that diversified firm rather than their separate counterparts would have more positive NPV investment.

Different researchers have had different viewpoints on whether diversification is a successful strategy for enhancing growth. Some of the empirical research findings established a positive relationship of diversification with economic performance (Singh et al, 2001), while other researchers reported a negative relationship with economic performance (Lins & Servaes, 2002; Markides, 1995; Gary, 2005). Interestingly, some studies established a curvilinear relationship (Varadarajan and Ramanujam, 1987; Palich, Cradinal and Miller, 2000; Kakani, 2000). One should also note that some studies observed lack of a relationship

(Grant, Jammine & Thomas, 1988; Montgomery, 1985).

It was reported by Berger and Ofek (1995) that well diversified firms overinvested in sectors with weaker investment realization opportunities, and thus destroyed firm value. This according to Berger and Ofek (1995) occurred because diversity created contexts in which firms could, without being scrutinized, inefficiently transfer funds from good businesses to bad ones and thus destroy overall value. It is no wonder that empirical research in developed economies has often pointed out that diversification resulted in poorer performance termed as 'diversification discount' (Montgomery & Wernerfelt, 1988; Varadarajan & Ramanujam, 1989). Lamont and Polk (2001; 2002) explained this diversification discount by two reasons. The first reason is more like a black box; diversification process somehow itself destroyed value. Secondly, Lamont and Polk (2001; 2002) observed that diversification and value are not to be causally related, but these terms purely echo firms' endogenous selections.

It needs to be stated that empirical work on establishing the relationship between corporate performance and diversification strategy had a long historical precedence both in the strategic management literature (Varadarajan & Ramanujam, 1989; Montgomery, 1994) and in financial management literature (Martin & Sayrak, 2003). It must also be noted that the research work in financial management, in particular, is concentrated on examination of two challenging

assessments of diversified firms. One interpretation is that diversified firms are better gifted to exploit expansive information sets that accompany such firms' radar and are better equipped to ration resources to construct strategy paths by their internal capital markets mechanisms than the financial markets (Caves, 1971; Myers & Majluf, 1984). While the antagonistic perspective is that diversified firms are overwhelmed by wastefulness due to agency problems with poor allocation of resources across business investments than would have been better allocated financial markets (Amihud & Lev, 1981). The point to be noted though in the Indian context is that as India is an emerging market with institutional voids (insufficient and inefficient market structures and poor institutional frameworks) as argued by Khanna (1997) greater diversification wouldn't dent firm performance. It is a logical argument that performance consequences of firm diversification will vary across countries, because of the effect of the institutional environs (Yigit & Behram, 2013).

Research Gaps & Objectives

Extant literature on diversification indicated that diversification has mixed results for performance for corporations in emerging economies (Wan & Hoskisson, 2003). There were however very few studies in the context of India. The fundamental aim of this research is to analyse the effect of diversification on the performance of Indian conglomerates. In other words this study is to ascertain whether diversification in the Indian con-

text is beneficial and diversified Indian business groups are performing better than industry peers in terms of economic growth and market share.

Data Collection & Methodology

For this research study the data was collected for the following conglomerates:

1. Adani Group
2. Mahindra & Mahindra Group
3. Aditya Birla Group
4. Reliance Group [ADAG]
5. Reliance Group [RIL]
6. RPG Enterprises Group
7. Tata Group

The main reason to choose these conglomerates as the research dataset was that these were the top most influential firms in Indian industry. Financial data of 324 firms of these 7 conglomerates from 80 different industry groups for the year 2013-14 was included and analysed in this research. The data for the group companies of each conglomerate and the industry group(s) in which they were operating was extracted from Centre for Monitoring Indian Economy (CMIE) database of Indian companies. The parameters considered for study by the author were:

- Company Income
- Company Profit After Tax
- Company Income Growth

- Industry Income
- Industry Profit After Tax
- Industry Income Growth
- Company Position in Industry

Comparative analysis was done on following parameters for all the group companies under each conglomerate:

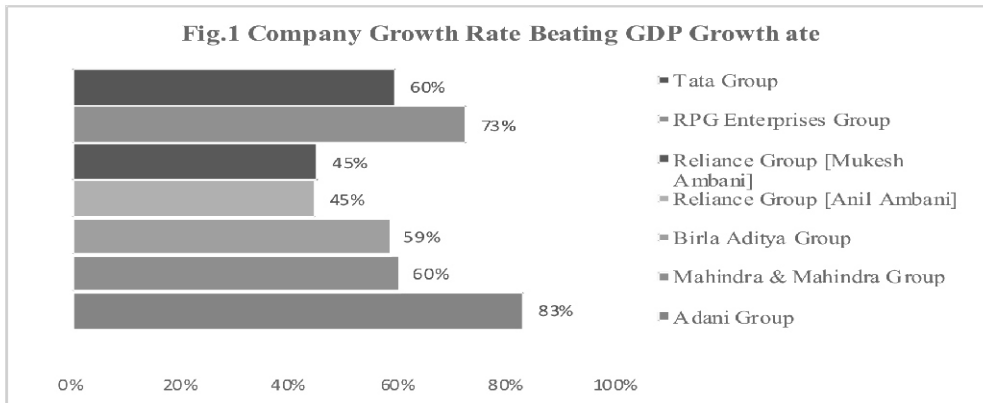
- Company growth rate was compared with industry growth rate
- Company, industry growth rates were compared with country's GDP growth rate
- Company PAT/Income ratio was compared with industry PAT/Income ratio
- Company rank (revenue basis) was analysed within the industry group

Company Growth vs Indian GDP Growth

The growth rate of each of the group companies was compared with India's GDP growth and the results are represented in fig.1. For comparative analysis Indian GDP growth for the fiscal year 2013-14 was taken as 4.7% (The Hindu, 2016). The results indicated that growth rate of about 60% of the total 7 group companies was beating the GDP growth for the fiscal 2013-14. The performance of Adani group was better when compared with other business groups under study.

Although specific reasons are beyond the scope of this paper, it was revealing to know that 40% of the companies of such industry giants failed to beat the Indian GDP

Fig.1 Company Growth Rate Beating GDP Growth Rate



% of each group companies beating the GDP growth rate

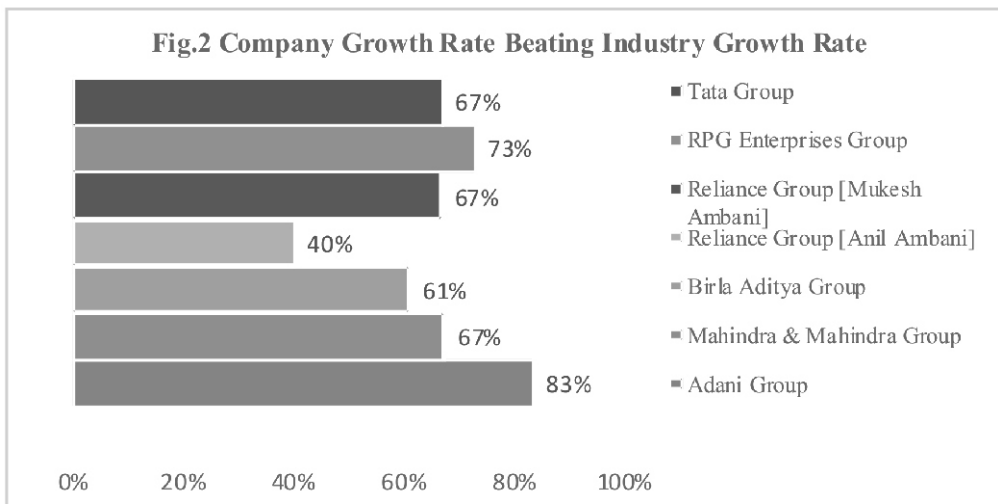
rate which was a mere 4.7% that year. It becomes imperative thus to know how each industry performed that year.

Company Growth vs Industry Growth

When growth rate of companies was compared with their respective indus-

try growth rate, there was a slight improvement. There's 65% of the companies from all the groups were found beating the respective industry growth rate. On this parameter, Adani Group fared well while Reliance Group [ADAG] performance was lagging behind when compared with other conglomerates (Fig.2).

Fig.2 Company Growth Rate Beating Industry Growth Rate



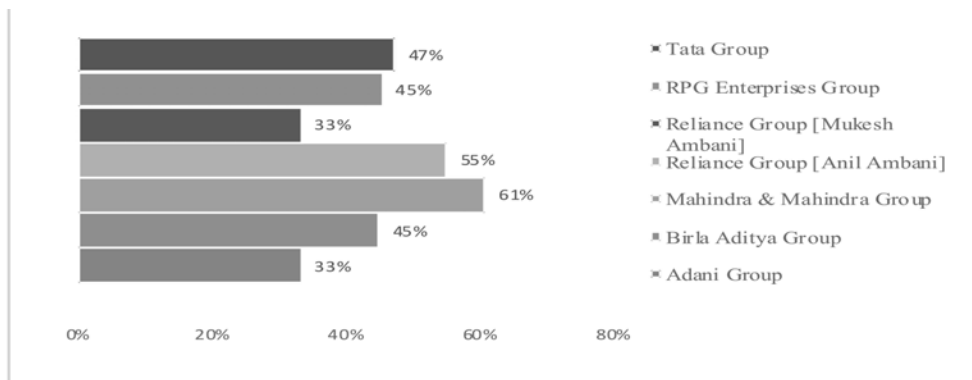
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The companies which beat both industry and GDP rates could be considered as star performers of their respective groups. More the number of star performers in a group one can argue that better would be the justification for diversification of that group.

Company PAT/Income vs Industry PAT/Income

We compared PAT/Income ratio of the companies with their respective industry PAT/income ratios. From fig. 3, it can be inferred that only 46% companies from all the conglomerate groups were able to beat the industry PAT/Income. On respective comparison among different groups for this parameter, Aditya Birla Group was found to be performing better while Adani Group and Reliance Group [RIL] were lagging behind the others.

Fig. 3 Company PAT/Income Beating Industry PAT/Income



% of each group companies beating the industry PAT/Income rate

Company Ranking among Peer Group

All 324 companies were ranked on market share parameter in their respective industry groups and a ranking matrix was developed as tabulated in Table 1. From the data points, it was inferred that only 10 % of the total group companies were the leaders (top 3) in their respective industry groups. The number increases to 25% if leaders are defined as top 10 in their respective industry groups.

However no clear pattern among different business groups regarding the performance of groups could be established.

Conclusion & Future Direction

The study performed on the four parameters for the year 2013-14 on Indian conglomerates demonstrated that diversification seems to have benefits on performances of most of group companies. Even though it was expected that having a strong brand name could bring cred-

Table 1 Ranking of Conglomerate Group Firms

GROUPS	RANKS									
	1-3	4-10	11-20	21-30	30-50	50-100	101-200	201-500	Above 500	Total
Adani Group	4	2	7	1	0	2	2	0	0	18
Mahindra & Mahindra Group	2	11	5	8	6	12	8	4	2	58
Birla Aditya Group	7	3	6	3	7	2	11	4	3	46
Reliance Group [Anil Ambani]	2	6	6	1	2	1	0	1	1	20
Reliance Group [Mukesh Ambani]	3	1	3	1	2	2	4	8	9	33
RPG Enterprises Group	1	2	2	4	1	4	4	2	2	22
Tata Group	18	21	21	14	11	25	7	6	4	127
Total	37	46	50	32	29	48	36	25	21	324

Indian conglomerates demonstrated that diversification seems to have benefits on performances of most of group companies.

ibility to the subsidiary companies compared to stand alone companies, performance may also have depended on other factors such as company strategy, quality of top management, quality of workforce, industry performance, and on many more factors (Rumelt, 1982; Montgomery, 1994; Palich, Cardinal & Miller, 2000; Varadarajan & Ramanujam, 1989). In the current scenario with the consolidation of all four parameters under Indian conglomerates, it was observed that 61% of the companies had beaten GDP growth. It is worth mentioning that the GDP growth in the year was subdued at less than 4.7%. In a year of subdued growth 61% of companies beating GDP indicate positive correlation between diversification and company performance. However a key aspect

is to note that only less than 10% of companies under conglomerates were ranked top 3 in the Industry. Performances of a few groups were much poorer than the study average for the conglomerates considered under the study. This may point to the inference that each group’s sustenance towards diversification decision had a mixed response for the year 2013-14 but mostly supporting positive relation between diversification and performance of the firm.

This study can be further taken to multiple levels of detailing in future researches pertaining to interest. For this study, the data collected was only for a single financial year. For doing a comparative study on the conglomerate performance data may be collected for 3-5 time periods spanning few blocks of years falling significantly apart. To carry out such a study, data for consecutive years for a time period can be taken and analysed. It is also possible to do a re-

search on other factors that curtail or amplify company performances under a conglomerate. Future research can also be conducted to derive the relation between diversification and company performance for predicting the future performances of these firms or to suggest from which lines of businesses each conglomerate should pull out, divest and on which lines of businesses conglomerates should invest in to reap maximum corporate level benefits.

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