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THE IMPACT OF DIVERSIFICATION STRATEGY ON FIRMS' PERFORMANCE

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Abstract:

Diversification strategies have been widely researched in the field of strategic management, but findings on their impact on firm performance are contradictory, indicating a need for further research. It is known that diversification can enhance firm performance, but the effects vary depending on the type of diversification and the time frame. This paper uses a systematic review of the existing literature to analyze the impact of diversification strategies on firm performance. Various studies on diversification were analyzed, leading to the conclusion that the related diversification is beneficial in the short term, while the unrelated one may lead to a loss of focus and the increased costs. The research results confirm the inverted U-shape theory in relation to diversification and firm performance, suggesting a need for careful management of diversification and consideration of contextual factors. The findings emphasize the importance of understanding the dynamics of diversification and its impact on firm performance and indicate the need for further research in strategic management to better comprehend effects of different diversification strategies.

Keywords:

diversification strategies, firm performance, related diversification, unrelated diversification, curvilinear model, inverted U-shape theory.

1. INTRODUCTION

Rapid development of the global business environment has led to a growing interest in analyzing diversification strategies and their impact on company's performance. This paper explores how diversification strategies can influence long-term results, with an emphasis on corporate governance and institutional factors that affect the decision-making process.

The primary focus of this research is on the impact of diversification strategies on business performance, examining the synergies and limitations they bring. The goal is to analyze how different forms of diversification affect profitability, market value, and long-term success of companies. Special attention is given to the phenomenon of the "too much of a good thing" effect, which points to operational issues that may arise after reaching the optimal level of diversification. This study also analyzes the impacts of various diversification strategies, taking into account legal frameworks, agency costs, and the effects of economic crises on resource allocation.

This research significantly contributes to understanding the economic and organizational aspects of diversification, providing valuable information for managers in making strategic decisions. Determining the point at which diversification shifts from beneficial to burdensome for a company is critical information for decision-makers. This study aims to fill a gap in the existing literature on the complex relationships between diversification, corporate governance, and firm performance. The analysis of national and institutional factors influencing strategy selection is a crucial aspect, as these choices may vary depending on legal and economic frameworks.

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Previous research indicates that the related diversification, which involves utilizing existing resources and knowledge, typically yields better results than the unrelated one. However, there are significant limitations in analyses that compare studies across different industries and market contexts, making it difficult to draw general conclusions. Although literature offers extensive analyses of diversification strategies, significant limitations arise from the incomplete analysis of institutional factors. For example, previous studies have mostly focused on economic aspects, often overlooking the legal and political contexts that also influence strategic decisions.

The motivation for this paper stems from the need to clarify the effects of different types of diversification in various industrial and institutional contexts to better understand the role of these strategies in modern business. Additionally, there is a growing need to understand how multinational companies implement diversification as a response to increasingly complex economic and political challenges. Another important aspect is finding solutions for better integration of internal capital markets and resource management during financial crises.

The central idea of this research is that diversification brings positive effects up to a certain level, after which additional levels of diversification can lead to negative outcomes. The research hypothesis is that the related diversification has a more positive impact on business performance compared to the unrelated one. A key aspect of this research is that diversification strategies play a vital role in the long-term sustainability of companies, especially in times of crisis, when internal capital markets and resource flexibility can provide a competitive advantage. This paper contributes to understanding the mechanisms that influence the effects of diversification on business performance, particularly in specific markets and institutional conditions.

Research findings indicate that the moderate diversification contributes to profitability growth, while the excessive one can lead to increased organizational costs and decreased efficiency. These results provide important guidelines for formulating diversification strategies under various market conditions. It has been shown that firms applying diversification strategies have greater financial management flexibility and are less exposed to risks from external market shocks. This finding highlights the need for a deeper understanding of resource and capital management in times of crisis. The article is structured so that, after a brief introduction, the existing research is analyzed, and through the results and discussion, advantages and limitations of diversification strategies are considered. In conclusion, the paper offers key recommendations and guidelines for future research.

2. LITERATURE REVIEW

Research on the relationship between diversification and firm performance shows that the effects of diversification can vary significantly depending on several factors. In the early stages, moderate diversification brings a positive impact on business results, but excessive diversification can lead to a decline in performance. The costs of organization and coordination often outweigh the benefits of additional diversification (Hashai, 2015).

The neoclassical model presented in the research of Maksimovic and Phillips (2002) points to the optimal size of the company depending on the industry specifics and capacity. Additionally, research on British manufacturing companies shows a positive correlation between product diversity and profitability up to a certain point, after which performance declines.

Companies that apply the related diversification usually achieve more profitable results because they can utilize the existing resources and knowledge. In contrast, the unrelated diversification, which involves investments in completely different industries, can lead to stabilization of cash flows but simultaneously to lower profitability (Amit & Livnat, 1988). An example of the related diversification could be a company that manufactures computers and decides to produce computer components, allowing it to leverage the existing capacities.

The core competencies of a company play a crucial role in its success in the global economy. These competencies enable creation of unique products and innovations, thus making the company competitive in the market (Prahalad & Hamel, 1990). Moreover, the concept of dominant logic (Prahalad & Bettis, 1986) helps companies shape their strategies based on internal assumptions and values, which is highly significant for successful diversification.

According to a resource theory, companies with surplus resources, whether physical, knowledge-based, or financial, have a greater chance of opting for diversification. Companies with an excess of physical and knowledge-based resources usually focus on the related diversification, while those with an excess of financial resources often choose the unrelated diversification (Chatterjee & Wernerfelt, 1991).

2.1. EVOLUTION OF DIVERSIFICATION AND IMPACT ON MARKET VALUATION

During the 1960s, companies that expanded into multiple industries did not have a high market valuation compared to those focused on a single activity. This phenomenon, known as the "diversification discount," shows that companies with a broader range of activities had a lower value than those specialized in one sector. However, during the 1970s, the discount gradually disappeared, and the market began to value diversified and focused firms equally. During this period, companies with high insider ownership, which in the 1960s was associated with negative diversification results, began adopting diversification strategies as the discount started to decline.

This discount, which represents a premium for focused companies, is often associated with advantages such as greater expertise and efficiency in management (Hund, Monk & Tice, 2012). The higher value that investors attribute to focused companies stems from their clear specialization and lower business complexity. Financial markets' reactions to new acquisitions and diversification strategies can be short-term and do not always reflect the company's true value. According to some research, the diversification discount may disappear or turn into a premium when proper benchmarking is applied (Villalonga, 2001). Successfully implemented diversification can increase the company's market value, but managers and investors must have a long-term perspective and carefully compare results with similar firms.

2.2. WAVE OF DE-DIVERSIFICATION AND STRATEGIC FOCUS

During the 1980s, the United States experienced a wave of de-diversification that significantly altered corporate strategies, with the concept of conglomerates losing popularity (Davis, Diekmann, & Tinsley, 1994). Companies began returning to core activities, leading to improved business performance. It was shown that excessive diversification could result in inefficient operations and greater complexity, prompting managers to focus on their core competencies and market demands.

Specialization proved to have an advantage over diversification, especially in the context of maximizing shareholder value (Comment & Jarrell, 1995). Companies that focused on a single activity had better control over resources and more efficient management, resulting in higher profitability. During the late 1980s, the process of de-diversification impacted numerous American firms, leading to a reduction in the sectors they operated in and improvement in their productivity (Lichtenberg, 1992).

2.3. DIVERSIFICATION AND ITS IMPACT ON COMPANY VALUE: INSTITUTIONAL FACTORS AND CONTEXTUAL CHANGES

Considering the question of whether diversification destroys firm value brings different perspectives. Although diversified companies often face a stock discount, this is not necessarily a direct result of diversification itself but reflects the previously discounted values of new business segments (Graham, Lemmon, & Wolf, 2002). According to some research, a lack of synergy between different activities can lead to a loss of company value (Berger & Ofek, 1995). An example is a manufacturing company entering the service sector without sufficient understanding of that area, which can lead to negative perceptions of investors and a drop in value.

Research on companies that are part of business groups has shown that they often enjoy a diversification premium due to the efficiency of internal markets and market power in the early stages of economic development (Lee, Peng, & Lee, 2008). However, in a more developed institutional environment, this premium may diminish or even turn into a discount. Therefore, it is crucial for companies to adjust their strategies to these changes, either by optimizing existing operations or even through de-diversification. Research on emerging markets shows that membership in business groups can lead to increased profitability (Khanna & Rivkin, 2001).

The benefits of membership in such groups include access to resources, synergies through collaboration, and better performance compared to independent firms. These firms also gain greater bargaining power and easier access to new markets. However, the mere diversity of the group is not a guarantee of positive outcomes (George & Kabir, 2012). The strategy and structure of the group, as well as its ability to respond to changes in the institutional environment, play a significant role in the success of diversification.

The connection between enterprises and institutions plays an important role in determining their activities. Institutions provide resources and legitimacy that can influence companies' decisions on diversification (Peng, Seung-Hyun & Wang, 2005). Additionally, institutional factors such as governments and regulatory bodies can encourage diversification through various incentives. Legal frameworks and corporate culture also shape firms' strategies, making them more cautious in decisions regarding expansion into new markets. Research in East Asian countries shows that economic instability can limit the success of diversification strategies (Chakrabarti et al., 2007). In environments with high economic risks, companies may face difficulties in achieving positive outcomes from their diversification efforts.

Contextual and institutional factors are key to understanding companies' ability to generate value through diversification (Khanna & Palepu, 2000). Laws, political systems, and cultural norms significantly impact the success of business groups and companies in implementing diversification strategies.

2.4. INSTITUTIONAL CONTEXTS AND THE ROLE OF DIVERSIFICATION IN CORPORATE PERFORMANCE

The evolution of large European corporations reveals the importance of institutional and national factors in shaping diversification strategies and their impact on performance. Legal systems and economic circumstances in different countries play a key role in shaping diversification strategies, leading to specific models in various national frameworks. This variation illustrates how institutional differences influence diversification decisions.

Furthermore, during financial crises, diversified companies have greater flexibility in capital allocation, which was particularly evident during the 2007-2009 recession (Volkov & Smith, 2015). This approach allows companies to leverage their internal resources when the external sources of capital are unavailable (Kuppuswamy & Villalonga, 2010).

Research indicates that highly diversified firms are less dependent on internal cash flows when making investment decisions, making them more resilient to financial shocks (Shin & Stulz, 1998). This aspect leads to better managerial flexibility across different business segments. However, the crossing of financial flows between segments can lead to inefficient resource allocation (Chevalier, 2004).

Internal capital markets play a crucial role in times of crisis by helping allocate capital during the instability of external financing sources (Matvos & Seru, 2012). While companies with large cash reserves can more easily access acquisition funds, this strategy is not always effective, as cash accumulation often results from operating losses (Harford, 1999; Opler et al., 1999).

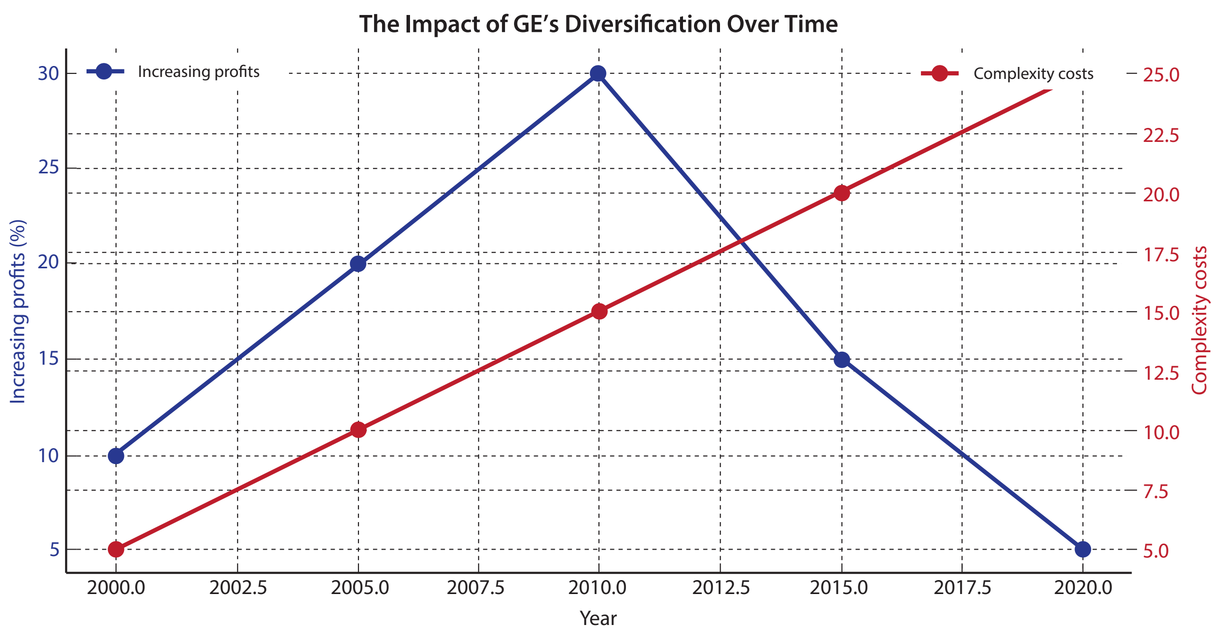
Conflicts of interest between managers and shareholders can undermine investment efficiency, especially when managers have uncontrolled access to cash flows, which can result in unnecessary investments and a decrease in company value (Rajan, Servaes & Zingales, 2000). A solution to this problem could be borrowing, which would motivate management to make more rational investment decisions, thereby better aligning shareholder and managerial interests (Jensen, 1986).

3. RESULTS AND DISCUSSION

Research on the impact of diversification on the business performance of companies indicates the complexity of these relationships, where moderate diversification often yields positive effects. This phenomenon can be explained by the inverted "U" theory, which suggests that up to a certain point, diversification genuinely increases profitability and reduces risks. However, beyond that critical point, the complexity of management and rising costs may lead to a decline in the company's performance.

For example, General Electric (GE) actively diversified its operations into various industries, including energy, healthcare, and finance, in the early 2000s. While initially this strategy resulted in significant increases in profits and market value, the sheer number of different businesses became extremely difficult to manage. As the company reached a higher level of diversification, the costs of coordination and management complexity led to a decrease in performance. In 2015, GE began a restructuring process and withdrew from certain segments, indicating the difficulties caused by excessive diversification.

Illustration 1. The Impact of GE’s Diversification Over Time.



Source: Cascade Strategy (n.d.), Thompson (2003), and Chicago Booth Review (n.d.).

The chart illustrates the impact of General Electric's (GE) diversification over time. The blue line shows an increase in profits from 2000 to 2010, when the company experienced significant growth. However, starting in 2010, there was a noticeable decline in profit growth, reaching a low in 2015, when the restructuring process began. The red line represents the increasing costs of management complexity, which steadily rose from 2000 to 2015. This indicates that while diversification was initially successful, it ultimately led to the increased costs and complexity over time, resulting in diminished performance.

This example illustrates how excessive diversification can negatively impact performance, confirming the inverted "U" theory in the context of business strategies.

Empirical research shows that companies that successfully integrate new activities into their existing structures achieve significant synergies and economic benefits. Key performance indicators, such as return on assets (ROA), return on equity (ROE), and revenue growth, play an important role in assessing the effectiveness of diversification strategies. For instance, ROA measures a company's asset management efficiency, indicating that firms that successfully integrate new business units tend to achieve higher ROA, which reflects better resource utilization. ROE, on the other hand, measures profitability in relation to shareholders' equity, meaning that diversification leading to higher ROE reflects a company's ability to generate greater returns for investors. A successful diversification strategy usually results in revenue growth, indicating an expansion of market share and increased sales.

One notable example is Amazon, which started as an online bookstore but diversified its business into various industries, including cloud computing through Amazon Web Services (AWS). This strategy led to an increase in ROA, suggesting better management of new resources, and ROE significantly rose, demonstrating Amazon's ability to generate profits for its shareholders (Amazon.com, Inc., 2021).

In contrast, unsuccessful integration can lead to rising costs and diminished performance. For example, Quaker Oats acquired Snapple in 1994 for $1.7 billion, but the integration process was problematic, resulting in a significant decline in both ROA and ROE. Ultimately, the company was forced to sell Snapple for only $300 million in 1997, illustrating the failure of the diversification strategy (Koller, Goedhart & Wessels, 2010).

Moreover, institutional factors play a crucial role in shaping diversification strategies. For instance, Tata Group in India has achieved success in diversification partly due to a favorable institutional environment that encourages innovation and offers various subsidies (Ghosh, 2019). These companies have managed to align their strategies with specific market conditions, achieving long-term success in their diversification efforts.

4. CONCLUSION

Research on synergies and limitations of diversification reveals the complexity of the relationship between diversification strategies and company performance. Based on the existing literature, it can be concluded that moderate diversification usually yields positive results, while excessive diversification can negatively affect company performance. It is crucial to find an optimal level of diversification, as after a certain point, coordination and adaptation costs may outweigh the benefits of new activities.

Neoclassical models point to a positive correlation between product diversity and profitability, up to a point after which there is a decline. In strategic diversification, related activities often produce better results than the unrelated ones, and core competencies play a significant role in creating competitive advantages. During the analysis, special attention was paid to institutional factors, which significantly influence the success of diversification strategies. Companies that can adapt their strategies to changes in the institutional context may achieve better results, both in existing and new markets.

The challenges companies face include dynamic market conditions, where rapid changes require adaptation, as well as the lack of synergy between different activities, which can lead to value loss. Identifying factors that prevent the realization of synergy is an important aspect of future research. Additionally, different institutional frameworks can significantly impact company strategies, but more detailed research is needed on how these factors function in different economic systems.

Future research directions include focusing on strategy adaptation, analyzing how companies can adjust their diversification strategies in the context of changing market conditions and institutional factors, as well as identifying key success factors. It is necessary to investigate which core competencies and resources contribute to success in diversification and which diversification models lead to successful performance. Analyzing specific examples of successful and unsuccessful diversification strategies can help understand the mechanisms behind these outcomes. These guidelines can contribute to the development of diversification theory and practical applications in corporate strategy, encouraging companies to make informed decisions about their future expansion.

It is important to emphasize that contextual and institutional factors play a key role in companies' ability to generate value through diversification. The implementation of various diversification strategies significantly depends on the specific legal and economic frameworks within which firms operate. This dependency confirms the importance of institutional factors in determining the success of diversification strategies, which is evident in the evolution of large European corporations, highlighting the significance of national economic circumstances.

In times of financial crises, diversified companies demonstrate greater flexibility in capital allocation, particularly visible during the 2007-2009 recession. Research suggests that highly diversified firms are less dependent on internal cash flows when making investment decisions, making them more resilient to financial shocks. However, it is important to note that cross-segment cash flows can lead to inefficient resource allocation.

Key challenges in future research will be identifying specific factors that affect different diversification models in different institutional contexts, as well as considering the effects of internal capital markets in times of crisis, especially regarding capital allocation under unstable external financing conditions. Future research could focus on analyzing the effects of cash reserve accumulation on strategic decisions, considering that cash accumulation may be a result of operational losses. It is important to explore conflicts of interest between management and shareholders, as well as the use of mechanisms such as debt to optimize investment decisions. The analysis of ownership structure and executive compensation represents a key aspect in the context of improving company performance. Such research could contribute to a deeper understanding of diversification dynamics in various economic and institutional frameworks, thus improving the strategies companies apply to generate value.

5. LITERATURE

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