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Institutional Contexts and Corporate Diversification Strategy

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Abstract

There has been a great deal of controversies concerning the performance implications of conglomerate (business group) strategy, often prevalent in emerging economies. The aim of this research is to develop a theoretical model that prescribes the viability of corporate diversification strategy in relation to institutional contexts. The theoretical model suggests that conglomerate strategy will be positively related to firm performance in institutional contexts where the functions of formal market controls and informal normative controls are inefficient, whereas focused/related diversification strategy will be positively related to firm performance in institutional contexts characterized by efficient market and normative controls. The framework synthesizing major theoretical perspectives will contribute to better understanding of the connection between institutional contexts and corporate diversification strategy.

Keywords: Conglomerate, Focused strategy, Institutional contexts

1. Introduction

The study of conglomerate strategy, often prevalent in emerging economies, and its impact on firm performance has been a major area of research (e.g., Khanna & Rivkin, 2001; Lee et al., 2008; Ramaswamy et al., 2012; Doh et al., 2017). A fundamental concern is clarifying the role of institutional contexts for firm's strategic behavior and choices (Khanna & Palepu, 2000; Doh et al., 2017). Significant research in international business has focused on institutional deficiencies and inefficiencies in emerging economies and firms' strategic responses to the market imperfections (e.g., Khanna & Palepu, 1997; Henisz & Zeineer, 2003). The national contexts within which firms operate have systemic effects on the behavior of firms within the economy (North, 1990). Previous researchers have focused on the implications of institutional voids or market imperfections for firm strategy and suggested that conglomerate strategy would be a viable business model in emerging economies where institutional systems are absent or inefficient (e.g., Khanna & Rivkin, 2001).

However, there has been a great deal of controversies centering on the performance implications of conglomerate strategy (e.g., Palich et al., 2000). In the practitioner circles, consultants and investors are pressuring business groups prevalent in emerging economies to reduce the scope of their business diversification, recommending a focused strategy with a few core businesses. Researchers focusing on managerial perspective suggest that conglomerate strategy would lead to inferior performance of affiliated firms due to diversification discount and lack of competitive advantage of affiliated firms involved in distinctively different industries (Markides & Williamson, 1994). Previous meta-analytic research reviewing 55 previously published studies found that moderate levels of diversification showed higher levels of performance than extensive diversification, and performance decreases as firms change from related diversification to unrelated business diversification such as conglomerate strategy (Palich et al., 2000). On the other hand, researchers focusing on transaction cost economies have argued that conglomerate strategy leads to superior performance of affiliated firms in institutional contexts characterized by inefficient market functions (Peng & Health, 1996; Singh et al., 2007). Previous studies examining the performance implications of affiliated firms with business groups as compared to unaffiliated firms have found varying results (e.g., Chang & Hong, 2002; Chu, 2004; Purkayastha & Lahiri, 2016).

In this vein, the purpose of this research is to develop a theoretical model that prescribes the viability of corporate diversification strategy in relation to institutional contexts. The theoretical framework presented in this research suggests a continuum of efficiency-inefficiency dimension in terms of formal market controls and informal normative controls that govern the behavior of economic players and further the transaction efficiency. The model proposes that conglomerate diversification will be positively related to firm performance in institutional contexts characterized by inefficient formal market controls and informal normative controls, whereas focused/related diversification will be positively related to firm performance in institutional contexts characterized by efficient market controls and normative controls. The framework synthesizing major theoretical perspectives on the subject will contribute to better understanding of the relationship between institutional contexts and

corporate diversification strategy.

2. Performance implications of Conglomerate Strategy

A great deal of researchers in business and economics have been studying diversified conglomerate structure or business groups, described as a collection of firms characterized by an intermediate level of binding (e.g., Chang & Choi, 1988; Kim et al., 2004). Conglomerates have group-affiliated companies that engage in businesses distinctively different from the core business area of the parent group. Some business groups operate as holding companies with full ownership in many enterprises and others are collections of publicly traded companies. It is a typical practice that a limited number of family members or relatives of the group chairman control the business group (Kim, et al., 2004). Conglomerates in many emerging economies have played a substantial role in the economy, such as Tata Group in India, CP Group in Thailand, Sallim Group in Indonesia, Samsung and LG groups (chaebols) in Korea, Ayla Corporation in the Philippines, and grupos in Latin America. Not only in emerging economies, in the U.S. there were business conglomerates until late 1970s, but the prevalence of conglomerates in the U.S. faded away in the 1980s.

The core issue in the discussion about conglomerates may be the diversification of business, specifically diversification into unrelated business arenas. Conglomerates are characterized or dominated by truly unrelated business activities in entirely different industries (Teece, 1982). The business structure of the conglomerate is not without economic justification. Parent company can tap personnel pool and fund from its affiliated firms and use them in expansion into new businesses. Focal companies can utilize the same proprietary knowledge and technology when entering a new business by transferring resources and capabilities to its affiliated firms. Conglomerate structure also enables the business group to overcome external market imperfections commonly found in emerging economies (Chang & Choi, 1988). As firms' strategies reflect both formal and informal institutional contexts governing market and nonmarket exchanges, characteristics of institutions in the economy influence firms' strategic behavior and structural forms (Funk & Hirschman, 2017). Given the unique institutional environments in developing economies, conglomerate business model may be an effective structural form to overcome the institutional voids (Khanna & Palepu, 2000). Although there is no agreed upon explanations for the antecedents of business group, some motives may be firm's growth aspiration, risk reduction, and lowering the entry barrier involved in firm expansion.

The review of extant literature suggests that little congruence has been achieved among theorists and practitioners on the performance implications of conglomerate strategy (e.g., Palich et al., 2000). Traditional theory of the firm (e.g., Williamson, 1975) suggests that highly diversified firms may outperform less diversified firms when the institutional infrastructure is not well established, thus causing higher transaction costs. Conglomerate business form may allow efficient transactions inside and outside of the firm, increasing the speed in boundary expansion activities. On the other hand, the resource-based view (e.g., Montgomery & Wernerfelt, 1988) suggests contradictory prescription that the firms with less specific assets may pursue a diversification strategy but will experience lower firm

performance. They emphasize the value of firm-specific assets and argue that the firms with more specific expertise may have lower levels of business diversification but earn higher profits. Anecdotal evidence suggests that heightened competitions in the industries have contributed to the dismantlement of many conglomerates in emerging economies, such as *chaebols* of Korea. A great deal of research has focused on the performance implications of conglomerate strategy, but little conclusive agreement exists both theoretically and empirically.

3. Institutional Contexts and Corporate Diversification Strategy: Developing a Theoretical Model

Corporate diversification represents a critical strategic decision that not only affects the business boundaries of the company, but also has long-term implications for the allocation of firm resources and capabilities (Jacquemin & Berry, 1979). Corporate diversification is also an adaptive response to environmental changes and the result of a firm's strategic pursuit to exploit market opportunities. Some companies choose to focus on their areas of core competence entering related business arenas (focused and related diversifiers), while other firms proactively seek business opportunities in distinctively different markets (conglomerate/unrelated diversifiers). A related diversification strategy represents a firm's domain expansion into closely related product markets for the purpose of achieving synergies via transfer of resources and skills (Porter, 1991). An unrelated diversification/conglomerate strategy seeks a proactive domain expansion into relatively unrelated product markets. Decisions to enter such unrelated product markets and subsequent efforts to manage the resulting product/market diversity are characterized by informational complexity and higher coordination costs in integrating distinctively different business units.

The effectiveness of corporate diversification strategy and performance implications may be explored through the lens of institutional contexts that provide a playground for firms competing within the economy. Institutional contexts consist of governmental structures, rules, policies, market systems, cultural norms, ethics, among others. Institutions serve as 'rules of the game' (North, 1990) through their influence on economic transactions (Keefer & Knack, 1997). For instance, missing pieces in market infrastructure and absence of norms in business exchanges may hamper efficient transactions in doing business, thus constraining a full utilization of corporate resources. The theoretical model developed in this research (see Figure 1) identify two contextual factors of formal market control and informal normative control as underpinning institutional contexts that prescribe the viability of conglomerate versus focused/related diversification. The framework focuses on a continuum of efficiency-inefficiency dimension in terms of market controls and normative controls that govern the behavior of economic players in business transactions.

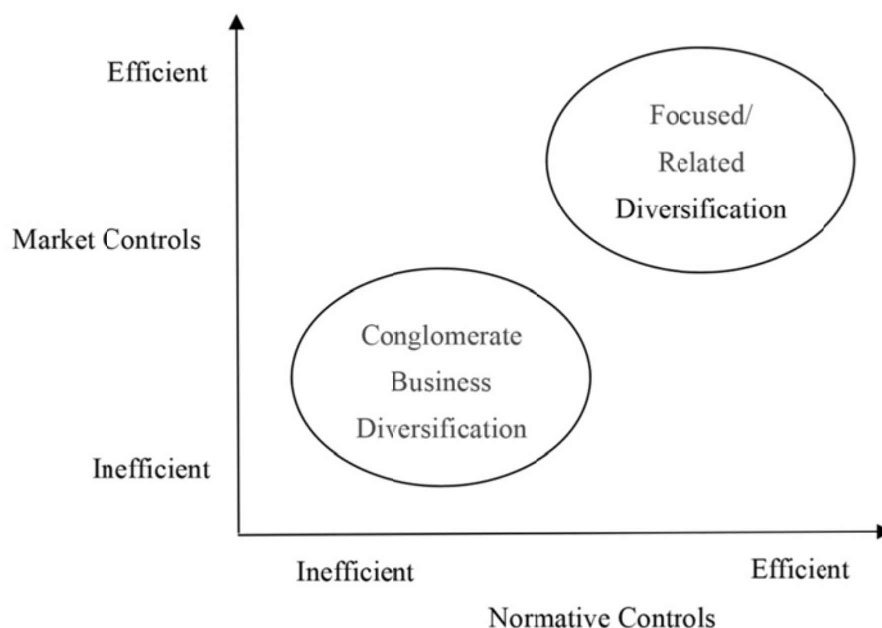

Figure 1. Institutional efficiency and corporate diversification strategy

3.1 Market Control Efficiency

Previous researchers have focused on how institutional features enable or disable organizational actions and strategies (e.g., Meyer & Peng, 2016; Dahan et al., 2010; Kostova & Hult, 2016). Institutional inefficiencies can occur in several institutional contexts, such as political, legal, and economic systems. Institutional conditions that constrain firms' strategies, for instance, include an uncertain regulatory environment, unreliable sources of capital market information, and inefficient judicial systems. A large portion of production factors in emerging economies are often state-owned and controlled, and firms face a higher degree of government interventions that distort the price mechanism in the market. Uncertainty in legal and regulatory enforcement increases opportunism in business transactions and contracts. These institutional inefficiencies decrease the efficiency of business exchanges between buyers and sellers, increasing the transaction costs.

Institutional inefficiencies in market control functions may legitimate conglomerate strategy (Khanna & Palepu, 2010). Firms facing institutional inefficiencies attempt to replace the external markets with in-house governance (Doh et al., 2012). Previous researchers focusing on corporate diversification have highlighted the internal market advantages derived from business diversification (Rumelt, 1982; Fisman & Khanna, 2004; Doh et al., 2012). Industrial organization economics suggests that diversified firms create and leverage market power advantages that are unavailable to a single-business firm (McCutchen, 1992). Conglomerates can leverage their established brand reputation for expansion into different product markets.

Favorable reciprocal buying among the affiliated firms would yield increased opportunity for greater diversification and sustained losses can be funded through cross-subsidization (Lang et al., 1995; Kim & Song, 2016). Predatory pricing may be useful for conglomerates in driving existing rivals out of the market, while discouraging potential rivals (Schere, 1980). Risk reduction would be obtained by combining businesses with less than perfectly correlated financial flows (e.g., Barney, 1997), reducing the costs of capital. In terms of labor market, conglomerates creating internal labor markets can spread the fixed costs of educating their employees and future managers over the businesses in the group (Khanna & Palepu, 1997). Additionally, given the unpredictable government behavior and regulatory bureaucracy in emerging economies, conglomerates can spread the cost of lobbying local government (Delmas & Montes-Sancho, 2010). Therefore, a highly diversified conglomerate would be a viable business structure in institutional contexts characterized by heightened market imperfections.

In advanced economies, well-established strong market-supporting institutions enhance efficiency in market transactions. Specialized intermediaries in market infrastructure provide the requisite information, and contract enforcement is efficient in business transactions. Independent nonprofit consumer groups and government watchdog agencies are actively involved in protecting consumer interests. Consumers enjoy the surplus of products in the market and have power over companies. Data on customer tastes and behaviors are easily available to companies and consumers. Capital markets are efficient in collecting savings and channeling the capital into corporate investments. Investors have access to a free flow of largely accurate information about companies thanks to reliable and independent financial reporting. Regulatory systems are efficient and legal institutions are well established to enforce business laws. Governmental dissemination of information is relatively efficient and transparent.

In these institutional contexts where market control functions are efficient, the necessity to develop internal markets to fill the institutional voids becomes less salient. The benefits that business group-affiliated firms derive from internal capital, product, and labor markets are not significant because external market functions are efficient enough. Rather, firms in these institutional contexts would focus on their own expertise areas and core competencies to win the market competition. From an organizational perspective, diversification discount associated with conglomerate strategy (e.g., higher coordination costs in integrating distinctively different business lines) outweigh the benefits accrued to conglomerate strategy. Furthermore, decisions to enter unrelated product markets and subsequent efforts to obtain synergies involve complex informational coordination and behavioral integration across business units. The corporate headquarters of conglomerates can be overwhelmed by the informational complexity in evaluating possible synergies and resource fits among affiliated firms. Therefore, focused/related business diversification would be a more viable business model in institutional contexts where market control functions are efficient.

Proposition 1. Conglomerate diversification will be positively related to firm performance in institutional contexts characterized by inefficient market control functions.

Proposition 2. Focused/related business diversification will be positively related to firm performance in institutional contexts characterized by efficient market control functions.

3.2 Normative Control Efficiency

Informal institutions also play a substantial role in market transactions, and formal and informal institutions interact with each other (Dhanaraj & Khanna, 2011; Doh et al., 2017). For instance, in institutional contexts characterized by inefficient market control functions, normative and cognitive institutions may be rich, serving as an alternative system of transactions that govern the transactional behavior among market players. Normative controls operate through more implicit, culturally constructed processes (Scott, 1995) and are shaped by traditions, values, ethics, standards, and norms. Normative controls set the conventions about expected behavior, facilitate efficient transactions, and shape the rules of the game in the market. Thus, the development of normative institutions underpins the market functions, reducing the transaction costs.

Filing institutional deficiencies and inefficiencies come at a cost. Inefficiencies in normative control systems may result in information asymmetries, incentive conflicts among market players, and a crisis of confidence in business transactions (Doh et al., 2012). Firms are pressured to identify business models and governance structures that fit their institutional contexts. To address institutional inefficiencies, firms may rely more heavily on normative controls to reduce the uncertainty in business transactions. The weak nature of institutions suggests that activities of firms revolve around social relationships, networks, or other connections. Individuals and firms often rely on informal networks and connections because the prevailing institutional conditions increase the likelihood of opportunism in business transactions and hamper efficient market transactions. Thus, interpersonal trust and networks serve as strategies to reduce risks of opportunism. The corporate structure of Keiretsu (networks and alliances among affiliated firms) in Japan, for example, highlight the role of networks and connections in business transactions. Sociological researchers argue that trust in relationships substitutes for incomplete contracts (Granovetter, 2005).

Corporations seek to substitute for missing institutions through reliance on a trusted network to mitigate risks in transactions (Landa, 2016). In this vein, conglomerate strategy, often characterized by concentrated ownership and strong integrative mechanisms inside the firm, would promote the development of efficient normative controls that help reduce the coordination and transaction costs. For instance, conglomerates in emerging economies, such as Tata in India have large scale of investments in firm-specific training programs emphasizing their core values and norms, which, in turn, strengthens their normative control systems, a crucial component for the achievement of economies of scale and scope with conglomerate strategy. Conglomerate business forms may also enhance the firm's legitimacy and trustworthiness of the firm. Drawing on the institutional theory (DiMaggio & Powell, 1983), large established organizations such as conglomerates are more likely to obtain social legitimacy. Enhanced legitimacy of the firm plays a significant role in obtaining scarce resources including talents and attracting potential investors and customers. Moreover, previous researchers have also highlighted how firms use nonmarket strategies that are

embedded in socio-political norms and networks (e.g., Fligstein, 1996; Funk & Hirschman, 2017). Firms use various nonmarket actions, such as exercise of political influence (Ramamurti, 2005), reciprocal relationship between the state and firms (Child et al., 2012), formation of partnership (Teegen et al., 2004), lobbying of government (Boddewyn & Doh, 2011), and other enactment activities. Conglomerates with heightened legitimacy in the economy leverage their unique networks in the use of these nonmarket strategies for firm growth. Conglomerates are often a part of lobbying bureaucrats gaining policy influence that favors their industries and firms. Therefore, conglomerate strategy would be a more viable business model in institutional contexts where the functions of normative controls are deficient or inefficient.

On the other side, in institutional contexts where the normative control systems are well established, the necessity to substitute inefficient normative controls becomes less salient. Rather, there are costs to such organizational arrangements of conglomerate. Conglomerates deal with overly complex organizational structures. The decision-making process associated with conglomerate strategy involves wide-ranging informational activities, such as the assessment of market opportunities new to the firm, the prediction of changes in distinctively different industries, and the assessment of resource availabilities for entering relatively unfamiliar markets to the focal firm. Due to the organizational complexity, inefficient decisions may persist, and conglomerates often fail to achieve synergies and economies of scope. Furthermore, conglomerate business forms (unrelated diversifiers) carrying a big battleship hinder the efficient and effective adaptations to fast-changing consumer needs and technologies in the industries. Managers of focused/related diversified firms are more attuned to changes occurring in their own expertise areas and industry environments. Therefore, focused/related business diversification would be a more viable business model in institutional contexts characterized by efficient normative controls.

Proposition 3. Conglomerate diversification will be positively related to firm performance in institutional contexts where normative control systems are inefficient.

Proposition 4. Focused/related business diversification will be positively related to firm performance in institutional contexts where normative control systems are efficient.

4. Discussion

The theoretical framework developed in this research suggests that the viability of corporate diversification strategy and subsequent performance implications may be explored through the lens of market controls and normative controls that govern the behavior of economic players and transactions. The theoretical model proposes that conglomerate diversification would be more viable in institutional contexts where the formal market control functions and normative control systems are inefficient, whereas focused/related diversification would be more effective in institutional contexts characterized by efficient market controls and normative controls. A fundamental premise is that corporate diversification strategy (e.g., conglomerate versus focused/related diversification) reflects the institutional contexts that affect the efficiency in economic transactions. The framework is also consistent with the resource-based view of the firm, which suggests firms with more specific assets and expertise

may have lower levels of diversification but obtain higher levels of firm performance. Strategic managers of firms are faced with complex diversification decisions as they confront different, often unique institutional contexts that either constrain their strategic choices or provide an opportunity to leverage their resources and capabilities. The theoretical model will contribute to a better understanding of the role of formal and informal institutional contexts for organizational actions and firm strategies such as corporate diversification. Multinational enterprises and domestic firms will be better informed by the framework in gauging their potential for growth, while minimizing strategic decision biases associated with business diversification. Further academic persistence and empirical testing will enhance the understanding of firm's strategic responses to socioeconomic institutional developments.

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