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Performance impact of business group affiliation: An analysis of the diversification-performance link in a developing economy

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Abstract

To understand the performance implications of corporate strategies as conditioned by business group affiliations, we analyze the relation between corporate diversification and performance for 889 Indian firms. We find that diversified firms perform significantly worse than focused firms and that there exists a significant negative relation between the degree of diversification and firm performance. A comparative analysis of firms affiliated with Indian business groups and those affiliated with MNCs indicates that the sources of negative impact of diversification on performance are conditioned by the nature of a firm's affiliation. For multinational affiliates, diversification is associated with poor asset quality and asset management, which is an indicator of possible agency conflict. For domestic business group affiliates, diversification is associated with cost inefficiencies and poor performance.

Keywords: Diversification discount; Operating performance; Agency cost; Business groups; Emerging markets

1. Introduction

In recent years, we have seen a heightened interest in studying the relation between a firm's business group affiliation and its performance. For example, studies by Silva et al. (2006), Khanna and Palepu (2000), Ferris et al. (2003), and De Holan and Sanz (2006), among others, examine whether corporate performance is influenced by a firm's affiliation with business groups. The current Indian corporate sector – wherein firms continue to remain diversified but without a legally protected and privileged position as in the past – provides an interesting investigative setting to understand if being an affiliate, and the type of affiliation, moderates the diversification–performance relation.

Since the early 1990s, the Indian corporate sector has been experiencing significant changes in its financial markets, and the legal and competitive environments. In the current business climate, with increased degree of investment, trade, and financial liberalization, already powerful business houses have been relatively more successful in expanding their scale and scope although not necessarily translating this expansion into higher profitability (Reed, 2002). In fact, according to Reed (2002), measured over the 1997–1999 period, in contrast to the set of all non-financial firms, the largest business houses (Paid-up capital > Rs. 250 m) have shown the greatest decline in their profitability. It is suggested that even during the pre-liberalization era, big businesses were able to generate profits only through their rent seeking activities, stifling competition, and gaining legal protections through licensing regulation (Paranjape, 1980).

In the changed environment, with eroding rent-seeking opportunities, a decline in the profitability of these large and diversified businesses reflects their inability to generate synergy, capture gains from scale and scope economies, or use competitive advantage that might result from operating in a diversified market. The changed environment serves as a laboratory setting where one can delineate the impact of diversification from rent-seeking opportunities on corporate performance. While in the pre-liberalization era when the

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government licensed even industrial capacity, it was difficult to distinguish between corporate power related rent-seeking and diversification consequent performance gains as a source of profits, now that rent-seeking opportunities have declined significantly, the relation between diversification and corporate performance can be brought out more sharply.

This paper traces the origin of the poor performance – as measured by return on assets and return on equity – of large Indian firms in their business diversification strategies. At the first stage of our investigation, our univariate tests show that diversified firms significantly underperform focused firms. In the multivariate framework, our findings suggest that focused firms, as a group, are superior performers relative to diversified firms. Further, there appears to be a significant negative relation between performance and the degree of diversification. Finally, our results indicate that the sources of the performance discount depend on the type of affiliation. While for affiliates of multinational corporations (MNCs) the negative impact of diversification on performance appears to be agency conflict driven, for domestic affiliates, cost inefficiencies appear to cause the diversification discount.

The structure of the paper is as follows. In the next section, we describe the theoretical and empirical framework and develop our main hypotheses. In Section 3 we present the sample data and description of variables. Section 4 reports our findings and their discussion. In Section 5 we present our conclusions.

2. Literature review

2.1. Performance consequences of corporate scope strategies

It is argued that diversification benefits performance through financial synergies and increased debt capacity (Lewellen, 1971), greater efficiency of internal capital markets (Williamson, 1986), mitigation of underinvestment problem (Stulz, 1990) and risk reduction. However, there is evidence that diversification may be value destroying. It is suggested that with the current trend of rising capital market sophistication, reduced regulation, better information transparency, and globalization, benefits of diversification (Markides, 1995) have eroded. Simultaneously, the costs of diversification have gone up, given the increased business environment uncertainty and volatility resulting in loss of information and control in diversified firm hierarchies (Hill and Hoskisson, 1987). In addition, there is evidence that diversification adversely affects performance in terms of long-term stock performance (Comment and Jarrell, 1995) and Tobin's Q (Lang and Stulz, 1994). Evidence also suggests that the recent trend towards increase in focus as reported, among others, by Comment and Jarrell (1995), is a consequence of corporations realizing that unrelated diversification decreases firm value (Berger and Ofek, 1995) and that increase in focus leads to positive valuation effects for sellers (John and Ofek, 1995).

Agency arguments suggest that managers derive private benefits from diversification in terms of added power and prestige and size related compensation benefits (Jensen, 1986 and Jensen and Murphy, 1990 respectively), and diversification of human capital (Morck et al., 1990). Denis et al. (1997) provide evidence on the agency hypothesis. However, some recent evidence suggests that the existence of the diversification discount is not a settled issue given some data measurement errors (Villalonga, 2004; Whited, 2001) and lack of a well specified relation between firm characteristics and performance (Campa and Kedia, 2002). To avoid these unsettled measurement and methodological issues of value discount, we focus on the more traditional performance measures of return on assets and equity.

2.2. Diversification in the context of emerging markets

Given the greater information asymmetries and inefficiencies due to underdeveloped legal and contracting institutions in emerging markets, diversifying at the firm level can enhance performance by internalizing market transactions that would otherwise entail cost of designing, enforcing, and monitoring contracts with external market agents (Williamson, 1976).

Further, given (La Porta et al., 1999) that there is higher concentrated ownership in systems with lower investor protection, in the entrenchment hypothesis framework (Morck et al., 1988), one can argue that in these systems there would be higher degree of managerial agency problems. De Holan and Sanz (2006) suggest that family dynamics and legal environments interactively influence the degree of agency conflict. Further, the existence of poor accounting standards in emerging markets implies a greater degree of information asymmetry. Thus, in the emerging markets context, diversification may yield performance gains by avoiding problems associated with information asymmetries and market imperfections, and reducing agency problems by facilitating better internal monitoring.

It may, however, be argued that in emerging markets where proper monitoring mechanisms do not exist, market based checks and balances are absent, and an active market for corporate control is practically non-existent, agency led diversification may be a strong possibility. This may especially be the case in India given the historical dominance of the corporate sector by family dominated big business houses with almost unchecked political power and financial strength.

2.3. Evidence on the diversification-performance relation in emerging markets

Fauver et al. (2005) report that while in developed economies, there exists a significant diversification discount, in the lower income economies with segmented markets, there is no diversification discount. Lins and Servaes (2002) report that in seven Asian emerging markets, including India, diversified firms trade at a discount and that entrenched insiders use the diversified firm structure to expropriate wealth from minority shareholders.

Majumdar (1997), using a sample of 1020 Indian firms, concludes that due to market-restricting industrial policies followed in India, older firms are more productive but less profitable while larger firms are more profitable but less