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How do institutional transitions impact the efficacy of related and unrelated diversification strategies used by business groups?

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ABSTRACT

Drawing from institutional theory and organizational theory, this paper reports findings from a longitudinal study of Indian business groups as they were responding to pro-market institutional reforms. It explores their diversification choices at the group level, and the group performance consequences of these choices during a period of institutional change (1988–2012). Results show that although overall group diversification had a positive impact on performance, as institutions developed and market reforms took root, *unrelated diversification* resulted in poorer performance. However, *related diversification* strategies resulted in positive group performance outcomes after pro-market reforms had taken root. This suggests that the performance consequences of alternative diversification strategies adopted by business groups change as institutional development occurs, an important facet of business group evolution that has received limited attention in the extant literature.

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1. Introduction

Studies of the antecedents and consequences of diversification strategies have been the staple of scholars across a wide variety of fields ranging from strategic management and organization theory to industrial organization economics, political economy, and developmental economics. One sub-stream of research that has gained considerable attention is the examination of the role of context in influencing performance outcomes associated with diversification. Substantial intellectual energy in this regard has focused on the costs and benefits of business groups as ideal structures set up to manage diversification in different country settings (see Jones & Colpan, 2010 for a concise history of business groups and Carney, Gedajlovic, Heugens, Essen, & Oosterhout, 2011 for a comprehensive review of the literature in the area).

While this stream of research has indeed yielded rich insights into the role of institutional contexts and the salience of business groups, a comprehensive grasp of this area is still beyond our reach. Some of the questions relating to the efficacy of alternative group diversification strategies and their performance consequences at the business group level are less widely understood (Carney et al., 2011). Specifically, this study is positioned (i) to remedy a key shortcoming in the literature as identified by Carney et al. (2011) namely the relative dearth of systematic examinations of the strategic choices pursued by business groups and their attendant performance impacts, (ii) to explore the consequences of the changing institutional context and the manner in which the changes influence the performance impact of business group strategy choices, and (iii) to provide a robust, well-grounded statistical approach that establishes clear links between group level strategies and group level performance, an alignment that Carney et al. (2011) suggest has not been emphasized in many of the studies that formed part of their meta-analysis. In accomplishing these objectives, the study makes three significant contributions to the larger literature.

First, this study draws upon institutional theory and organization theory literatures (e.g., Carney et al., 2011; Chakrabarti, Singh, & Mahmood, 2007; Haveman, Russo, & Meyer, 2001; Khanna & Palepu, 2000a, 2000b; Kim, Kim, & Hoskisson, 2010; Smith & Grimm, 1987) to develop a coherent theoretical rationale explaining the performance implications of diversification choices that business groups confront in navigating their organizations through periods of significant institutional upheavals. While many of the past studies in this genre have focused on exogenous shocks (e.g., the Asian financial crisis or the economic shock therapy following the collapse of the Soviet Union), this study focuses on *incremental institutional reforms* and their impacts on business group strategy and performance.

Second, in a noteworthy departure from prior efforts that have largely focused on the consequences of pro-market reforms on group-affiliated firms versus non-group affiliated firms (Chari & David, 2012; Cuervo–Cazurra & Dau, 2009; Kim et al., 2010), this study explicitly models group-level diversification behavior. Few studies have explicitly accounted for the type of diversification strategy followed by a business group, relying instead on the implicit assumption that the group

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variable proxies for diversification as well (see for example Khanna & Rivkin, 2001; Majumdar & Bhattacharjee, 2014; Singh, Nejadmalayeri, & Mathur, 2007; Ramaswamy, Li, & Petitt, 2012). To muddy things further, several of these studies tend to postulate effects based on group-level phenomena but rely on firm-level (affiliate) data to extrapolate to the group level. Thus, with very few exceptions (Ghemawat & Khanna, 1998; Kumar, Gaur, & Pattnaik, 2012), prior research has not clearly established direct equivalence between construct and measurement (i.e., group-level phenomena with group-level performance).

Our study examines whether the nature of the relationship between group diversification and group performance, changes with the unfolding of pro-market reforms. In doing so, it establishes stronger correspondence between the underlying theoretical rationale that seeks to explain group-level performance outcomes, and provides a strong empirical test of the relationship between group-level strategic choices and group-level performance. Further, by focusing more closely on alternative types of group diversification strategies it provides a richer palette of findings that can enable progress toward a middle range theory of business groups.

Lastly, this study represents several important methodological refinements. These refinements include (a) the application of an index approach to characterize institutional environments and changes thereto, (b) using an excess ROA measure, conceptually similar to the excess value measure proposed by Berger and Ofek (1995), which represents a more precise approach to characterize performance outcomes, and (c) explicitly controlling for the endogeneity of the diversification decision by using the two-stage least squares methodology pioneered by Campa and Kedia (2002). Collectively, these empirical refinements go a long way toward addressing the lack of rigor that Carney et al. (2011) identified as a key factor that has constrained the emergence of fine-grained insights in this field of inquiry.

2. Diversification strategies, business groups, and institutional contexts

Although the rationale behind the emergence of business groups has been widely studied across various disciplines (Chang & Hong, 2000; Chung & Mahmood, 2010; Fisman, 2001; Granovetter, 2005; Guillén, 2000; Kim, 2010; Khanna & Palepu, 2000a, 2000b; Lien & Li, 2013; Sarkar, 2010), the efficacy of such groups following institutional reforms is an area that has received less empirical attention. The widely-held view suggests that as market-based institutions evolve in an economy, business groups will no longer benefit from playing the role of market substitutes. Thus, the performance of such groups is expected to decline with the emergence of pro-market institutions (Lee, Peng, & Lee, 2008; Ramaswamy et al., 2012). While this logic is intuitively appealing, empirical support for such a decline seems to be less evident in the few studies that have sought to examine these relationships (see for example Chakrabarti et al., 2007; Chari & Banalieva, 2015; Chari & David, 2012; Zattoni, Pedersen, & Kumar, 2009), especially at the group level (Carney et al., 2011). We posit that the lack of coherence between theoretical expectations and empirical findings could be due to the manner in which the relationship has been operationalized and explored.

The literature on business groups encompasses numerous studies that have provided valuable insights into the costs and benefits of group membership (Chacar & Vissa, 2005; Chittoor, Kale, & Puranam, 2015; Gaur & Kumar, 2009; Khanna & Rivkin, 2001; Khanna & Yafeh, 2005; Kogut, Walker, & Anand, 2002), however, it does not shed sufficient light on the efficacy of alternative diversification strategies (related v. unrelated) that groups adopt. It is evident that business groups reflect significant variation in the nature of the diversification strategies that they deploy (see for example Delios & Ma, 2010; Fracchia, Mesquita, & Quiroga, 2010; Khanna & Palepu, 1999; Khandwalla, 2002; Li, Ramaswamy, & Petitt, 2006).

While some groups choose a narrow competitive focus by restricting the range of industries they populate (e.g., TVS Group of India in transportation, PTT Group of Thailand in oil and gas, Paulmann Group of Chile in retail, CEMEX Group of Mexico in cement and construction) others span much broader domains encompassing multiple industries (e.g., Tatas of India, Carso of Mexico, CP Group of Thailand, Itaúsa of Brazil). Therefore it is axiomatic that these competitive scope choices will have performance consequences that are quite independent of the group effects. However, there has been little effort thus far to examine the consequences of business group diversification strategies independent of business group affiliation effects (Carney et al., 2011).

3. Structural reforms, diversification strategies, and performance outcomes

Although several of the past studies in this stream of inquiry have yielded significant insights addressing the impact of institutional reforms (cf. Chakrabarti et al., 2007; Kim et al., 2010; Lim, Das, & Das, 2009) on business groups, the scope of these findings has been constrained partly because of the manner in which the post-reform period has been conceptualized. The dominant approach to modelling organizational responses to environmental changes has been to use a pre-event versus post-event methodology (see for example, Chakrabarti et al., 2007; Dieleman, 2010; Lim et al., 2009). While such approaches can offer a broad understanding of the nature of changes that accompany reforms, they do not provide the level of granularity required to develop a more nuanced understanding of the change process. Questions such as the nature of strategic changes pursued by business groups responding to institutional reforms, and the timing and efficacy of such changes require more fine grained analysis.

In providing a comprehensive theoretical analysis of the changing institutional landscape and the efficacy of strategic choices made by business groups in aligning their business portfolios, it is useful to borrow from the approaches that have been adopted by scholars in the fields of institutional theory and organization theory. In their study set in the Korean context, Kim et al. (2010) built on the concept of institutional convergence and institutional friction to develop a diachronic model of organizational changes in response to institutional reforms introduced by the government. They suggested that the onset of change is heralded by periods of institutional friction where newly emerging market institutions seek power and legitimacy as they are forced to coexist with the prevailing established institutional architecture that cannot be supplanted quickly. This is followed by a period of institutional convergence where the dominance of newly emerged market institutions is clearly visible and becomes established. Based on this characterization, Kim et al. (2010) argued that these two periods would exert a differential performance impact on group affiliated and unaffiliated firms. This model of institutional change and organizational response captures the wider received view of change as reflected in the organization theory literature (see for example Haveman et al., 2001; Kim & Prescott, 2002; Reger, Duhaime, & Stimpert, 1992; Smith & Grimm, 1987; Thompson, 1967). The unifying theme that cuts across this school of literature is the focus on environmental triggers that set off environmental changes resulting in disequilibrium between the organization and its environment that in turn threatens organizational performance. *Re*-alignment of organizational strategy with the new demands of the environment is seen as the crucial response to reverse potential performance decline. This study builds on these core tenets of organizational theory as captured by Kim and Prescott (2002) to provide fine-grained insights into the efficacy of changing business group strategy in response to institutional change.

In contrast to past approaches that have viewed institutional reform and business group responses from a pre-reform versus post-reform lens, this study adapted Kim et al. (2010) to conceptualize the process unfolding across three time periods. This approach is likely to yield richer insights and is particularly relevant in exploring contexts where institutional reforms are introduced gradually, allowing business groups the luxury of time to design appropriate strategic responses.

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