



The logic of demand-side diversification: Evidence from the US telecommunications sector, 1990–1996

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ABSTRACT

The logic of demand-side diversification articulated herein explains that a firm's demand-side strategic assets motivate its choice to diversify into an industry whose production function warrant possession of different supply-side strategic assets. The concept of demand-side relatedness, which underpins the logic of demand-side diversification, clarifies the conditions under which a firm's demand-side strategic assets provide it with the motivation to explore opportunities for realizing consumer synergies. We invoke this logic to explain the observed variation in the decision of monopoly local telephone service providers to diversify into the competitive long distance telephone services markets in the U.S. during 1990–1996. We find that the likelihood of a monopoly local telephone company to diversify into the long-distance services market within its area of franchise increases in the (a) quality of its customer-base for local telephony, and (b) competitive intensity of the market for long-distance services.

1. Introduction

The theory developed herein explicates the logic of demand-side diversification.¹ An emerging stream of literature, which responds to the classic scope question, why firms diversify, purports to explain the demand-side drivers of firms' choice to diversify. Our primary objective is to provide rigor to this emerging perspective. The other objective is to provide conceptual clarity to *demand-side relatedness* that underpins the aforementioned logic.² Bereft of such rigor, exemplified for instance by a *seemingly* tautological relationship between demand-side relatedness and demand-side diversification, the logic of such a diversification choice may seem unfounded. We seek to explain why a seller of product A (home-market) would diversify into another industry to offer a complementary product B (target-market) to its customer-base in home-

market without possessing the resources or capabilities that can be shared in producing and/or delivering the two products?

The *missing* logic for hitherto unexplained strategic behavior of many multi-product and/or multi-business corporations motivates our theory. A veritable collage of disparate albeit inter-linked strands have developed over time (as if) in response to the classic scope question to provide myriad strategic logic of multi-product corporations. Yet, a conceptual gap persists due to the missing theoretical rationale for the strategic behavior of those multi-product corporations that offer a portfolio of complementary products.

The logic of demand-side diversification supports a theoretical explanation for such patterns of diversification that seem paradoxical (i.e., unrelated) when viewed with the extant *product-centric* lens of supply-side relatedness. Table 1 explains how demand-side

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¹ A firm is a collection of activities (Stigler, 1951). Diversification is defined as the addition of new activities by the firm (Rubin, 1973). A logical extension of this argument would be to distinguish between supply-side diversification and demand-side diversification as based on whether the economizing and/or value generating effect of related diversification is due to the increase in supply-side activities or demand-side activities. Priem et al. (2012) suggest that a good perspective on the distinction between supply-side and demand-side activities is achieved by looking *upstream* (towards factor markets and producers) and *downstream* (towards product markets and consumers) from the focal firm to identify the value-creating activities. Hence, for a manufacturer customer-service would still be considered a supply-side activity since it is a part of the firm's or the industry's value chain. However, the activities organized around the customers' experience of searching, evaluating, or using the product, can be considered as demand-side activities if they are a part of the buyers' value chain.

² Manral and Harrigan (2016) conceptualize demand-side diversification to include those cases of product-market diversification wherein the focal firm leverages its demand-side strategic assets (developed in home-market for product A) to successfully enter another industry (target-market for complementary product B) that requires altogether different supply-side strategic assets. They explain and empirically verify the performance benefits of demand-side diversification in terms of the value generating effect accruing to diversified firms that shared demand-side strategic assets across their portfolio businesses. Manral and Harrigan (2016) define demand-side relatedness in terms of shared firms' shared demand-side strategic resources (customer-base) and/or demand-side competences (customer-knowledge and customer-relationship) across its home- and target-market(s). While they employ the concept to explain the superior performance of such related diversifiers they do not explain the conditions under which such assets might influence firms' decision to diversify in the first place.

Table 1
A comparison of the strategic logic of Demand-side Diversification with other similar product scope decisions.

Characteristics	Strategic choice(s)		Umbrella branding	Cross-selling	Demand-side diversification
	Product variety	Narrow-scope Differentiation (Multi-variety)			
Type of strategy			Broad-scope Differentiation (within-industry diversification in horizontally fragmented industries)	Product-Market Diversification (within- and inter-industry diversification)	Product-Market Diversification (Inter-industry diversification)
Firm behavior	The focal firm offers multiple variants within a product category to fill empty locations in a hypothetical multi-dimensional product-attribute space	The focal firm offers a portfolio of products that belong to different product-market segments in a horizontally fragmented industry under the same brand name	The focal firm offers its customers a portfolio of related or even unrelated products – that may belong to the same or different industries – to increase order-size and to convert single-product users into multi-product users	The focal firm offers its customers a portfolio of related or even unrelated products – that may belong to the same or different industries – to increase order-size and to convert single-product users into multi-product users	The focal firm diversifies into another industry to offer a portfolio of complementary products – that belong to distinct industries and therefore require different production techniques – to create customer value
Strategic logic of firm behavior	To manage consumer heterogeneity (refer Lancaster, 1990) and demand uncertainty (Carlton & Dana, 2008)	To manage the risks and costs of entering new product market segments of an industry (e.g., Montgomery & Wernerfelt, 1992; Wernerfelt, 1988), which a firm may do to exploit the economizing and Value generating effects arising from supply-side synergies (e.g., Teece, 1982; Panzar & Willig, 1981)	Ford selling a wide variety of cars across various segments such as sedans, vans, SUVs, etc.	To manage customer relationship (e.g., Akçura & Srinivasan, 2005; Kamakura, 2008)	To benefit from the economizing and Value generating effects that arise due to demand-side synergies (e.g., Ye et al., 2012; Schmidt, Majkadok, and Keil, forthcoming; Manral and Harrigan, forthcoming)
Examples	Gap selling a wide variety of a particular apparel line (say) men's jeans			Citibank selling checking account, savings account, money market accounts, mortgage, pension to the same customer.	A home-builder (D R Horton) diversifies into mortgage services (DHI Mortgage)

diversification differs from other similar concepts that explain the strategic logic of multi-product and/or multi-business corporations. The latter include multi-variety within a product category (refer Lancaster, 1990; Carlton & Dana, 2008), umbrella branding across product-market segments (e.g., Montgomery & Wernerfelt, 1992; Wernerfelt, 1988), and cross-selling products that belong to one or even more than one industry (Akçura & Srinivasan, 2005; Kamakura, 2008).

Another theoretical motivation is to broaden the related diversification framework (see Ramanujam & Varadarajan, 1989; Hoskisson & Hitt, 1990; Montgomery, 1994; Palich, Cardinal, & Miller, 2000 for reviews), which primarily emphasizes supply-side synergies, to also view relatedness from a demand-side perspective that emphasizes consumer synergies (e.g., Ye, Priem, & Alshwer, 2012; Schmidt, Makadok, & Keil, 2016). A fertile area of inquiry within the related diversification framework has been to *ex-ante* identify idiosyncratic firm resources and/or capabilities to explain the strategic rationale to diversify into businesses that also require these inputs (e.g., Argyres, 1996; Chatterjee & Wernerfelt, 1991; Farjoun, 1998; Prahalad & Bettis, 1986; Robins & Wiersema, 1995; Silverman, 1999). In response to the classic ‘scope’ question – why do firms diversify – the related diversification framework restricts the explanation of firms’ choice to diversify into only those product markets that satisfy the relatedness test for supply-side resources and/or capabilities (e.g., production technology, platforms, or sales/distribution channel) with their served markets (e.g., Chatterjee & Wernerfelt, 1991; Montgomery & Wernerfelt, 1988; Teece, 1982; Villasalero, 2017).

The logic of demand-side diversification addresses a conceptual gap in the related diversification framework, which is primarily underpinned by ‘supply-side’ relatedness. It does so by invoking the concept of demand-side relatedness to explain the demand-side drivers of diversification. The concept of demand-side relatedness explains the sharing, applying, and/or transferring of demand-side strategic assets across the portfolio businesses of a diversified firm (e.g., Manral & Harrigan, 2016). This concept expands the conceptual underpinnings of related diversification, which until now primarily rested on relatedness of ‘supply-side’ resources and/or capabilities (employed in manufacturing or distribution) across the portfolio businesses.

The logic of demand-side diversification builds on the foundational assumptions outlined in the nascent stream of literature on the demand-side drivers of diversification, which has so far only identified a few necessary conditions for a hypothetical firm to realize ‘consumer synergies’ across its portfolio businesses. The first necessary condition identified by the literature is that the said diversifier serves the same set of customers across the product markets (e.g., Ye et al., 2012). The other necessary condition is the presence of [multiproduct] consumers with a willingness to purchase multiple products from the same diversified seller (e.g., Manral, 2015; Manral & Harrigan, 2016; Schmidt et al., 2016). The third necessary condition for a diversified firm to realize consumer synergies is for it to offer a portfolio of products with positively correlated consumer valuations (Ye et al., 2012; Manral & Harrigan, 2016; Schmidt et al., 2016). Yet, several issues remain unaddressed.

First, it is quite possible that multiproduct firms, which serve multiproduct consumers with more than one product and consequently enjoy either lower costs of offering those products or a higher growth trajectory, may be exploiting operational synergies. In other words, many instances of ‘consumer synergy’ described in the nascent literature could actually be cases of ‘operational synergy’. We assert that the critical test to distinguish the two types of potential synergies is to examine the underlying strategic assets shared across the related businesses that generate the ‘cost reducing’ or ‘sales growth’ effect of synergy. However, in many cases a firm may be motivated to diversify by a desire to achieve either of the two *ex-ante* outcomes – to lower operational costs or move into a higher growth trajectory – by exploiting both supply-side and demand-side strategic assets. It therefore becomes imperative to explain the logic employed by hypothetical diversifiers to

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