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FINANCIAL PERFORMANCE AND DIVERSIFICATION STRATEGY OF INDIAN BUSINESS GROUPS

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ABSTRACT

Product focus based on strong core competencies combined with international diversification has been the success mantra, propounded by academicians and consultants alike. This strategy is adopted by many a successful transnational corporation such as Microsoft, Nokia, Lafarge and Coca-Cola, to name a few, in the western world, especially during the last two decades of growing liberalization and globalization. Most of the business groups in the eastern world adopting this strategy were also successful, contrary to some recent theories proposing product diversification as a success mantra in the emerging markets vis-à-vis focused strategy as success mantra in the developed world. Large number of business groups, which diversified their product range more and more claiming synergies, which were either illusory or were over-rated, eroded their shareholder's wealth, while, the ones which diversified internationally had a higher success rate.

KEYWORDS
Indian business groups, financial performance.

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BACKGROUND

Business groups are defined in the literature as collections of formally independent firms (or affiliates) under single common administrative and financial controls, owned by either families or trusts or foundations. These business networks are usually owned through investment firms with crossholdings in affiliates. In most countries of the eastern world, industrial scenario has been and continues to be dominated by these business houses. India's industrial sector remains no different and continues to be dominated by business houses.

First, we would argue that each Indian business group could be regarded as a corporate with a larger scope of operation, since:

(a) The managers of member firms are appointed by the business group (or after taking the consent of the business group) to exercise control over their member firms.

Moreover, we do observe member firms helping one another with financial and/or real resource transfers in times of financial distress or business hardship or otherwise. Therefore, for our purpose, the business groups with affiliated companies under them are not radically different from the U.S. conglomerates with many divisions under them or the Japanese keiretsus with member firms under them.

TABLE 1: DESCRIPTIVE STATISTICS OF SELECT VARIABLES OF SAMPLE BUSINESS GROUPS

Name of the Variable	Mean			Standard Deviation		
	2010-11	2011-12	2010-11	2010-11	2011-12	2010-11
Annual Growth in Total Assets (in %age)	52.91	64.14	8.26	66.99	73.84	15.59
Return on Capital Employed (in %age)	15.54	15.13	10.86	6.04	5.46	7.77
Modified Tobin's Q Ratio	1.20	1.56	1.08	0.29	0.67	0.50
Age of the Group (in Years)			45.71			26.49
Net Exports of the Group (in %age)	-3.60	-1.48	-0.02	12.46	13.35	14.94
International Trade of the Group (in %age)	14.89	20.31	23.96	15.26	19.87	21.88
Product Diversity (Montgomery's 3-digit SIC measure)	0.45	0.52	0.54	0.28	0.26	0.24
Total Assets (in Rs. crores)	271.14	700.59	1534.74	667.45	1695.93	3722.75

After independence, India has seen large-scale industrialization. In this expansion business groups adopted varied strategies, some more successfully than others did. Business groups' long-term performance would chiefly be an outcome of their corporate strategy including their product and international diversity. This choice and implementation of strategies got a boost after 1985, with the arrival of the era of de-licensing of industries. Such strategies comprise decisions to efficiently utilize, add, retain, or divest its resources relative to their portfolio of resources. Little empirical work has been done on the relationship between Indian groups' financial performance and product/international diversification strategies. The primary objective of our study is to look into the relationship between these diversification strategies and financial performance of large Indian business groups.

DIVERSIFICATION ISSUES OF GROUPS

Product Diversification: Galbraith (1998) suggested that there are three types of product diversification. They are – related, linked, and unrelated diversification. While in unrelated diversification the common features are generally limited to finance and business management; in related diversification, on the other hand, additional synergies are present, such as technological know-how, marketing and distribution expertise, or facilities in production. Linked diversification, unlike related diversification, involves moving into new industries and operating at different centers of concern in those industries. However, there is some kind of a chain (integration) among various businesses.

Research on business groups has been scanty in comparison to firm-level research (Granovetter, 1994). Previous empirical studies have mostly compared the performance between business group affiliated firms and unaffiliated firms. We list some of the important research done in the area:

- Chang and Choi (1988) found that the top four Korean chaebols outperform other domestic firms of the economy including smaller chaebol and unaffiliated firms.
- Khanna and Palepu (1999) found that Indian business groups have strengthened the ties that bind their affiliate's together post-liberalization and that their product and geographic scope has generally increased after 1991.[8]
- Khanna and Palepu (2000) aggregated the affiliate members' performance measures to construct group Tobin's Q and group ROA measures. They found that accounting and stock market based measures of firm (affiliate) performance initially decline with business group product diversification and subsequently

increase once group product diversification exceeds a certain threshold level. They constructed an industry-adjusted Tobin's Q by subtracting from group Tobin's Q a weighted average of industry Tobin's Q's. As in firm level estimations, a regression of industry adjusted group Tobin's Q on group size and group product diversification revealed a quadratic relationship between performance and group diversification.

FRAMEWORK OF OUR STUDY

Shareholder value (i.e., *'owner's wealth'*) maximization is a widely accepted objective of business organizations. Value maximization also provides a good conceptual and operational framework for assessing corporate diversification strategies (Alberts and McTaggart, 1979) of groups. This is done by identifying shareholder value as a measure and locating four determinants of value, namely; profitability, growth, risk and capital market conditions (Branch and Gale, 1983). Varaiya et. al. (1987) demonstrated theoretically and empirically that growth and profitability of an organization decide its shareholder value. Since, the market value of a firm is a function of its financial return, given the level of its risk (Fruhan, 1979), we focus on risk as a third determinant of value. Risk affects both growth and profitability of an organization, and would indirectly determine value.

RESEARCH METHODOLOGY

Data Sources: The financial statement and capital market data for our research are obtained primarily from publicly available databases maintained by Centre for Monitoring the Indian Economy (CMIE) and Bombay Stock Exchange (BSE)[12]. The product-wise sales data for calculating the product diversification indices was also obtained from CMIE. These standard Indian databases are most widely used by academic researchers and executives to analyze Indian firms/business groups.

Identifying Group Affiliation[13]: The data set we used in our analysis consists of all Indian business groups affiliated to private sector and listed on the stock exchanges with the required data and a listing history of at least 10 years by their affiliates. For this purpose, we adopted the CMIE database's classification of firms into groups. There is no ambiguity between CMIE's classification of firms into groups and those attempted by other reliable sources against which we have cross-checked. In the case of family controlled groups, succession from one generation to another often results in the group being split into multiple parts. We identified several groups that had gone through such periods of succession in the past two decades, and checked to see that CMIE had indeed classified each sub-group separately.

Sample and Size: For the purpose of our research, we take a firm as belonging to a particular business group in which the sample business group has at least 10 percent of the control rights of the company and which is not controlled by anybody else (similar to Claessens et. al., 1999). This study covers public limited companies only, quoted in any one of the Indian stock exchanges. Availability of data being the constraint, the study included all dominant business houses (final size of 240) in India in the sample.

Time Span of Study: To avoid factors such as temporal stability and economic/business cycles influencing our study, we used a longer time frame of study of a twelve-year period. As the business houses and firms were at liberty to choose their diversification strategy from 1985 onwards (due to delicensing of industries), the study would be carried out for the period 1987-1999. This total period of study of 12 years was divided into 3 equal sub-periods of 4 years each. Period 1 would be from financial year 1987-88 to financial year 1990-91 (period of pre-liberalization). Period 2 would be from 1991-92 to 1994-95 (period of post-liberalization; growth phase). Period 3 would be from 1995-96 to 1998-99 (period of post-liberalization; recession phase).

Measures of Independent Variables: Give the constraints on the data availability for using the best measures such as international diversification, we computed the aggregate group independent variables based on their ratios and formulas given in table 3. To make our results comparable with previous studies in the area we will use one categorical product diversification measure and two continuous product diversification measures.

Econometric Analysis: We tested the diversification strategy and financial performance linkage using linear multiple regression techniques which model group performance as a function of size of the group, its diversification, leverage, and industry fixed effects among others as shown as follows:

Performance = f(product diversification, size, leverage, long-term solvency, short-term solvency, insider ownership, foreign ownership, domestic institutional ownership, international diversification, net exports, age, industry fixed effects***)***

The regressions were computed all the three periods for each of dependent variable with the nine relevant explanatory variables. For period 3, the regressions were also performed using each of dependent variables with the twelve explanatory variables. These linear multiple full model regressions were performed using both the best variables and the standard variables. We also made use of transformations of product diversification variable in the multivariate regression techniques to look into the exact fit between performance and diversification variable given all the control variables. Both the continuous and non-continuous measures of diversification were used separately for performing these multiple regressions. Also regressions using the ten industry control dummy variables were performed separately.

PRODUCT DIVERSIFICATION RESULTS

We found that shareholder value creation was negatively related to product diversification level of business houses during all the three periods. The econometric results were quite robust considering the large sample size, multiple diversification measures, long time frame, multiple aggregate group performance measures, and more control variables used. On further analysis, we found that during period 1 and 2, the result was driven by the negative relationship between a group's product diversification strategy and its profitability. For period 1, *ceteris paribus*, we found that more diversified business groups had lesser profit margins and higher levels of risk in comparison to less diversified groups driving the negative product diversification-profitability relationship. For period 2, *ceteris paribus*, we found that highly diversified business groups had both, lesser margins and lower sales turnover in comparison to more focused groups. *Ceteris paribus*, we found highly diversified groups growth and sales turnover ratio to be lower than less diversified groups in period 3. Presumably, the adverse capital market outlook towards diversified business groups in India, as in other parts of the world (see Servaes, 1996; Lamont and Polk, 1999), also drove the relation during the later period of study.

INTERNATIONAL DIVERSIFICATION, NET EXPORTS AND PERFORMANCE

International diversification was positively related to business groups growth, profitability, profit margin, and shareholder value during period 1 and 2, while in period 3 we find that net exports was positively related to business groups' profitability and shareholder value. Either international diversification or net exports positive significance indicates benefits to the business groups having high international exposure. Therefore, movement into international markets may allow groups to achieve a long-term strategic competitiveness and hence higher shareholder value. The result apparently conveys that geographic diversification allows groups to exploit their core competencies and distinctive group capabilities across units in different international markets (Hoskisson and Hitt, 1990). International exposure might have also provided a broader base of markets for obtaining returns from innovation and provide new market possibilities (Wan, 1998).

The positive relation between net exports and performance in later periods probably suggests that exporters benefited from incentives given by the state. Also, business groups with high exports, probably gained from the learning they had in the global markets (say, in terms of better packaging, technological innovation). Moreover, capital markets seem to have favored businesses and business groups that were net exporters during this period.

LIMITATIONS

We deleted in our study all Indian business groups that had a size lower than Rs. 5 crores during the period of study; or had a negative net-worth during one of the periods of the study. Thus, the sample may contain relatively large number of better performing large business groups. Data constraints also led us to use coefficient of variance in earnings as the measure for risk. A better measure based on the market returns could have revealed more information. Also use of market based performance measures such as Sharpe and Trey nor measures, apart from tested strategic variables such as brand value could have led to more insights into the factors determining excellence.

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