Diversification Linkage Model and Firm Performance: A Literature Review

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Abstract

This paper focuses on diversification as a strategic choice with long term implications. Purpose of this study to describe the fundamental theories of diversification and forms relationship of diversification model and firm performance. The approach is to review diversification theory and firm performance, and examines the relationship model of diversification and firm performance. Research findings show the fundamental theory of diversification: Market Power View, Resources Based View, Internal Transaction Cost and Agency Theory viewed as the creation of the firm performance. It was found that relationship between diversification to firm performance can shapes linear, curviliniear and intermediate linkage models.

Key Words: *Diversification, Firm Performance*

1. Introduction

The company goal is to conduct a diversification strategy to expand the business by opening multiple business units or new subsidiaries, both in the same line of business (related) to the core business as well as in different business units (unrelated) to the core business. Some previous researchers provide some definition of diversification. Datta et al. (1991) define diversification, degree of diversification, referring to the breadth or the degree firms diversify itself into the business, product or a different market. Bettis & Mahajan (1985) defines business diversification level as diversification of businesses both related and unrelated. While Ramanujam & Varadaran (1990) defines diversification as the entry of the company into new lines of business activities through internal business development and acquisitions. One pioneer was Rumelt (1982), developed four major and nine minor categories of diversification. Major category is single business, dominant business, related business and unrelated business. Minor category consist of single business, dominant vertical, dominant constrained, linked dominant, dominant unrelated, linked dominant-unrelated, related constrained, related linked, and unrelated business. These categories provide a spectrum of the essential diversification for company, both for related or unrelated.

There are many reasons why companies implement enterprise-level diversification as a strategy. Most companies implement diversification to enhance overall corporate strategic competitiveness. If this is achieved, firm total value will increase (Hitt et al., 1997:186-187). These reasons were categorized into three motives: first, the motive increasing economic value that includes the scope, financial strength and market economy. The second motive, value-neutral consisting of tax incentives, anti-trust regulation, future cash flow, reduction of corporate risk. Last motive is devaluation, managerial job risk diversification and improved managerial competencies.

This study is organized into several sections. Section 2 discusses the fundamental theories of diversification. Section 3 discusses the linkage of diversification and firm value. Section 4 conveyed conclusions with some implications and recommendations.

2. Fundamental Theories of Diversification

Various motives in description above are potential to diversify. Therefore, emerge the fundamental theory as Market Based View (contingency theory), Resource Based View, Internal Transaction Cost Theory and Agency Theory

2.1. Market Based View (contingency theory)

The first argument refers to Porter opinion (1980:3-5). Basic formulation of competitive strategy is to connect the company with its environment. The higher competitive with competitive approach, companies must be able to distinguish his position with competitors in an industry environment, to create competitive advantage. Porter (1980) said the corporate environment was an industry where the company compete. The industrial structure has a strong influence in determining the competition rules and there is a strategy game potentially available to company. Competition in an industry is rooted in its underlying economic structure and goes beyond existing competitors behavior. The competition in an industry depends on five basic competitive forces.

Barney (2002) explains that diversification is one strategies to overcome the competition. By diversifying, companies can build market power. Clarkson & Miller (1983), Scherer (1980) in Sulastri (2004) states that market power can lead to collusion (collusion theory). Companies that have high market power would easily exercise control over the market price to make a profit above average. Palich et al. (2000) found that firms with market power would be easier to practice discounts, cross subsidies and reciprocal purchase and sale as a tool to prevent potential competitors enter the industry.

Market-based view approach explains that company diversify with motivation to overcome the competition complexity, to build financial strength and cost efficiency. Market-based view approach is part of contingency theory Ginsberg & Ventkatraman (1985), Luthans & Stewart (1977), Fisher (1998), Dickinson & Ramaseshan (2004), Ray (2004). Mealia & Lee (1979) stated the organization success depends on integration of macro and micro factors as contingency variables. Based on MBV context, diversification undertaken to overcome the competition, a way to build market power. The ultimate goal of this approach is cost efficiency and building financial strength.

2.2. Resource Based View (RBV)

Resources Based View approach (Teece, 1997; Barney 1991) uses assumption that company undertake managerial efforts to steer the SCA. Penrose (1959) concert to that company as a set combination of resources, so there is the growth of the firm theory. This theory explains that company's growth is limited by opportunities that exist as a function of a set of the company's earning power source. Penrose's theory gave birth to RBV, which later became one of the most dominant approaches to the analysis of SCA.

RBV basic reason was the guide, type, amount and nature of enterprise resources should be considered first in selecting, establishing strategies that can lead to sustainable competitive advantage. David (2003:180) uses RBV approach to gain a competitive advantage, believe that internal resources is more important for the company rather than external factors, in order to achieve and sustain competitive advantage.

Prahalad & Hamel (1990) suggests the emergence of large firms because the success in building distinctive capabilitas as a source of SCA. Barney (1991) also argues that diversification can create economies scope by sharing activities and core competences transfer as a source of SCA. The essence of RBV is an action strategy to position relationship between the business unit as a foundation for the organization multibussiness, and emphasizes the company's ability to exploit the potential synergies between resources, to produce higher performance. Hitt et al. (1997:18) describes resources as inputs to production process, such capital goods, workers ability, patents, finances and talented managers. In general, resources are classified into three categories: physical, human and organization resources.

Key RBV models based on three resources as main foundation in discovering and developing core competencies. Core competencies are considered as a capability or expertise within company business. Pearce & Robinson (2011: 215) stated resource is separated into three, called the core resources, as the basis for specific competencies. They are tangible assets, such as buildings; intangible assets, such as leases, organization costs, licensing, patents, trademarks, franchises, goodwill, and organizational capabilities.

Potential economic diversification using the RBV focuses on resource allocation (sharing activities) and competence transfer. Exploitation of potential synergies expected from sharing activities through joint cost that will result in distinctive as a source of competitive cost. Exploitation of competence potential synergies expected from complementary assets, in turn generate a distinctive competitive advantage (Barney, 2002). In this case, the cost is distinctive advantage and SCA distinctive sources.

Based on the company's resources as an input to production process that consists of physical resources, human resources and organization, it will determine what abilities owned by firm. Capabilities should be integrated as a single unit, allowing the company become better than its competitors. This potential is a source of SCA, so the company able to outperform its competitors, in figure above is linked to the profit achievement as one of business activity. Currently the company has resources and capabilities that cannot be duplicated and cannot be replaced, the company will choose and implement strategies to obtain above-average profits.

The core of the RBV approach is control mechanisms subjected to internal management to create a more efficient of resources allocation and adopt it as a competitive advantage. As described above, this approach based on Hitt et al. (1997), Barney (1991, 2002); firms resources and capabilities factors become strategic asset for firm to become SCA source. The mechanism of strategic assets is done by sharing activities and integrated competence transfer.

2.3. Internal Transaction Cost

In diversification context, internal cost efficiency is possible if the company develops diversification through vertical integration between complementary business. Development of vertical integration and complementary businesses be done to meet assumptions of Transaction Cost Economic-TCE. There is a relationship between the frequency the business unit intensity to cope uncertainty and a prioritized on specific business transactions.

Porter (1980: 263) explains that vertical integration is a combination of production processes, distribution, sale and/or other economic processes, which are different technologies within the boundaries of a single firm. This reflects that company decision was to use internal transactions rather than market transactions in order to achieve economic goals. According to Porter, one benefits of vertical integration is company improve the company's ability to offer a value added differentiation and more under management control.

David (2003:161-162) also outlines that vertical integration allows a company to gain control over distributors, suppliers and competitors. Vertical integration strategy divided into three parts namely: forward integration, backward integration, and horizontal integration. Something to distinguishes the three are seeking ownership or increased control over distributors or retailers (forward), firms suppliers (backward) and competitors (horizontal).

TCE view assumes that value creation can be obtained through the reduction of transaction cost inefficiencies (Foss, 2003). This theory preceded Coase in 1937, states the cost happened because the market mechanism would be smaller if the company able to coordinate the transaction. Williamson (1989) connects the market with the managerial hierarchy in company organization, to support interactions within company to provide lower incentives cost with greater ownership than the market, which includes ownership and contractual rights in a multi-business company. In Williamson view, the change from non-market to market based on two assumptions: individual rationality is limited (bounded rationality) and opportunism nature of economic actors.

The focus of transaction cost theory lies in the argument that in order to keep the contract could go well then it need costs. Each contract basically done in a limited rationality situation. Based on these properties, the information never occurs symmetrically (asymmetric information). In other words, the transaction costs would arise because the information is not available perfectly. Thus, firms exist because companies are more efficient than market. Efficiency occurs because internalization of transaction costs and market monitoring mechanism against opportunistic behavior and economic actors (Williamson, 1989).

2.4. Agency Theory

Agency theory (Jensen & Meckling, 1976) explains that separation between the owner and manager of company will always followed by emergence of cost because the lack of interests alignment between owners and managers. These costs are called agency costs, include: expenditure to monitor the managers activities, expenditure to create an organizational structure to minimizes the unwanted managers actions, as well as the opportunity cost arising from the condition in which the manager cannot make decisions immediately without shareholder approval. One important implication of the agency problem is related to the company's financial policy, especially against two choices whether using debt or equity to finance business activities.

Jensen (1986) explains that interest conflict between managers and shareholders occurs with assuming the owners (shareholders) and managers (agents) each want a high return on investment to projects but with different interests to risk (Jensen, 1986; Amihud & Lev, 1981; Lane et al., 1998). The difference is explained by the risk (Amihud & Lev, 1981), that shareholders more interested in the systematic risk, while managers were more interested in the unsystematic risk. In particular, these conflicts occur in companies with substantial free cash flow, because the manager will choose to invest excess cash to optimize profit, compared with a cash payment to shareholders.

Based on description above, agency theory can explain why firms diversify, and also explains why diversification does not create value for company. The essence was diversification undertaken to gain efficiencies and to ensure benefits to all stakeholders that organization's activities are run in a professional manner and free from any interest conflict. Therefore the firm value should be increased. Rationality is a diversified company to address the agency conflicts within firm. Diversification can provide incentives for agents through investment and ownership. Therefore, the emphasis is not only based on performance evaluation of financial outcomes, but more emphasis on optimize behavior (Jensen & Meckling, 1976; Jensen, 1986; Adams, 1994).

3. Relationship of Diversification and Corporate Performance

Many empirical studies conducted to explain the diversification relationship with performance. For example, Rumelt (1982) was the first author that connects classification with a diversified economic performance, suggesting there are performance differences at different types of classification diversification and stressed that company limitation in developing enterprise wide due the lack of managerial and resources. Pandya & Rao (1998) also stated the same thing, managerial and resource constraints is one causes of diseconomies scope, at higher diversification level. It is also interpreted by some researchers such as Datta et al. (1991), Murkherjee (1998), concluded that diversification literature has failed to find a consensus on the relationship between corporate diversification and performance. The above argument is also supported by Palich et al. (2000), who argued that relationship between diversification and performance can shape linear and non-linear. curves, as explained below:

3.1. Linear Linkage Model

The model was developed in market based view and internal transaction cost economies perspective. Company diversification can create value through market power advantages exploitation. Positive linear relationship between diversification and performance can be caused by internal market efficiency through market power. Furthermore, by diversifying the company can access internal cash resources through cross subsidization. Another advantage as a performance source is if the company has an advantage in the specific-assets, such as reputation, customer loyalty and technology, through diversification can exploit these resources at a lower cost internalization.

3.2. Curvilinear Linkage Model

Curvilinear linkage illustrates that diversification incremental is not associated with improved performance in certain continuum. There are two alternative curvilinear linkage, Inverted-U Model and Intermediate Model. Inverted-U Model shows the diversification performance has optimum limits. This means that diversification does not produce benefits in accordance with the increase in diversification level of sharing resources, because the costs (such as coordination costs) is increasing, so creating diseconomies scope (Hoskisson & Hitt, 1990; Palich et al., 2000). Diversification and performance relationship in the form of inverted-U model described by Palich et al. (2000); Lubatkin & Chatterjee (1994), said that performance is limited when a company is limited to single industry. The company does not have a chance to exploit the benefits of synergies between the resources and capabilities of the division. This cause the limited diversification does not generate above-average profits. While related diversification will provide superior performance advantage of economies scope (Porter, 1980; Shleifer & Vishny, 1991; Nayyar, 1993), through the exploitation of synergy sharing activities and transfer competencies (Barney, 2002). However, the higher diversification level in a portfolio of separate business, the higher coordination cost due of loss control, so the marginal cost is increasing. Markides (1992) also argues, the high diversification level will lead to inefficiency due the conflict between doing business in internal capital market. It is an interpretation of the higher diversification level, the lower performance.

3.3. Intermediate Linkage Model

The combination of two models above are called intermediate linkage model. This model gives attention to the positive relationship between diversification and performance, but at degree of diminishing returns organization (Palich et al., 2000). When company increased diversification level away from the core business, the marginal benefit of diversification will decrease. This is because the company diversification, initially to take advantage of asset capacity. However, if the asset is used in excess, it can lead competitive advantage loss with implications the declining of marginal profit function (Wernerfelt & Montgomery, 1988; Markides 1992).

4. Conclusion

As an alternative strategy, diversification can be implemented by the company. Some fundamental theories became foundation for company to diversify. When firms diversify, the consequences faced was the change organization structure and business structure become larger and comprehensive.

Diversification and firm performance relationship can forms linear and nonlinear curve models. Linear curve model is developed based on market based view perspective and internal transaction cost economies, the increased company performance is because the advantage of exploiting market power. Nonlinear curve model describes the diversification is not associated with improved firm performance in a particular continuum. There are two alternatives of curvilinear linkage namely inverted-U and intermediate model. The relationship between diversification and firm performance in this paper is a literature in nature that is still to be proven empirically. The literature study is a way to solve problems both for the academic research and practitioner.

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