RI HUB

A research collaboration between the University of Melbourne and the Ruthven Institute

KEY FINDINGS

1. Focused firms outperform conglomerates over the long term. Focused firms tend to outperform firms diversifying into related areas if the extent of their diversification exceeds moderate levels.
2. Diversification remains a popular strategy as managers and boards seek to grow and use excess resources. Some do so in related industries, seeking to use their skills or capacities in different ways. Others seek to offset cyclical risk by moving into unrelated industries.
3. The lower performance of diversified firms primarily stems from the costs and inefficiencies associated with diversification despite the potential benefits.
4. The evidence on how investors react to diversification decisions is mixed, and results vary across countries due to differences in corporate ownership and governance.
5. Expanding internationally while retaining focus on the same industry constitutes another channel through which firms can improve their performance, but the extent of such expansion should remain at moderate levels.

AUTHORS

Sabutay Fatullayev &
André Sammartino

THE UNIVERSITY OF MELBOURNE

PRACTICE NOTE #2

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FOCUS OR DIVERSIFICATION?

The Issue: ***RI Rule #1 calls for focus to optimise firm performance, with growth via geographic expansion. Yet many firms do pursue inter-industry diversification. What do studies show is the path to long-term profitability?***

Focus is achieved by specialising in one industry, product or service. Diversification, on the other hand, is characterised by a change in the company's product line and/or market.

- A firm is considered focused if it operates within one industry class (as defined by a four-digit ANZSIC code).
- Focus allows firms to hone their competitive skills and resources and deepen their knowledge of the industry. Specialisation often leads to an improvement in proficiency and productivity and is hence a source of competitive advantage.
  — Firms' unit cost of production can reduce as their expertise increases or as they achieve economies of scale.
- Firms can diversify through organic growth or mergers and acquisitions.
- Diversification can either be related or unrelated. It is considered related when the firm's new business line is in a different industry class than the company's existing business lines but shares with them an industry group or subdivision (i.e., three- or two-digit SIC codes). It is considered unrelated when the new and existing business lines are in different industry subdivisions or divisions.
  — Related business lines tend to utilise similar core skills, share facilities, and/or exploit common factors of production.
  — Under Rule 1, related diversification is classified as theme conglomeration. Rule 1 distinguishes between theme conglomerates and classic conglomerates, the latter of which is more consistent with how conglomerates (i.e. unrelated diversifiers) are defined in academic studies.
  — Classic conglomerates are also a result of unrelated diversification and comprise business lines that operate in different industry divisions.

A firm's decision to diversify is often motivated by certain benefits that diversification may bring:

- The potential for economies of scope, which allows the spreading of costs over highly related tasks
- A larger pool of assets and resources to finance temporary setbacks or invest in business lines that need immediate funding.
- The potential for synergies between related business lines that may help the company to develop new strategic assets not readily imitable by specialised companies (achievable through related diversification only).
- A potential increase in the company's debt capacity and/or borrowing ability, and a decrease in the company's borrowing costs (unrelated diversification only). Conglomerates are also considered as lower risk by credit rating agencies, assuming they perceive the strategy to be sound.

Despite the abovementioned benefits, diversification may also bring in several costs and have significant implementation challenges.

- Learning about the new industry and honing the skills and resources necessary to compete with the established incumbents are costly and time-consuming. This task is especially challenging if the competitors are highly specialised.
  — Factors such as the age and size of the incumbents, how long incumbents have been operating in the industry, and at what stage of the industry's life cycle the company enters are all crucial to the company's survival in the new industry (see our Rule 2 Practice Note).
- The larger the number of divisions, the higher the chance that division managers will compete over resources and headquarter's attention, which will reduce the company's efficiency.
- Coordinating the use of shared resources among multiple related business lines becomes more and more difficult as the number of segments grows.
  — Coordination costs are likely to outweigh the benefits of related diversification if the extent of diversification exceeds moderate levels.
- The complexities described above with regards to learning and resource battle will inevitably increase the likelihood of overinvesting in poorly performing divisions and underinvesting into divisions with good investment opportunities. This issue is likely to be more severe in firms with a large pool of internal capital as a result of diversification.
- Highly diversified firms generally lack the flexibility of more focused firms.

Evidence regarding the overall impact of diversification on firm performance is mixed, but some conclusions can be drawn from the voluminous research.

- On average, focused firms tend to perform better than conglomerates and firms with high levels of related diversification. A lower level of related diversification, however, may improve performance.
- Conglomerate performance has been improving over the last couple of decades, likely due to a more cautious approach to diversification after a wave of early conglomerate failures.
- There is mixed evidence on how investors view diversification.
  - It varies significantly across countries, industries, and even over time.
  - Of the different firm structures, highly diversified conglomerates are likely to have the highest value loss when they have at least some amount of debt.
  - The loss of shareholder value in conglomerates contrasts with the potential improvement in their credit ratings and borrowing costs. However, companies can obtain similar improvements in their credit ratings through international diversification while still remaining focussed if they have the critical mass to be a real competitor in the new country.

International expansion can improve firm performance, but the evidence on investors' reaction to international expansion is mixed.

- Geographical expansion has many of the benefits and implementation challenges of inter-industry diversification.
- Firm performance may decline when the company initially expands into foreign markets, but is likely to improve and exceed the pre-expansion level of performance as the extent and duration of international expansion increase.
  - The initial dip in performance typically stems from the company's limited knowledge of the new market and the lack of experience in managing more complex operations.
  - Internationalisation is expected to be especially effective in R&D-intensive companies.
- At high levels of internationalisation, performance is likely to fall again as the costs of international expansion exceed its benefits.
- Evidence on how investors view global expansion is mixed, but there is some evidence to suggest that exchange rate volatility is an important driver of performance outcomes of internationalisation.