

THE EFFECT OF DIVERSIFICATION STRATEGY ON ORGANIZATIONAL PERFORMANCE

▪ *Moruff Sanjo Oladimeji, Itobowo Udosen*

Abstract

In today's dynamic and turbulent business environment, diversification has become a catalyst for achieving competitive advantages and the creation of synergy in market operations. This is because manufacturing companies operate in a highly competitive environment, especially among firms that produce the same or similar goods. This study examines the effect of a diversification strategy on an organization's performance in the manufacturing sector. A quasi-experimental study with an ex-post facto research design were used for the study. The respondent population consists of thirty-one organizations listed in Nigerian Stock Exchange (NSE) for a period of 20 years (1997-2017), while the sample size is comprised of six organizations purposively selected based on their life-span and level of diversification. Three hypotheses were formulated and tested using ratio analysis, while performance was measured in terms of ROA, ROI and ROE; organization size, organization value and growth; as well as leverage and liquidity. Data was drawn from the financial reports of the selected organizations, with E-View version 9 used for the data analysis. The study revealed that diversified organizations outperform undiversified ones in terms of ROA and ROI. While related diversified organizations were discovered to be positive in terms of ROA (26.8%), unrelated and hybrid diversified organizations were positive in ROE (81.7% and 20.5%). A diversification strategy leads to growth and profitability (20%) and a strong capital structure to cover liabilities (26%). The study concluded that diversification is a strategic tool for achieving strategic relevance and spontaneous performance.

Keywords: diversification strategy, performance, organization, profitability, competitive advantage

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1. INTRODUCTION

The effect of a diversification strategy on performance has over the decades attracted the attention of scholars in the field of management and social sciences. Nonetheless, the justifications for diversification as well as results vary, with some findings found to be inconclusive (Asrarhaghighiet al., 2013). Organizations may choose to diversify to survive the dynamics of business environment (Nyangiri & Ogollah, 2015); for expansion (Su & Tsang, 2015); increase profitabil-



ity (Karimi, 2013; Yigit & Tur, 2012); foster efficiency in the use of resources and create investment opportunities (Emel & Yildirim, 2016; Hasby et al., 2017); to achieve economies of scale to explore market options and opportunities (Sindhu et al., 2014); and as a turnaround strategy (Harrigan, 2012). Krivikapic et al. (2017) conclude that organizations diversify in order to have a better position in the market, while Akewushola (2015) opined that a diversification strategy enables an organization to expend its excess resources for economic use. However, subsequent studies have revealed contradictory results, some negative and others finding no relationship among variables (Shyu & Chen, 2009). Diversification does not necessarily lead to improved performance and not all diversified organizations are profitable (Manyuru et al., 2017; Nasiru et al., 2011; Jasper, 2016). Also, an increased diversity within a business portfolio may result in a loss of control by top executives, which also deteriorates business performance (Yigit & Tur, 2012; Uguwany & Ugwu, 2013). Schommer et al. (2019) found that the performance of diversified organizations declines with time, and decision makers who form diversification strategies find it increasingly difficult over time to avoid retrogressive performance.

The increasing demand for product varieties by consumers and their continuous substitution has forced organizations to come up with strategies on how to improve performance. Irrespective of opportunities in the business environment, organizations face threats that distort their performance, hence increase the difficulty of survival. This study, therefore, examines the effect of a diversification strategy on performance within the manufacturing sector in Nigeria with these specific objectives:

1. determine the significant variance among related, unrelated and hybrid diversification using the ROA, ROE and ROI measures of performance.
2. examine the significant variance among related, unrelated and hybrid diversification strategies in terms of size, value and growth.
3. access the significant variances between leverage and liquidity in terms of related, unrelated and hybrid diversification.

The study was divided into five sections, with section one introducing the subject matter, section two presenting a literature review, section three the research methodology employed for the study, section four the research findings and discussion of the findings, and section five provides the conclusion and recommendations of the study. The study was limited to six manufacturing companies out of the thirty-three companies listed in the Nigeria stock exchange.

2. THEORETICAL BACKGROUND

Diversification has become a popular survival strategy among organizations in an effort to outpace competitors (Haug & Ultich, 2013). Whether in related form or not, diversification is a strategic option used by more and more managers to improve performance (Castaldi & Giarratana, 2018; Makau & Ambose, 2018). Organizations have chosen from among several available strategic alternatives to make the best use of the available resources to reach predetermined goal regarding increased performance (Rowe, 2014; Xaxx, 2017).

Diversification is undertaken when an organization aims at changing its business definition either by developing new products or expanding into a new market individually or jointly with

another entity (Su & Tsang, 2015). It is a catalyst for competitive advantage and a means whereby an organization spreads its risk across several businesses to increase profitability, reduce the risk of bankruptcy, create synergy, enhance market operations and improve performance (Oladele, 2012). A diversification strategy helps in improving debt capacity, asset deployment and further allows the organization to use its existing skills, expertise and competences to produce unique products (Ajayi & Madhumati, 2012; Pandya & Rao, 2011; Junior & Funchai, 2013). Diversified organizations can effectively pool unsystematic risk in order to reduce the variability of operating cash flow to enjoy competitive advantages (Dosi & Teece, 1993). Nevertheless, diversification should not be seen as a panacea that will meet every single one of the various challenges faced by organizations in today's dynamic business environment.

Zheng-fend & Lingyan (2012) as well as Oladele (2012) have shown how organizations are exposed to huge risks and structural challenges that can stunt managerial decisions regarding whether to spin-off aspects of operations or to become part of a holding group structure. In addition, Ugwuany & Ugwu (2013) have affirmed that diversification can be value-destroying and usually leads to discount as a result of agency problems between managers and shareholders and those averse to taking on managerial risk. It may also result in the weakening of corporate governance structure and family relationships (Alli et al., 2016). Consequently, if not properly planned and implemented, diversification may lead to retrogressive performance, especially in less developed countries such as Nigeria which are plagued with instability, economic uncertainty, incessant shut-downs of economic activities, a lack of technology and resources, as well as deteriorating infrastructure (Haim, 2015; Thompson & Stickland, 2003). Sahu (2017) has concluded that diversification is not a very efficient strategy to increase an organization's profit and may result in poor performance, while higher diversification is retrogressive in terms of overall performance. Santarelli & Tran (2016) have presented similar opinions regarding these variables.

2.1 Theoretical framework

Two theories, Modern Portfolio Theory by Henry Markowitz and the Resource-based view by Birger Wernerfelt, are germane to the present study, which is based on aptitude in the explanation of the dependent and independent variables.

Modern Portfolio Theory (MPT) was introduced to assist in the selection and formation of the most efficient diversified portfolio in order to most greatly reduce risk. MPT is a tool that guides investors on the expected risk and returns associated with investments. At the most basic level, the theory recommends that investors should invest in several portfolios rather than rely on a single portfolio, by which investors can reap the benefits of diversification through reduced risk by spreading it among portfolios.

Resource-based theory (RBT) allows an organization to leverage upon its inward capabilities which are rare and inimitable to achieve competitive edge over other organizations. The theory states that all organizations have in their possession several untapped resources with potential that makes them superior over competitors and also enables increased performance when properly combined.



2.2 Empirical reviews of the use of a diversification strategy and organization of performance

In the study on the effect of a diversification strategy on organizations' performance, using panel dataset of 68 European retailers from 19 countries between 1997 and 2010; Oh et al. (2014) affirmed that both inter-regional and intra-regional diversification have horizontal S-curve relationship with performance. However, a subsequent study by Hashai (2015) linked within industry adjustment cost and coordination cost as reasons for the S-Curve. Valis-Boas & Gonzelaz (2015) using Entropy, Tobin-q and Herfindahl indexes highlighted that the S-curve seems appropriate in the measure of diversification and performance because diversification is negatively linked to performance due to organizations' inability to transfer knowledge, negotiable contracts and handle institutional practices in host countries. Moreover, international diversification was deemed harmful to performance.

Zheng-Feng & Lingyan (2012) used 3050 organizations from COMPUSTAT using the Tobin-q equation and Standard Industrial Classification code to disclose that organizations' decision to diversify depends on the interaction of two effects - economies of scale and agent problems where diversification get smaller once the organization engages in more than 3 industries. However, Keng (2010) opined that companies with numerous portfolios have greater advantage over single industries. Castaldi & Giarratana (2018) studied diversification on the performance of professional service firms using US-based management consulting firms from 2000 to 2009. The panel regression results showed that diversification is advantageous to professional service firms while performance is positively related to the strategy used by specialized barrow brands.

LaRocca & Stagliano (2012) examined the effect of unrelated diversification on performance using 2,613 organizations in Italy from 1980 to 2007. To avoid unobservable organizations' heterogeneity, three economic methods, fixed-effect estimator, instrument variable estimator, and Hecman, were used for the study. It was revealed that the benefits of diversification outweighs its cost. Also in US, Akkermans (2010) conducted a study using 354 organizations listed in the US Standard and Poor 500 Index data span from 2005-2006 and 2008-2009. Using multiple regression to test the hypothesis, the study revealed that diversification is less positively associated with performance and the benefits associated with unrelated diversification are harder to make during periods of crisis.

Gul (2011) examined the effect of integrated strategies on performance, using 147 manufacturing organizations in Denmark. Entropy and Herfindahl Indexes were used to measure diversification. The study revealed that manufacturing industries have the highest average performance measure and related integrated companies outperform unrelated diversified organization. Martinez-Campilo (2016) built on agency-stewardship approach to examine the benefits of related and unrelated diversification strategies on leadership style, using 183 firms in Spain. The result highlighted that the relevance of leadership style has a positive impact on the profitability and growth of diversified firms.

Makau & Ambrose (2017) examined the impact of portfolio diversification on financial performance of investment organizations listed in Nairobi Stock Exchange, Kenya. Explanatory non-experimental research design was used for the study with the conclusion that diversification

strategy remains a universal research phenomenon for researchers in the field of management and social science since the resultant effect remains inconclusive. Manyuru et al. (2017) conducted a study on 38 companies listed in NSE, Kenya. The study concluded that managers need to be courteous in pursuing diversification because the cost outweighs the benefits. Nyaingiri & Ogollah (2015) studied Semeer Group using experimental research design. It was indicated that the general economic environment, organizations' characteristics and co-insurance affect the performance of diversified firms in Kenya.

Santarelli & Tran (2016) conducted a study in Vietnam on firm's profitability and diversification activities. The study showed that diversification has a curvilinear effect on profitability but with an associated decline in performance. Rishi, Rudra and Vinay (2014) took a sample of 44 companies in India using Tobin-q, Ulton and Entropy Indexes to measure diversification. The result showed that companies involved in the product diversification are more profitable and increase their tangible assets when compared to undiversified firms. However, Sahu (2017) stated that diversification though profitable does not necessarily lead to improvement in performance.

Sindu et al. (2014) examined 20 diversified and 20 undiversified firms in Pakistan. The study revealed no multi-collinearity between diversified and undiversified firms since diversified firms are risky. Quershi et al. (2012) showed that diversified organisations are more profitable compared to the undiversified ones. However, Weirsmar & Beck (2017) disputed the credibility of the subjective grouping organizations as diversified without clarity on the degree and extend of diversification. Krivokapic et al. (2017) sampled 23 industries using Entropy and Hausman test to determine the relationship between diversification and performance of insurance companies in Siberia. The study showed that diversified insurance companies outsmart the undiversified ones. Ivan & Maja (2010) stated otherwise.

Diversification is fundamental to the success of organization in the face of downturn. To determine the effect of diversification on performance, Akewushola (2015) studied 13 selected ICT firms, concluding that the performance impact of related market diversification is not the same for all organizations and it is largely relative and moderated by the intensity of the ICT usage within organizations. Ayeni (2013) predicted the effects of economic diversification on the development of tourism in Nigeria. The study revealed the positive roles of tourism in development. It concluded that Nigerian economy would be prosperous if it diversified into tourism.

In a study on marketing capabilities and diversification on performance of product manufacturing organizations based in Lagos State, Sulaimon et al. (2015) revealed that a significant relationship exists between market capabilities and organizations' performance while diversification has a significantly strong impact on performance. Ugwuanyi & Ugwu (2012) sampled 18 banks using expose-facto research design. The study discovered that diversified banks can pool their internally generated funds and resources to create financial synergy to ensure growth. This corresponds with the Modern portfolio theory since organizations can identify their rare capabilities or channel their resources to produce economic good.

Oyedijo (2012) took a sample of 48 companies made up of 15 specialized, 11 related, 14 unrelated and 8 mixed diversified organizations to study the effect of product-market diversification strategy on corporate financial performance. Nigerian organizations seeking sustainable fast



growth and superior performance should pursue related product-market diversification strategy or specialized strategy or both. Oladele (2012) using manufacturing companies listed in Nigerian Stock Exchange revealed that an inverse relationship exists between diversification strategy and performance due to shareholders' influence.

3. RESEARCH OBJECTIVE, METHODOLOGY AND DATA

The study used ex-post facto research design with the study population of thirty-three (33) manufacturing companies listed in Nigerian Stock Exchange (December 2017). Purposive sampling technique was applied in the selection of 6 (six) companies based on their level of diversification whether related or mixed, and lifespan. The companies are Nestle, Unilever, Cadbury, Mayer & Baker, Lafarge and Honeywell. The data were drawn from the annual reports of the companies for a period of 20 years (1993-2018). A ratio analysis was used to establish the variance among the variables, while all variables were tested using performance indicators.

Based on the aforementioned objectives, the following research hypotheses were stated:

H₀₁: There is no significant variance among related, unrelated and hybrid diversification using the ROA, ROE and ROI measures of performance.

H₀₂: There is no significant variance among related, unrelated and hybrid diversification strategies in terms of size, value and growth.

H₀₃: There is no significant variance between leverage and liquidity in terms of related, unrelated and hybrid diversification.

3.1. Analysis of Variables

Tab. 1 – Descriptive Statistics of the Variables. Source: own research

	OrgSIZ	OrgVAL	GRW	LEV	LIQ	ROA	ROE	ROI
Mean	15.9302	95.4942	20.9356	26.3374	19.48561	14.3278	34.6920	6.46803
Median	15.9052	80.1762	18.0799	11.4041	11.68823	11.3450	22.6728	4.13546
Max.	22.1992	332.434	22.42882	74.3122	12.81130	15.3369	33.9455	73.5798
Min.	7.4373	0.0228	-11.9144	-4.6663	0.066174	-22.6595	-21.026	-12.181
Std. Dev.	2.0867	72.8602	19.9606	10.5966	26.52504	13.6494	30.5970	65.7071
Skewness	-1.0534	1.2866	11.0771	4.8398	3.077717	11.0772	10.6777	10.9840
Kurtosis	7.3680	4.5450	1.238051	2.67619	11.47017	12.3806	11.7329	12.2405
Obs	126	126	126	126	126	126	126	126

Table 1 presents the descriptive statistics for all the organizations sampled to ascertain the appropriateness of the data collected from the financial reports. The table reveals that the measures of performance were all positive (ROA, ROE and ROI). This suggests that over time all the organizations sampled were experiencing high returns on assets, equity and investment.

4. RESULTS AND DISCUSSION

Tab. 2 – Comparison of ROA, ROE and ROI of Related, Unrelated and Hybrid Diversifications. Source: own research

	Related			Unrelated			Hybrid		
	Average	Std. Dev	CoV	Average	Std. Dev	CoV	Average	Std. Dev	CoV
ROA	26.8190	19.2971	0.7185	10.258	9.86132	0.961	22.4211	0.1827	1.3461
ROE	14.2235	71.5736	5.0320	20.579	50.2622	2.442	81.7116	52.3659	0.6408
ROI	12.1520	92.9401	7.6481	12.738	12.7174	0.998	53.9034	68.2278	1.2657

Table 2 presents a ratio analysis of performance indicators in measuring which of the diversification strategies enhances the organization's performance. Based on the results, the average ROA of organizations that adopted a related diversification strategy is 26.8%, which is higher than that of a hybrid diversification strategy (22.4%) and unrelated diversification strategy (10.2%). The average ROE of organizations that adopted a hybrid diversification strategy is 81.71%, which is higher than that of a related diversification strategy (14.22%) and unrelated diversification strategy (20.58%). The average ROI of organizations that adopted a hybrid diversification strategy is 53.90%, which is higher than that of a related diversification strategy (12.15%) and unrelated diversification strategy (12.72%).

ROA is more efficient, i.e. it uses related diversification as evidence from the least covariance value (0.71850) compared to other measures of performance such as ROE and ROI, which have a higher covariance of 5.0320 and 7.6481 respectively.

Similarly, ROA is more efficient when unrelated diversification is adopted. However, using hybrid diversification, the ROE with the least covariance value of 0.6408 is a more efficient measure of performance compared to other two measures.

Tab. 3 – Comparison of the Control Variables (Size, Value and Growth) for Related, Unrelated and Hybrid Diversification Strategies. Source: own research

	Related			Unrelated			Hybrid		
	Average	Std. Dev	COV	Average	Std. Dev	COV	Average	Std. Dev	COV
OrgSIZE	16.8599	1.2580	0.074	14.464	1.3085	0.090	15.268	2.677	0.175
OrgVAL	95.6706	54.2171	0.566	13.950	74.034	5.306	73.223	86.981	1.187
GRW	39.1722	28.2211	0.720	14.160	12.254	0.865	35.142	42.306	1.203

From Table 3, it can be seen that the organizations pursuing a diversification strategy have a higher size (16.8%) in terms of total assets. This follows from the organizations' extension of existing resources and use of assets to produce more goods in the same line, a strategy which brings competition-enhancing opportunities for transferring valuable expertise, technological know-how or other capabilities from one line of business to another. Hybrid diversified organizations fared well (15.25%) compared to unrelated diversified organizations (14.4%).

Organisation size is more efficient using related diversification as evidence from the least covariance value (0.074) compared to other measures of performance such as organisation value and organisation growth with a higher covariance of 0.566 and 0.720 respectively.

Similarly, organization size is more efficient when unrelated and hybrid diversifications were adopted.

Tab. 4 – Comparison of Leverage and Liquidity in terms of Related, Unrelated and Hybrid Diversifications. Source: own research

	Related			Unrelated			Hybrid		
	Average	Std. Dev	COV	Average	Std. Dev	COV	Average	Std. Dev	COV
LEV	21.379	10.867	0.508	49.789	40.820	0.819	46.694	12.478	0.267
LIQ	11.670	43.271	3.707	27.559	28.153	1.021	27.171	39.272	1.445

The leverage and liquidity positions of the sampled organizations revealed in Table 4 indicate that organizations pursuing an unrelated diversification strategy are highly geared (49.7%), while hybrid diversified organizations have about 46% debt in their capital structure and the ones with a related strategy have a low gearing ratio (21.3%). This suggests that organizations involved in the related diversification strategy have more equity in their capital structure and less debt, while unrelated diversified organizations have about 49% of their capital structure composed of debt.

Leverage is more efficient using related, unrelated and hybrid diversification as evidence from the least covariance values 0.508, 0.819 and 0.267 compared to liquidity, with a higher covariance of 3.707, 1.021 and 1.445 respectively.

From the analysis, it was revealed that related diversified organizations outperform unrelated and hybrid diversified organizations in terms of ROA and ROI through use of their capabilities and assets to attain a competitive advantage, whereas the hybrid diversified organizations generate higher returns in terms of ROE as compared to organizations using other diversification strategies. Hybrid diversified organizations have a higher risk return as compared to those pursuing a related diversification and unrelated diversification strategy, which exhibited a high level of risk in terms of leverage and liquidity.

The study also showed that organization size is more efficient in the use of a related, unrelated and hybrid diversification strategy as compared to organization value and growth. Although this was in line with results from the study of Krivokapic et al. (2017), Qureshi et al. (2012) and Gul (2011), our study linked performance in terms of profit, market structure, and the level of concentration. Contradicting these findings, Mohindru & Chander (2010) as well as Akpinar & Yigit (2016) found that organizations with the unrelated strategy outperform those with a related or hybrid strategy. While Ivan & Maja (2010), Oladele (2012) and Adamu et al. (2011) ascertained that undiversified companies outperform highly diversified ones in terms of return on assets and profit margin, moderately diversified organizations were found to outperform highly diversified entities in terms of return on equity, return on asset and profit margin.

5. CONCLUSION

It was observed that while diversified organizations outperform undiversified organizations in terms of profitability, market value and shareholder value, there were also periods when these organizations were experiencing dwindling performance since the ROI, ROE and liquidity were found to be unstable and unpredictable for a particular specified period. Further, organizations pursuing related strategies perform better than unrelated and hybrid organizations. Nevertheless, organizations pursuing a hybrid strategy and unrelated strategy generate higher returns in ROE and ROI. The study concluded that the benefit of diversification outweighs the cost, thus, diversification has a positive effect on an organization's performance.

Based on these findings, it is recommended that organizations that wish to achieve economies of scale and redeem their financial position in the face of downturn or decline in the product life cycle should diversify its product lines to better meet customers' demands, as well as to achieve profitability and expansion as well as increase performance, since diversified organizations were found to perform better than the undiversified entities. Furthermore, organizations should identify their rare and inimitable capabilities in order to achieve economies of scale and outsmart competitors. Finally, R&D centres should be developed to achieve the most cost-effective channelling of resources, the identification of opportunities as they arise in the business environment, as well as to select other strategic options in the most effective way.

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Contact Information

Moruff Sanjo Oladimeji (Ph.D.)
 Department of Business Administration
 Faculty of Administration & Management Sciences
 Olabisi Onabanjo University
 Nigeria
 Email: moruff.oladimeji@oonagoivoye.edu.ng

Udosen Itobowo
 Postgraduate school
 Babcock University, Ilisan- Remo
 Ogun State
 Nigeria