The Frequency of Implementing Diversification Strategy in Croatia

Darko Tipuric, PhD., Faculty of Economics and Business Zagreb, 10 000 Zagreb, Croatia
Maja Darabos, M.Sc., Faculty of Economics and Business Zagreb, 10 000 Zagreb, Croatia

ABSTRACT

Diversification is a corporate strategy that introduces the company into new businesses or industries that can be related or unrelated to its core business and thus increases the diversity of businesses that are monitored by managers. This paper is focused on the analysis of the diversification strategy through macro level factors, especially the industry as the determinant of implementing the diversification strategy in Croatian companies. The main objective of the paper is to determine whether companies in Croatia are more frequently applying related or unrelated diversification and are there any correlations depending on the industry in which firm operates. The research has been made on a sample of 78 large companies in Croatia.

Keywords: *related diversification strategy, unrelated diversification strategy, industry, large Croatian firms*

INTRODUCTION

The diversification strategy is common research field and topic of many researches in the world. In Croatia, despite the growing use of diversification strategies, researches on the frequency of its application and the reasons for diversification are limited.

Diversification strategy is corporate growth strategy in which the company is expanding its activities and entering into new business activities, to disseminate rank areas in which they can successfully invest for the purpose of profit and growth, generate consistent and stable growth due to participate in more activities, the potential for faster growth with less risk and the greater number of middle management positions in the company.

Diversification strategy has two mayor types: related and unrelated diversification. Related diversification represents a strategy when firm operates in multiple industries, or businesses, which have some linkages with the firm's existing business. However, there are several reasons when the implementation of related diversification strategy can be problematic. First, the time and cost involved in top management at the corporate level who seeks to assure that the benefits of connectivity are created through the sharing or transferring between business units. Second, it is difficult to share resources with other business units, or more difficult to adjust managers to corporate policies, especially when they are motivated and rewarded for independent performance of their business units (Johnson, Scholes and Whittington, 2005).

On the other hand, it is possible for firms to pursue numerous different businesses or industries with no linkages between them. The reasons for unrelated diversification strategy are varied: support to some divisions with cash flow of other firm divisions in the periods of development or temporary difficulties, the use of a division's profits to cover costs of other division; encourage growth, taking advantage of development opportunities; distribution of risk by serving several completely different and separate markets; improving profitability and flexibility; achieving better access to capital markets and better stability and earnings growth; increase in firms' stock prices; or realizing the benefits of synergy.

Potential benefits can be achieved from vertical (hierarchical) relation through the creation of synergies by the interaction of a corporate center with individual business units. First, in a way that the corporate centers takes care of certain business or restructure it, while another way to create a synergy is that the corporate center adds value by monitoring the entire corporation as a whole and allocate resources to optimize the corporate objectives of profitability, cash flow and growth. In addition, the corporate center adds value by specifying an appropriate system of control of human resources and financial controls for each business unit (Dess, Lumpkin and Taylor, 2005).

THEORETICAL DETERMINANTS OF CORPORATE DIVERSIFICATION STRATEGY

Extensive research has focused on the relation between types of diversification and firm performance, while specific motives for implementing diversification strategy were investigated at lesser extent as well as differences in implementation depending on the industry in which the firm operates (Darabos, 2011).

If the firm has unused resources or competencies that cannot be effectively rejected, or submitted to other potential customers, it makes sense to use those resources or competences by diversifying into new business.

Santalo and *Beccera* (2005) propose that in industries in which all firms present a similar pattern of diversification, i. e. they are active in a similar industries, the proportion of activity accounted by specialized firms is going to be smaller, because they cannot take advantages of economies of scope of diversifiers. In contrast, if firms in the industry present a non-homogeneous pattern of diversification, each one being present in very different industries, there is no evidence of economies of scope and specialized firms would not have a disadvantage over diversifiers.

Studies have shown that the use of related diversification is superior to unrelated diversification in world and we have also got same results for Croatian firms (Darabos, 2011). If the company can develop and exploit the potential synergy from resources, managerial skills and core competencies of its diversified activities, then it will probably create a sustainable competitive advantage. In achieving the desired synergy, the capability of strategic governance of various businesses and development of sustainable competitive advantage is crucial, regardless of the level of business relatedness (Coulter, 2002).

In the long run, the rate of return available from competing in any industry is a function of its underlying structure. Enter into an attractive industry with high average rate of return on investment is difficult because of high entry barriers, modest bargaining power of suppliers and customers, the small number of substitute products or services and stable competition among competitors. Unattractive industry has structural flaws, including a plethora of alternatives, powerful and cost-sensitive buyers, and rivalry that is caused by excessively high fixed costs and a large group of competitors, many of whom have government support. Industry does not have to be attractive before diversification. In fact, the company can benefit from entering the industry before the same show its full potential. Diversification can also change the structure of the industry (De Wit and Meyer, 2005).

Furthermore, diversification cannot increase the value if the entry barriers for new industry are higher than expected revenues. Strong market forces, however, work to achieve just that. The firm may enter into a new industry through acquisitions or initial starting of a business. With the acquisition the buyer wins the market if you pay a price that fully reflects the prospects of the new unit. Starting up a business firm should overcome barriers to entry. It is a hopeless situation because the attractive industries are attractive especially because of high entry barriers. The more attractive industry is, the higher are barriers. Defray the total cost of entry barriers can waste all the potential profits, or other companies entering the industry, would cut into its profitability. The company has to make a significant competitive advantage of the new business unit, or a new business unit has to offer a potential for significant competition to the company. Sometimes, benefits for a new business unit are reflected only once, when entering, when a company promotes a great review of their strategies and introduced a superior management team. While another type of diversification, related diversification produces a competitive advantage if the new unit can place its product on the market through well-developed distribution system of its affiliated units.

Thus, we could outline the key demands of corporate strategy. Multibusiness firms need to be more than the sum of their parts. They should create more added value than the extra costs of managing a more complex organization. They need to identify opportunities for synergy between business areas and manage the organization in such way that the synergies can be realized.

Some researchers claim that diversification reduces firm performance on average (Lang-Stultz, 1994; Berger- Ofek ,1995), while some recent research argues in favor of a positive effect once the endogenity issue is accounted for, because the decision of firms to diversify may be associated with their initial lower performance (Campa, 2002 and Graham, Lemmons and Wolf, 2002). *Palich, Cardinale* and *Miller* (2000) conclude that firms that diversify in businesses related to their core business have better performance than others.

The effect of diversification on performance should not be homogenous across all industries; i. e. there should not be necessarily neither positive nor negative diversification – performance relationship valid across all industries. *Santalo* and *Beccera* (2005) showed that the underlying industry characteristics make or not diversifiers more efficient or dominant players in an industry.

Hence, the importance of diversification can be viewed from an economic point of view by increasing the efficiency of firm or in terms of firms' top management. First, it is necessary to identify the significant economies of scope among the various businesses of the firm. Secondly, the management must be the holder of the identification of such economies of scope, because if the outside investors are capable of finding them independently, and at lower cost, they will have less incentive to engage management to do that for them (Besanko, Dranove, Shanley and Schaefer, 2007).

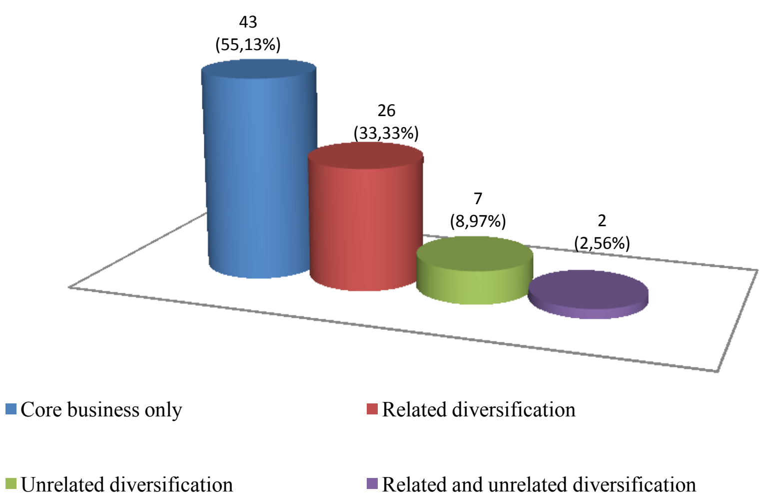
METHODOLOGY

The subject of this research is focused on the analysis of the diversification strategy by observing the macro-level factors, especially the industry as a guideline of implementing diversification strategy of large firms in Croatia. The characteristics of individual industry are very important determinants of the decision on which type of the diversification strategy, related or unrelated, the firm will apply.

In order to realize the objectives of the research, frequency of implementation of the diversification strategy in Croatian companies, the population of large firms has been used. The sample of firms was taken from the Business Register, where large enterprises are defined by the Accounting Act. Thus, the large companies must meet two of three conditions: the total assets of HRK 130,000,000.00, the total revenue of HRK 260,000,000.00, the average number of employees during the year, increasing from 250. Analysis was conducted for 78 large Croatian firms.

The figure shows the structure of the sample and the number of firms in relation to the scope and variety of businesses in which they operate. More than half of firms from the sample (55,13%) operates only within their core business, and do not apply the diversification strategy. 33.33% of firm from the sample operates in other businesses that are associated with the core business of the company, and apply related diversification strategy, while 8,97% of companies from the sample operates in businesses different than the core business (unrelated diversification). From the results of research has arisen that there are companies in the sample (2,56%), which simultaneously use both, related and unrelated diversification strategy or operate in industries that are associated with the core business, but also in completely different industries that their core business is in.

Fig 1.Sample description

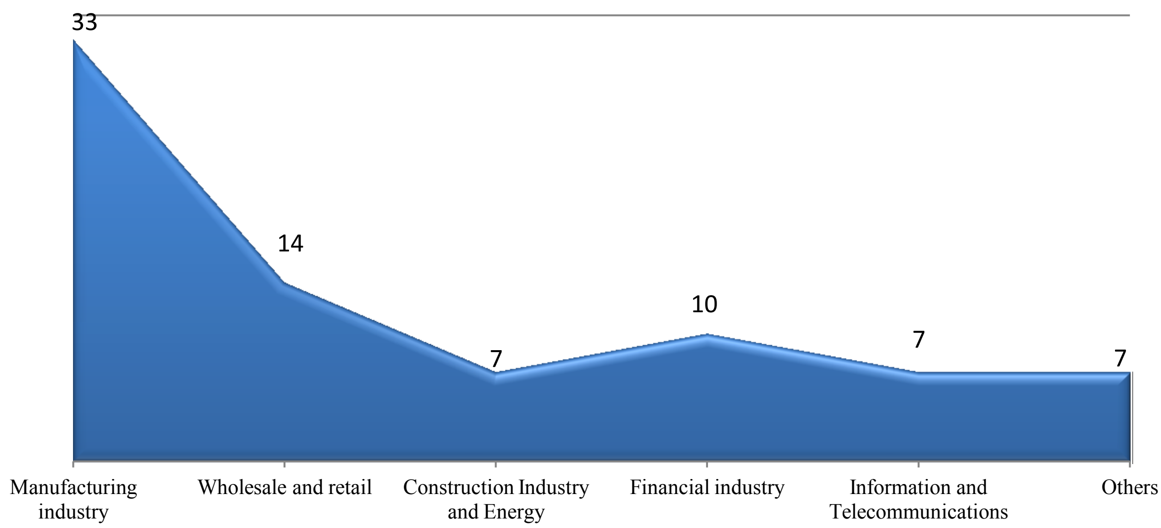


In order to improve the hypothesis, firms from the sample are grouped into industry groups, according to the core business they operate in. Industries are grouped into six groups: 1 - *Manufacturing*, 2 - *Wholesale and*

Retail Trade, 3 - *Construction Industry and Energy*, 4 - *The Financial Industry*, 5 - *Informatics and Telecommunications*, 6 - *Others*. The sixth group consist of the companies that according to their core business we weren't able to group in any of the previous classes, thus we arrange them in the group named *Others*.

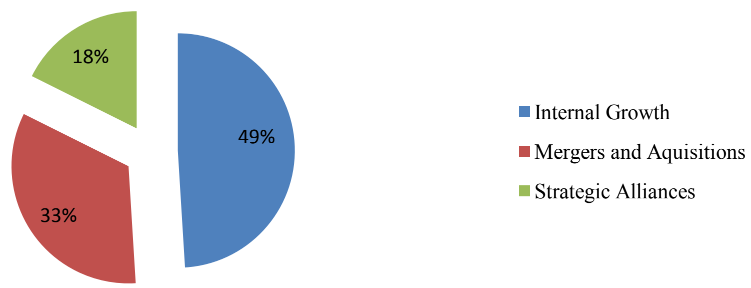
The figure 2 shows the distribution of firms from the sample into industry groups, regardless of implementing a diversification strategy or not. *The Manufacturing industry* makes 33 companies in the sample, *Wholesale and Retail Trade* 14 companies, 10 in *Financial Industry* companies, while in the group *Construction Industry and Energy* as well as *Information and Telecommunications*, and the group *Others* were 7 companies in each group.

Fig. 2 Distribution of firms from a sample into industry groups



We have also examined the ways of implementing a diversification strategy, for companies from the sample. The most common way of implementing this strategy is internal growth (49% of companies from the sample), that is an expected result given the frequent use of diversification strategies associated with the companies from the sample. 33% of companies from the sample have implemented a diversification strategy through mergers and acquisitions, while strategic alliances are the least represented as a way of implementing a diversification strategy (18%).

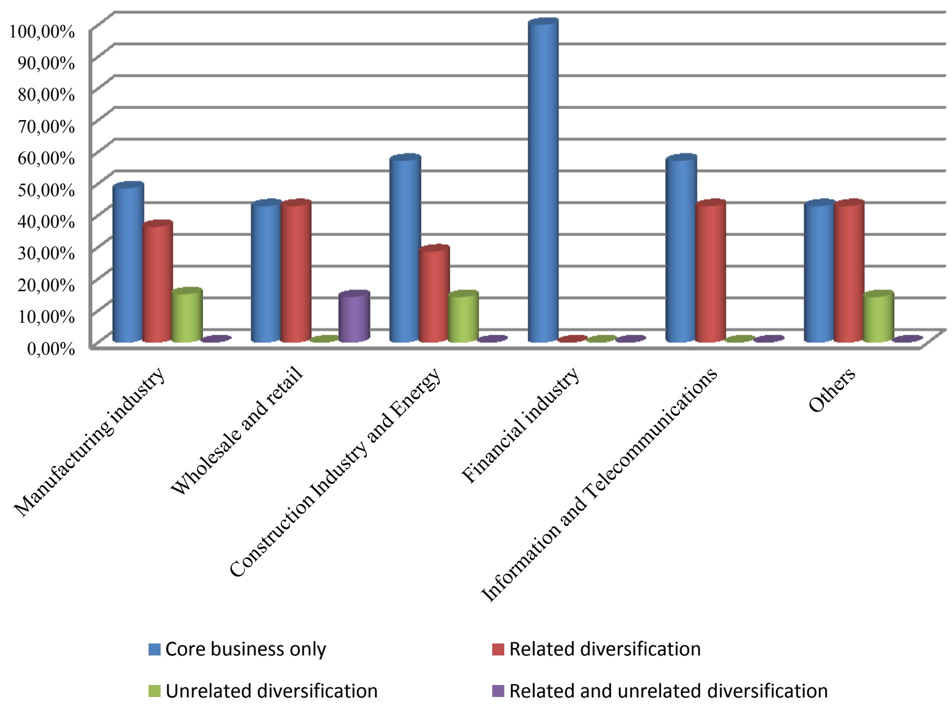
Fig. 3 Ways of implementing diversification strategy in firms from the sample



RESULTS AND DISCUSSION

Next figure is a graphical representation of the implementation frequency of certain types of diversification strategies in relation to industry in which firms operate.

Fig. 4 Implementation frequency of certain types of diversification strategies across industries



In order to test the frequency of using related and unrelated diversification strategy in large Croatian firms we have selected firms from the sample that are implementing a strategy of diversification and we have grouped them depending on the type of diversification strategy they are using. Firms were distributed into 3 groups for the purpose of descriptive analysis: (1) firms that are implementing related diversification, (2) firms that are implementing unrelated diversification, and (3) firms that are implementing simultaneously both, related and unrelated diversification strategy. The number of firms from the sample that are implementing related diversification strategy was compared to the number of firms that are using unrelated diversification strategy. The results showed that there is a difference in number of firms that are implementing related diversification strategy, that is 74,29% i.e. 26 firms from the sample, compared with firms that are implementing unrelated diversification, that is 20% i.e. 7 firms from the sample, while 2 firms from the sample, i.e. 5,71% are implementing both strategies simultaneously, related and unrelated diversification strategy.

Fig. 5 Number of firms from the sample according to the type of diversification strategy they are implementing

	No. of firms	**%**
Firm is operating in other businesses that are connected to its core business (related diversification)	26	74,29%
Firm is operating in other industries that are totally different to its core business (unrelated diversification)	7	20,00%
Firm is operating in both, related and unrelated businesses	2	5,71%
Total	**35**	**100,00%**

There was statistically significant difference between two groups of firms (z=3, 5763; p< 0, 01), that shows that in large Croatian firms related diversification strategy is more prevalent than unrelated diversification strategy.

Next figure shows the distribution of firms within industry groups, depending on the type of diversification strategies they are implementing. Implementation of the diversification strategy is present the most in firms, which are classified in group *Wholesale and Retail Trade* (57,14%), and in firms in the group *Others* (57,14%). The following are firms within the group *Manufacturing Industry* (51,52%), and firms within the industry group *Information and Telecommunications* as well as *Construction Industry and Energy* (42,86%). It is interesting to note that within the firms classified in group *Financial Industry* no single firm is implementing diversification strategy. This is partly possible to explain through the specific system of regulation of operations of commercial banks and other financial institutions in Croatian economy, specified by the objectives and role of monetary and credit policy in the economy and the level of sovereignty of monetary institutions. In the financial industry oversight and supervision of the financial institutions is a system that applies individual country to safeguard stability in the banking system, based on the legal framework and regulatory measures of supervisory authorities.

Fig. 6 Distribution of firms by industry groups, depending on the type of diversification strategies

INDUSTRY	*Core business only*	*Related diversification*	*Unrelated diversification*	*Related and unrelated diversification*	**No. firms**
Manufacturing Industry	16 (48,48%)	12 (36,36%)	5 (15,15%)	0 (0,00%)	**33**
Wholesale and Retail Trade	6 (42,86%)	6 (42,86%)	0 (0,00%)	2 (14,29%)	**14**
Construction Industry and Energy	4 (57,14%)	2 (28,57%)	1 (14,29%)	0 (0,00%)	**7**
Financial Industry	10 (100,00%)	0 (0,00%)	0 (0,00%)	0 (0,00%)	**10**
Information and Telecommunications	4 (57,14%)	3 (42,86%)	0 (0,00%)	0 (0,00%)	**7**
Others	3 (42,86%)	3 (42,86%)	1 (14,29%)	0 (0,00%)	**7**
Sum	**43 (55,13%)**	**26 (33,33%)**	**7 (8,97%)**	**2 (2,56%)**	**78**

In order to determine whether there is a difference in the frequency in implementation of a diversification strategy depending on the industry in which the firm operates the non-parametric test for independent samples - Kruskal - Wallis test has been applied, since the sample of firms that apply a diversification strategy was relatively small. Focus is on the fact that there are differences in the frequency of implementing diversification strategy and that the difference depends on the industry in which the firm operates. The results showed that there is a statistically significant difference in the implementation of a diversification strategy and that it varies across the industries (α=10%, χ^2=9,545, df =5, p- value=0.089).

It is interesting to note that there is more common use of related diversification strategy than unrelated diversification strategy in all industry groups. Moreover, it's important to point out that it is highly represented in firms within the group *Wholesale and Retail Trade, Informations and Telecomunications*, as well as in group *Others* (42,86%). While unrelated diversification strategy is the most frequently used in firms within the group *Manufacturing Industry* (15,15%).

The results obtained on a sample of large Croatian firms are in accordance with the results of previous research in the world that have shown differences in the implementation of the diversification strategy as well as different types of diversification strategy across different industries that can be explained by certain characteristics of particular industry, such as high entry barriers, number of competitors in the industry, higher transaction costs, industry volatility, etc. Therefore, we can conclude that present results showed that in large Croatian companies there is a difference in the frequency of implementation diversification strategy in addition to the types of diversification strategy they are applying, that distinguish depending on the industry in which the firm operates.

CONCLUSION

The significance of diversification strategy implementation can be seen through potential increase of firm performance or through managerial motives to diversify (an increase in compensations). Motives for the implementation of the diversification strategy are numerous and vary from company to company. Existing research has identified several common motives for the diversification strategy, such as firm growth, survival of the company, risks reduce and increase in profitability, depending on the type of diversification (related or unrelated) they are implementing.

Effective implementation of diversification strategy may possibly increase firm value. However, diversification should be under the control of internal corporate governance mechanisms in order to avoid or minimize the potential costs that implementation can bring, as well as any intentions of managers for excessive diversification.

The competitiveness of the firm could be improved through implementation of diversification strategy, however the level to which they will diversify its resources, especially financial, as well as key competencies and the opportunities and threats within the institutional environment in which they operate need to be properly determined.

This paper examined the difference in the diversification strategy implementation as well as different types of diversification in relation to industries in which firm operates. Results showed there is a different frequency of implementing related under unrelated diversification strategy among different industries in large Croatian firms and this could be partially explained through different characteristics of particular industry in which the firm operates (the level of rivalry in the industry, high entry barriers, higher transaction costs, volatility of individual industries, etc).

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