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ECONOMIC ASSESSMENT OF DIVERSIFICATION AS A STRATEGIC DEVELOPMENT ALTERNATIVE

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The article gives a better understanding of the companies' diversification strategy, considering the factors that should be taken into account in diversification decision process and choices.

Qualitative and quantitative evaluation-based approach, that could be used in diversification decision making process, was proposed. Qualitative standards were used to narrow the field of diversification opportunities, and the numerical criteria were applied to select the preferred strategy or strategies.

Key words*: strategic development, vertical diversification, horizontal diversification, lateral diversification, economic assessment.*

INTRODUCTION

Diversification is a frequently utilized strategy for expanding a firm's market or increasing sales, profitability, etc. A great familiarity exists among corporate executives the world over about the different avenues for implementing such a strategy (merger, acquisition, internal start-up, joint venture, etc.).

Firms diversify their operation either across different national markets (international market diversification) or across multiple lines of business (product diversification) or both increase economy of scale and economy of scope, thus increasing their efficiency, learning, and innovation respectively [1].

Corporate diversification represents one of the most important lines of research in the field of strategic management [2]. Following Rumelt's seminal work, several strategic management scholars were attracted to the study of corporate diversification as a gateway to understanding variance in firm growth and performance, spawning a large array of subsequent studies [3].

A great preponderance focused on investigating the differential effects of related and unrelated diversification on firm performance [2, 4].

A sheer volume of research on diversification is an indication of the importance and relevance of the topic.

A producer's decision to diversify (the same as all human) is triggered by the recognition of an untenable situation. The diversification decision may be structured into a number of distinct steps, as described by the human action literature [5].

Given a great volume of research [4, 6-8, 10-16] on the topic of diversification, one may be lead to believe that all the issues of diversification have been fully investigated. This is certainly not the case.

The aim of the paper is to establish a better understanding of the diversification strategy, considering factors that should be taken into account in diversification decision process and

choices as well as to develop methodological approach to economic assessment of diversification.

DETERMINANTS FOR CHOICE OF DIVERSIFICATION DIRECTION. DIFFICULTIES OF ITS ASSESSMENT AND IMPLEMENTATION

Development and maintenance of competitive advantages involve managerial decisions regarding what activities, businesses, and technologies the company should target for investment, relative to the investments made by competing companies [6].

Some companies within the market are diversified, meaning they are involved in many different kinds of businesses, while other are focused, which implies that they are focused on one business segment.

Diversification generally requires new skills, new techniques, and new facilities. As a result, it almost invariably leads to physical and organizational changes in the structure of the business which represent a distinct break with past business experience [7].

The type of diversification strategy that is used by the firm partly depends on the relatedness of new products, markets, and technologies with its present ones. Product diversification, defined as expansion into product markets new to the company, has been a highly popular strategy among large and growing companies. However, given the degree of international activities of most companies, both in sales and in production, many are confronted with the choice for international or domestic diversification. This choice implies not only that companies have to decide whether they intend to operate in other businesses domestically or internationally, but that once a choice for international diversification is made, companies still have to consider a certain concentration on particular countries or international regions [8].

On the whole, there are three types of opportunities:

1. Each product manufactured by a company is made up of functional components, parts, and basic materials which go into the final assembly. A manufacturing concern usually buys a large fraction of these from outside suppliers. One way to diversify, commonly known as vertical diversification, is to branch out into production of components, parts, and materials. At first glance, vertical diversification seems inconsistent with our definition of a diversification strategy. However, the respective missions which components, parts, and materials are designed to perform are distinct from the mission of the overall product. Furthermore, the technology in fabrication and manufacture of these parts and materials is likely to be very different from the technology of manufacturing the final product. Thus, vertical diversification does imply both catering to new missions and introduction of new products.

2. Another possible way to go is horizontal diversification. This can be described as the introduction of new products which, while they do not contribute to the present product line in any way, cater to missions which lie within the company's know-how and experience in technology, finance, and marketing.

3. It is also possible, by lateral diversification, to move beyond the confines of the industry to which a company belongs. This obviously opens a great many possibilities, from operating banana boats to building atomic reactors. While vertical and horizontal diversification are restrictive, in the sense that they delimit the field of interest, lateral diversification is "wide open." It is an announcement of the company's intent to range far afield from its present market structure [7].

The literature [4, 6-8, 10-16] explains the reasons for a diversification strategy according to a number of motives. Diversification may facilitate the deployment of resources and thereby enhance efficiency. The effective and efficient resource deployment encompasses two fundamental elements of any company’s strategy: the range and relatedness of the products sold and the company’s relative emphasis on foreign versus domestic operations [6]. Amihud and Lev [9] and Markides [10] motivate corporate diversification in terms of the reduction of dependence on a few products and markets

while limiting the effects of uncertainty in markets and technological developments. Thus, the essence of diversification is taken to be an expansion into new businesses and markets, requiring the development of new competences or the augmentation of existing ones.

Another motive that is more intangible refers to the aspiration and goals of top management. Managers can also motivate diversification with the reduction of the probability of bankruptcy in order to provide job security and preserve their firm-specific human-capital investment [11].

According to Montgomery [12] a diversification explained by the resource view implies that the company has excess resources that can be profitably employed in other businesses, while the market power view implies that diversification strategies gain better market power compared to competitors. One of the approaches to create value by gaining market power is the strategy of vertical integration. Early studies [13] showed that, under acceptable assumptions about financial markets, there are no economic motives for unrelated diversification. Later studies however [14], have shown that if one introduces some frictions into the financial markets such as bankruptcy costs and taxes, there may be financial motives for non-synergistic mergers.

Motives that prompt diversification also differ depending whether it is related or unrelated diversification.

In related diversification, companies have a strategic fit with the new venture. To make this strategy work, you capitalize on the strengths or competitive advantage you've already established. Unrelated diversification has nothing to do with leveraging your current business strengths or weaknesses. It's more about not putting all your eggs in one basket. For example, an investor diversifies his financial portfolio to protect against losses. Many entrepreneurs execute this strategy unknowingly by becoming involved in multiple, unrelated businesses. Unrelated diversification is the most risky of all the market level strategies [15].

The specific objectives of diversification can be grouped into three general categories: growth objectives, which are designed to improve the balance under favorable trend conditions; stability objectives, designed as protection against unfavorable trends and foreseeable contingencies; and flexibility objectives, to strengthen the company against unforeseeable contingencies.

In general, when a company starts thinking of a diversification it has already set up its business, the company has considerable experience and strives to continue successful series of running a business, to try itself in a new business and gain important incomes and experience. It starts a new business confidently, intrepidly makes steps toward diversification, despite the fact that likelihood of success might not be big. One of incentives in this case is expected considerable benefit. There are many circumstances that complicates forecast of the results of the diversification. When we are dealing with transition economy countries increase in the number of circumstances is caused by crisis events and undergoes characteristic corrections. Despite the fact that such companies might have important success in their business, they do not feel confident at the market and try to compensate such condition by means of diversification. Under such conditions companies have to work in an "emergency regime". Obviously, this does not encourage conduction of relevant analysis in order to make decision on diversification. Therefore, frequently managers have no opportunity to guide themselves with rational ideas.

Difficulties in designing successful strategy of diversification are created by: first, deficiency of preliminary strategic inputs that mainly implies that existing situation during the decision-making process does not support in-depth analysis and full usage of its results in decision-making process. Second, often Board of Directors demands quick entering of new markets from top executive managers. Meanwhile lot of information gathers for the managers of the companies, the information, which should be quickly processed. Due to mainly environmental uncertainty and its extreme complexity, managers find it difficult to make relevant decisions [16].

There are frequent cases when strategic decision does not bring planned success or when taking of needed measures is delayed. Managers are facing serious challenge – to find set of interrelated measures in order to decrease risks of diversification. That's why there is a need to develop methodological approach that would assist managers to assess diversification opportunities of company development.

METHODOLOGICAL APPROACH TO ECONOMIC ASSESSMENT OF THE DIVERSIFICATION AS A STRATEGIC DEVELOPMENT ALTERNATIVE

Qualitative evaluation of strategic development alternative

One of the aims of this paper is to relate diversification to the overall growth perspectives of management, establish reasons which may lead a company to prefer diversification to other growth alternatives and trace a relationship between overall growth objectives and special diversification objectives. This will provide us with a partly qualitative, partly quantitative method for selecting diversification or specialization strategy which will be the best suited to long-term growth of a company. We can use qualitative criteria to reduce the total number of possible strategies to the most promising few, and then apply organizational performance measure to narrow the choice of plans still further.

Long-Term Trends

In deciding whether to diversify, management should carefully analyze its future growth prospects. It should think of market penetration, market development, and product development as parts of its over-all product strategy and ask whether this strategy should be broadened to include diversification.

A standard method of analyzing future company growth prospects is to use long-range sales forecasts.

Such forecasts usually assume that company management will be aggressive and that management policies will take full advantage of the opportunities offered by the different trends. They are, in other words, estimates of the best possible results the business can hope to achieve short of diversification.

Different patterns of forecasted growth should be presented in graphic form, with hypothetical growth curves for the national economy (GNP) and the company's industry added for purposes of comparison. A sales curve which declines with time may be the result of an expected contraction of demand, the obsolescence of manufacturing techniques, emergence of new products better suited to the mission to which the company caters, or other changes. Another typical pattern, frequently caused by seasonal variations in demand, is one of cyclic sales activity. Less apparent, but more important, are slower cyclic changes, such as trends in construction or the peace-war variation in demand in the aircraft industry.

If the most optimistic sales estimates which can be attained short of diversification fall in either of the preceding cases, diversification is strongly indicated. However, a company may choose to diversify even if its prospects do, on the whole, appear favorable. This will be illustrated by the "slow growth curve." The curve will indicate rising sales which, in fact, grow faster than the economy as a whole. Nevertheless, the particular company may belong to one of the so-called "growth industries" which as a whole is surging ahead. Such a company may diversify because it feels that its prospective growth rate is unsatisfactory in comparison to the industry growth rate.

Making trend forecasts is far from a precise science. The characteristics of the basic environmental trends, as well as the effect of these trends on the industry, are always uncertain. Furthermore, the ability of a particular business organization to perform in the new environment is very difficult to assess. Consequently, any realistic company forecast should include several different trend forecasts, each with an explicitly or implicitly assigned probability [7]. As an alternative, the company's growth trend forecast may be represented by a widening spread between two extremes.

Contingencies

In addition to trends, another class of events may make diversification desirable. These are certain environmental conditions which, if they occur, will have a great effect on sales; however, we cannot predict their occurrence with certainty.

The two types of sales forecast can be illustrated for a hypothetical company. Sales curves S1 and S2 will represent a spread of trend forecasts; and S3 and S4, two contingent forecasts for the same event. The difference between the two types, both in starting time and effect on sales, lies in the degree of uncertainty associated with each.

In the case of trend forecasts we can trace a crude time history of sales based on events which we fully expect to happen. Any uncertainty arises from not knowing exactly when they will take place and how they will influence business. In the case of contingency forecasts, we can again trace a crude time history, but our uncertainty is greater. We lack precise knowledge of not only when the event will occur but also whether it will occur. In going from a trend to a contingency forecast, we advance, so to speak, one notch up the scale of ignorance.

In considering the relative weight we should give to contingent events in diversification planning, we must consider not only the magnitude of their effect on sales, but also the relative probability of their occurrence. For example, if a severe economic depression were to occur, it effect on many industries would be devastating. Many companies feel safe in neglecting it in their planning, however, because they feel that the likelihood of a deep depression is very small at least for the near future.

It is a common business practice to put primary emphasis on trend forecasts; in fact, in many cases businessmen devote their long-range planning exclusively to these forecasts. The usually view a possible catastrophe as "something one cannot plan for" or as a second-order correction to be applied only after the trend have been taken into account. The emphasis is on planning for growth, and planning for contingencies is viewed as an "insurance policy" against reversals [7].

Measured Sales Goals

Management can and should state the objective of growth and stability in quantitative terms as long-range sales objectives. Let's assume that S1 – sales curve that represents hypothetical company's forecasted performance without diversification under a general trend and S2 – in contingency. The improved performance as a result of diversification will be representing with curve S3 for continuation of normal trends and curve S4 curve for a major reverse.

Growth

Management's first aim in diversifying is to improve the growth pattern of the company.

The growth objective can be stated as follows:

Under trend conditions the growth rate of sales after diversification should exceed the growth rate of sales of the original product line by a minimum specified margin. Or to illustrate in mathematical shorthand, the objective for the company would be:

$$S3 - S1 \geq \rho, \qquad (1)$$

where the value of the margin ρ is specified for each year after diversification.

Some companies (particularly in the growth industries) fix an annual rate of growth which they wish to attain. Every year this rate of growth is compared to the actual growth during the past year. A decision on diversification action for the coming year is then based upon the disparity between the objective and the actual rate of growth.

Stability. The second effect desired of diversification is improvement in company stability under contingent conditions. Not only should diversification prevent sales from dropping as low as they might have before diversification, but the percentage drop should also be lower. The second sales objective is thus a stability objective [7].

It can be stated as follows:

Under contingent conditions the percentage decline in sales which may occur without diversification should exceed the percentage drop in sales with diversification by an adequate margin, or algebraically:

$$(S1\text{-}S2)/S1 - (S3\text{-}S4)/S3 \geq \delta \, . \qquad (2)$$

Using this equation, it is possible to relate the sales volumes before and after diversification to a rough measure of the resulting stability.

Industry concentration

From the early works in industrial organization (Bain, 1956) industry concentration has been considered as a strong indicator of barriers to entry [17]. Harris (1998) also empirically shows that higher industry concentration is correlated with lower levels of disclosure by the firms [18]. However, in highly concentrated industries, market power enjoyed by firms may allow them to sustain high levels of profitability. In industrial organization, market concentration may used as a measure of competition, theorized to be positively related to the rate of profit in the industry [17].

A commonly accepted measure of market concentration is the Herfindahl-Hirschman Index (HHI). It is calculated by squaring the market share of each firm competing in a market, and then summing the resulting numbers. The HHI number can range from close to zero to 10,000. The HHI is expressed as:

$$HHI = s_1^2 + s_2^2 + s_3^2 + ... + s_n^2 \, , \qquad (3)$$

where s_n is the market share of the i-th firm.

The closer a market is to being a monopoly, the higher the market's concentration (and the lower its competition) is. The U.S. Department of Justice considers a market with a result of less than 1,000 to be a competitive marketplace; a result of 1,000-1,800 to be a moderately concentrated marketplace; and a result of 1,800 or greater to be a highly concentrated marketplace [19].

The major benefit of the Herfindahl index in relationship to such measures as the concentration ratio is that it gives more weight to larger firms. However, the usefulness of this index is directly dependent on a proper definition of a particular market.

Two steps should be taken to apply the criteria for diversification to individual opportunities: (1) apply the qualitative standards to narrow the field of diversification opportunities; (2) apply the numerical criteria to select the preferred strategy or strategies.

The long-range product-market policy is used as a criterion for the first rough cut in the qualitative evaluation. It can be used to divide a large field of opportunities into classes of diversification moves consistent with the company's basic character. For example, a company whose policy is to compete on the basis of the technical excellence of its products would eliminate as inconsistent classes of consumer products which are sold on the strength of advertising appeal rather than superior quality.

Next, the company can compare each individual diversification opportunity with the individual diversification objectives. This process tends to eliminate opportunities which, while still consistent with the desired product-market make-up, are nevertheless likely to lead to an imbalance between the company product line and the probable environment. For example, a company which wishes to preserve and expand its technical excellence in design of large, highly stressed machines controlled by feedback techniques may find consistent product opportunities both inside and outside the industry to which it caters, but if one of its major diversification objectives is to correct cyclic variations in demand that are characteristic of the industry, it would choose an opportunity that lies outside [3].

Each diversification opportunity which has gone through the two screening steps satisfies at least one diversification objective, but probably it will not satisfy all of them. Therefore, before subjecting them to the quantitative evaluation, it is necessary to group them into several alternative over-all company product-market strategies, composed of the

original strategy and one or more of the remaining diversification strategies. These alternative overall strategies should be roughly equivalent in meeting all of the diversification objectives.

At this stage it is particularly important to allow for the unforeseeable contingencies. Since the techniques of numerical evaluation are applicable only to trends and foreseeable contingencies, it is important to make sure that the different alternatives chosen give the company a broad enough technological base. In practice this process is less formidable than it may appear. For example, a company in the aircraft industry has to consider the areas of technology in which major discoveries are likely to affect the future of the industry. This would include atomic propulsion, certain areas of electronics, automation of complex processes, and so forth. In designing alternative overall strategies the company would then make sure that each contains product entries which will give the fir a desirable and comparable degree of participation in these future growth areas.

Quantitative evaluation of strategic development alternative

The purpose of quantitative evaluation is to compare the profit potential of the alternatives. Unfortunately, there is no single yardstick among those commonly used in business that gives an accurate measurement of performance. The techniques currently used for measurement of business performance constitute, at best, an imprecise art.

Organizational performance should be operationalised using several commonly used accounting-based measures: return on assets (ROA), return on equity (ROE), and return on sales (ROS).

In addition, change in ROA, change in ROE, and change in ROS should be also included as measures of performance differences over the period studied. Several measures of organizational performance will be used in an attempt to mitigate the discrepancies and biases of using only one measure, and to ensure the comparability of the present study with past research in the strategy area [4]

We believe, this measure is helpful to management, providing insight into how much profit is being produced per dollar of sales. As with many ratios, it is best to compare a company's ROS over time to look for trends, and compare it to other companies in the industry. An increasing ROS indicates the company is growing more efficient, while a decreasing ROS could signal looming financial troubles [20].

Despite the existing debate over the use of accounting versus market performance measures, Robins & Wiersema report a number of advantages for the former, including their close connection to the decision variables controlled by managers and their enabling direct comparison with a substantial body of research on diversification and performance in strategic management [21].

Operational performance measure

ROA is an indicator of how profitable a company is relative to its total assets. ROA gives an idea as to how efficient management is at using its assets to generate earnings. Calculated by dividing a company's annual earnings by its total assets, ROA is displayed as a percentage. Sometimes this is referred to as "return on investment".

The formula for return on assets is:

$$\text{ROA} = \frac{\text{Net income}}{\text{Total assets}} \tag{4}$$

ROA tells you what earnings were generated from invested capital (assets). ROA for public companies can vary substantially and will be highly dependent on the industry. This is why when using ROA as a comparative measure, it is best to compare it against a company's previous ROA numbers or the ROA of a similar company.

The assets of the company are comprised of both debt and equity. Both of these types of financing are used to fund the operations of the company. The ROA figure gives investors

an idea of how effectively the company is converting the money it has to invest into net income. The higher the ROA number, the better, because the company is earning more money on less investment.

ROA has been shown to be related to a variety of other indicators of firm financial performance and has been widely employed in the diversification-performance literature [22].

ROE is the amount of net income returned as a percentage of shareholders equity. Return on equity measures a corporation's profitability by revealing how much profit a company generates with the money shareholders have invested.

ROE is expressed as a percentage and is calculated as:

$$\text{ROE} = \frac{\text{Net income}}{\text{Shareholder's equity}} \tag{5}$$

Net income is for the full fiscal year (before dividends paid to common stock holders but after dividends to preferred stock.) Shareholder's equity does not include preferred shares.

In general, financial analysts consider return on equity ratios in the 15-20% range as representing attractive levels of investment quality.

While highly regarded as a profitability indicator, the ROE metric does have a recognized weakness. Analysts need to be aware that a disproportionate amount of debt in a company's capital structure would translate into a smaller equity base. Thus, a small amount of net income (the numerator) could still produce a high ROE off a modest equity base (the denominator) [23].

ROS is widely used to evaluate a company's operational efficiency. It is also known as a firm's "operating profit margin". It is calculated using this formula:

$$\text{ROS} = \frac{\text{Net income (Before Interest and Tax)}}{\text{Sales}} \tag{6}$$

Debt burden

Managerial discretion in the allocation of organizational resources across the organization's operations can be reduced in the face of high debt level. In effect, the firm's debt burden compels management to invest wisely and be more efficient [24]. We measure debt burden as the firm's debt to shareholder equity ratio [10].

The debt to equity ratio is a financial metric used to assess a company's capital structure, or "capital stack." Specifically, the ratio measures the relative proportions of the firm's assets that are funded by debt or equity. The debt to equity ratio (also called the risk ratio or leverage ratio) provides a quick tool to financial analysts and prospective investors for determining the amount of financial leverage a company is using, and thus its exposure to interest rate increases or insolvency.

The debt to equity ratio of 1, for example, indicates that the company funds its projects with an even mix of debt and equity. A low ratio (below about 0.30) is generally considered good, because the company has a low amount of debt, and is therefore exposed to less risk in terms of interest rate increases or credit rating. Generally, a high debt to equity ratio (2, for example) is worrisome, as it indicates a precarious amount of leverage. However, in some industries this is appropriate.

The debt to equity ratio should never be used alone. For example, if a company's debt to equity ratio is quite high, you might reasonably worry about their ability to service their debt. To address this concern, you can also analyze the firm's interest coverage ratio, which is the company's operating income divided by debt service payments. A high operating income will allow even a debt-burdened firm to meets its obligations [25].

CONCLUSIONS

Business has four basic growth alternatives. It can grow through increased market penetration, through market development, through product development, or through diversification.

A company which accepts diversification as a part of its planned approach to growth undertakes the task of continually weighing and comparing the advantages of these four alternatives, selecting first one combination and then another one, depending on the particular circumstances in long-range development planning.

Companies diversify to compensate for technological obsolescence, to distribute risk, to utilize excess productive capacity, to reinvest earnings, to obtain top management, and so forth [13]. Generally, three groups of diversification objectives can be defined: 1) growth objectives, 2) flexibility objectives and 3) stability objectives.

However, diversification direction which is highly desirable for one of the objectives is likely to be less desirable for others. For example:

- If a company is diversifying because its sales trend shows a declining volume of demand, it would be unwise to consider vertical diversification, since this would be at best a temporary device to stave off an eventual decline of business.
- If a company's industry shows every sign of healthy growth, then vertical and, in particular, horizontal diversification would be a desirable device for strengthening the position of the company in a field in which its knowledge and experience are concentrated.
- If the major concern is stability under a contingent forecast, chances are that both horizontal and vertical diversification could not provide a sufficient stabilizing influence and that lateral action is called for.
- If management's concern is with the narrowness of the technological base in the face of what we have called unforeseeable contingencies, then lateral diversification into new areas of technology would be clearly indicated [7].

While they are an integral part of the overall growth pattern, diversification decisions present certain unique problems. Much more than other growth alternatives, they require a break with past patterns and traditions of a company and an entry onto new and uncharted paths.

This article aims to establish a better understanding of the diversification strategy, considering factors that companies' should be taken into account in diversification decision process and choices.

The paper considers the concept of diversification as a strategic development alternative. The determinants of diversification direction choice were analyzed, and the difficulties of the assessment and implementation of the diversification strategy were determined. In addition, methodological approach to economic assessment of the diversification as strategic development alternative was developed. The method consists of qualitative evaluation to reduce the total number of possible strategies to the most promising few, and then numerical criteria is applied for selecting preferred strategy or strategies.

РЕЗЮМЕ

ЕКОНОМІЧНА ОЦІНКА ДИВЕРСИФІКАЦІЇ ЯК АЛЬТЕРНАТИВИ СТРАТЕГІЧНОГО РОЗВИТКУ

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Стаття дає краще розуміння диверсифікаційної стратегії компаній, враховуючи фактори, які повинні бути взятими до уваги під час процесу прийняття рішення щодо диверсифікації.

Авторами розроблено метод, оснований на якісній та кількісній оцінках, який може бути використаний під час прийняття рішення щодо диверсифікації. Якісні стандарти були використані з

метою звуження кола диверсифікаційних можливостей, а кількісні критерії були застосовані для того, щоб обрати найкращу стратегію чи стратегії.

Ключові слова: *стратегічний розвиток, вертикальна диверсифікація, горизонтальна диверсифікація, бічна диверсифікація, економічна оцінка.*

РЕЗЮМЕ

ЭКОНОМИЧЕСКАЯ ОЦЕНКА ДИВЕРСИФИКАЦИИ КАК АЛЬТЕРНАТИВЫ СТРАТЕГИЧЕСКОГО РАЗВИТИЯ

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Статья даёт лучшее понимание диверсификационной стратегии кампаний, учитывая факторы, которые должны быть взяты во внимание при принятии решения относительно диверсификации.

Был разработан метод, основанный на качественной и количественной оценках, который может быть использован во время принятия решения относительно диверсификации. Качественные стандарты были использованы с целью сужения круга диверсификационных возможностей, а количественные критерии были применены для выбора преимущественной стратегии или стратегий.

Ключевые слова: *стратегическое развитие, вертикальная диверсификация, горизонтальная диверсификация, боковая диверсификация, экономическая оценка.*

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