

THE RELATIONSHIP BETWEEN DIVERSIFICATION STRATEGY AND ORGANIZATIONAL PERFORMANCE IN DEVELOPED AND EMERGING ECONOMY CONTEXTS: EVIDENCE FROM TURKEY AND NETHERLANDS[†]

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Abstract: The aim of this study is to determine whether there is a significant difference between types of diversification and performance values comparing Turkey and Netherlands. Diversification strategy and organizational performance relationship seems to differ across developed and developing countries. The data from 2007-2011 of 154 business groups in Netherlands and 125 business groups in Turkey were analyzed. ROA and ROS for organizational performance and Rumelt's measure for diversification were used. According to the results, when organizational performance values are high for single businesses and unrelated diversification in Turkey, organizational performance is high for dominant businesses in Netherlands.

Keywords: Diversification Strategy, Organizational Performance, Emerging Country

1. Introduction

Corporate diversification has remained an important strategy for many firms worldwide for the last half century. It should not be considered as just a trend; rather it is based on logical reasons. These reasons include increased profitability, reduction in risk, increased market share, increased debt capacity, higher growth, extension of business life cycle, and efficient utilization of human and financial resources. Many writers proved diversification to be a successful strategy in their studies but still a number of researchers have different views (Afza *et al.* 2008). Palich *et al.* (2000) suggested that there has been inconsistency in the findings of the diversification-performance research for more than 30 years and there is a lack of consensus. Some of the empirical findings were either a positive relationship with economic performance (e.g., Pandaya and Rao, 1998; Singh *et al.* 2001; Piscitello, 2004), a negative relationship with economic performance (e.g. Markides, 1995; Lins and Servaes, 2002; Gary, 2005), a curvilinear relationship depending on the level of diversification (Varadarajan and Ramanujam, 1987; Palich *et al.* 2000; Kakani, 2000) or lack of a relationship (Grant *et al.* 1988; Montgomery, 1985).

All of these mixed and inconclusive empirical research evidences have led to a need for researchers examining how diversification strategy affects firm performance in different institutional environments and market

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conditions. In accordance with this need, the primary motivation of this study is to examine the relationship between diversification strategy and organizational performance in the contexts of developed and emerging economies. Thus we analyze and compare how diversification affects organizational performance in Turkey as an emerging economy and in Netherlands a developed economy. The 2007-2011 data of Borsa Istanbul (formerly named as Istanbul Stock Exchange) and Amsterdam Stock Exchange were used in the study, so 224 firm for Turkey and 318 firms for Netherlands in business level and 125 firms for Turkey and 154 firms for Netherlands for corporate level were analyzed. The findings show that while the performance of unrelated diversification and single businesses is high in Turkey, the performance of dominant business diversification measure is high in Netherlands. As in the literature, the reasons of this result are considered as the internal factors such as sources and skills in Netherlands, a developed country and the factors such as the absence of perfect competition conditions, low running costs and government-employer relationships in Turkey, a developing country.

2. Conceptual Framework

Investigations into the relationship between diversification strategy and organizational performance represent one of the most actively investigated areas in the fields of strategy and finance (Rumelt, 1974; Hoskisson and Hitt, 1990; Montgomery, 1994; Kakani 2000; Khanna and Palepu, 2000; Miller, 2004; Chakrabarti *et al.* 2007). Despite the enormous interest in the field, the debate on whether corporate diversification creates or destroys value remains inconclusive with several studies offering differing results on the phenomena among different institutional context (Rejie, 2007) and market conditions.

The outcomes of firm diversification will vary across countries, because of the influence of the institutional environment within which diversification takes place. Khanna and Palepu (1997) suggested that the degree of market and institutional development is an important determinant of the efficacy of diversification. In general, the potential returns from diversification decrease with market and institutional development, so that diversification would not improve firm performance in perfect markets. So it is expected that firms in less institutionally developed economies will benefit more substantially from diversification than firms in more institutionally developed economies (Chakrabarti *et al.* 2007).

2.1. *Diversification-Performance Relationship in Emerging Economy Context*

Several studies propose that diversification strategy is more likely to be profitable in emerging economies (Guillen, 2000; Khanna and Palepu, 1997; Kock and Guillen, 2001; Anil *et al.* 2013). The underlying argument is that key aspects of institutional environments in emerging economies are

the lack of well-established product markets, financial markets and labor markets, coupled with the lack of necessary laws, regulations and inconsistent enforcement of contracts. More specifically, to cope effectively with this institutional environment companies may wish to pursue unrelated diversification strategy as an effective means of gaining self-generated institutional support. Consequently, the nature of the institutional environment and the resultant need for firms to employ an unrelated diversification strategy element in a poorly structured institutional environment constitute the institutional environment management explanation of the diversification and performance relationship (Li and Wong, 2003).

Khanna and Palepu (1997; 2000) argue that greater diversification may not harm performance in emerging economies because of insufficient market and institutional development. By diversifying, firms create internal markets that may be more effective than inefficient external markets. These firms enjoy scope and scale advantages from internalizing functions provided by external intermediaries or institutions in advanced economies. As intermediaries are often absent or inefficient in developing economies, internalization may be viable and profitable (Chakrabarti *et al.* 2007). Lins and Servaes (2002) also argued that in institutionally developing economies, the absence or inefficiency of external intermediate institutions results in firms developing these institutions internally, which helps firms to lower their costs. Thus, internalization in less developed institutional environments would bring about greater net marginal benefits (Purkayastha *et al.* 2012).

On the other hand, the severe market imperfections in emerging economies also increase the potential agency costs associated with diversification. Higher asymmetric information might allow management and large stakeholders to more easily exploit the firm for their own purposes. Such opportunities for exploitation are likely exacerbated when the rule of law is weak, which makes contract enforcement difficult; when accounting standards are poor; and when shareholders have fewer rights. Such imperfections make it easier for diversified firms in emerging economies to engage in empire building (Lins and Servaes, 2002).

2.2. *Diversification-Performance Relationship in Developed Economy Context*

Recent evidence indicates that corporate diversification has not enhanced the value of firms in the US, the UK, Germany and Japan (Lang and Stulz, 1994; Berger and Ofek, 1995; Servaes, 1996; Lins and Servaes, 1999). The evidence in these papers suggest that, for the average firm operating in developed capital markets, the costs of diversification outweigh the benefits (Lins and Servaes, 2002).

Efficient markets in developed economies detect and penalize diversification costs more than the less efficient markets of institutionally developing economies. This may be because the internal intermediate

institutions of diversified firms in developed economies cannot match the efficiency levels of open market institutions. Diversified firms thus have higher costs, which results in lowering their performance (Purkayastha *et al.* 2012; Leaven and Levine, 2007; Villalonga, 2004).

According to the transaction cost theory based explanation, most developed economies have strong and well developed institutions with efficient product, labor and capital markets. Hence, the market structure would be a much more efficient mechanism for transactions. In this light, there are higher costs associated with diversified firm structure and therefore it is predicted that conglomerates would be poor performers in strong and mature market. Transaction cost also predicts that diversified group structure is a beneficial organization form in emerging economies (Mishra and Akbar, 2007).

Resource-based-view theorists argue that diversification in developed economies would be efficient if it were based on specific resources, rather than generic resources, so that synergistic benefits from economies of scope can be exploited. Purkayastha *et al.* (2012) argued that in developed economies, only firm-specific resources would lead to sustainable competitive advantage, and hence firms should concentrate on one industry or at best on a limited number of related industries.

3. Methodology of Research

The aim of this research is to determine whether there is a significant difference between types of diversification and performance values comparing Turkey and Netherlands. The research universe is the firms listed in Borsa Istanbul (formerly named as Istanbul Stock Exchange) and Amsterdam Stock Exchange. The main reason to choose these stock markets as research universe is accessing the ownership structure, income statement and balance sheets needed for measuring performance and diversification measure reliably and exactly. Also, all businesses registered in both stocks of Turkey and Netherlands were included in the research and 2007-2011 data were used without regarding sectors. Thus, 224 firms listed in Borsa Istanbul during the specified years (5 years) were included in the research. The data of the businesses operating in Turkey were obtained from Borsa Istanbul (<http://www.borsaistanbul.com/>) and www.kap.gov.tr. These web sites are formal sites which are designed to allow everyone to have access to correct, timely, fair, and complete information about the Borsa Istanbul companies. All information and documents to be publicly disclosed must be sent to these web sites by ISE companies. These web sites serve as an electronic archive which allows easy and low-cost access to historical information. All the data for Netherlands were accessed from Bloomberg database so that 160 firms whose 5 year data exist in Netherlands were included in the research. Then, these firms were grouped according to their ownership structure and 154 business groups for Netherlands and 125 business groups for Turkey were obtained. The two

biggest shareholders were used to group these firms according to diversification measure.

3.1. Variables and Measurement Methods of the Research

The independent variable of the research is measure of diversification and dependent variable is organizational performance.

Diversification Measure: In this research Rumelt's classification is used for measuring diversification. According to Rumelt's measure of diversification; *Specialization Ratio-SR*: The ratio of the strategic business unit or group with the highest revenue to total revenues of the corporation, *Relationship Ratio (Related Ratio-RR)*: denotes, analyzing the amount of revenues, the status of interrelatedness of the areas of the strategic business units that make up this amount; Rumelt's Measure of Diversification; Single Company ($SR \geq 0.95$), Dominant Company ($0.95 > SR \geq 0.70$), Related Company ($SR < 0.70$ and $RR > 0.70$), Unrelated Company ($SR < 0.70$ and $RR < 0.70$). The distinction between the designated categories of related and unrelated strategic business units is made within the framework 4-digit and 2-digit SIC code. According to this distinction, the companies which are associated with a 4-digit were considered related and 2-digit ones considered unrelated. As stated earlier, in majority of prior studies (Rumelt, 1982; Palepu, 1985; Markides and Williamson, 1994, 1996; Markides, 1995; Busija *et al.* 1997; Chakrabarti *et al.* 2007) SIC code within Rumelt's classification is used for the related-unrelated discrimination.

Organizational Performance: Analysis to measure organizational performance, financial measures utilized and reasons for using these measures are summarized below.

Researches in which Performance is measured by ROA (Return on Assets): ROA is accepted as an important indicator to measure the effectiveness of management by the researchers that measure organizational performance by ROA value only. In addition, external shareholders and business managers who need the performance of the business organization express that ROA is a sufficient criterion to evaluate the performance of organization (Tihanyi *et al.* 2003; Dubofsky and Varadarajan, 1987; Ravichandran *et al.* 2009). On the other hand, according to Rumelt (1977), Christensen and Montgomery (1981) ROA is a standardized measure of performance (Dubofsky and Varadarajan, 1987). This rate shows to what extent the assets are used effectively in other words how much revenue can a company make over its assets. This rate shows to what extent the assets are used effectively in other words how much revenue can a company make over its assets.

Researches in which Performance is measured by ROS (Return on Sales): the reason that researchers use the ROS value only or with other financial measures for organizational performance is that the ROS ratio is calculated after deducting taxes and other expenses. The ROS value is

accepted as an important factor in measuring the efficiency of operational activities (Palepu, 1985; Markides, 1995, 1996).

3.2. The Hypothesis of Study

In accordance with existing empirical researches (Guillen, 2000; Kock and Guillen, 2001; Lins and Servaes, 2002; Li and Wong, 2003; Khanna and Palepu, 1997, 2000; Chakrabarti *et al.* 2007) mentioned in Conceptual Framework section, it is expected that in Turkey the performance of single and unrelated diversified businesses will be higher because of conditions in an emerging economy such as excess of environmental opportunities, institutional gaps and lack of perfect competition conditions. On the other hand, as a developed economy, the performance of dominant businesses will be higher in Netherlands because of resources and skills. Considering these factors, the hypotheses of the study are as below:

H₁: Single businesses' organizational performance is higher in Turkey than in Netherlands.

H₂: Dominant businesses' organizational performance is higher in Netherlands than in Turkey.

H₃: Unrelated diversification's organizational performance is higher in Turkey than in Netherlands.

3.3. Frequencies for Diversification in Period of 2007-2011, ROA and ROS Values

At Table 1, the frequencies according to the extent of diversification, operating frequency and indicators of the average performance in each measure of diversification of the enterprises within the research, are presented. The reason for this is that one person or investment group has shares in different firms. Thus, the number of firms, corporations and businesses differ in Netherlands. The same situation was observed rarely in Turkey. According to table 1 illustrating the corporate level, 96 corporations of the total 125 in Turkey are single businesses, 5 of the corporations are related diversified. Based on the data, single businesses have the highest ratio of 76.8% among the groups. According to table 1, 113 corporations of the total 154 in Netherlands are single businesses, 1 of the companies are related diversified. Based on the data, single businesses have the highest ratio of 73.37% among the groups.

Table 1. Frequencies for diversification in 2007-2011 period, ROA, ROS values

Diversification Measure	Corporate Level				Business Level				Performance Indicators			
	Frequency		Percentage		Frequency		Percentage		ROA		ROS	
	TR	NL	TR	NL	TR	NL	TR	NL	TR	NL	TR	NL
Single	96	113	76.8	73.37	100	127	44.64	39.93	0.046	0.018	0.051	0.030
Dominant	10	13	8	8.44	34	33	15.1	10.37	0.260	0.048	0.067	0.044
Related	5	1	4	0.64	10	4	4.46	1.25	-0.023	0.245	-0.012	0.115
Unrelated	14	27	11.2	17.53	90	154	40.17	48.42	0.016	0.046	0.023	0.042
Total	125	154	100	100	224	318	100	100	0.054	0.027	0.047	0.034

Additionally, normal distribution analysis (one sample KS; and histograms) was applied before testing hypotheses. As the results were not normal, nonparametric analysis was chosen. Accordingly, Mann-Whitney U test was applied to measure the difference between two variables.

4. Results

4.1. Diversification Strategy (Single Businesses) and Organizational Performance

The results of Mann-Whitney U test which is one of the Rumelt's diversification measures and was made for single businesses will be presented under this title. The tables are for comparing Turkey and Netherlands. When 127 firms in business level in Netherlands are organized according to Rumelt's single business category, 113 business groups were obtained. In Turkey, 100 firms were organized as 96 business groups.

4.1.1. Diversification Strategy (Single Businesses) and Return on Sales (ROS)

The first hypothesis (H_1) asserted that single businesses' organizational performance is higher in Turkey than in Netherlands was not supported for ROS.

There isn't a significant difference in performance (ROS) between Turkey and Netherlands (Table 2). Yet it is seen that the performance values of single businesses in Turkey are higher than in Netherlands when the average and median values are examined.

Table 2. 2007-2011 period diversification strategy (single businesses) and return on sales (ROS)

Country	# of firms		Median	Mean	S.D.
	Corporate Level	Business Level			
Turkey	96	100	0.034	0.0513	0.12040
Netherlands	113	127	0.024	0.0303	0.19430
Total	209	227	0.029	0.0399	0.16452
Mann-Whitney U	4,694.000				
Wilcoxon W	11,437.000				
Z	-0.982				
Sig. (2-tailed)	0.326				

4.1.2. Diversification Strategy (Single Businesses) and Return on Assets (ROA)

Our results support the hypothesis H_1 for ROA. There is a significant difference in performance (ROA) between Turkey and Netherlands ($p=0, 1$).

Table 3. 2007-2011 period diversification strategy (single businesses) and return on assets (ROA)

Country	# of firms		Median	Mean	S.D.
	Corporate Level	Business Level			
Turkey	96	100	0.0361	0.0388	0.06585
Netherlands	113	127	0.0276	0.0177	0.08941
Total	209	227	0.0329	0.0273	0.07997
Mann-Whitney U	4,694.000				
Wilcoxon W	11,135.000				
Z	-1.675				
Sig. (2-tailed)	0.094				

Also, it is seen that the performance values in Turkey are higher than in Netherlands when the average and median values are examined (Table 3). It is thought that environmental opportunities are higher in Turkey for single businesses and there is absence of perfect competition conditions according to this result. Also, there can be profitability in some sectors.

4.2. Diversification Strategy (Dominant Businesses) and Organizational Performance

The results of Mann-Whitney U test, one of Rumelt's diversification measures, made for dominant businesses will be presented. ROA and ROS values are shown in the tables separately and they are for comparing

Turkey and Netherlands. . When 33 firms in business level in Netherlands are organized according to Rumelt's dominant business category, 13 business groups were obtained. In Turkey, 34 firms were organized as 10 business groups.

4.2.1. Diversification Strategy (Dominant Businesses) and Return on Sales (ROS)

Table 4 summarizes the findings for the hypothesis H₂. As indicated, the hypothesis H₂ was not supported for ROS. There isn't a significant difference in performance (ROS) between Turkey and Netherlands, but when the average and median values are examined, it is understood that the performance values of dominant businesses in Netherlands are higher than in Turkey.

Table 4. 2007-2011 period diversification strategy (dominant businesses) and return on sales (ROS)

Country	# of firms		Median	Mean	S.D.
	Corporate Level	Business Level			
Turkey	10	34	0.0354	0.1004	0.16709
Netherlands	13	33	0.0498	0.0445	0.02474
Total	23	67	0.0498	0.0688	0.11206
Mann-Whitney U	63.000				
Wilcoxon W	118.000				
Z	-0.124				
Sig. (2-tailed)	0.901				

4.2.2. Diversification Strategy (Dominant Businesses) and Return on Assets (ROA)

As shown on Table 5, the hypothesis H₂ was also not supported for ROA. There isn't a significant difference in performance (ROA) between Turkey and Netherlands, but when the average and median values are examined, it is understood that the performance values of dominant businesses in Netherlands are higher than in Turkey. According to this result, even the hypotheses are refused; the average and median based findings show that internal factors in Netherlands such as sources and skills can increase performance.

Table 5. 2007-2011 period diversification strategy (dominant businesses) and return on assets (ROA)

Country	# of firms		Median	Mean	S.D.
	Corporate Level	Business Level			
Turkey	10	34	0.0231	0.0318	0.04888
Netherlands	13	33	0.0431	0.0480	0.03423
Total	23	67	0.0356	0.0410	0.04103
Mann-Whitney U	48.000				
Wilcoxon W	103.000				
Z	-1.054				
Sig. (2-tailed)	0.292				

4.3. Diversification Strategy (Unrelated Diversification) and Organizational Performance

The results of Mann-Whitney U test, one of Rumelt's diversification measures, made for unrelated diversification will be presented. ROA and ROS values are shown in the tables separately and they are for comparing Turkey and Netherlands. When 154 firms in business level in Netherlands are organized according to Rumelt's unrelated diversification category, 27 business groups were obtained. In Turkey, 90 firms were organized as 14 business groups.

4.3.1. Diversification Strategy (Unrelated Diversification) and Return on Sales (ROS)

The third hypothesis (H_3) asserted that unrelated diversification's organizational performance is higher in Turkey than in Netherlands was not supported for ROS.

There isn't a significant difference in performance (ROS) between Turkey and Netherlands, but when the average and median values are examined, it is understood that the performance values of unrelated businesses in Turkey are higher than in Netherlands (Table 6). The reason of high unrelated diversification performance values can be effectiveness of such factors like high environmental opportunities, absence of perfect competition conditions in all sectors.

Table 6. 2007-2011 period diversification strategy (unrelated diversification) and return on sales (ROS)

Country	# of firms		Median	Mean	S.D.
	Corporate Level	Business Level			
Turkey	14	90	0.0563	0.0906	0.20723
Netherlands	27	154	0.0397	0.0425	0.03514
Total	41	244	0.0397	0.0589	0.12366
Mann-Whitney U	178.000				
Wilcoxon W	556.000				
Z	-0.302				
Sig. (2-tailed)	0.762				

4.3.2. Diversification Strategy (Unrelated Diversification) and Return on Sales (ROA)

Our results indicate that the hypothesis H_3 was also not supported for ROA. There isn't a significant difference in performance (ROA) between Turkey and Netherlands (Table 7). However, it is understood that the performance values of unrelated businesses in Netherlands are higher than in Turkey when the average and median values are examined. Yet, there is not a high average difference for these two countries according to the average and median values. It can be thought that factors within organization and environmental factors have similar effects in Turkey and Netherlands according to this result for ROA.

Table 7. 2007-2011 period diversification strategy (unrelated diversification) and return on assets (ROA)

Country	# of firms		Median	Mean	S.D.
	Corporate Level	Business Level			
Turkey	14	90	0.0444	0.0306	0.05816
Netherlands	27	154	0.0456	0.0442	0.03270
Total	41	244	0.0442	0.0405	0.04297
Mann-Whitney U	169.000				
Wilcoxon W	274.000				
Z	-0.550				
Sig. (2-tailed)	0.582				

5. Conclusion

This study shows that the relationship between diversification strategy and organizational performance differs in Turkey and Netherlands. The performance of single businesses and unrelated diversification is higher in

Turkey. Moreover, the findings of another research made in Turkey show that the businesses whose degree of diversification is low have a higher performance than the businesses whose degree of diversification is high and the factors such as size and industry have an effect on this relationship (Tevfik and Oktay, 2008; Yigit, 2011). As emphasized by the researches mentioned above concerning the developing countries, these findings appear to stem from conditions that are thought to be differentiated in Turkey. The relationship between diversification and performance is thought to be affected by factors such as some of the privatization policies in Turkey, working conditions, crises conditions that coincide with the period of research, absence of perfect competition conditions in Turkey, and some sectors in developing countries being at the end of product life cycle curve while being at point of entry in Turkey.

In terms of dominant businesses, the average organizational performance in Netherlands is higher than in Turkey. Rumelt's dominant business category includes related diversification partially. It is considered that the business groups of Netherlands prefer diversification focusing on the internal resources rather than environmental opportunities because of high averages and results similar to developed countries in the literature. Also, Entropy Index measure based study included six Asian countries and showed that the relationship between diversification strategy and organizational performance differs in these countries. According to this study, while the relationship between diversification and performance is positive in India, it is negative in Korea and Japan. Also, while this relationship is statistically significant for these three countries, there are findings that corporate environmental factors such as national income and sectoral ROA have an effect on this relationship in the developing countries Malaysia and Thailand. Yet, there is not a statistical significance in Singapore (Chakrabarti *et al.* 2007). According to another study's findings, there were different results for the same sample in different times. Accordingly, while there is not a significant difference between the performance values and diversification measures of the groups for the period 1978-1984, there is a significant difference for the period 1983-1987 (Busija *et al.* 1997).

According to the findings of this study and other related studies, while diversification strategy-organizational performance relationship can differ from country to country, different results can exist in the same country in different periods. Changing environmental conditions in countries can be considered as the reasons of this situation. If it is assumed that Turkey, a developing country, will be a developed country in future, it can be suggested that businesses operating and willing to invest in Turkey should choose related diversification based growth strategy. Also, in order to retain the advantages of sources and skills, it can be suggested to prefer related diversification in Netherlands. Even there is a separation based on developing and developed countries in literature, it can be thought that this relationship can differ from country to country regarding changing environmental conditions. Within the framework of the results emerging

from this study, the following recommendations are proposed to researchers and executives: Results of this research can stimulate new researches; as below:

- The same study can be carried out including more developed and developing countries. Also, some variables such as crisis conditions, agency problems, business growth, national income and trend rate of gross national product growth.
- The same studies can be carried out using only Entropy Index or both Rumelt's diversification measure and Entropy Index.
- In order to separate related and unrelated diversification 2-digit SIC was used in this study. Another study where 3-digit is used for this separation can be carried out.

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