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Integrated Mechanism through Diversification Strategy, Capital Structure and Firm Performance: An International Business Outlook

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Abstract
The purpose of this paper is to develop and describe an integrated mechanism of significant variables like diversification strategy, capital structure and firm performance. The research emphasizes that diversification strategy is an important tool for retreating corporate growth, specifically at the time of global recession. The essence of the study is a conceptual model, associating various market variables like capital intensity, firm responsiveness, use of technology etc, with other variables like capital structure and firm performance.
An additional aim of the present study is to categorize the literature of past five decades on relationship between the variables and to analyze the results of various studies taken into consideration. An effort has been made to fill the gap in academic literature on integrated mechanism of the above mentioned variables as most of them have been discussed in isolation but the integrated effect is often ignored.

Keywords: *Diversification strategy, Capital Structure, Firm performance, Integrated Mechanism*

1. Introduction

The concept of diversification strategy was first delineated by Ansoff (1957) in his seminal work, on diversification as a growth strategy. The study emphasized various reasons for corporate diversification. Most importantly, companies diversify to compensate for technological obsolescence, distribute risk, utilize excess productive capacity, re-invest earnings, to obtain top management etc. Generally while deciding on whether to diversify or not, management is expected to carefully analyze its future growth prospects. Market penetration, market development, and product development are other important factors contributing to over-all product strategy. A quantity of studies have hypothesized that diversification strategy improves profitability and success. This happens through financial system or economies of extent in anticipation of product space. The greater part of research work on the said topic is concentrated in countries like USA, Europe and Australia but there are numerous nations which have not gained the attention of researchers.

Diversification strategies are used to make corporate operations larger by adding up markets, products, services or stages of profit to the present business. The rationale of diversification is to permit the companionship to enter lines of business that are dissimilar from existing operations. Diversification is a form of growth strategy, but cannot be a guaranteed route to success Montgomery (1994). Probable growth also increases earnings, in strenuous industries. However, substituting growth rates of companies themselves do not have an effect on fallout much. This also signifies that self-growth is also a sensible alternative for demand growth. The current study examines and shows the integrated relationship of diversification strategy (DS), capital structure (CS) and corporate performance (FP) for sustainable business.

Evaluating the impact of diversification strategy on capital structure, it's very important to of throw some light on importance of capital structure. Significant contribution of Modigliani and Miller, (1958) has provoked many readers and policy makers to recognize the importance of corporate capital structure decisions. An in-depth literature review discussed theories and interpretations such as static buy and sells off, group cost and empirically tested these theories to be acquainted with aspects influencing the corporate capital structure decisions. However, these findings demonstrate that corporate capital structure is prejudiced by numerous corporate linked characteristics such as non debt tax shield, profitability, size and tangibility, Titman and Wessels, (1988); Haris and Raviv, (1991).

Large multi businesses corporate have been observed to develop and exploit corporate level distinctive competencies and enhance their performance. The relationships between corporate level distinctive competencies and performance, with different diversification strategies have different type of results. The corporate level distinctive competencies / performance relationships were found to vary by type of diversification strategy but not by type of corporate structure. The specific relationships between corporate level distinctive competencies and performance and their normative implications were also explored by various researchers.

Montogomery (1982, 1994) while assessing the relationship between diversification had defined diversification and confirmed that measuring its associated returns is not very straight forward. Researches in the management field and industrial organization have developed positive relationships between a corporate total amount of diversification and its overall profitability. Wan (2009), also from his research suggested that diversification is a strategic choice of a corporate to improve performance. However, there are opposing views in studies examining diversification and performance relationship. The first view favors focused corporate while the other favors diversified corporate. Amit and Livnat (1988), suggest that both of these strategies are pursued based on two motives which are synergistic and financial motives. If corporate have synergistic motive, they may pursue focused strategy but if they have financial motive, then the diversified strategy would be adopted and is more advisable. Nevertheless, pursuing these strategies to increase performance would not assure obtaining the expected result as debate over which strategy is most suitable remains ongoing.

2. Review of Past Literature/Studies

Studies reveal that diversification strategy may affect corporate capital structure by three basic ways: co-insurance effect, transaction cost analysis, and agency cost analysis. The co-insurance effect has a positive influence on corporate debt capacity, due to the reduction in the volatility of corporate revenues and profits. This effect is expected to be more intense in companies that develop unrelated diversification strategies. Companies that follow unrelated diversification can issue more debt and benefit from the fiscal advantages related to debt financing.

Another potential linkage between corporate debt and diversification can be established according to transaction cost economics. This theoretical approach to corporate finance examines corporate financial decisions in terms of the specificity of corporate assets. Research shows that when asset specificity is high, equity is the preferred financial instrument. This is because of the limited re-deploy ability of these assets and therefore their low value as collateral in the event of corporate liquidation. By contrast, when corporate assets are not specific, debt is the preferred financing tool. On the other hand, corporate diversify their activity in response to the presence of an excess of unutilized assets (Penrose, 1959).

Explanation by transaction cost suggests that companies following related diversification strategies are suggested as equity as source of capital, other hand, while companies that follow unrelated diversification may prefer debt financing. Agency theory is interested in mitigating the conflicts arising from the divergence of interests between shareholders and managers.

The agency theory presents debt financing as a governance device useful in reducing the conflicts of interest between shareholders and managers. Debt reduces the agency costs of free cash flow and prevents managers from adopting value-decreasing decisions in the corporate. Consequently, debt reduces the risk of managers adopting unrelated diversification strategies that do not create value from a shareholder viewpoint.

The finance literature addresses the motives for unrelated diversification when there are no synergies to be gained. On the other hand some other studies in this literature reflect that under financial market assumptions, there are no economic motives for unrelated diversification. Alternatively, the reduced risk may benefit managers through the additional diversification of their personal portfolio. Each of these motives may have different effects on the capital structure and the systematic risk of a corporate.

Barton and Gordon (1988) in a very significant study have delineated that undiversified and related strategy companies (i.e. companies pursuing related diversification) have lower debt levels, while those pursuing unrelated diversification have higher debt levels. Kochhar and Hitt (1998), who showed that related diversification, are commonly associated with equity financing, and unrelated diversification with debt financing thus supported the above view. They also found that diversification via acquisition is often associated with public financing, while internal development is usually funded through private financing. Interestingly, Alonso (2003), using a sample of 480 Spanish manufacturing corporate, did not find support for the effect of corporate diversification on debt levels.

Jahera (1996) reported that asset type, corporate diversification, and availability of tax shields are the strongest determinants of corporate leverage. Several other researchers also on similar lines found that the more profitable the corporate, the lower the debt ratio, and that asset tangibility affect total and long-term debt decisions differently. Therefore, it seems a natural progression to study the moderating effect of the environment on the relation between diversification and debt financing level.

Daud, Salamudin and Ahmad (2009) examined relationship between diversification effect on performance using multiple measures of performance namely accounting and market measurements. The evidence produced some interesting findings with respect to risk factors. The diversification strategy was reported to have an effect on corporate performance while other factors are

consistent with previous findings. In particular, companies that adopt the focused strategy perform better than those with diversified strategy. Different measures of performance used in the study produced varying results after controlling for risk, corporate size and economic condition, using the inflation rate as a proxy.

Diversified companies as per literature review are more profitable because they are able to deploy their assets more efficiently. Thus, empirical studies in the industrial organizational literature attempt to compare the profitability of diversified and undiversified corporate. On the contrary Gort (1962) and Maikham (1973) empirically found the profitability of diversified companies to be similar to that of undiversified corporate. Rumelt (1974) also in his research emphasized the benefits from diversification into related businesses. Rumelt (1974) (1982), Christensen, Kurt, and Montgomery (1981), and very significantly Palepu (1985) show that corporate, that have diversified into related businesses are usually more profitable, utilizing various accounting measures of profitability because of the obvious reason of utilization of core competency. Related diversification would be obvious choice only for those companies which have an excess of highly specific assets, because these assets can only be transferred across similar business. The adoption of an unrelated diversification strategy indicates the presence of an excess of non-specific assets in the corporate. Chatterjee and Wernerfelt, (1991). Bettis (1981) and Amit and Livnat (1988) emphasized the importance of the risk-return trade-off in assessing the performance of companies that have diversified into related businesses.

Several studies have compared the performance and characteristics of companies that have diversified into related businesses with those that have diversified into unrelated businesses. It was found that companies choose their diversification strategy according to some desired tradeoff between profitability and risk. Most companies that diversify into related areas are characterized by higher profits and greater operating risk. On the other hand, companies that diversify into unrelated areas of business are characterized by lower operating risk, offset by lower profitability.

Lubatkin and Rogers (1989) in their study, confirmed that the companies that are diversified in a constrained manner demonstrated significantly lower levels of systematic risk and significantly higher levels of shareholder returns than companies employing other strategies. The findings accentuate the popular, though weakly supported, belief that controlled diversity is associated with the highest performance. Raphael and Livnat (1988), in their cross-sectional path analysis also confirmed that corporate trade off the reduction in operating risk due to diversification with increased financial leverage, and thus the systematic risk remains the same. Their study uses theoretical considerations and empirically examines the effects of various diversification strategies on the capital structure of companies and on the systematic risk. The study also documents that companies reduce their operating risk by diversification and increase financial leverage to take advantage of tax benefits. Chatterjee and Lubatkin (1994) on the other hand proved that the relationship between corporate diversification and both forms of stock return risk generates a U-shaped graph. Thus, the author recommended that an important way for corporations to minimize risk is to diversify into similar businesses rather than into identical or very different businesses.

Another stream of evidence indicates that diversified strategy could be used to enhance corporate performance (Geringer et al., 2000; Gourlay and Seaton, 2004; Lee, Hall and Rutherford, 2003; Nachum, 2004). Diversified strategy seems to dominate corporate action from the middle of twentieth century till date in US as shown by Rumelt (1982). However, this behavior of US companies changed due to new control and policy introduced by the government in the early 1980's resulting in widespread sale of non-core asset. Bettis and Mahajan (1985) from their research also suggested that diversified companies have significantly able to reduce their systematic risk and increase returns. The author had also very strongly confirmed that there is still some level of correlation between related diversification and corporate performance but the unrelated corporate performance bears a negative correlation with diversification.

Agency cost, cash flow and transaction cost are the three most important reasons that have been mentioned by Amit and Livnat (1988) on why companies pursue diversified strategy. As already seen, agency cost arises from conflict of interest between managers and owners of corporate. Nevertheless, Aggarwal and Samwick (2003) argue that managers could not get involved in an industry that is totally different from existing operations without the owners' permission. Another reason is associated with surplus funds available to corporate. Extra money means companies are not tied to debt obligations; therefore, they could diversify their business with the expectation of improving performance (Hitt, Hitt and Hoskisson, 1992). Finally, the most important reason as mentioned by several researchers, reason is linked to transaction cost where certain assets could not be rented or sold; hence, diversified strategy becomes an option to efficient use of those assets (Amit and Livnat, 1988).

Companies in developing countries would be better off by adopting diversified strategy due to the presence of the commodity sectors as revealed from study by Kim (1989). Most empirical studies relating to diversification and performance were done using manufacturing sector data particularly in developed countries. Therefore, result obtained in developed countries may not be applicable to developing countries. In addition, presence of market imperfections in developing countries could benefit diversified corporate.

Leontiades (1979) have theoretically emphasized that unrelated product diversification leads to success and have discarded some of the old theories and concept in the area. The researchers concluded that conglomerate companies are not inherently superior or inferior to horizontally or vertically structured corporate. Furthermore, Geringer et al., (2000) who studied Japanese companies suggest that every country has their own uniqueness which could explain variation in the result obtained. Lee et al., (2003) found similar finding when they performed a comparative study between Korean and United States of America (US) markets during the period 1992 to 1996. Diversification creates positive results for Korean companies and vice versa for US corporate. This finding seems to be the reason why companies in emerging markets pursue diversified strategy. It is possible that differences in executing diversification strategy brought about contrasting outcome between Korea and US.

3. Other Factors Affecting Performance

Contrasting evidence thus far may be due to different variables being used in respective studies. There are various studies which have examined variables that may explain corporate performance. However, these studies offered mixed results, in a way that most of the researchers concluded from their studies that diversification strategy can lead the company's profitability to a new paradigm therefore every company should try to diversify based on the specificity of the corporate. On the contrary there are some very strong objection to such a research in which some researchers claim that the research conducted by them proves a very week or negative relationship between diversification and market performance of the corporate. The justification offered by them is that a company can gain expertise in manufacturing of only one type of product in such situation if the company starts making more than one product than the core competency of that company tends to lose.

There are even some researchers which claim that if a company follows related diversification strategy than there are chances of profit, where as those companies whose line of product are unrelated shows a negative response as far as profitability or market value is concerned. One major problem is the existence of market imperfections brought about by economical, political and operating environments in each country (Lee. 2003). Kracaw, Lewellen & Woo (1992) support those findings in which they mentioned that inflation variable also influences performance. Apart from inflation, leverage also significantly influence performance.

Similarly, literature has two sets of findings with respect to diversification and leverage relationship. Even though researchers are divided on the effect of leverage, they have reached a consensus pertaining to influence of corporate size on performance. Their evidence exhibits that large companies can utilize their resources efficiently and minimize downside risk, leading to improved corporate performance. Besides that, risk is another important variable that attract little attention in the study pertaining to diversification issue. Risk needs to be controlled because the theory states that high risk is associated with high return. Kim et al., (1993) used variance of return on assets as a proxy for risk to control the risk profile of companies and capture effects on corporate performance.

Based on the categorization of literature review, it can be seen that the involvement of research work in the same area for the duration has been constantly escalating all through the present time, the focus of researchers has also shifted towards emerging economies to get sustainable advantage.

4. Objective and Rationale of the Study

The aim of this research paper is to emphasize on the integrated mechanism of DS, CS and FP with other variables which has been discussed by various researchers, but has not been observed, and given due importance as a holistic model. This study also methodically assembles the precedent literature by reviewing the studies on the variables considered and had tried to integrate these variables in this review /research study. Thus, the concept of integrated mechanism of different variables have been emerging based on the past research conducted from time to time and had also grown widely all over the world particularly in developed countries like USA etc. However, developing countries like India, because of financial frame work and markets need to be studied to make the profits from transnational diversification of firms, which is a successful process and required for their benefits in long run.

Subsequent segment discusses research methodology followed for achieving the objectives. The last part explains the literature on integrated mechanism of diversification strategy, capital structure and firm performance and provides some concluding remarks including scope of future research and implications.

5. Methodology

A set of 107 research papers which have been considered from 1950 to 2012 were critically studied and considered to make out the suitable classification. Accordingly, on the basis of comprehensive evaluation, the total text of literature on DS, CS and FP was classified using structure model shown in Figure 1. It was felt that for attaining the rationale of the present study, categorization of DS, CS and FP integration, their integrated mechanism of literature data on the source of this model would provide evidence to be supportive. As revealed in Table 1, the entire DS, CP and FP integration literature can be arranged into the subsequent categories like Research Methodology/statistical tools used for data analysis, Year wise categorization of studies and country wise allotment of studies. The accompanying table is an extract of most important studies out of the 107 published papers, tabulated for the research.

Author(s), year and country of study	Title of study	Sample data (no. of years)	No. of sample countries	Methodology/ tools adopted for data analysis	Findings and conclusions
Ajay R. and Madhumathi R., 2012, India	Impact of diversification strategy on the capital structure decisions of manufacturing firms in India	6	1	Panel Data Regression	Research suggested that diversified firms differs significantly from counterparts with respect to leverage, tangibility, non-debt tax shield, age, size and agency cost, with geographic diversifications also having impact on capital structure.
Aleson M.R. and Escuer M.E., 2002, Spain	The impact of product diversification strategy on the corporate performance of large Spanish firms	3	1	Analysis of Variance	Firms with intermediate levels of product diversification have higher performance, as compared low and high levels of diversification.
Author(s), year and country of study	**Title of study**	**Sample data (no. of years)**	**No. of sample countries**	**Methodology/tools adopted for data analysis**	**Findings and conclusions**
Alonso E.J.M., 2003, Spain	Does diversification strategy matter in explaining capital structure? some evidence from Spain	3	1	Regression	Impact of diversification strategy on firm capital structure was captured and a non significant relationship between firm leverage and the degree of firm diversification was reported.
Ansoff H.I., 1957, USA	A model for diversification	Theoretical Model	---	Mathematical Explanation	A theoretical model explaining both qualitative and quantitative aspect of diversification, and choose opportunities which are consistent with the company's objectives and long-range policy.
Ansoff H.I., 1972, USA	"Strategies for diversification"	Theoretical Model	---	Not Defined	Establish reasons which may lead a company to prefer diversification to other growth alternatives, and trace a relationship between over-all growth objectives and special diversification objectives.
Christensen H.K. and Montgomery C.A., 1981, USA	Corporate economic performance: diversification strategy versus market structure	5	1	Regression	Results indicate that performance differences could be demonstrated for some of Rumelt's categories, but, across the range of categories, a hypothesis of performance differences was rejected.
Hoskisson R. E., Hitt M.A., Johnson R.A. and Moesel D.D., 1993, USA	Construct validity of an objective categorical measure of diversification strategy	1	1	Regression	Results indicate strong convergent criterion related validity for the entropy measure of diversification.
Montgomery C.A., 1982, USA	The measurement of firm diversification: An empirical evidence	4	1	Comparison	The study concludes that unrelated portfolio firms were less successful performers than related linked firms.

Table 1: Table showing a sample of Categorising of literature

5.1. Development of Integrated Mechanism using the Variables

This segment of the study represents the outcome of the literature review on integrated mechanism using the variables. This review is done and an extensive Table is formed which provides a comprehensive cataloging of the several studies on DS, CS and FP and their integrated mechanism, outlined on the ground of the exceeding classified variables. Each of such variables and the outcome attained from the judgment are established.

6. Methodology/Statistical Tools Adopted for Data Analysis

Figure 2 shows the occurrence and frequency of various statistical tools used for data analysis in the research studies considered in the current study. From Figure 2, it can be seen that the mainstream of research studies have used regression for testing. It was found that use of regression is so widespread for the reason that this research tool adds significantly to the accepting of economic, political, and social phenomena, followed by ANOVA, Correlation Test, OLS Regression, F-test, Hausman Test, Comparative Analysis Method, Mathematical Explanation, Path Analysis, SEM Technique, Wilcoxin Test for probing the linkages among the firms. The other test like covariance, Cragg's two-part model, Descriptive Statistics, Logit Model, Mann-Whitney U-test, Market Model of Return, Multivariate Point Process Model, Pearson Correlations, Risk and Market Adjusted model, Simulation Model, Structural Break Model.

Among the various statistical tools and techniques used to study the relationship between variables discusses in the study Analysis of Variance (ANOVA) and regression were the two most important tools to support the respective hypothesis. Researchers like Aleson and Escuer (2002) used ANOVA and Bonferroni's multiple range tests to perform pair wise comparisons between the Rumelt's four groups and control their overall error rate.

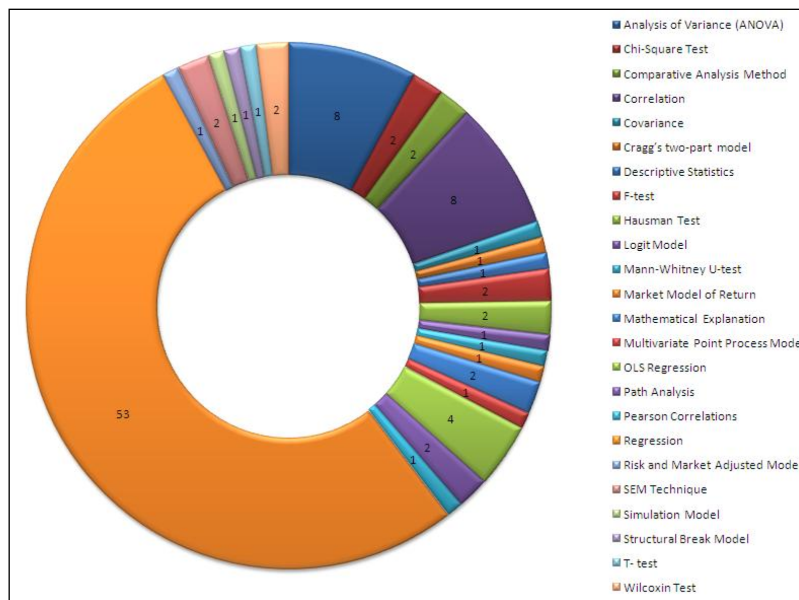

Figure 1: Frequency Statistical tool used for Data Analysis

6.1. Year wise categorization of Studies

In this section, year wise categorizing of research work is represented in Table 2. It can be evidently seen, that the study on relationship between DS and CS and FP and there integration had been attractive in the middle and towards the end of last century. But the researchers have lost interest in the area specifically near the recessionary times of 2007-08, where this relationship could have been extremely effective. In relation to 70 percent of the research work was finished in the last study period, i.e. in recent four years of study from 2009 to 2012.

S.No.	Year	No. of Studies
1	1957-1960	1
2	1961- 1970	0
3	1971-1980	7
4	1981-1990	17
5	1991-2000	23
6	2001-2010	33
7	2011-2013	16

Table 2: Year wise Categorization of Studies using Integrated Mechanism through DS, CS and FP

6.2. Country wise distribution of studies

Figure 2 shows and recapitulate the country wise distribution of studies conducted on DS, CS and FP integrated mechanism. Figure 2 disclose that in out of entire 107 studies measured in this study, 46 percent studies are from USA, 19 percent studies are from Europe , 4 percent from India and remaining 31 percent studies are in combination from countries like Spain, China, Japan, Singapore, Italy, Indonesia, Malaysia, Australia, Thailand, UK, South Korea.

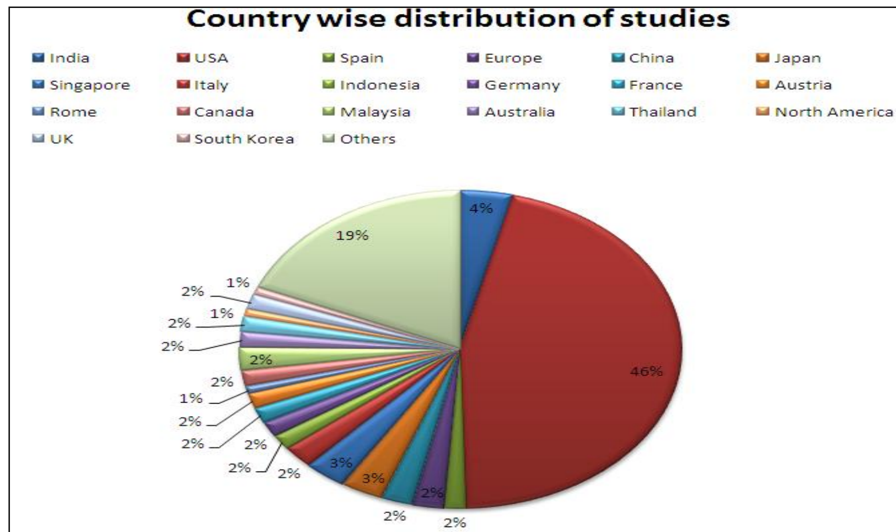

Figure 2: Country wise distribution of studies on DS, CS and FP

6.3. Number of years taken as a sample data set

The number of years measured as sample data for every study is established in Figure 3 as beneath. It can be contingent that nearly every study has considered the integration of DS, CS and FP for the given time frame let say i.e. 0-5 years. It could also be seen that out of 107, 80 studies have data set with the time outline which exists between one and thirty years where as 39 studies have a data set existing between reference to 5 years and remaining 19 studies have a data set which falls and sandwiched between time frames of 6 and 10 years. The time period of the study plays a significant role in determining several characteristics of the study like analyzing the effect of certain economic parameters like recession etc on the study because they have a huge impact on the study as far as the scope of our study is concern. Any company following any strategic decision is significantly hampered when economic problems like recession hits the economy. So if the time period of the study is such that some portion of the same is impacted by recessionary phase the researcher can very well compare and gauge the impact of the strategy in that period thus helping the business men to take a better decision looking into the situation.

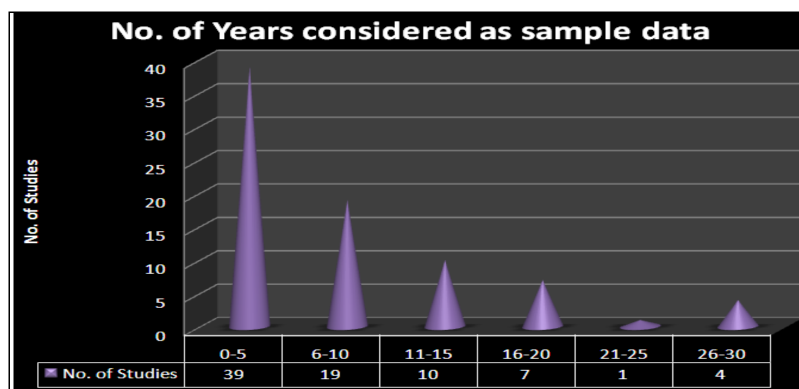

Figure 3. Number of years considered as sample data for studies on DS, CS and FP

7. Conceptual Model

The conceptual model presented in Figure 4 is the extract of the study and shows relationship between diversification strategy, capital structure and its impact on firm performance for achieving firm's sustainable growth. In addition to the existing business framework i.e. the economic environment of the firm there are several parameters which affect the model. Some of these are use of technology, firm responsiveness, use of Information technology capital intensity and above all social acceptability.

These are general, technical as well as societal aspects other than the economic ones which may lead to the company's growth to a next level or vice versa. A good number of studies connecting diversification strategy to technology found that use latest equipment, machinery can help the company to produce quality products even if the company is not expert or is starting a new line of business. So this will always affect the size of the firm, tangible assets, growth and thus profitability of the firm.

Similarly another component such as information technology also impacts the principle components in the similar fashion. Firm Responsiveness is yet another important parameter affecting the model. This factor impacts the product diversification decision and other such decisions by the management of the firm. More significantly it refers to the seriousness paid to certain issues like extent of involvement of technology in terms of operations, IT as well as whether the firm should be capital intensive or not. And all these factors directly affect the performance of the company and significantly impact the profitability. Evidently, Ravichandran Liu, Han and Hasan (2009) very critically commented that examining the performance effects of diversification is incomplete without taking into consideration the corporate information technology (IT) spending. The results indicate that while IT spending interacts with related diversification to have a positive effect on corporate performance, similar interactions with unrelated diversification do not have any effects on corporate performance

The term Capital Intensity refers to the amount of fixed or real capital present with respect to other factors of production, especially labor and estimated by the capital/labor ratio. Betiss R.A. (1981) investigated performance differences between related and unrelated diversified firms using regression models. The study suggested that performance differences are associated with advertising expenditures, accounting determined risk, research and development expenditures and capital intensity. The model suggested that research and development expenditures are an important determinant in the performance advantage enjoyed by related diversified firms.

The model was generated by keeping into mind both internal as well as external factors of an organization. It can be inferred from the model that all these market forces cannot be evaluated in isolation but there effect can be observed in an integrated fashion. These resources are mostly overlooked but can prove to offer competitive advantage if developed as core competencies.

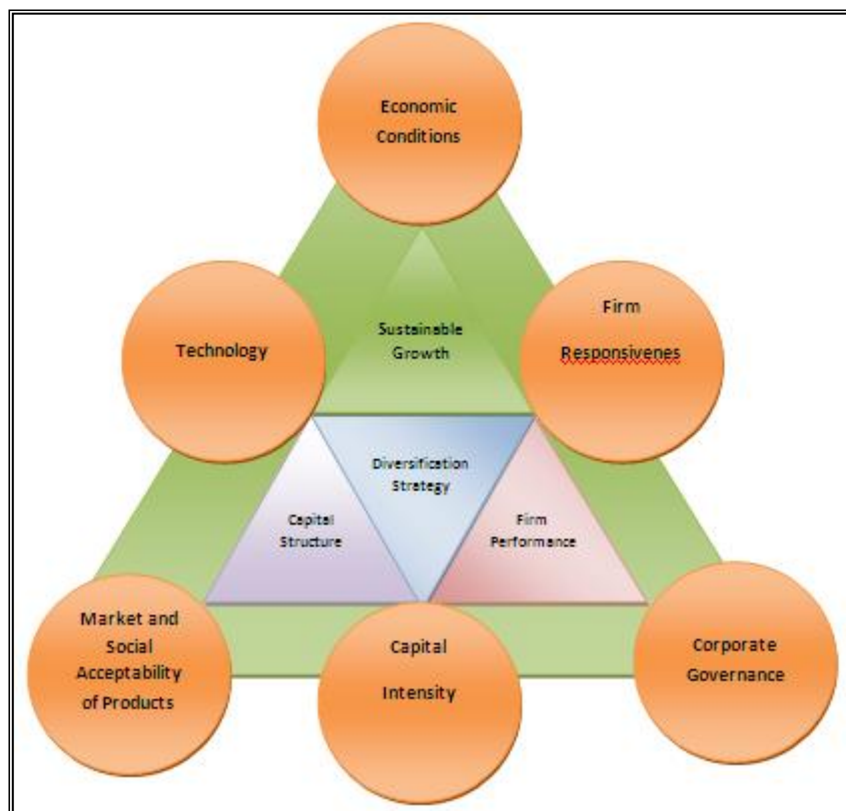

Figure 4: Foundation structure model, representing Integrated mechanism of DS, CS, SR and FP literature for Firm Sustainable growth

8. Conclusion of the Study and Research Implication

Based on the categorization of literature review, it can be seen that the involvement of research work in the same area for the duration has been constantly escalating all through the p

recent time, especially from 2006 to 2012. The exposure of integration of DS, CS and FP across promising economies has attempted positive in recent years because the focus of researchers has also shifted towards emerging economies to get sustainable advantage.

On doing the in-depth research and analysis on the topic, we conclude that diversification strategy have a strong and a positive relationship with firm performance and sustainable growth. Subsequent to critical reviewing all the papers considered in the study for integrated mechanism, it was revealed that there is prominent growth in the research work linked with diversification strategy (DS) and their related issues on how to grow a business by diversifying successfully. Nevertheless, there has not been much attention paid and looked properly by researchers concerning the relevance of research work on integrated mechanism of DS, CS and FP with significant economic variables. A quantity of studies have hypothesized that diversification strategy may improve

profitability and success, all the way through financial system or economies of extent and/or in the course of the anticipating of product space.
Consequently, the research actions were determined on recognizing the scale and degree of relationship surrounded by business markets except for their speculation for it. Accordingly, there is a need for further research in the identical area which would attempt to discover the rationale of integration among DS, CS and FP and the dynamic issues that may have an effect on the degree of amalgamation i.e. integration at global level.
Due to the elusive nature of research there is difficulty found in perusing such lines of action specifically in its implementation. Majority of the studies discussing the effect of diversification strategy on firm performance or other variables have concluded on confirmatory analysis of variables. Very few studies have dealt with the implementation perspective of this phenomenon. At this issue this area had received a global criticism and thus point of future work on the area.

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