Conglomerate Diversification, Mergers & FDI

Introduction

In recent years there has been a considerable growth in the large organizations and their impact on economy. Large diversified firms have known to be operating in developed economies. Such firms' account for considerable proportions of economic activity which might be otherwise taken by separate firms. This session discusses the consequences of conglomerate diversification and its possible effects on economic welfare.

When in principle a firm produces more than one product or a service it is called 'diversified'.

A firm which produces a number of closely substitutable products would usually be regarded as horizontally integrated.

A firm which produces products or services enjoying significant input –output relationships would be regarded as vertically integrated.

Diversification as earlier defined will therefore exclude production of highly substitutable or significantly vertically related products.

Three types of diversification have been identified by federal trade commission, USA. They are;

a) Product extension diversification: it involves the production of products related to some extent in their production or demand. When products are related in demand it is called marketing concentricity. When products are related in production processes, it is called technological concentricity.

b) Market extension diversification: it involves sale of products in geographically distinct markets.

c) Conglomerate diversification: it involves production of products which are unrelated in production or demand.

A conglomerate, by definition, is a large corporation with diversified product lines**,** owned and run by the same management. Conglomerates are defended for their synergies, and for the benefits of diversity as a hedge against failure in one sector. But conglomerates are inherently more vulnerable than other companies. As many economists have argued, the burden of proof is on the company's management to show that these diverse businesses are better off together than they would be independently.

Diversification: measures

Measure of diversification are formally analogous to measures of concentration. A measure of concentration summarizes the number and relative sizes of firms in a given industry. A measure of diversification, in contrast, summarizes the number and relative sizes of industries operated in by a given firm.

Add graph

It is useful to proceed with references to what we may call the diversification curve analogous to the concentration curve. This plots the cumulative percentage of a firm's employment (or some other measure of firm size) against the cumulative number of industries in which the firm operates, ranked form the most important to the least. Three such curves for firms A, B and C are plotted in the figure here.

The curves in the figure are concave from below, in the limit being straight lines. This reflects cumulation of employment from the largest industry in which a firm operates, with a straight line applying when a firm operates equally in a number of industries. Hence relative inequality in a firm's distribution on industrial activities is reflected in the concavity of the curves, and the number of industries in which it operates is reflected in the slope of a line drawn between the endpoint of each curve.

Second higher curves indicate greater concentration or specialization of a firm's industrial activities. Hence a firm is more diversified if its diversification curve lies everywhere below that of another firm. In the figure, therefore, firm C is more diversified than firm A, since for any number of industries operated in, firm C has a smaller proportion of its activity committed to those industries. If there are k industries in total, then a completely diversified firm would operate equally in all k industries (shown by dashed diagonal line in the figure).

Finally when diversification curves cross, then no unambiguous ranking of firms by diversification exists. In the figure, firm C operates in more markets than firm B but it also has more of its employment concentrated in a limited number of industries. Which firm is regarded as more diversified, therefore, depends on the weight attached to different parts of the diversification curve. As in the case of concentration, different indices give different weights to different parts of the curve, and so may result in different rankings of firms when curves intersect. As in the case of concentration, such diversification can be measured in a number of alternative ways.

Number of industries

The simplest index is to count the number of industries in which the firm operates. This is analogous to using the reciprocal of firm numbers as an index of concentration. The principal weakness of this index is that it gives no weight at all to the distribution of the firm's employment over those industries.

Specialization ratio

A second index, which because of its simplicity and its ready availability in Census of production publications is frequently used in empirical work, is the specialization ratio. This index is defined as the ratio of the firm's primary employment to its total employment.

Importance of diversification

Diversification can offer companies many advantages. From a financial point of view, they include cost reduction, asset depreciation and risk reduction. Strategic advantages involve synergies or the expansion, creation and improvement of long-term strategic assets. These advantages are particularly evident in the tourism sector: synergies, cost sharing, risk reduction or brand improvement. In addition, resource diversification contributes to long-term sustainability and regional development.

Diversification Strategy

Any company's strategic emphasis is increasing sales volumes, boosting market share and cultivating a loyal clientele. Organizations pursue opportunities for geographical market diversification. The natural sequence for geographical diversification is local to regional to national to international. The degree of penetration will however differ from area to area depending on the profit potentials. The strategies of diversification can include internal development of new products or markets, acquisition of a firm, alliance with a complementary company, licensing of new technologies, and distributing or importing a product line manufactured by another firm. Generally, the final strategy involves a combination of these options.

Determinants of Diversification

Diversification is influenced by several factors. These include;

1. **Financial health/attractiveness of the industry:**

Availability of finances is important because diversification requires financial outlays of significant size. Attractiveness of the industry and/or market is important because diversification into an industry or market that is not performing well due to general economic conditions or local problems can result in a significant loss of income and security.

2. **Availability of workforce resources:**

Firms should have sufficient resources that cater for different initiatives undertaken during diversification as well as Firms should have sufficient resources that cater for different initiatives undertaken during diversification as well as ensuring that existing business activities are functioning effectively.

3. **Government regulatory policies**:

Government regulatory policies impact on the diversification decision. Government can limit or even foreclose entry into industries with such controls as licensing requirements.

4. **Institutional environment:**

Diversification can also be influenced by factors such as dynamic capabilities, knowledge searching and institutional environment. A firm’s expansions are more persistent when they are related to its core skills and when it has a higher level of diversification experience, underscoring the importance of organizational learning and search for knowledge. Institutional environment is also important in diversification because business groups consist of individual firms, that are associated by multiple links such as cross-ownership, close market ties and social relations, all of which are coordinated to achieve business objectives.

5. **Information asymmetry:**

A considerable literature suggests that corporate diversification is a leading example of the agency relationship between shareholders and managers and therefore, diversified firms are subject to larger asymmetric information problems more than focused firms are. The source of the difference in asymmetry is that diversified firms are less transparent than focused firms are .For instance, while managers of diversified firms can observe divisional cash flows, outsiders can observe only crude estimates of divisional cash flows. Thus, the problems of account translation and consolidation make company reports less transparent to outsiders, and reported earnings will convey less value-relevant information. To the extent that accounting figures for diversified firms are less transparent compared to those of focused firms, they provide a greater incentive for difficult to detect earnings management.

Research and development (R&D) can increase the problem of information asymmetry, increase agency problems and decrease transparency. Research and development investments can be used to manipulate earnings.

6. **Investment misallocation**

Investment decisions in diversified firms are known to incur three types of risks. The first is the opportunism in the choice of investment projects. Diversified firms tend to misallocate their investment funds by cross subsidizing poorly performing divisions.

7. **Cultural diversity**

Culture relates to core organizational values. In turn, values are paramount factors to organizations and underpin attitudes, decisions and behavior. An increasing number of successful organizations have, at least partly, attributed their success to effective cultural management. The firm can base its employee values on the principals of respect, integrity, transparency and excellence. The problem of diversified firms is that they have numerous subsidiaries and that each subsidiary may have a particular culture that can diverge from that of other subsidiaries. The problem of cultural diversity is worsened if industrially diversified firms are also geographically diversified. The faraway operations are more difficult to control, notably because they put firms in contact with other cultures

Consequences of diversification:

1. **Diversification and competition**

The effects of such diversification are socially beneficial as diversified new entry leads to increases competition and lower price cost margins in an industry. In some cases, it is suggested that diversification may have ambiguous or socially harmful effects, warranting the consideration of public policy intervention.

2. **Diversified entry**

A diversified firm is likely to be able to raise capital on terms more nearly comparable to existing firms, either from the capital market or from its own sources. In addition, diversified firm can more readily stand an initial period of loss making in a new market until it establishes sufficiently to move into profit. On both counts, therefore diversified entry is likely to provide an important supplementary force tending to promote competition in situations where entry by a new specialist firm would be difficult. Ceteris paribus, such entry would tend to increase competition and lead to lower price cost margins. There may be other offsetting effects but diversified entry is likely to be socially beneficial.

3. **Cost savings**

If lower costs exist, then the firm may be able to attain a high market share and a high price cost margin. The social benefits obtained may be greater than the alternative of specialized production if the latter would mean a loss in efficiency. Both market power and cost savings may co-exist in a concentrated market where superior efficiency is a feature of certain firms.

4. **Group interdependence**

A diversified firm will take group decisions which will result in different process etc. for its subsidiaries compared with specialized firms. Two possible reasons for this are that interrelationships may exist between the diversified firm's product and that in a situation of uncertainty, firms may be risk averse.

On the demand side, substitutability between products will tend to lead to higher prices in diversified firms compared with equivalent profit maximizing specialist firms. Conversely if the firm produces complementary products, it would tend to reduce the prices. On the production side if marginal cost of one product was lowered by an increase in production of the other, or alternatively if costs of diversified production were lower than for a specialized production at a given output rate, then a diversified firm would tend to produce more than equivalent specialized firm.

A risk averse diversified firm will adopt different process from equivalent risk averse specialized firms.

5. **Predatory pricing**

Diversification in conjunction with market dominance may give rise to predatory pricing and other aggressive business practices. Predatory pricing occurs when dominant firm or firms cut price to drive out or discipline competition in the short run in order raise prices towards monopoly levels in the longer run.

6. Spheres of influence

When diversified companies face each other in a number of markets, it is sometimes suggested that they will adopt a less competitive stance than would equivalent specialist firms. The diversified firms will avoid taking competitive action in any one market if this risks retaliatory action by diversified rivals in other markets. The diversified firms will develop spheres of influence and that their rival will adopt live and let live policies. The result would be general stability and lack of vigorous competition in such markets, implying higher prices to the detriment of consumers.

Mergers

Merger activity has been one of the important means by which diversification has taken place. Over a thirty year period beginning from 1948, the vast majority of large acquisitions are classified as conglomerate mergers. This indicates that the acquiring firm had, in the majority of businesses, used merger as the means to enter into new line of business rather than to build upon activity in an old line i.e horizontal or vertical expansion is less preferred.

On one hand, conglomerate mergers probably indicate the attractiveness of diversification; strategic considerations may call the firm to broaden its base. The acquisition of going business may be the most cost effective means for the firms to do so. If entry into new market requires development of a new brand and the consumer loyalty which goes with it, it may be easier to acquire an established firm and its product than to expand by internal growth. On the other hand, the appeal of conglomerate mergers probably indicates the effect of public policy as well. With the fairly stringent guidelines on mergers, the large firm may be discouraged from pursuing horizontal and vertical acquisitions. Though not all mergers aim at growth, some may be motivated by the purpose of increasing efficiency or achieving economies of scale. Sometimes conglomerate mergers also bring an improvement in the management techniques or operations. In these cases, their takeover is motivated by a willingness and ability to replace an inferior management team with a superior one. On the other hand certain horizontal, vertical and even conglomerate mergers may seek to establish market advantage. It is possible although not very likely, given by the legal constraints that such a merger seeks directly to establish a monopoly. But it is more likely that the merger seeks to establish an advantage over the competition, existing or potential by raising the latter's costs or by reducing its opportunities. In this case it is assumed that there does exist some form of natural barriers to entry if the strategy is to succeed. Assessing entry conditions calls for intensive fact-finding and is unique to each industry.

Three basic kinds of mergers may have this effect: horizontal mergers, which involve two competitors; vertical mergers, which involve firms in a buyer-seller relationship; and potential competition mergers, in which the buyer is likely to enter the market and become a potential competitor of the seller, or vice versa.

Horizontal Mergers

There are two ways that a merger between competitors can lessen competition and harm consumers: (1) by creating or enhancing the ability of the remaining firms to act in a coordinated way on some competitive dimension (coordinated interaction), or (2) by permitting the merged firm to raise prices profitably on its own (unilateral effect). In either case, consumers may face higher prices, lower quality, reduced service, or fewer choices as a result of the merger.

Advantages of Horizontal Merger

1. The biggest advantage of horizontal merger is that it reduces the competition by reducing the number of companies which are there in the industry and hence company has to spend less time on taking undue stress about how to tackle competition and can concentrate more on improving its product and giving the customer best services by producing good quality product at lowest price.
2. Horizontal merger give companies benefit of economics of scale because as size of company increases price per unit of production for product decreases as there is elimination of duplication of machinery, increase in bargaining power with suppliers due to massive size of merged company, less expenditure on advertising and publicity leading to company delivering the product at lower price to its customers than before.
3. It is easier for top management of the acquiring company to manage the target company which is in the same business rather than acquiring taking over that company which has completely different business and hence chances of top management successfully handling both the companies increases in case of horizontal merger.

Disadvantages of Horizontal Merger

1. The biggest disadvantage of this type of merger is that it increases the chances of merged company having monopoly powers due to sheer big size of merged company and we all know that a company having monopoly powers will tend to exploit customers by charging higher price than normal from its customers and hence in the end it is the customer who has to suffer.

2. Another disadvantage of this type of merger is that it is difficult to integrate the culture, employee behavior and other such things of two companies which are merged and if company is unable to achieve the integration then the whole idea of merging two businesses will go out of window and it will result in failure of the merged entity.
3. Horizontal merger results in company putting all its egg in one basket implying that if the product which is being sold by the company go out of fashion as is the case with technological products or if there is some government policy which makes production of product unattractive as is the case with mining products. Hence a company doing horizontal merger is basically investing all its wealth or cash into one business and there is no diversification and can cost the company big time if the situation arises.

Vertical merger

Vertical merger is the term used in the context of merger and acquisitions, it refers to a merger between two companies which though are operating in the same industry but does not sell the same product rather they do business with each other. In simple words it is a merger between two companies which have a buyer and seller relationship.

Advantages of Vertical Merger

1. The biggest advantage of vertical merger is that it reduces the company's dependence on the supplier of raw material because in vertical merger company is buying the supplier's business and therefore company has complete control over the supply of raw material and there is no stress of

supplier demanding higher price or late delivery of raw material or any other illegitimate suppliers demand.

2. It also leads to economies of scale for the company as it reduces the various costs associated with procurement of raw material like transport cost, transactions cost, labor and so on.
3. It helps the company in research and development of product because after vertical merger company has people with knowledge of both raw material and finished product which helps the company in producing the better product than before at very lower cost leading to higher profits for the company.

Disadvantages of Vertical Merger

1. The biggest disadvantage of vertical merger is that it forces small suppliers to go out of business because once the company starts acquiring big suppliers than small suppliers lose pricing power and eventually they go out of business.
2. Another disadvantage of vertical merger is that the whole idea of this type of merger is to take control of supplies of raw material and if there are large number of suppliers and if competitor companies are able to acquire raw material at cheaper rate from other suppliers than company will lose competitiveness in terms of cost to other companies.
3. It results in locking of capital of the company which could have been used for some other profitable projects and hence company should take into account opportunity cost of capital also before going for vertical merger.

Foreign Direct Investment

A **foreign direct investment** (FDI) is an investment in the form of a controlling ownership in a business in one country by an entity based in another country. Foreign direct investment includes "mergers and acquisitions, building new facilities, reinvesting profits earned from overseas operations and intra company loans"

The features are;

- It took momentum in the 1960s,
- Reasons are explained by neoclassical economics based on macro-economic principles.
- It is based on the classical theory of trade.
- The motive behind trade was a result of the difference in the costs of production of goods between two countries.
- Focus was on low cost of production

Types of FDI

1. **Horizontal FDI** arises when a firm duplicates its home country-based activities at the same value chain stage in a host country through FDI.
2. **Platform FDI** Foreign direct investment from a source country into a destination country for the purpose of exporting to a third country.
3. **Vertical FDI** takes place when a firm through FDI moves upstream or downstream in different value chains i.e., when firms perform value-adding activities stage by stage in a vertical fashion in a host country.

Methods

The foreign direct investor may acquire voting power of an enterprise in an economy through any of the following methods:

- by incorporating a wholly owned subsidiary or company anywhere
- by acquiring shares in an associated enterprise
- through a merger or an acquisition of an unrelated enterprise
- participating in an equity joint venture with another investor or enterprise

Summary

Conglomerate diversification is a measure used by firms to synergize efficiencies. Monopoly motives could be there but legal restrictions try to make such alliances favorable to society. With many benefits like cost savings, increased output and enhance efficiencies, there may be problems of management as well as cultural diversities. Mergers on the other hand are also attractive options to improve financial health of the companies. Such measure not only makes the industry structure attractive but maximizes benefits for both merging and acquiring firms consequently leading to economic growth. An introduction about FDI was also mentioned as the growth in the same is a resultant feature of growing mergers and acquisitions in developing countries. Such large scale operations attract foreign investments and help boost economic growth.