Performance Implications of Corporate Strategic Behavior of Firms in an Emerging Economy during Economic Liberalization

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Abstract

Emerging economies, which have been charting a new path of development, popularly known as economic liberalization, have drawn increasing attention of the strategy scholars. A growing body of literature is emerging to record how firms from these economies transform themselves to adapt to the emerging situation. This paper adds to this body of knowledge by presenting an analysis of the corporate strategic behaviour of firms in India, a giant emerging economy undergoing economic reforms over the last one decade. Based on existing theories a multivariate model has been developed to explore the link between various corporate strategy dimensions and performance. The model has also been empirically verified in LISREL framework by using primary and secondary data on 111 firms mainly belonging to the list of top 500 firms in India. It is observed that strategy of scale expansion seems to be the most effective corporate strategic response. In the absence of any significant negative impact of greater degree of diversification and higher diversity of operation on performance, unfocussed strategy and unrelated diversification per se is not be detrimental to firms. However, managers need to be selective in diversification moves for superior performance during the early years of economic liberalization.

Key words: emerging markets, economic liberalization, india, strategic response, corporate strategy, performance.

Introduction

One of the prime concerns for strategic management as a field of inquiry is the phenomenon of strategic adaptation of firms, i.e., how firms achieve a proper `fit' with the environment through changes in strategy (Summer et al., 1990; Zajac, Kraatz and Bresser, 2000). This remains the primary concern because better strategic `fit' of a firm with its environment results in superior performance (Venkatraman and Prescott, 1990). As a result, there has been a plethora of research in exploring strategy and performance linkage in a variety of contexts. However, most of these studies have been conducted in the contexts of market driven economies where firms are by and large free from governments' direct intervention and control. These economies have never undergone economic reforms of such magnitude that have been experienced by many Asian, European and Latin American countries in recent years. With the legacy of a socialistic and planning oriented institutional framework, the recent economic transformations in these countries present a unique business environment for firms that is distinctly different from what a typical Western firm would encounter (Luo and Peng, 1999; Peng and Hearth, 1996). The environmental contingencies faced by firms from the economies undergoing liberalization and globalization are likely to be unique and demand unique adaptive response.

During the past two decades a number of countries have been moving from an insular command and planning oriented economy towards increasingly liberalized, globalized, and market oriented economy. The rapid and widespread adoption of market based policies and administrative reforms in these countries are popularly known as economic liberalization. Though economic lib-

eralization has a history of almost two decades in different country contexts, firm level studies on the impact of economic liberalization are very limited (Hoskisson et al., 2000; Ray, 2003).

Recently quite a few firm level studies on the impact of economic liberalization have been reported. These studies (e.g., Appiah-Adu, K., 1999; Child and Lu, 1996; Golden et al., 1995; Keister, 1998; Lukas et al., 2001; Luo and Peng, 1999; Luo, Tan and Shenkar, 1998; Suhomlinova, 1999; Tan and Litschart, 1994) mostly researched state owned enterprises and explored primarily business level strategic behavior of firms. However, economic liberalization creates a context where a large scale changes in corporate level strategies are expected. An exploration of this phenomenon is likely to shed some new light on the contingency research in strategy.

In this paper we have developed and empirically verified a multivariate model explaining the linkages between various dimensions of corporate strategy and performance of firms in the context of a liberalizing economy of India.

Economic Liberalization in India. An Overview

Deregulation of selected industries in India started in the early 1980s. However, it was only since July 1991, Government of India initiated a sustained policy and administrative reforms, popularly known as economic liberalization. Economic liberalization in India is associated with a number of economy wide policies and administrative reforms cutting across sectors such as trade, banking, and commerce, capital and labor markets. Regulatory policies were done away with or modified to facilitate entry of private and foreign investors in a bunch of industries, supply of resources, and raising funds from the domestic and international capital markets. Special thrust and support were given to promote selected industries to boost exports and develop infrastructure. Along with the freedom from government control, greater opportunities and autonomy to industries, policies were initiated to bring in more competition in the economic system by exposing industries to competition from domestic and foreign firms (Desai, 1993).

Economic liberalization gives easier and more economical access to foreign technology, raw materials, plant and machinery, etc., to domestic firms. Rationalization of exchange rate and full convertibility of currency brings opportunities for domestic firms to improve the cost competitiveness and thereby improve export prospects. However, the capital cost of imported technology, plants, and equipment may also go up. Before reforms firms in India had often faced various constraints in getting funds to finance their investments. Often state-owned financial institutions and banks were the only sources of funds. However, in the liberalized era, a proliferation of financial services firms provides several alternative sources of funds to industry. The deregulation of interest rate structure also allows banks and financial institutions to set the interest rate depending on their perception of risk. Thus, terms of lending may be varying across firms depending on various factors such as reputation and performance of firms, composition of their business portfolio, and strategic plans for future. Moreover, in approaching the capital market for funding investments, firms used to face a lot of constraints. However, capital market reforms enable firms to use capital market as an alternative source of funds. The domestic firms are also allowed to raise large amount of funds from the domestic and international capital markets at costs comparable to borrowing from banks and financial institutions.

Along with reforms providing better supply side environment to firms, deregulation, privatization and globalization measures have also led to highly competitive domestic market. Reduction of import tariffs has resulted in lower protection to domestic firms from foreign imports. Unrestricted entry by foreign firms into most industries and permission to hold controlling stakes have created pressures on domestic firms to perform or perish. In the area of public sector, in exchange of more autonomy, government has been reducing budgetary support, divesting equity to private investors to bring in more accountability in their management, and also forcing them to augment their own financial resources. Moreover, domestic consumers, being exposed to foreign goods and services, have become increasingly conscious of quality of products and services and exercise their rights by demanding more value for money.

Economic liberalization also offers a host of new opportunities for expansion, diversification, internationalization, divestment, consolidation, mergers and acquisitions, forming strategic

alliances and joint ventures, etc. in a more liberalized regime free from direct government inter-vention in strategic and operational decision making. Firms get greater autonomy in areas such as capacity and business expansions, export compulsions, choice of technology and raw materials, decisions about the location of their production units, product pricing and product mix, technology imports, etc. Thus, translated to firms economic liberalization means not only more competition; but also more autonomy to do business; more strategic options to choose from; greater opportuni-ties for growth and profit; easier access to funds and other resources; improved infrastructures and better institutional support; lower regulatory interference and hurdles, etc.

In response to these emerging opportunities and threats it has been observed that in liber-alized Indian firms in general aimed at higher growth and return; increased the scale of operation; diversified into new products and business lines; expanded the geographical base in domestic and international markets; offered a wider range of products to their customers, catered to many new and diverse customer segments, introduced foreign technology and emphasised modernisation of plants and equipment, and increased the sharing of resources across departments, divisions, and business units within the firm (Ray and Dixit, 2000). However, which of these strategic responses resulted in superior performance would be of prime interest for scholars and managers. At the fol-lowing pages we have presented a multivariate model liking different corporate strategies and per-formance of firms and the results of empirical verification of the model.

Constructs and Propositions

Corporate Strategy Variables

The most critical choice in corporate strategy is the choice of businesses (scope or con-figuration) – which product and what customer to serve and how to manage the interlinkages of different businesses (organisations) to better utilise corporate resources (Collis and Montgomery, 1995). Therefore, strategic management at the corporate level involves mainly one of the follow-ing four activities: portfolio management, restructuring, transferring skills, and sharing activities across businesses (Porter, 1987).

Strategy literature has identified three dimensions related to scope such as vertical scope, product scope and geographical one (Barney, 1998). Vertical scope and product one respectively indicate the vertical and horizontal spreads of product market choices and together outline the total domain or scope of firm business (Ansoff, 1965). In a pioneering study of multinational firms, Stopford and Wells (1972) identified the extent of area diversification, i.e., geographic scope, as an important growth strategy. Geographical scope captures geographical spread of both factor and product markets. Again geographical scope has two aspects – spread of business activities in the domestic market and spread in the international market, i.e., extent of internationalization. In our model we include these two dimensions related to scope, namely, business scope and geographical one.

Firms are also concerned about decisions regarding how much to produce, how many manufacturing and other facilities, and the size of the organization in terms of structure and number of employees, etc. Scale of operation, which subsumes both size of operation and size of organization, captures this facet of corporate strategy. Moreover, there are similarities and differ-ences in various aspects such as suppliers, customers, technology, and regulatory agencies across different lines of businesses, geographical markets, and product lines. The more the number of customer segments covered, the higher is the requirement of knowledge and information process-ing about customers to design appropriate marketing mix. The more the products produced by a firm, the wider the complexity and variety of designs and production processes are (Thompson, 1967). The complexity in management also increases with technical intricacy of products and processes (Mintzberg, 1979). All these add to a different dimension of corporate strategy called diversity of operation.

Finally, another dimension of corporate strategy called sharing of resources indicates the common use of tangible and intangible resources by different constituents of a firm either simulta-neously or sequentially or both. The constituents may be different business units, divisions or de-

partments. The single business firms also have geographical or product divisions, regional offices, departments which, for effective functioning and deriving synergy, need exchanging and sharing of resources. Sharing and scope are not the same dimension as one firm may increase the scope without sharing of resources. However, sharing of resources is essential for exploiting the economy of scope (Teece, 1980).

Thus, we find that there are at least five key dimensions of corporate strategy – business scope, geographical scope, scale of operation, diversity of operation, and sharing of resources. The changes in these corporate strategy dimensions together constitute the corporate strategic behavior of firms during economic liberalization.

Performance Variables

Performance is a difficult concept, both in terms of definition and measurement (Keats and Hitt, 1988). Measurement of performance is a very controversial issue in literature (Meyer and Gupta, 1994). As objective measures, both accounting based operating, and market based performance measures were used. Researchers (e.g., Rapaport, 1986) suggested that stock market adjusts or compensates for deficiencies in the accounting data and market return is an important measure of performance. Market price of the firm's stock indicates the long-run performance of firm (Hitt and Ireland, 1985). While operating performance provides an evaluative referent and indicates the results of past and present responses, market performance indicates the future outcome of a response (Keats and Hitt, 1988). Thus, operating performance may not be free from lead-lag problem, but the market based measure is likely to be free from this problem. Indicators for market based measures of performance used were market return adjusted for market risk (Hitt and Ireland, 1985). Market return is based on the capital asset pricing model which has been widely accepted as a measure of strategic performance (Lubatkin, 1983). The indicators of operating performance used are profitability measures such as return on sales, return on assets and return on net worth.

Propositions

This section develops the theoretical arguments to hypothesize relationships between various dimensions identified in the previous section. These hypotheses are the building blocks for specifying the relationships within the set of variables included in the model.

Firms that are willing and able to change to strategies more effective in an emerging environment should perform better than those firms, which are unable or unwilling to adopt appropriate strategies (Forte et al., 2000). The relationships between different dimensions of corporate strategies and performance have been well-researched. Scale expansions or horizontal ones (Ansoff, 1965) are by and large more successful than other strategies for generating higher return (Pennings et al., 1994). In fact, microeconomics theory provides a strong basis for the potential effect on scale of operation. Increase in scale helps firms to reduce per unit cost of production up to a point. This has a dual benefit (Porter, 1980). Lowering cost of production provides competitive advantage and boosts up sales growth. The benefit of scale is realized through every activity of a firm's value chain (Porter, 1985). As firms in India historically operated at sub-optimal scales (Desai, 1993), the expansion of scale of operation improves profitability, and the firms adopting the strategy of scale expansion are viewed favorably by stock investors. Hence it is proposed that:

Proposition 1. Scale of operation has direct positive relations with profitability as well as market performance.

The diversification-profitability link, although is a well-explored research topic in strategic management, remains inconclusive (Datta, Rajagopalan, and Rasheed, 1991). Diversification has been the often-adopted route for growth and spreading of risk across market (Luffman and Reed, 1982; Rumelt, 1974). Diversification into new industries and product lines helps firms to reduce risk in the existing business domain. Profits are easier to achieve, if risks are distributed across businesses and geographical markets with higher environmental munificence (Keats and Hitt, 1988). Although long history of research on diversification fails to provide any conclusive evidence, related diversification is believed to generate greater earnings than unrelated diversification (Montgomery, 1994; Ramanujam and Varadarajan, 1989). The oft-cited reasons are that firms

often face difficulties in integrating diverse market mechanisms, technologies, products, skills and other specialized resources of the unrelated business with those of existing businesses. Restructuring a large number of diversified corporations around the world in the nineties rising on the wave of the concept of core competencies (Prahalad and Hamel, 1990) symbolizes this dominant belief of the modern era that conglomerates fail to perform.

However, some authors in the recent years have argued that in the emerging markets such as India focusing on core competencies is not necessary and unrelated diversification may not lead to under performance (Khanna and Palepu, 1997; 2000, Khanna and Rivkin, 2001). The main arguments are: markets and institutions are not well-developed in these countries, hence a conglomerates can add value in dealing with capital, labour, and product markets and make better utilization of regulatory framework and enforcement of contracts. In absence of the well-developed market the corporate head quarters can play the role of the efficient market and corporate brands can more easily and effectively utilize on a large array of businesses where entry in the business is more difficult than competing in the business.

Any form of diversification, even if it is closely related to the existing business domain, adds to diversity in operation because the markets and products are not the same. However, in related business domains, managers are more familiar with supplier and customer profiles, which help them cater to the needs of the market better and avoid costly mistakes. Relatedness also facilitates firms to share intangible resources and derive the benefits of synergy (Bettis, 1981). When a firm has a number of business units and divisions it can attempt to exploit the scope economies accrued due to sharing of cost at some parts of the value chain (Porter, 1985). Thus, higher sharing of resources helps firms to gain cost advantage and achieve higher profit. However, the extent to which scope economies are achievable depends on the fungibility of the existing assets across business and product lines (Barney, 1991). Moreover, conceiving and implementing radically new projects may require specific skills to be developed at several stages of value chain which in turn require time and investments and make firms more vulnerable. Hence, stock investors find diversification a riskier strategy than scale expansion and penalize firms. Thus, we propose that while increase in business scope because of careful diversification into profitable industries has a favourable impact on the profitability of the firm, greater diversity of operation due to unrelated diversification will lead to lower profitability and erosion of market value. Therefore it is proposed that:

Proposition 2: Business scope has direct positive relation with profitability and a direct negative relation with market performance.

Proposition 3: Sharing resources has direct positive relation with profitability.

Proposition 4: Diversity of operation has direct negative relations with profitability as well as market performance.

The linkage of geographical scope and performance is established in strategy literature (Delios and Beamish, 1999). The ability to source lower cost of inputs, opportunity to exploit proprietary assets across a greater number of markets, and at a lower marginal cost yield distinct benefit. Geographical dispersion is an effective strategy for risk dispersion (Kim, Hwang and Burgers, 1989). Covering a wider geographical market even within the country helps firms to spread the risk in the existing business and create new niches. In the face of heightened competition in the domestic market firms may prefer geographical expansion to foreign markets to diversification (Buhner, 1987). Earlier researchers (e.g., Delios and Beamish, 1999; Hitt, Hoskinsson, and Kim, 1997; Tallman and Li, 1996) found positive effect of geographical scope on firms' profitability. This strategy is likely to be favoured by stock investors, having a positive impact on stock prices. Hence it is proposed that:

Proposition 5: Geographical scope has direct positive relations with profitability as well as market performance.

Model Specification and Identification

The research model summarizing the propositions is presented in Figure 1. The research model has been tested with a sample of firms in India in LISREL 8 framework (Joreskog and Sorbom, 1993). The integrated structural equation model consists of ten observed variables corresponding to five latent corporate strategy variables. All these variables are capturing the extent of change that has taken place in each of the strategy dimensions during the post liberalization period. For example the observed variables for indicators of the latent construct scale of business are the change in scale of operation, organizational scale, number of employees and total assets.
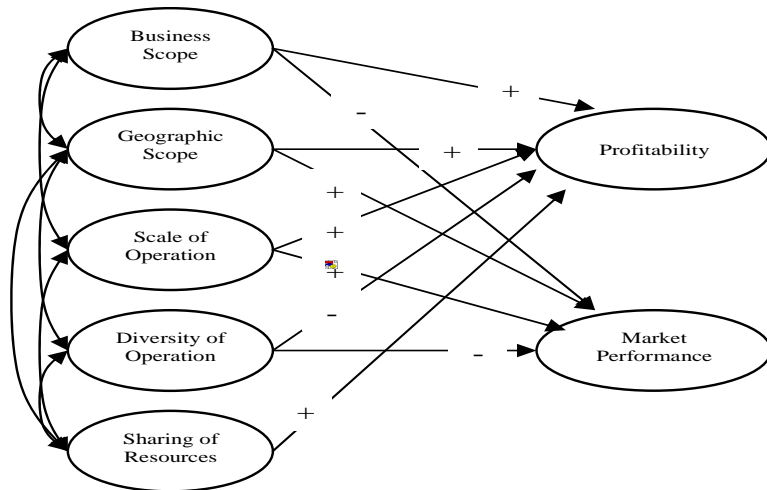

Fig. 1. Proposed Research Moded

Similarly, the change in domestic scope and international scope together constitute the latent construct change in geographical scope. Along with the change in product-market scope, as reported by firms, we have included an objective indicator, change in business line, to capture the latent construct change in business scope of firms. There is one observed variable each for diversity of operation and sharing of resources. All the observed variables that are derived from the survey data as reported by firms are the composite of multi-items scales with Cornbach Alpha ranging from 0.7 to 0.86. Three indicators of profitability performance used are return on sales, return on assets, and return on net worth. Indicator for market based measures of performance is the market return adjusted for market risk.

Methodology

The empirical verification of the model required systematic identification of the change in corporate strategies and recording of performance of firms. Required data for all strategy variables for Indian firms were not available from the secondary sources. So, a large sample survey design was adopted and primary data were collected through a structured questionnaire. These were verified wherever possible by information from the published documents and secondary sources such as Centre for Monitoring Indian Economy (CMIE) data base, Stock Exchange Directory, Business Magazines like Business World, Business Today, and Business India, and newspapers like The Economic Times, Business Standard, and Financial Express.

Survey Instrument Design

A list of items that correspond to various dimensions of corporate strategy was generated based on the exhaustive review of literature and interview with managers. The list was independ-

ently evaluated by the principal researcher and 5 others familiar with the literature in the field for face/ content validity. A survey instrument was prepared based on the final list of items. The survey instrument was pre-tested with 6 firms from the targeted population.

All the questions were sought to be answered on a seven point semantic rating scale as if they are interval data. The respondents were asked to indicate their preferences for strategy items by choosing one from seven options between "significantly increased" to "significantly decreased." It is expected that use of semantic scales for some variables may lead to certain measurement error, but in absence of readily quantifiable proxies this method serves our purpose quite well. The notion that judgements of knowledgeable respondents about variables is at least as likely to produce useful answers as quantitative estimates is well-accepted by researchers (Levin, 1988).

Data Collection and Sampling

State and privately owned firms that were listed in the major stock exchanges in India and also appeared in the list of top 500 firms as compiled by *The Economic Times* and *Business Standard,* comprised the primary population for the survey. The questionnaire and accompanying letters advised that only top level executives, i.e., either the chief executive officer himself or a very senior level executive should complete the questionnaire. This was to ensure that only those persons are familiar with the business environment in India for at least a decade and the issues of strategic importance to the firms would complete the questionnaires. As strategic decisions are taken based on the perception of the dominant coalition in a firm, it was assumed that response from a top level executive who is a part of the dominant coalition would be a good proxy. Though there are problems associated with this key informant approach (Philips, 1981; Huber and Power, 1985), it is an accepted norm in strategy research.

Table 1

Sample Characteristics

Variable	Mean	Std. Dev.	Min.	Max.
Net Sales (Rupees in million)	7923.09	16654.07	236.6	125261.6
Total Asset (Rupees in million)	9674.06	16242.57	258.1	85746.3
Net Worth (Rupees in million)	4359.87	1703.10	-215.01	43124.02
Net Profit (Rupees in million)	507.44	1475.32	-1147.5	9974.01
Number Of Employees	4252.36	6955.98	74	49739
No. Of Business Line	3.19	2.34	1	11
Age (Years)	40.95	26.26	10	143

Note: USD 1 = Rupees 48.00.

The survey was conducted in early 1997. After several reminder letters, personal visits, and telephone calls, 118 responses and 9 declines were received. Out of 118 responses, 111 were found to be usable making the effective response rate to be about 23%. This is much better in comparison to those of earlier studies in India and quite reasonable for such target population in any other contexts. This paper reports on the data from 111 firms. Table 1 presents the summary sample characteristics. The size of sampled firms in terms of net sales, net assets, and number of employees showed wide variations, reflecting a huge range of size. The sample also carried a good mix of state owned public sector enterprises, and privately owned both Indian and foreign firms. This mix is important because all three types of firms have significant contributions to total industrial output of India. A wide range of industries was also covered by the sample leaving little doubt about the representative nature of the sample.

We measured the profitability performance of firms as six years average between April 1993 and March 1999. Market performance was measured as the average market return adjusted for risk between April 1993 and March 1997. Profitability data from 1993 onwards and upto 1999 were taken to accommodate the lag effect of strategy on performance. Data on financial and mar-

ket performance were obtained from the electronic data base of the Centre of Monetary Indian Economy.

Analysis and Results

A nested model approach as suggested by Anderson and Gerbing (1988) has been followed to test hypotheses concerning the structural relationships among variables. The first model is the measurement model with the paths between observed variables and associated latent constructs freed and latent constructs allowed to correlate freely. After the measurement model the theoretical model, with all paths not specifically hypothesized to exist fixed to zero, has been fitted with the data. The latent strategy variables are also allowed to correlate. Initial model indicated a poor fit with the data. Following the suggestion by Joreskog and Sorbom (1993), an attempt was made in steps, after successive examination of the normalized residuals, semleaf plots, and modification indexes, to develop the best fitting model by deleting nonsignificant paths.

The overall fit of the final model to the data is respectable with GFI = 0.914 CFI = 0.972, IFI = 0.973 and NNFI = 0.961. The value in excess of 0.9 signifies a good data model fit (Mueller, 1996). The ratio of chi-square and degrees of freedom is also quite small. Moreover, RMSEA is 0.0444 and p value for test of close fit (RMSEA < 0.05) is nonsignificant (p = 0.585). The measurement model shows that all factors, loadings of latent variables on respective observed variables as specified are significant, values in all cases are higher than 0.4, and consistent between the measurement model and final model. The significant factor loadings are good evidence of convergent validity of the latent constructs. Maximum likelihood standardized estimates and t statistics of each of the significant structural parameters of the final model are summarized in Table 2.

Table 2

Estimates of Structural Paths of LISREL Model

Structural Path	Standardized Path Coefficient
Scale of Operation ---> Profitability	0.538 (3.552)
Scale of Operation ---> Market Performance	0.718 (1.756)
Business Scope ---> Profitability	0.230 (0.943)
Business Scope ---> Market Performance	- 0.539 (-1.345)
Geographical Scope ---> Profitability	-0.052 (-0.208)
Geographical Scope ---> Market Performance	0.206 (0.631)
Diversity of Operation ---> Profitability	-0.113 (- 0.575)
Diversity of Operation ---> Market Performance	-0.129 (- 0.538)
Sharing of Resources ---> Profitability	0.037 (0.271)

Note: Figure in bracket shows the corresponding t-value. t > 3 indicates statistical significance at p < 0.001, t > 2.59 indicates statistical significance at p < 0.01, and t > 1.645 indicates statistical significance at p < 0.1.

Discussion and Conclusion

It is observed that though there are relationships between all strategy and performance variables in the proposed direction, only paths connecting scale of business and both the performance variables are statistically significant. Though not significant, as hypothesized change in business scope is found to have a strong negative relationship with market performance. With significant positive impact on all performance indicators scale expansion seems to be the most effective strategic response in liberalized India. The increase in scale of operation was often associated with upgradation and modernization of manufacturing facilities. As a result, firms adopting scale expansion strategies not only had the scale advantage but also emerged out technologically more sophisticated to deliver better quality products to customers.

Change in diversity did not have any significant impact on performance. The general prescription that concentrating on core competencies and core businesses would yield superior performance did not find support. This implies that unrelated diversification *per se* might not be detrimental to firms at least in the short run. One must notice that underlying in the debate of non-focus conglomerate strategies of business groups in the emerging markets (Kakani and Ramachandran, 2001; Khanna and Pallepu, 1997) is the assumption that the role of corporate advantage in shaping the competitive advantage in the individual businesses is overbearingly high. Gaining access to industries and capital back up to gain a foothold in those industries may be more crucial than better management of the individual businesses. This assumption is justified in a less competitive market. However, when industries are highly competitive, which most Indian industries have been fast becoming, this crucial assumption will be challenged. At least the stock investors were wary of such moves by firms as observed from the significant negative influence of business scope on market return.

In a highly competitive market generalised corporate capabilities such as raising and allocating capital or relationship with regulators no longer add so much value that the company can perform in a large array of businesses even in the absence of a well-developed competitive advantage at the business level. Managers in the liberalized environment need to be selective in diversification moves. During initial years of economic reforms, the inefficiencies of managing unrelated businesses by diversified firms might be shielded by the presence of high growth and profit opportunities in a large number recently deregulated industries. Only a few public sector firms had prior experience and skills in those industries. Thus, all new entrants would get some time to exploit the growth and profit opportunities. However, eventually those firms, which can achieve the economic scale early by aggressively expanding the scale of operation, develop the required skills for the new businesses faster, and can extract some benefit of synergy from the existing business by transferring tangible and intangible resources, are likely to withstand the emerging competitive pressure and achieve sustained success.

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