

# International diversification:

A “quick fix” for pressures in company performance?

- Siah Hwee Ang

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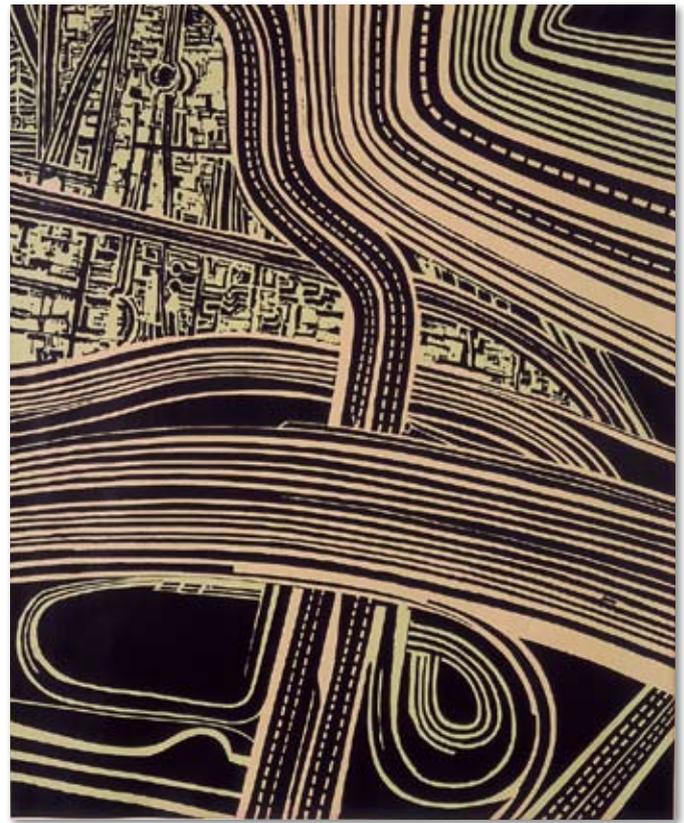
## A 'quick fix' for pressures in company performance?

International diversification as a response to poor performance may not be always effective

By Siah Hwee Ang

There is plenty of evidence to suggest that companies in some parts of the world are increasingly moving into foreign markets as part of their growth strategy<sup>1</sup>—a phenomenon that is closely linked to the effects of globalisation and the rising intensity of competition. Access to opportunities in foreign markets can overcome growth challenges, and might enhance a company's overall performance. In our own region, the remoteness and relative size of New Zealand and Australia's domestic markets often compound the challenge of growth, making it imperative even for larger and more established companies to diversify internationally. International diversification is the geographical breadth of a company's international presence.<sup>2</sup> It also provides an indication of a company's extent of dependence on foreign markets.<sup>3</sup>

Academically, various perspectives have been used to explain the phenomenon of international diversification. Theoretical foundations such as the portfolio investment theory,<sup>4</sup> various foreign direct investment theories,<sup>5</sup> and more recently, the resource-based view<sup>6</sup> all suggest that economies of scale and scope, learning, operational flexibility and stable profits<sup>7</sup> can be achieved through international diversification. However, despite the advantages that international diversification can provide, research suggests that offshore diversification does not always lead to better performance. The process often requires a company to absorb substantial costs resulting from



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any restructuring or the reorientation of resources, including issues like the resistance to change;<sup>8</sup> management challenges related to structural complexity; new administrative structures; increased information processing;<sup>9</sup> and the coordination, communications and motivation issues arising from cultural differences. Exchange rate fluctuations, inflation<sup>10</sup> and political uncertainty<sup>11</sup> may also bring unexpected costs, which can be substantial.

There are suggestions that staying focused has its benefits<sup>12</sup> and hence there should not be any performance difference between companies with differing degrees of international diversification. It is then not surprising to find that empirical research in the international diversification literature shows mixed evidence. While some studies have found a positive relationship,<sup>13</sup> others have found a negative association<sup>14</sup> between international diversification and performance. More recently, researchers have proposed that the relationship between international diversification and performance is non-linear and found this to appear in the form of U-shaped,<sup>15</sup> inverted-U shaped,<sup>16</sup> and S-shaped.<sup>17</sup> Most of this research has been conducted using large companies from more industrialised countries. In many, if not all of these studies, companies are implicitly assumed to have

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internationalised to maximize profits—and as the samples usually consist of large companies, the constraint to engage in international diversification activities is assumed away. In the context of New Zealand and Australia, even larger and more established companies are comparatively smaller in size than their counterparts from Europe, North America and even Asia. The smaller domestic markets necessitate the need for growth and put enormous pressures on performance. Given these conditions, the question is whether international diversification can serve as a 'quick fix' for better performance for New Zealand and Australian companies.

## Executive Brief

The remoteness and relative size of New Zealand and Australia's domestic markets often compound performance pressures, making it imperative for companies to diversify internationally. Using a sample of 152 listed companies in New Zealand and Australia, this study finds that those companies that have diversified beyond the Australasia region to a larger extent have actually performed better than those that diversify mainly regionally and those that do not diversify. In addition, the analyses also show that prior performance of a company is a key determinant of international diversification efforts, except in the case of regional international diversification. That is, poor performance constrains a company's ability to diversify internationally, except to neighbouring countries. These findings challenge the practices of using international diversification as a 'quick fix' for companies facing performance pressures and the effectiveness of diversifying into regional markets on the presumption of cultural and geographical proximity.

## IS PERFORMANCE A DRIVER OF INTERNATIONAL DIVERSIFICATION?

If international diversification allows companies to improve their performance, it is likely that they will engage in this strategy in order to capitalise on new opportunities. However, poor performing companies are likely to lack the accumulated resources necessary for internationalisation activities. Without further inducing debt, the internationalisation desire of poor performing companies is constrained by their ability to do so. It seems then that performance and international diversification will form a self-enhancing vicious circle. While most strong performing companies will continue to engage in appropriate levels of international diversification to enhance performance, most poor performing ones will be stuck in their current positions with the inability to diversify offshore. We also know that costs would increase with complexity and coordination as international diversification increases. When these costs escalate, the involvement in international activities will reduce as incremental costs exceed marginal benefits, making it unattractive to diversify indefinitely. These arguments point to a potential non-linear effect of a company's performance on its level of international diversification.

## ABOUT THE RESEARCH

The sample of this study includes manufacturing companies listed on the stock exchanges in New Zealand and Australia in year 2004. As multiple years of data are required for the analysis, only companies that had been listed since 2001 were included. New Zealand company information was collected from the Datex Company Information database while Australian company information was collected from the Aspect Equity Review database. These data sources were supplemented by the Datex Company Annual Report database and the Australian Stock Exchange website. For each company, data collected included key variables such as company profitability, sales, composition of sales by countries/regions, total liabilities, shareholder equity, the year of incorporation, market performance, and industry of participation. There were 152 companies in the final sample for analysis.

Following previous research,<sup>18</sup> the level of international diversification is measured by the proportion of sales generated outside the domestic market. Studies on location choice have suggested that companies that internationalise tend to narrow their choices initially to locations that are geographically and culturally closer to their home country.<sup>19</sup> Market familiarity presupposes relatively similar consumer tastes and distributions systems compared to culturally and/or geographically distant locations and hence the companies will better be able to leverage their competences in these locations. These suggest the importance of taking into consideration the geographical distribution of international diversification activities of companies.

This study further classifies a company's international diversification efforts into non-regional and regional international diversification. Regional international diversification occurs when a company generates revenue from Australasia (less home country), while non-regional international diversification refers to any internationalisation efforts beyond Australasia. In the sample of 152 companies, 75 have undertaken both non-regional and regional international diversification, 34 have undertaken only non-regional international diversification, 30 have undertaken only regional international diversification and 13 have no international diversification activity at all.

Performance is measured using net profit before abnormal items. This profitability measure eliminates one-off or non-recurring items and their tax effects. It gives a better indication of a company's long-term earnings trend. For prior performance, the average net profit before abnormal items in 2002 and 2003 is taken. Ten industry dummy control variables are included to control for industry differences in profitability (Automobile & Components, Capital Goods, Commercial Services & Supplies, Consumer Durables & Apparel, Food Beverage & Tobacco, Healthcare Equipment & Services, Materials, Pharmaceuticals & Biotech, Software & Services, and Technology Hardware & Equipment).

Several other control variables are also introduced for their effects on the international diversification-performance relationship. Company age is measured as the number of years

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a company has been in operation from its inception to 2004. More established companies would have accumulated more resources and knowledge that entice them to expand abroad. Relative market performance is the difference in percentage performance between a company's stock return and the overall stock market return. For example, if a company's stock return is 15 percent and the market return is 10 percent for a given period, then the relative market performance will be 5 percent. Market performance reflects the market's perception of the future prospects of a company and is measured by the average of relative market performance in 2002 and 2003.

International expansion is inherently risky and requires specific knowledge.

Organisational life cycle theory suggests that company growth progresses sequentially through major development stages and each stage is distinguished by a distinct set of dominant problems.<sup>20</sup> The underlying notion that sales growth is lower in a company's later stages than in the earlier stages of its organisational life cycle is well grounded theoretically and supported in organisational life cycle research.<sup>21</sup> Organisational life cycle is measured by the average sales growth in 2002 and 2003. The smaller the score, the later a company is in its organisational life cycle. Organisational slack is defined as the pool of resources in a company that is in excess of the minimum necessary to produce a given level of organisational output.<sup>22</sup> It is often the result of good performance<sup>23</sup> and arises from companies' tendencies to refrain from using all the resources available in order to buffer against uncertainty and/or facilitate initiatives.<sup>24</sup> Organisational slack is measured by the average of debt-to-equity ratio in 2002 and 2003 – the smaller the ratio, the greater the organisational slack.

In order to fully understand the effect of prior performance on international diversification, it is important to first investigate whether the international diversification efforts have been effective based on the current sample. If international diversification is found to have a positive impact on performance in the study sample, then we can draw greater inferences from the test of the extent of effect of company performance on international diversification.

Linear regression analyses were first conducted on the test of international diversification on company performance. The results (full table of results can be found on the UABR website) show that international diversification, and more specifically non-regional international diversification, has a positive effect on company performance. In addition, those companies with greater extent of non-regional international diversification as compared to regional international diversification also have better performance.

Next, analyses were done on the test of prior performance on international diversification, which will allow us to know the extent of constraint prior performance has on international diversification activities given that these have resulted in better performance in the current sample. The results show that prior performance does have a positive significant effect on

international diversification. While a non-linear effect of prior performance on non-regional international diversification is found (i.e. non-regional international diversification increases with better prior performance to a certain threshold to which this relationship will taper off), there is no relationship between prior performance and regional international diversification. Prior performance also has a non-linear relationship with the difference in international diversification (non-regional minus regional).

## DISCUSSION

Linking international diversification to company performance suggests that prior performance may be an important driver to diversifying internationally. In order to establish this link, the international diversification-performance relationship has been tested in this study, controlling for other factors such as company age, market performance, organisational life cycle, level of organisational slack, and industry of participation. These factors are a mix of push and pull factors for international diversification.

The results show that in general, international diversification has a positive relationship with performance, except in the case of regional international diversification. One would expect that companies that diversify internationally can reap economies of scale and scope as well as ownership advantages by operating in another location. However, expanding regionally does not necessarily lead to better performance. While ownership advantages and the proximity of regional markets may generate greater profitability, it is possible that the smaller markets in Australasia allow limited economies of scale and scope – and thus in fact limit profit potential.

The prior performance of a company is a key determinant of international diversification, except in the case of regional international diversification. Specifically, in the case of non-regional diversification, prior performance has an inverted-U relationship with international diversification. That is, the extent of international diversification increases as prior performance increases. However, beyond a threshold level of prior performance, the extent of international diversification actually decreases or tapers off. This result is similar to the effect on the difference between non-regional and regional international diversification. While poor performing companies would like to diversify internationally to boost performance, they probably lack the necessary resources. Poor performance constrains a company's ability to restructure its current system and adapt to new environments. However, if companies with strong prior performance tend to have more tendencies to diversify internationally, and that international diversification leads to better performance, then one might expect to see a bandwagon effect. Interestingly, this is not the case. International expansion is inherently risky and requires specific knowledge. The capacity of a company

Regional expansion may be a matter of survival rather than an attempt to increase profitability.



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to expand and absorb new experiences is limited, and the learning required to operate in a variety of foreign settings cannot be compressed in time.<sup>25</sup> Thus, as international diversification increases, costs escalate with increased structural complexity, and coordination and communications difficulties emerge. Therefore, companies with the highest level of performance may seek to exploit their current international diversification portfolio rather than continuing to diversify into new markets.

The finding that prior performance has no effect on the extent of regional international diversification challenges the fundamental premise of international diversification as a response to performance pressures. Regional expansion may be a matter of survival rather than an attempt to increase profitability. Regardless of a company's prior performance, it will have a greater extent of regional international diversification as it moves along its organisational life cycle. In any case, given the finding that better performance is achieved when a

company is diversifying beyond the region, it will be imperative to investigate the fundamental drivers of the levels of international diversification activities. This finding, incidentally, also challenges the incremental model of internationalisation that suggests that companies internationalise initially to similar markets or markets with geographical proximity.

## CONCLUSION

This study, like any other, has several limitations. As the sample includes only listed companies, the observations are biased towards larger companies. Related to this, as larger companies tend to engage in international diversification through both exporting and foreign direct investment and exporting is a cheaper way of international diversification more commonly used by smaller companies, caution should be taken with regards to implications for smaller companies. The generally larger size of sample companies also helps to

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segregate the test of size effects from performance effects on international diversification. Clearly, the inclusion of size as a variable is necessary in the test of international diversification for a sample with larger size variation. The study also does not take into account that some companies are more diversified than others in terms of product markets. Product diversification could have an effect on the level of international diversification as companies that are in more product markets may face greater competitive pressures in domestic markets and hence have more desire to diversify internationally.

Despite these limitations, this study has provided the support that international diversification strategy cannot be a “quick fix” for companies facing performance pressures. It also shows that in the course of international diversification, non-regional international diversification seems to provide better benefits than regional international diversification. This latter finding provides empirical support to New Zealand companies’ inability to perform well when diversifying into

Australia. In fact, as this study has shown, those companies that have diversified beyond the region have actually performed better.

Finally, from the research point of view, this study has incorporated both depth and breadth in the measurement of international diversification – which allows deeper understanding of the international diversification-performance relationship. Taking into consideration measurement issues that have previously resulted in diverse findings, it is important for future studies to work on more composite measures of international diversification. Related to this, the measurement for performance and sampling issues such as the choice of sample companies (large versus small, industrialised versus developing, multiple versus single industry) certainly need greater attention as these tend to influence the outcome of our observations. This will call for a greater need for replication studies<sup>26</sup> to reach some level of consensus that will aid future developments in this area of research.

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Table 1. Effects of International Diversification on Performance (N=152)

Variable	Model 1	Model 2	Model 3	Model 4
Constant	0.389 (0.872)	-0.722 (1.028)	-0.243 (1.045)	0.343 (0.853)
Company Age	0.351*** (0.014)	0.351*** (0.014)	0.339*** (0.014)	0.336*** (0.014)
Market Performance	-0.117 (0.009)	-0.107 (0.009)	-0.120 (0.008)	-0.126 (0.008)
Organisational Life Cycle	0.041 (0.170)	0.045 (0.168)	0.070 (0.169)	0.074 (0.169)
Organisational Slack	-0.018 (0.236)	-0.002 (0.235)	-0.001 (0.232)	-0.008 (0.231)
Automobile & Components	-0.027 (2.403)	-0.018 (2.381)	-0.011 (2.358)	-0.013 (2.356)
Capital Goods	-0.144 <sup>+</sup> (1.129)	-0.119 (1.129)	-0.134 (1.121)	-0.148 <sup>+</sup> (1.105)
Commercial Services & Supplies	-0.101 (1.467)	-0.063 (1.490)	-0.069 (1.475)	-0.087 (1.439)
Consumer Durables & Apparel	-0.100 (1.468)	-0.101 (1.452)	-0.107 (1.438)	-0.107 (1.437)
Food Beverage & Tobacco	-0.068 (1.476)	-0.056 (1.464)	-0.059 (1.449)	-0.065 (1.445)
Healthcare Eqpt & Services	-0.131 (1.379)	-0.133 (1.364)	-0.159 <sup>+</sup> (1.367)	-0.164* (1.364)
Pharmaceuticals & Biotech	-0.039 (1.998)	-0.059 (1.992)	-0.087 (2.002)	-0.084 (2.000)
Software & Services	-0.029 (2.398)	-0.019 (2.378)	-0.027 (2.355)	-0.033 (2.347)
Technology Hardware & Eqpt	-0.103 (1.830)	-0.118 (1.817)	-0.136 (1.807)	-0.133 (1.806)
International Diversification		0.163* (1.117)		
Non-regional International Diversification			0.220** (1.183)	
Regional International Diversification			-0.031 (1.829)	
Difference in International Diversification				0.214** (0.851)
Adjusted R-Squared	0.094(13)	0.113(14)	0.132(15)	0.132(14)
F-Statistic	2.210*	2.377**	2.533**	2.647**
Improvement over Baseline Model		3.914*	4.000*	7.137**

<sup>+</sup> p < 0.10; \* p < 0.05; \*\* p < 0.01; \*\*\* p < 0.001; standard errors are in parentheses

Table 2. Effects of Performance on International Diversification (N=152)

Variable	International Diversification		Difference in International Diversification		Non-regional International Diversification		Regional International Diversification	
	Model 1	Model 2	Model 3	Model 4	Model 5	Model 6	Model 7	Model 8
Constant	0.501*** (0.066)	0.483*** (0.065)	0.020 (0.085)	-0.012 (0.083)	0.260*** (0.064)	0.235*** (0.062)	0.240*** (0.041)	0.247*** (0.042)
Company Age	0.002 (0.001)	-0.111 (0.001)	0.069 (0.001)	-0.086 (0.002)	0.047 (0.001)	-0.113 (0.001)	-0.071 (0.001)	0.000 (0.001)
Market Performance	-0.058 (0.001)	-0.025 (0.001)	0.045 (0.001)	0.090 (0.001)	0.000 (0.001)	0.046 (0.001)	-0.095 (0.000)	-0.116 (0.000)
Organisational Life Cycle	-0.020 (0.013)	-0.036 (0.013)	-0.152 <sup>+</sup> (0.017)	-0.174* (0.016)	-0.110 (0.012)	-0.133 <sup>+</sup> (0.012)	0.144 <sup>+</sup> (0.008)	0.154 <sup>+</sup> (0.008)
Organisational Slack	-0.102 (0.018)	-0.094 (0.017)	-0.048 (0.023)	-0.037 (0.022)	-0.084 (0.017)	-0.072 (0.017)	-0.033 (0.011)	-0.038 (0.011)
Automobile & Components	-0.050 (0.181)	-0.039 (0.178)	-0.061 (0.235)	-0.045 (0.226)	-0.066 (0.176)	-0.050 (0.169)	0.023 (0.114)	0.016 (0.114)
Capital Goods	-0.154 <sup>+</sup> (0.085)	-0.102 (0.086)	0.018 (0.110)	0.090 (0.109)	-0.067 (0.083)	0.007 (0.081)	-0.146 (0.054)	-0.179 <sup>+</sup> (0.055)
Commercial Services & Supplies	-0.230** (0.111)	-0.201* (0.110)	-0.066 (0.144)	-0.026 (0.139)	-0.161 <sup>+</sup> (0.108)	-0.120 (0.104)	-0.119 (0.070)	-0.137 (0.070)
Consumer Durables & Apparel	0.009 (0.111)	0.042 (0.110)	0.036 (0.144)	0.081 (0.139)	0.028 (0.108)	0.075 (0.104)	-0.030 (0.070)	-0.051 (0.070)
Food Beverage & Tobacco	-0.073 (0.111)	-0.066 (0.110)	-0.018 (0.144)	-0.009 (0.139)	-0.049 (0.108)	-0.039 (0.104)	-0.041 (0.070)	-0.045 (0.070)
Healthcare Eqpt & Services	0.010 (0.104)	0.054 (0.104)	0.150 <sup>+</sup> (0.135)	0.212* (0.132)	0.104 (0.101)	0.167* (0.099)	-0.151 <sup>+</sup> (0.065)	-0.179* (0.067)
Pharmaceuticals & Biotech	0.121 (0.151)	0.137 <sup>+</sup> (0.148)	0.211* (0.196)	0.233** (0.188)	0.201** (0.147)	0.223** (0.140)	-0.124 (0.095)	-0.134 (0.095)
Software & Services	-0.062 (0.181)	-0.049 (0.178)	0.017 (0.235)	0.036 (0.226)	-0.020 (0.176)	-0.001 (0.168)	-0.069 (0.114)	-0.078 (0.114)
Technology Hardware & Eqpt	0.092 (0.138)	0.135 (0.138)	0.141 (0.179)	0.201* (0.175)	0.140 (0.134)	0.201* (0.130)	-0.074 (0.087)	-0.102 (0.088)
Prior Performance		0.566* (0.028)		0.787** (0.035)		0.807** (0.026)		-0.368 (0.018)
Prior Performance <sup>2</sup>		-0.369 (0.001)		-0.521* (0.001)		-0.531* (0.001)		0.247 (0.001)
Adjusted R-Squared	0.047(13)	0.081(15)	0.032(13)	0.109(15)	0.059(13)	0.141(15)	-0.017(13)	-0.013(15)
F-Statistic	1.571 <sup>+</sup>	1.888*	1.385	2.226**	1.727 <sup>+</sup>	2.656***	0.803	0.870
Improvement over Baseline Model		3.531*		6.944***		7.653***		1.342

<sup>+</sup> p < 0.10; \* p < 0.05; \*\* p < 0.01; \*\*\* p < 0.001; standard errors are in parentheses