On the Perils, Pitfalls, and Opportunities of Global Diversification: A High–Stakes Gamble?

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A company that recognizes its business as potentially global in nature must be willing to risk the heavy investment that global diversification can bring. To succeed, a firm must clearly understand what kind and level of resources–over how long a period–will be required to establish a presence in overseas markets.

There is considerable evidence that too many companies have undertaken diversification efforts without thoroughly understanding the complexities of the process. Biggadike [4] made this clear in his study of over 200 firms that had attempted diversification, and others have reported similar findings ([1],[2],[3],[4],[5],[6],[7],[8],[9],[10],[11],[12],[13],[14],[15],[16],[17]). From his study, Biggadike [4] concluded that companies contemplating diversification should be aware that:

- large scale market entry will substantially improve the probability of success;
- an emphasis on very rapid early gains in relative market share is the best way to reduce the length of time over which losses must be incurred;
- even in narrowly defined market segments small-scale entry significantly reduces the probability of success;
- one should back a diversification effort as long as it continues to build market share; and
- resources should be withdrawn from a profitable venture if profits have been gained at the cost of market share (i.e., a profitable diversification effort based on low or declining market share is destined to be tomorrow's dog).

The objective of this study was to apply Biggadike's [4] analytical approach to a sample of international diversification efforts in order to identify any parallels that might exist, and to operationalize these findings in terms of a prescriptive model of practical value to decision makers. As in Biggadike's study, no attempt was made to develop statistical inferences from the results because even though the data were

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collected in a standardized fashion, some diversifications were related, others were conglomerate in nature, and some did not fit neatly in a category. For example, does Exxon's Hong Kong electric utility constitute a related or conglomerate diversification? They say related, while a strict academic interpretation might suggest otherwise. In addition, significant scale differences were present, and, where some questions were concerned, respondents were free to exercise considerable discretion in answering. As an example, while "later phase of market and share development" was defined, it was left to the respondent to interpret "relative market share" given that firm's definition of its market(s). And, with respect to what constituted a "small," "medium," or "large" scale entry, respondents were given a description of each but were then left to decide where their diversification effort belonged. These insights are offered to assist the reader in judging the limitations of the study and its conclusions.

The Sample

Data for this study were drawn from a sample of 97 companies that have undertaken significant international product-market diversification efforts during the past 20 years. A significant international product market diversification effort was defined as:

> a product or market diversification involving the creation of at least a profit center in one or more foreign markets selling a distinct set of products or services to an identifiable target market where meaningful competition exists and where capital has been put at risk.

Under this definition, gaining entry to a foreign market by simply selling through a broker or manufacturer's representative would not constitute a "significant" product–market diversification because no direct foreign investment has taken place. Correspondingly, a firm that creates an offshore production facility, the output from which it imports for use in manufacturing a finished good, would not satisfy the "profit center" or "meaningful competition" criteria. Corporate acquisitions were included only if the venture represented a significant international product–market diversification for the acquiring firm. As an example, Unilever's acquisition of National Starch was included because it represented both product and market diversification for Unilever, direct foreign investment was involved, a profit center was created, a distinct set of products was being sold to identifiable target markets, and meaningful competition was present. On the other hand, 3M's acquisition of Ferrania was not included because it was undertaken to acquire technology to improve its own film products which it was already marketing worldwide.

Firms receiving questionnaires were identified through a review of the trade literature (*The National Review of Corporate Acquisitions*, *Wall Street Journal*, *Business Week*, *The Financial Times*, The European Edition of the *Wall Street Journal*, *Forbes*, the Asian Edition of the *Wall Street Journal*, and others) as having undertaken foreign diversification. In some instances these turned out to be fairly recent diversification efforts but others represented investments extending back nearly 20 years. A wide range of experience was represented with respect to time of operation, financial performance, stage of market development, market versus financial performance, market shares, scale of operation, and scale of market entry. Because this was a convenience sample, no attempt was made to extrapolate the results to a broader population. Furthermore, no effort was made to correlate performance with geographical markets or to identify what might constitute a successful diversification.

Financial Performance

As a group, sample firms experienced significant losses for at least the first four to five years, some even longer. Selected measures of financial performance are presented in Table 1. Clearly, the first six years was a period of marginal performance for most of the sample firms.

Table 1
Median Financial Performance During the First Six Years

	Years		
Financial Ratios	1–2	3–4	5–6
Gross Margin	21	30	33
Operating Margin	–31	–13	– 3
ROI	–36	–17	– 5
DNCF/Investment[a]	–48	–26	–14

[a]DNCF (Discretionary net cash flow)= Net income plus all non-cash expenditures minus capital expenditures necessary to maintain the investment and required debt retirement.

Not all diversification efforts resulted in losses. In fact, 27 of the sample firms recorded profits during the first two years of operation. However, eight of these later lost money, suggesting that early success is no guarantee of ongoing profitability. Holding market share appeared to be an important determinant of longer term success.

In general, sample firms found that "going international" is apt to result in prolonged negative cash flows. None of the diversification efforts generated a positive discretionary net cash flow during the first six years.

Gross profit was the most encouraging area of financial performance. Even here, however, marginal gains in gross returns during years five and six remained quite modest. This was also true of operating expenses. Most operating expenses declined as a percent of sales over the first six years, but at a diminishing rate. And these gains came not as a consequence of reduced spending, but from rapid growth in sales. The median rate of growth in sales for the period was 37 percent.

Once again, being able to grow market share, as opposed to simply increasing revenue through higher prices, appeared to be of critical importance for sample firms achieving long-term success. And any firm that undertakes an international diversification effort anticipating significant gains once "start-up" capital and operating outlays are covered may be surprised. Results obtained here would suggest the possibility of significant losses for an extended period. For the firm that is unable to quickly achieve a major improvement in sales, high operating expenses and capital requirements as a percent of sales are apt to lead to a permanently weakened competitive position.

Taking losses for a period of time in association with any new venture is not unusual. Consequently, knowing for how long and being able to anticipate the rate of improvement in performance are certainly important considerations. In exploring these issues the sample was arrayed on a time series basis and examined during the "early," "intermediate," and "later" phases of market development. More recent diversification efforts were categorized based on years of experience and unsuccessful efforts were tracked until they failed. Table 2 presents these results.

Table 2
Median Performance in Early, Intermediate, and Late Phases of Market Development

Financial Ratios	Early Phase		Intermediate Phase		Later Phase
	Years 1-2	Years 3-4	Years 5-6	Years 7-8	Years 9-10
Gross Margin	21	30	33	34	43
Operating Margin	-31	-13	-3	2	13
ROI	-36	-17	-5	7	21
DNCF/Investment	-48	-26	-14	1	7

The message conveyed here is that, for the firms in the sample, significant international product market diversification efforts required an average of seven to eight years to achieve profitability. Given this result, it would appear that international diversification may not be for the impatient or for those lacking "deep pockets." Under such circumstances a firm with extraordinary patience and a long term strategic orientation, unencumbered by concerns about annual returns to stockholders, and with a surplus of low cost capital would seem to have a distinct competitive advantage. It is probably not coincidence that these qualities characterize many Japanese multinationals.

There is considerable "real world" evidence that, over time a strong positive correlation exists between relative market share, ROI and cash flow from operations (i.e., the PIMS study). And while building market share may compromise financial performance, long term returns to growth through expanded relative market share appear to make such compromises worthwhile.

To examine the impact of market share on financial performance the sample was divided into three groups arbitrarily defined as "low," "medium," and "high" relative market share diversification efforts. Table 3 presents the results of a comparison of such efforts for the first two years and for second two years of the diversification.

Table 3
A Comparison of Relative Market Share and Financial Performance

Financial Ratios	RMS Years 1 and 2 (below 10%)	RMS Years 1 and 2 (10%-50%)	RMS Years 1 and 2 (over 50%)	RMS Years 3 and 4 (below 10%)	RMS Years 3 and 4 (10%-50%)	RMS Years 3 and 4 (over 50%)
Gross Margin	19	23	28	18	25	36
Operating Margin	–56	–29	–19	–41	–21	–15
ROI	–68	–30	–22	–39	–15	–8
DNCF/Investment	–81	–47	–31	–60	–25	–12

Sample firms experienced a positive relationship between market share and financial performance both initially and over time. Overall, these results seem to support the contention that market share is worth spending for given that management is strategically inclined and willing to live for some time with significant negative cash flows.

Here an important distinction must be made between having market share and growing market share. In general, having market share seemed to constitute a competitive advantage but having to grow market share from a low market share position appeared to compromise financial performance. Table 4 looks at the financial consequences of having to grow market share over the first four years of an international diversification effort.

Table 4
The Financial Cost of Growing Relative Market Share

Financial Ratios	Growth in Relative Market Share: Rapid	Moderate	Slow
Gross Margin	20	31	38
Operating Margin	–37	–13	–3
ROI	–41	–20	–7
DNCF/Investment	–63	–33	–23

These results indicate that management, intent on rapidly building market share, may have to pay a handsome premium in terms of financial performance. In particular, the impact on discretionary cash flow is apt to be especially burdensome. This would seem to auger well for those firms able to readily draw cash from other SBUs within their corporate portfolios.

It appears that the scramble for market share during the early years of an international diversification effort can have a deleterious impact on financial performance. What is less clear are the relative benefits that might obtain for those competitors that, if necessary, are willing and able to sustain significant losses to capture and hold market share on a long term basis. Table 5 looks at financial performance among low, medium, and high market share companies in years nine and ten, defined here as the "later phase" in terms of market and share development.

Table 5
Relative Market Share and Financial Performance in the "Later Phase" of Market and Share Development

	Relative Market Share		
Financial Ratios	Low	Medium	High
Gross Margin	37	42	51
Operating Margin	12	15	21
ROI	17	23	31
DNCF/Investment	5	11	20

For sample firms, high relative market share, while costly to achieve, was well worth the sacrifice. If this is true, the implication is clear: Capturing market share is important and the earlier the better. Growing market share can be a very costly proposition, especially when trying to work up from a low market share position against entrenched competition.

In order to further explore the importance of scale of entry, the financial performance of small, medium, and large scale entrants was examined. The sample was grouped according to entry level strategies which were defined as follows: (1) *small scale entry*: limited investment, limited financial risk, grow over time, (2) *medium scale entry*: moderate investment, moderate financial risk, grow over time, (3) *large scale entry*: required level of investment, required financial risk, quickly capture and hold dominant market share. Table 6 correlates financial performance with entry level strategies for the first two years.

Table 6
Scale of Entry and Financial Performance

	Scale of Entry		
Financial Ratios	Small Scale	Medium Scale	Large Scale
Gross Margin	20	21	37
Operating Margin	–51	–35	–17
ROI	–61	–33	–19
DNCF/Investment	–73	–51	–30

A strategy based on a small scale of entry would appear to be suboptimal. Furthermore, when one reflects on the "financial cost" of growing market share, an aggressive entry strategy would seem to represent the best alternative, at least in most instances.

Strategic Implications

For a company committed to undertaking a successful international product-market diversification effort, the experience of firms in this study may be of interest.

While some firms experience immediate profits, most incurred significant losses for up to six or seven years. Also, large negative cash flows obtained and firms unable to draw on other sources of financing to grow market share were at a distinct competitive disadvantage.

With respect to market share, clear advantages in financial performance generally resulted for those companies able to capture and hold high relative market shares. While there were exceptions, the high relative market share companies in this study generally outperformed low share companies in each phase of market development. However, high relative market share did not assure profitability. Rather, it was one means to that end.

In terms of market entry, the probability of a successful international product market diversification effort would appear to be substantially enhanced by following a large scale market entry strategy. Sample firms that took a less aggressive approach experienced compromised financial performance and faced the costly process of growing market share.

In short, much of what Biggadike [4] suggested as characteristic of domestic diversification efforts would seem to characterize the international diversification efforts examined in this study. Based on these results, the firm interested in formulating and implementing an optimal international diversification strategy should be prepared to sustain losses for up to eight years, focus on achieving a dominant relative market share as early as possible, and avoid having to grow market share over time by putting resources "up front" to achieve a large scale market entry. Furthermore, today's profitable diversification effort with a low or declining market share has the potential to become tomorrow's dog.

Global diversification is indeed a high-stakes gamble but one that many companies have taken with considerable success. What this study has attempted to offer is anecdotal evidence to demonstrate that there may be a right way to go about diversifying internationally.

The limitations of this study are clear, however, and this is an area of research with great potential for further investigation of a more rigorous nature. Also, it is an area of real interest to practitioners and one where scholars can have a meaningful impact.

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