

Relational Determinants of Firm Diversifications

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Abstract

In this paper, I apply a social network perspective to the study of firm diversification. Under the assumption that firms depend on the relationships with other firms to reduce the uncertainty of market response, I suggest that relational attributes affect the way in which firms diversify. After providing a review of literature on the type of firm diversification, I propose that strong ties and structurally equivalent relationships facilitate both related and unrelated diversification. I also propose that weak ties accentuate related diversification, but they do not lead unrelated diversification. Finally I discuss implications for future research. Keywords: firm diversification, social network, strong tie, weak tie, structural equivalent, uncertainty

Introduction

The determinants of the type of firm diversification have been of important concern to strategic management researchers. Much of the recent research has focused on around five major perspectives, namely, resource based view, transaction cost theory, internal structure of firm, environmental factors, and social network perspective. Prior studies have widely taken a neoclassical economics approach that does not assume the existence of uncertainty or a neoinstitutional approach that accepts uncertainty and regards hierarchy as a mechanism to control uncertainty. The viewpoint of neoinstitutional economics is much like that of neoclassical economics in that it acknowledges that firms can overcome the challenges of uncertainty.

Once firms confronted with market uncertainty decide to diversify, on which criteria do they make a decision related to the type of diversification? To what extent do they trust their own judgment and do they really alleviate egocentric uncertainty – a focal actor's uncertainty regarding how inputs are changed into output (Podolny, 2001) - by themselves?

As a part of an effort to illuminate how firms behave when market responses are ambiguous, White (1981) argued that firms observe other firms to define their strategic position. In other words, firms depend on social referents rather than their own preference, since uncertainty makes the assessment of cause-effect relationships difficult. Similarly, the social network perspective emphasizes relations and structure which emerges from the patterns of interactions. The social network perspective focuses on relations among interacting firms, while other perspectives in diversification literature put their emphasis on the behavior of the focal firms. This is marked difference between the social network perspective and other perspectives. Although a number of studies taking a network perspective in the prior study of strategic management have emphasized the role of relational attributes in determining the type of diversification, limited attention has been devoted to exploring how particular relationships affect particular diversification patterns.

In the current study, I seek to complement limitations of existing research on firm diversification. I argue that firms have the inherent uncertainty of market and hence rely on the social network in which they are embedded to attenuate uncertainty. Specifically, I propose that relational attributes of firms significantly affect the way in which they diversify. To explain the role of relational attributes in the process of determining the type of firm diversification, I introduce three types of relations that are likely to influence firms' strategic decision making. Overall, this article extends prior research by providing a proper theoretical understanding of the effects of relational attributes.

Theoretical Development of firm diversification

Scholars have offered various models of the type of firm diversification (e. g., Chatterjee & Wernerfelt, 1991; Hill & Hoskisson, 1987; Lane, Cannell, & Lubatkin, 1998; Hong & Hwang, 1997; Chang & Park, 2005). These models attempt to account for the factors that impact firms' diversification strategy. Of these models, one of the most extensively researched is resource based view. In resource based view, resources a firm possesses are a critical factor in determining the type of diversification, since the firm diversifies to obtain competitive advantage which depends on the firm's specific resources. On the basis of this approach, Gorecki (1975) stressed the importance of specific asset of value in determining diversification. He argued that firms choose to enter industries where they can minimize transfer costs which arise, because entering new industries requires the asset to be modified or adapted. Thus, it stands to reason that related diversification adds value to firm possessing industry-specific resources. Chatterjee and Wernerfelt (1991), more specifically, suggested that both physical resources and intangible assets relatively inflexible lead to related diversification by decreasing transfer costs and increasing competitive advantage. They also proposed that firms with high leverage pursue relatively stable strategy (related

diversification) whereas firms with high internal funds attempt prospective but risky strategy (unrelated diversification). Consistent with above arguments, a number of studies have explored the link between resources, such as platform technology and dynamic capability, and diversification (e.g., Doving & Gooderham, 2008; Kim & Kogut, 1996).

Another highly insightful view on firm diversification is transaction cost theory. According to transaction cost theory, firms take strategic actions to reduce costs from transaction inefficiencies (Williamson, 1975). This perspective suggests that synergistic economy is associated with related diversification, because this strategic action removes opportunistic behavior of partner and simultaneously encourages joint activities, while financial economies can be accomplished by unrelated diversification because of its opportunity to apply portfolio management using internal capital markets (Hill & Hoskisson, 1987). Jones and Hill (1988) further included managerial costs as a critical factor in considering diversification. They suggest that because diversification both reduces transaction costs and increase managerial costs, firms should consider bureaucratic costs with various benefits of diversification. Integrating resource based view and transaction cost theory, Silverman (1999) explicitly contended that although a firm has excess resources, in the case that contractual hazards - low possibility of licensing its technological resources, high need for secrecy of resources, and high degree of tacit knowledge related with resources - are high, diversification is less likely to occur.

Rather than focusing on resource based view or transaction cost theory, Amihud and Lev (1981) examined the internal structure of firm in relation to diversification. They found that managers engage in unrelated diversification in an effort to reduce risk, even when this is contrary to the interests of shareholders. However, there are competing arguments about the effect of ownership structure on diversification (Amihud & Lev, 1999; Lane, Cannella, & Lubatkin, 1998).

Industrial structure approach has also answered the question which factors are associated with the type of firm diversification (Gorecki, 1975). Hong and Hwang (1999) suggested that unrelated diversification is more common at where industry attractiveness, such as growth rate, entry barrier, concentration ration, is low. Furthermore, these industry characteristics are widely believed to relate to firm diversification by most of strategic management scholars.

Recently, researchers have conducted several studies suggesting that social network may influence the extent to which firms diversify and the type of firm diversification. What decisively marks off the social network perspective from prior studies which take a neoclassical economics theory and a neoinstitutional economics theory as the foundations of their theories is a viewpoint on uncertainty. In contrast to the neoclassical economics approach that focuses on the ideal types of the perfect market, the social network perspective assumes the existence of uncertainty. Although the neoinstitutional economics approach

acknowledges uncertainty, there is a significant disparity between the social network perspective and the neoinstitutional economics approach in a way of coping with uncertainty. The social network perspective, more exactly, suggests that actors rely on relationships with partners and the structure in which they are embedded while the neoinstitutional economics approach regard hierarchy as a mechanism to reduce uncertainty (Granovetter, 1985).

A number of studies on the diversification are driven by this insight of the social network theory. For instance, some researchers found that network externalities – represented by previous experience by other firms in the same business group, same industry, or same home-country industry – are strongly related to multinational diversification (Chang & Park, 2005; Guillen, 2002). Further, Kock and Guillen (2001) proposed that entrepreneurs' diverse contacts affect pursuing unrelated diversification, since diverse contacts are not necessarily function in the form of certain industry specific. These social capitals - not only network externalities and entrepreneurs' contacts but other types of social network based resources, such as reputation, legitimacy, and status - could be built through strategic alliances (Ireland, Hitt, & Vaidyanath, 2002; Stuart, 2000).

However, although a social network perspective has made significant contribution to the firm diversification literature, there is a limitation that they mainly emphasize the overall link between social network and diversification. For this reason, more attention should be devoted to exploring how particular relationships as reference points for determining the type of diversification affect particular diversification patterns. According to White (1981), firms coping with market uncertainty depend on other firms' behavior to attenuate uncertainty and to decide their strategic positioning. A social network perspective also suggests that actors are influenced by other actors in their social networks. Findings from social network studies have demonstrated that both structural equivalence which reflects the similarity of structural position and cohesion which could be conceptualized as the strength of tie are meaningful social referents in the terms of social comparison theory and social information processing theory (Burt, 1987; Coleman, Katz, & Menzel, 1966; Ferrin, Dirks, & Shah, 2006; Kilduff & Oh, 2006; Shah, 1998). By explaining the role of these relational attributes of social referents, I attempt to outline an alternative view to the determinants of the type of firm diversification.

Relational Determinants of Firm Diversifications

Strong Tie

The strength of tie is one of the most attracted concepts used to estimate the extent of social interaction (Granovetter, 1973). Strong ties include relatively high frequency of interaction and emotional intimacy through which social support and trust are built and sustained (Krackhardt, 1992). Strong relationship enhances the receptiveness to asymmetric exchange, since it produces long-term expectation through trust and reciprocity (Lin, Ensel,

& Vaghn, 1981). Because strong ties are associated with similarity of attitude, value, and behavior, actors strongly linked tend to imitate each other (Brass, Butterfield, & Skaggs, 1998).

With the problems of willingness and ability in knowledge transfer (Hansen, 1999), strong ties have further importance. Sources may be unwilling to share their knowledge with others, because knowledge transfer involves the loss of power, time and energy consumption, and lack incentives (Porter, 1985). Recipients are also likely to be reluctant to accept information from out-group in their trust network. In addition, complex and tacit knowledge is difficult to transfer, because it requires consistent two-way interaction for articulated explanation (Hansen, 1999). Given that strong ties facilitate trust, emotional support, and continuous two-way interaction, however, actors in strong relationship will participate in sharing not only one's own information but also tacit knowledge.

Firm diversification is supposed to impact firm performance and survival. Thus, the knowledge and experience of diversification will be hardly transferred. However, strong and high frequent alliance relationship may help the flow of knowledge necessary for the successful diversification. Effective alliance partnerships are characterized by mutual interdependence and trust-based relationship (Ireland, Hitt, & Vaidyanath, 2002), which means that firms in strong alliance relationship have built knowledge structures and work systems for knowledge sharing. To put it differently, intimate alliances increase the probability of willingness and ability to transfer the knowledge for diversification success. These arguments suggest that firms' experience in diversification will be related with diversification of other firms in strong alliance partnerships.

Proposition 1a. A firm's experience in related diversification will positively affect the tendency with which strongly allied firms pursue related diversification.

Proposition 1b. A firm's experience in unrelated diversification will positively affect the tendency with which it's strongly allied firms pursue unrelated diversification.

Weak Tie

In contrast to strong ties, weak ties involve low frequency of interaction and emotional attachment, which leads to relatively low interdependence, trust, and similarity of attitude, value, and behavior (Granovetter, 1982). However, weak ties may have diverse contacts and low degree of constraint on behavior, since they are likely to have nonredundant relationships (Granovetter, 1973). This nonredundancy may improve the opportunities to access diverse information, which can, in turn, provide benefits of getting novel knowledge (Perry-Smith, 2006). Furthermore, considering that weak ties have potential to connect otherwise separated actors, actors who have many weak ties could enjoy the benefit of structural holes which derive from the brokerage roles of getting more diverse information and controlling the flow of information (Burt, 1992).

Although weak ties are helpful for diverse information search, they may also constrain the transfer of complex information and tacit knowledge (Hansen, 1999). To put it differently, weak ties may cause unwillingness to share knowledge because of low level of reciprocity and trust, and do not foster ability to transfer noncodified knowledge because of low level of knowledge structures and work systems for knowledge sharing.

Since firms in weak alliance relationship are not deeply interdependent and do not have both willingness and ability for knowledge transfer, a firm's experience in diversification is not expected to affect weakly allied firms' diversification. However, firms pursuing related diversification may face relatively little market uncertainty, because they attempt to diversify into more familiar market than firms pursuing unrelated diversification. Therefore, it is assumed that when a firm expands into related industry, it can predict market responses without deep interaction with firms in weak relationship. Weak ties do not provide willingness and ability for successful execution of diversification strategy, but they provide diverse information associated with diversification. Accordingly, a firm's related diversification may influence related diversification of weakly tied firms' whereas a firm's unrelated diversification may not.

Proposition 2a. A firm's experience in related diversification will positively affect the tendency with which weakly allied firms pursue related diversification.

Proposition 2b. A firm's experience in unrelated diversification will not affect the tendency with which it's strongly allied firms pursue unrelated diversification.

Structural Equivalence

Some actors in social network are categorized into similar group based on patterns of interaction. When two actors are tied to same actors, they are considered to be structurally equivalent (Lorrain & White, 1971). That is, the relationship between two actors is defined by the interaction with common third parties, not by direct tie between them. Structurally equivalent actors may perceive each other as similar, and refer to each other's behavior. Similar behavior of structurally equivalent actors could be explained by two processes: contagion and competition. Similar interaction patterns may contribute to building similar networks, which, in turn, influence perceptions, attitudes, and behaviors (Brass, 1985). Krackhardt and Porter (1986) found that employees were more likely to quit their job, when structurally similar coworkers leave. This "misery loves company effect" comes from the role similarity which leads people to regard more similar coworker's behavior as relevant. Structurally equivalent actors may view each other as competitors, since they conform to the same target and resources. Burt (1987), in the same vein, contended that the diffusion of medical innovation is driven by structural equivalence, which means individuals are motivated by competition.

Structurally equivalent firms in alliance networks are supposed to develop similar strategy by the contagion effects of structural equivalence. A firm's diversification is therefore influenced by those with whom it shares common alliance. As related diversification provides strategic advantage to firms and promotes industry competition related to other firms' survival and performance, a firm's related diversification probably stimulate rival firms to pursue the same type of diversification. Although unrelated diversification has no direct impact on market competition and rival firm's performance, strategic decision making for unrelated diversification of a firm could be equal potential to structurally equivalent firms, because they have similar network which provide same opportunities and constraint. Consequently, structurally similar firms may simultaneously pursue firm diversification.

Proposition 3a. A firm's experience in related diversification will positively affect the tendency with which structurally equivalent firms pursue related diversification.

Proposition 3b. A firm's experience in unrelated diversification will positively affect the tendency with which it's structurally equivalent firms pursue unrelated diversification.

Conclusion and Future Direction

This study contributes to the present understanding of firm diversification by demonstrating the causal process in which relational attributes influence the type of diversification. Sharing the assumption of economic sociology that firms depend on the relationships with other firms to reduce the uncertainty of market response, I argue that relational attributes affect the way in which firms diversify. By applying social network perspective, I suggest that strong ties and structurally equivalent relationships facilitate both related and unrelated diversification. I also propose that weak ties promote related diversification but they do not lead unrelated diversification.

Although this study focuses on relational attributes of firm, other network characteristics could be brought to bear on the questions of why firms diversify. The social network perspective emphasizes not only relations but also structure in which actors are embedded. In social network studies researchers have argued the importance of structural position and network closure (Coleman, 1988). Firms occupying central position have benefits to access to important information and to control flow of information, which help firms identify and response to potential threats and opportunities (Powell, Kopt, & Smith-Doerr, 1996; Zaheer & Bell, 2005). Network closure - the degree to which actors are interconnected - also provides firms opportunities to reduce the possibilities of mutual destructive competition and miscommunication by fostering trust and reciprocity norm (Ahuja, 2000; Dyer & Nobeoka, 2000). Given the link between structural characteristics and

firms' motivation for strategic action, it is appropriate to study network position and network closure as distinct predictors of firm diversification. Thus, network position and network closure may help to closer look at the effects of firms' relational attributes on determining the type of diversification.

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