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IDENTIFYING THE IMPACT OF DIVERSIFICATION ON THE RELATIONSHIP BETWEEN PROFITABILITY AND ASSET MANAGEMENT EFFICIENCY OF ITC LTD IN THE PRE- AND POST-DIVERSIFICATION PERIODS

Dr. Surovi Gupta[1]

[1]*Assistant Professor, Department of Commerce, Asansol Girls' College, Asansol-713304, Burdwan, West Bengal, India*

Dr. Debasish Sur[2]

[2]*Professor, Department of Commerce, The University of Burdwan, Burdwan- 713104, West Bengal, India*

ABSTRACT

Diversification is a buzzing word in the present business world. It is the strategy for growth where a business ventures into new product line and or markets. A survey of literature on this issue shows that this strategy along with its effects has been explored by many researchers, but very little work has been done on Indian context. In India, ITC Ltd can be recognized as one of the biggest and most successful conglomerate, whose diversification has been a prime strategy of growth. In the present study, a modest attempt was made to make a comparative analysis of the impact of diversification strategy on the association between profit earning capability of ITC Ltd with its asset management efficiency in the pre and post-diversification periods. The period of study considered here was from 1994-95 to 2013-14, which was segregated into pre-diversification and post-diversification period.

KEYWORDS: *Diversification, Profitability, Asset Management Efficiency.*

INTRODUCTION

In an ever changing environment where we struggle to survive and grow, dynamism is an essentiality. Business activities are no exception to this generalization. As business is much influenced and affected both by the internal and the external environment where it is embedded it has to be dynamic in its functioning. The worldwide wave of globalization started since the last quarter of the twentieth century changed completely the micro and macro environment in and around the business establishments vis-à-vis the central economy which forced the political masters, economic planners, policymakers, business entrepreneurs and their associates to look for different route of business practices to attain economic efficiency and to contribute to social equity. The paradigm shift from state-controlled subsidized economy to market-dominated open economy took place as a natural corollary to the worldwide wave of privatization, liberalization and globalization. Callous competition came into being and in particular, since the last two decades it becomes so stiff for the business ventures that without adopting "strategic planning" vis-à-vis "strategic management" it becomes even hard to survive and to achieve break even economic targets. Firm's survival is dependent upon its ability to adapt successfully to the changing environment and strategic planning is one tool to manage such turbulence (Ringbakk, 1975). Strategy, in this context, refers to the framework, techniques and plans used by the managers to eliminate competitive threats or to exploit opportunities in order to increase organizational wealth and security. While strategic management is the process through which managers ensure the long-term adaptation of their firm to its environment (Miles & Snow, 1978,Miles, 1982). To be noted that every company passes through five stages in its life, which are emergence, growth, maturity, regeneration and decline (James, 1973). If a company wants to delay the last phase one has to adapt growth strategy otherwise it cannot survive in today's cut-throat competition. A company that fails to grow will be driven out of the market by the overactive new entrants. A growing company enjoys certain advantages like economies of large-scale operation, government concessions, shareholders cooperation and creditors support. Growth also motivates managers who are achievement seekers and it also provides satisfaction to the employees by way of opening promotional avenues. A company also acquires prestige in the society while growing. Growth thus provides multi-dimensional evolution. Diversification is one out of many growth strategies.

Defining Diversification

The term 'diverse' means various and hence, it can be said that 'diversification' refers to variety. Variety indicates different, discrete, separate etc. Different authors have defined diversification in their own ways. Ansoff (1957, 1965) defined 'diversification' as the entry of firms into new markets with new products. Rumelt (1974) stated that "Diversification move is an entry into new product market activity that requires or implies an appreciable increase in the available managerial competence within the firm". Diversification, in fact, is the extent to which firms operate in different business simultaneously (Pitts and Hopkins, 1982). It represents an increase in the number of industries in which the firm operates (Berry C.,1975). However, a very comprehensive definition is given by Booz, et.al (1985) which includes the objectives, the direction as well as the means to achieve the diversification. To them, diversification as a means of spreading the base of a business to achieve growth and reduce overall risk by including all investments except those supporting the competitiveness of the existing business directly. Further, they stated, diversification can be in the form of any investment in relation to new product or products, services, customer segments or geographic markets. Besides this, the task of diversification can be achieved by any of the methods including internal development, acquisitions, joint ventures, licensing agreement etc.

SURVEY OF EXISTING LITERATURE

Before starting discussion on the issue addressed in the present study, let us get familiar with a few studies conducted on the concerned issue.

Lee and Jang (2007) while conducting their study chose a sample of 36 publicly traded companies to analyse the difference in financial performance and stability between market-diversified and undiversified hotel companies. The study revealed that diversification did not improve profitability but partially improved the stability of performance. The authors concluded that market diversification was not a method of improving financial performance

In a study by **Lee & Hall, (2010)** attempt was made to analyze the combining effect of both product diversification and international diversification on firm performance from globalization point of view by considering a cross cultural sample of 186 firms across US, Japan and EEC. The researchers came up with the conclusion that there existed a non-linear relationship between product and international diversification and firm performance. However the direction of curvilinearity varied with different types of diversification and performance measures used. Although results using product diversification revealed a U-shaped curve but the direction of linearity was reversed. Normal U-shaped curves did not reveal an optimal level of product diversification (high & low levels of product diversification) both showed higher levels of performance when ROA was used as performance indicator.

Oyedijo (2012) examined the performance of a sample of 48 companies of Nigeria segregated into 18 specialized, 13 related and 17 unrelated firms ,using four financial performance ratios i.e. ROE, ROA, Sales growth and profit margin. Panel Data Regression Analysis was used to analyse the combined data set for five years (2006-2010). From the results he concluded that the financial performance and growth of sales in Nigerian companies were influenced by the mode of diversification. It was inferred that firms that stuck to their core business performed better and grew faster. Overall, Firms following specialization and related diversification out performed firms following unrelated and mixed diversification strategy, in a growing economy like Nigeria.

Another study with Nigerian manufacturing firms, by **Patrick (2012)** reflected the impact of product diversification on their performance during the period

2006 to 2010. The results revealed that increase in size resulted in product diversification by manufacturing firms. It was found that diversified firms had a higher ROA. Ownership structure was found to be negatively but significantly related to performance indicating that lesser decisions of diversification would be taken with the increase in number of shareholders. Last but not the least, leverage was found to be positively and significantly associated with performance which meant that total debt level might influence diversification decisions and thus improve performance.

Park and Jang (2013) examined a sample of restaurant industry to study the impact of within-industry and related diversification on their short-run and long-run performance. The findings from the study showed that in the short-run, within-industry, diversification strategies had a negative impact on the firm profitability but no significant impact on sales growth was observed. Whereas, in the long-run, within-industry diversification had a significantly positive effect on profitability but it had no impact on sales growth. In case of related diversification, it had a positive and significant impact on profitability in the short-run but became negative in the long-run, which was significant. Again, the interaction model used in the study indicated that when both the strategies were simultaneously adopted it enhanced efficiency and synergy was quickly realized.

With a sample of US Fortune 500 firms for the period from 1996 to 2003, **Su and Tsang(2014)** came up with the observations that the secondary stakeholders played a positive moderating role in the association between product diversification and financial performance and this moderating influence gained strength in case of unrelated diversification in comparison to related diversification. Hence, it was suggested that it was beneficial if firms would maintain association with different secondary stakeholder scopes proportionate with their product diversification levels to improve financial performance.

Having made an extensive literature survey on the relationship between product diversification and financial performance, it is very interesting to note that this domain of study has been investigated by a good number of researchers from different perspectives. A careful scrutiny reveals that study on the consistency of performance influenced by diversification strategy has hardly been done. It is also found that time series analysis of the financial performance of a particular company whose major growth strategy is product diversification has not yet been done. Literature survey also shows that very little work has been done with Indian companies as well. The present study seeks to bridge these gaps as its focus is on the financial performance of an Indian Conglomerate giant, ITC whose one of the most important growth strategy is diversification. The study has been conducted over a period of 20 years taking into consideration the consistency of performance in the pre and post diversification periods. The remaining paper consists of the objectives of the study, methodology adapted in the study, a brief profile of the company under study, findings of the study and lastly, the concluding remarks.

A Brief Profile of ITC Ltd

ITC Ltd is one among a few companies in the world who have travelled a 100 year journey, undergone extraordinary transformation from a small outpost of a overseas-owned company with a single product to one of India's most valuable and admired multi-dimensional and multi-business enterprise and yet have managed to remain contemporary, relevant and competitive.

The way ITC has followed the strategy of diversification for sustainability and growth; very few companies have done so. The long inspiring journey of challenge and change has unfolded in tandem with the nation's growth and evolution across ten decades. In this journey, ITC has consciously put country before corporate; it is an enterprise that has proudly echoed the credo "Let's put India first". In such endeavor it has not only lead in shareholders' value creation but also in serving all stakeholders and ivn meeting societal expectations. In its voyage ITC has gained global recognition and stood as an example in sustainable practices. It is the only company of its size in the world which at the same time carbon positive, water positive and solid waste recycling positive. But the most satisfying and meaningful achievement of the company has been the creation of over 5 million sustainable livelihood. ITC is an outstanding market leader in its traditional business of Cigarette, Hotels, Paperboards, Packaging and Agri-export. It is rapidly gaining market share in nascent businesses of Packaged Foods & confectionary, Branded Apparel, Personal care and Stationary. In the last four decades ITC's topline grew from Rs 145 crore in 1970 to over Rs 45,000 crore in 2014, profit after tax soared from Rs 4 crore to cross Rs 8,700 crore and market capitalization catapulted from around Rs 35 crore to more than Rs2,75,000 crore. From being a one product category, ITC's portfolio now spans 20 categories with over 1,500 stock keeping units. Today a network of 100 factories churn out ITC's products, compared to just six units set up in the first 50 odd years. At present, ITC is one of India's foremost private sector companies with a market capitalization of over US$33 billion and turnover of US$7 billion. ITC is rated among the World's Best Big Companies, Asia's Fab 50' and the World's Most Reputable Companies by Forbes magazine, among India's Most Respected Companies by Business World and among India's Most Valuable Companies by Business today. ITC ranks among India's 10 most valuable (company) brands in a study conducted by Brand Finance and published by the Economic Times. ITC also ranks among Asia's 50 best performing companies compiled by Business Week. ITC has gained a unique diversified status by following such corporate strategy which aimed at creating multiple drivers of growth anchored on its time-tested core competencies, which are unmatched distribution reach, Superior brand building capabilities, effective supply chain management and acknowledged service skills in hoteliering.

OBJECTIVES OF THE STUDY

The prime objective of the study is to assess the impact of diversification strategy on the relationship between the profitability of the selected and its asset management efficiency. More specifically, the present study has the following objectives:

1. To examine the nature and extent of relationship between the selected profitability indicator of ITC and its determinants (asset management efficiency ratios) in the pre-diversification and post diversification periods.
2. To identify the factors making significant contribution towards the overall profitability of ITC in both the pre-diversification and post-diversification periods

RESEARCH METHODOLOGY OF THE STUDY

This study is mainly analytical and examining in nature. This study focuses on examining the relationship between the profitability of the selected company in Indian corporate sector and its determinants, under the influence of diversification strategy.

i) Sample Design and Source of Data Collection:

In the present study giant Indian Conglomerate, ITC Ltd has been selected as sample. In this study purposive sampling procedure was followed. The data used in the present study was collected from the secondary sources i.e. published annual reports of the ITC Ltd. The database was collected from the company's

ii) Period of Study:

In the present study, 1994-95 to 2013-14 has been considered as the period of study where, 1994-95 to 2003-04 has been considered as the pre diversification period and 2004-05 to 2013-14 has been chosen as the post diversification period. During the initial years of the former period, i.e. 1994-95 to 2003-04, ITC adopted the strategy of refocusing or anti diversification.. Hence the period can be justifiably called the pre-diversification period. Although ITC started to diversify into a foray of products since 2000, its impact could not be reflected in its financial performance immediately because the diversification strategy was implemented step by step taking a few more years, as such 2004-05 has been considered as the initial year of post-diversification period, up to the recent past i.e. 2013-14. Attempt has been made to conduct a comparative analysis of the profitability position of the selected company in the pre-diversification i.e. 1994-95 to 2003-04 and the post-diversification period i.e. 2004-05 to 2013-2014.

(iii) Analysis of Data

Generally a firm utilizes its funds in two ways-by investing in fixed assets and by investing in working capital. So, the profitability of a firm is directly influenced by the efficiency with which fixed assets and working capital is managed. Again, any major change in the policy of a firm will be reflected in capital employed. As such when a company adopts the policy of product diversification, it will affect a firm's asset management, which again has a direct bearing on its overall profit earning capability. It is already known that ROCE measures the overall profitability of a firm. The efficiency with which assets are managed is gleaned from turnover ratios. They measure how rapidly the assets are being turned into sales. The way in which assets are managed can have a significant impact on the profitability of the company. The turnover ratios or the asset management efficiency ratios selected in the present study are fixed assets turnover ratio (FATR), inventory turnover ratio (ITR), debtors turnover ratio (DTR) and cash turnover ratio (CTR). Fixed asset turnover ratio (FATR) measures the efficiency of a firm in managing its investment in fixed assets. A high value of this ratio implies a high degree of fixed asset management efficiency while a low value indicates inefficiency in fixed asset management. Inventory turnover ratio (ITR) evaluates the inventory management efficiency. A high value of ITR is good from the liquidity point of view and implies sound inventory management while a low ratio is undesirable. Debtors turnover ratio (DTR) indicates the efficiency of the credit and collection policies adopted by the firm. This ratio also measures the quality of debtors. Cash turnover ratio (CTR) measures how efficiently cash is managed. (Sur, 2012)

In the present paper an attempt was made to examine the nature and extent of relationship between the selected profitability indicator of ITC and its determinants in the pre-diversification and post diversification periods through correlation coefficients between ROCE and each of the selected measures relating to asset management efficiency by taking into account their magnitudes (i.e. by Pearson's simple correlation coefficient), ranking of their magnitudes (i.e. by Spearman's rank coefficient) and the nature of their associated changes (i.e. by Kendall's coefficient). The correlation coefficients were tested using't' test. For studying the joint influence of the selected measures relating to asset management on the profitability multiple correlation and multiple regression techniques were also applied. The multiple correlation coefficients were tested by F test. Besides this, an estimation of the total performance of the selected company for the pre-diversification period and post-diversification period under study was also made by using multiple regression equation of ROCE on fixed assets turnover ratio (FATR), inventory turnover ratio (ITR), debtors turnover ratio (DTR) and cash turnover ratio (CTR). The partial regression coefficients were tested by 't' test.

FINDINGS OF THE STUDY

Table- 1 discloses that in the pre-diversification period positive correlation was noticed between ROCE and ITR, ROCE and DTR, and between ROCE and CTR among which the correlation coefficients between ROCE and DTR were found to be statistically significant. It indicates that a notable degree of positive association between the efficiency of debtors' management of ITC and its earning capability was present in the pre-diversification period. The correlation coefficients between ROCE and FATR in the pre-diversification period were negative which were found to be statistically significant. It implies that the fixed asset management of the company made a considerable negative contribution towards enhancing its overall profitability in the pre-diversification period. The table also shows that in the post-diversification period the correlation coefficients between ROCE and FATR, ROCE and ITR and between ROCE and DTR, and between ROCE and CTR were positive as well as statistically significant at 1% level of significance. The outcomes reveal that fixed asset management, inventory management, debtors' management and cash management of ITC was able to make a notable contribution towards enhancing its overall profitability in the post-diversification period.

It was attempted in Table-2, to identify the factors making significant contribution towards the overall profitability of ITC in both the pre-diversification and post-diversification periods with the application of multiple regression analysis as well as multiple correlation analysis. While adopting this technique it was assumed that ROCE=„$\{FATR, ITR, DTR, CTR\}$. The regression equation which was fitted to the study is $ROCE= b_0 + b_1 FATR+ b_2 ITR+b_3 DTR+b_4 CTR+ e$. Here, b_0 is the intercept term, b_1, b_2, b_3 and b_4 are the partial regression coefficients and e denotes the error term. The partial regression coefficients were tested using't' test. To measure the joint effect of FATR, ITR, DTR and CTR on the company's ROCE, multiple correlation coefficient (R) was used which was tested applying F test. Enough care was taken in selecting the independent variables (FATR, ITR, DTR and CTR) to estimate the dependent variable (ROCE) so as to ensure that multi- co-linearity was reduced to the minimum. Table- 2 discloses that for one unit increase in FATR, the ROCE of ITC decreased by 8.881 units in the pre-diversification period while the ROCE increased by 43.674 units in the post-diversification period. Only in the post-diversification period the partial regression coefficient was found to be statistically significant. When ITR increased by one unit, the ROCE of the company increased by 1.366 units in the pre-diversification while the ROCE increased by 6.967 units in the post-diversification periods. Again the coefficient of only the post-diversification period was found to be statistically significant. For an increase of DTR by one unit, the ROCE of ITC increased by 0.133 unit in the pre-diversification period and by 8.862 unit in the post-diversification period. Here also the partial regression coefficient of only the post-diversification period was found to be statistically significant. When CTR increased by one unit, the ROCE of the company stepped up by 0.041 units and by 9.136 units in the pre-diversification period and post-diversification period respectively. Here also both the partial regression coefficient of only the post-diversification period was found to be statistically significant. The net outcome derived from the analysis of multiple regressions as made in Table 2 confirms the results obtained from the analysis of correlation as shown in Table 1.

The multiple correlation coefficient of ROCE on FATR, ITR, DTR and CTR in the pre-diversification period was 0.543 which was not found to be statistically significant while the same coefficient in the pre-diversification period was 0.941 which was found to be statistically significant at 0.05 level. It signifies that the joint influence of efficiency in the management of fixed assets, inventory, debtors and cash of the company on its overall earning capability was noticeable only in the post-diversification period. The coefficient of multiple determinations (R^2) as shown in Table 4B.2 indicates that 27.3 per cent and 88.5 per cent of the variation in ROCE of ITC were contributed by its FATR, ITR, DTR and CTR in the pre-diversification and post-diversification periods respectively.

CONCLUSION

It is a known fact that better the asset management higher will be the profitability. The objective of the study was to identity the impact of diversification strategy on the relationship between profitability and asset management efficiency taking ITC Ltd as the sample. Findings from the two tables reveal that asset management was able to positively influence the overall profitability individually as well jointly in the post diversification period but the results were not favourable in the pre-diversification period. So it can be said that diversification influences the relationship of profitability and asset management efficiency to some extent. However, there might be other deciding factors which have not been considered in the study. Hence, this field requires much more research.

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TABLES

Table 1: Analysis of Correlation between Selected Profitability Measure and its Determinants of ITC in the Pre- and Post-diversification Periods

Correlation between	ROCE and FATR		ROCE and ITR		ROCE and DTR		ROCE and CTR	
Correlation measure	Pre-Div period	Post-Div period	Pre-Div period	Post-Div period	Pre-Div period	Post-Div period	Pre-Div period	Post-Div period
Pearson	-0.889**	0.785*	0.612	0.842*	0.795**	0.838*	0.503	0.869*
Kendall	-0.733**	0.811*	0.511*	0.800*	0.511*	0.767*	0.378	0.711*
Spearman	-0.842**	0.852*	0.612	0.709*	0.636*	0.852*	0.491	0.867*

Source: Complied and computed from published Annual Reports of ITC for the period 1994-95 to 2013-14

* significant at 5% level of significance.
** significant at 1% level of significance

Table- 2: Analysis of Multiple Correlations and Multiple Regression of Selected Profitability Measure on its Determinants of ITC in the Pre- and Post-diversification Periods

Regression Equation: $ROCE= b_0 + b_1 FATR+ b_2 ITR+b_3 DTR+b_4 CTR+ e$

	Pre-diversification Period	Post-diversification Period
b_0 (Constant)	52.024 (1.113)	-14.920 (-0.285)
b_1	-8.881 (-1.397)	33.674 (4.589)
b_2	1.366 (0.201)	6.967 (3.281)
b_3	0.133 (0.378)	8.862 (4.251)
b_4	0.041 (1.253)	9.136 (4.111)
R	0.523	0.941
R^2	0.846	0.885**
F	0.471	9.665

Figures in the parenthesis indicates't' values

Source: Complied and computed from published Annual Reports of ITC for the period 1994-95 to 2013-14

* significant at 5% level of significance.
** significant at 1% level of significance