Discussion paper

Impacts of geographic diversification on restaurant firms’ risk: Domestic vs. international diversification

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ABSTRACT

In the hospitality context, the diversification literature has evolved to mostly focus on the impact of diversification on firm performance. However, without accounting for risk, the effect of diversification on firm value likely provides an incomplete picture. Therefore, this study investigates the influence of domestic and international geographic diversification on restaurant firms’ risk. This study uses the Berry-Herfindahl Index to measure the degree of domestic and international geographic diversification. Findings show a non-linear relationship between geographic diversification and restaurant firms’ risk. However, different shapes of the non-linear relationship are revealed between domestic and international geographic diversification and between operational and market-based risk. The results of this study indicate that the risk-reduction effects argued from the modern portfolio theory may be partially applicable to the geographic diversification for restaurant firms, suggesting a different view toward financial diversification and corporate diversification.

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1. Introduction

As one of the diversification strategies, geographic diversification has been considered a major corporate strategy for not only general business but also hospitality firms (Kang et al., 2012; Tallman and Li, 1996) and is defined as a firm’s business expansion into diverse locations (Hitt et al., 1997). To examine corporate diversification and its effect on firm risk, many previous researchers have used the portfolio concept, which was originally developed in the field of securities management (Kang et al., 2012). However, West (1967) argued that the modern portfolio theory may be inappropriate to explain the risk-reduction effect of corporate diversification, citing differences between a stock portfolio and a business portfolio. Some researchers found inconsistent results with the modern portfolio theory that corporate diversification reduces not only unsystematic risk but also systematic risk (Hughes et al., 1975; Lubatkin and Chatterjee, 1994), while others found that corporate diversification can even increase systematic risk (Montgomery and Singh, 1984). In addition, some researchers investigated operational risk, arguing that it reflects both systematic and unsystematic risk (Beaver et al., 1970). Thus, the current study investigates the effects of diversification on operational risk and market-based risk.

Notwithstanding the importance of the risk-reduction effect of geographic diversification and inconclusive findings in the existing literature, previous research on diversification in the hospitality context has invariably focused on its effects on firm performance, not risk (Chen and Chang, 2012; Choi et al., 2011; Park, 2010; Rhou and Koh, 2014). Although Kang et al. (2012) investigated the effect of geographic diversification on risk within the U.S. casino industry, the relationship between geographic diversification and risk is scarcely researched in the hospitality context, including the restaurant industry. Without accounting for risk, the evaluation of a geographic diversification strategy might present a biased result, and the effect of geographic diversification on firm value likely provides an incomplete picture. Thus, a study of the relationship of geographic diversification and risk in the restaurant context would add value to the hospitality literature.

It has been argued that restaurant firms extensively implemented geographic diversification in order to accommodate the needs of different markets and take advantage of economies of scale (Kang and Lee, 2015; Madanoglu, 2005). According to Birkinshaw et al. (1995), the benefits of geographic diversification can be acquired in the industry or market where economies of scale, local differentiation of production, and standardized market demand across locations (e.g., countries) are possible and valued. Considering the characteristics of the restaurant industry, such as difficulties in standardizing food demand and managerial capabilities, it seems that these requirements could be met more efficiently in the domestic market than the international
market. Thus, domestic geographic diversification may be helpful for restaurant firms seeking to stabilize their performance. However, the benefits from domestic geographic diversification may not hold for excessive degrees of geographic diversification. According to the de-diversification (or refocusing) literature in strategic management, there is an optimal point of diversification because an excessive diversification can bring a firm loss of internal control, distorted information, and dominant logic, which can lead to business failures (Bass et al., 1978; Prahalad and Bettis, 1986; Williamson, 1967). Following this argument, the current study expects that restaurant firms’ geographic diversification beyond an optimal point will bring negative effects, and thus, we propose a curvilinear relationship between domestic geographic diversification and firm risk.

Also, previous research in the restaurant industry contended that food consumption habits are different in each country, and food culture significantly affects customers’ decision-making process for choosing restaurants (Kim et al., 2009). Thus, successful restaurant firms in international markets need to demonstrate a high degree of flexibility in ingredients, menus, and food delivery (Chapdelaine and Kindelan, 1995). More importantly, replicating domestic products and services is not favored in the international setting, thus firms tend to alter their products and services to fit foreign markets (Chapdelaine and Kindelan, 1995). Due to these characteristics of the restaurant industry, this study proposes that internationally-diversified firms require a longer time to adapt to environmental and cultural differences, which may initially increase their risk. However, organizational learning theory indicates that firms can improve their capabilities and competitiveness through learning (Barney, 1991; Kogut and Zander, 1992). Also, these improved capabilities can act as insurance for reducing risk (Volberda, 1996). Thus, internationally-diversified firms may consequently reduce their risk as they accumulate experiences in diverse international markets. Therefore, we propose that a curvilinear relationship exists between international geographic diversification and risk, but in an opposite direction to the case of domestic diversification.

In sum, considering the unique characteristics of the restaurant industry, distinctive findings are expected for a relationship between geographic diversification and risk in domestic and international settings. Specifically, the current study examines whether there are different influences between domestic and international geographic diversification on restaurant firms’ risk. The relevant literature review and methodology follow in the next section, and results and conclusion are presented afterward. This study also provides theoretical and managerial implications for the restaurant literature and industry.

2. Literature review

2.1. Modern portfolio theory and diversification strategy from market-based view

2.1.1. Financial diversification

The finance management literature has examined diversification, highlighting its value from the point of view of stockholders. Modern portfolio theory (Markowitz, 1952, 1959) and the capital asset pricing model (Lintner, 1965; Mossin, 1966; Sharpe, 1964) have explained the component of a firm’s risk as a total risk which is composed of systematic and unsystematic risk. Systematic risk, or market-related risk (beta), refers to the macroeconomic influences and is associated with market movements such as changes in tax laws, policies, monetary factors, etc. (Kim et al., 2007; Lubatkin and Chatterjee, 1994; Madanoglu, 2005). Unsystematic risk, on the other hand, often refers to firm-specific risks such as the loss of a major customer, the death of an experienced executive, or critical technology issues (Lubatkin and Chatterjee, 1994). This traditional financial theory views investment from a portfolio perspective and assumes that the unsystematic risks of a particular firm can be diversified away by building a well-diversified portfolio (Gu and Kim, 2003; Markowitz, 1952). Systematic risk is a firm’s covariance with the market, and thus cannot be neutralized due to market events that the firm cannot control (Gu and Kim, 2003). In other words, the only risk that affects investors is systematic risk, which is associated with variability in the market and cannot be diversified away (Lubatkin, 2003).

However, some researchers have maintained that systematic risk (beta) alone is not sufficient to explain the firm’s risk because unsystematic risk may not be completely diversified away. Van Horne (1998) contended that unsystematic risk can be offset only when a perfect market exists and the portfolio is well-diversified. Specifically, unsystematic risk is likely to affect the firm’s value due to the possibility of bankruptcy, and the conditions of an imperfect market, e.g., transaction costs and costly information, prevent unsystematic risk from being diversified away. As a result, unsystematic risk may also play a role in firm valuation (Cheng and Roulac, 2007). Peavy (1984) also asserted that unsystematic risk affects systematic risk, implying that firm-specific factors may affect the market structure. Therefore, an examination of both systematic risk and unsystematic risk may provide a more comprehensive picture.

2.1.2. Corporate diversification

In the strategic management context, corporate diversification, such as product, geographic, and brand diversification, is often justified on the grounds that it helps reduce a firm’s risk or the volatility of earnings by reducing the firm’s exposure to any single industry or market (Lubatkin and Chatterjee, 1994). This theoretical rationale is borrowed from the modern portfolio theory (Kang et al., 2012), which was originally intended for the domain of securities management.

However, West (1967) argued that modern portfolio theory may be inappropriate as a way to explain the risk-reduction effect of firms’ diversification efforts. In the financial market, substituting or adding an asset within a well-diversified portfolio does not significantly affect the risk and return of other assets. Therefore, unsystematic risk can be diminished by investing in less correlated assets. This may not be the case in the corporate diversification. Any business components of a firm likely affect each other as well as the firm’s competitors’ strategies in the market (Bettis and Hall, 1982). Aligning with this standpoint, Jacquillat and Solnik (1978) found that investing in U.S. multinational firms is not a substitute for investing in an international stock portfolio. Challenging the modern portfolio theory, Hughes et al. (1975) also contended that both systematic risk and unsystematic risk can be reduced by international geographic diversification.

A review of literature on the modern portfolio theory indicates no consensus as to which risk is more relevant to corporate diversification strategies (Lubatkin and Chatterjee, 1994). Specifically, while efforts to reduce unsystematic risk through the implementation of a diversification strategy have been strongly supported by theoretical arguments (Hughes et al., 1975), reducing systematic risk has been weakly supported by previous studies and remains a point of debate. For example, Montgomery and Singh (1984) examined the relationship between corporate diversification and systematic risk, suggesting that corporate diversification, especially diversification with a weak correlation among businesses, increases market-based risk (systematic risk), due to low market power, low capital intensity, and high debt positions. Conversely, the findings of Lubatkin and Chatterjee (1994) show that corporate diversification can achieve a reduction in systematic risk. All
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