



The impact of diversification strategy on corporate financial performance

Yunnan Baiyao Diversification Case Study

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ABSTRACT. Using Yunnan Baiyao as a research case, this paper examines the impact of a firm's diversification strategy on its financial performance after its implementation. By exploring the impact of the firm's dynamic capabilities on the diversification strategy and analyzing the financial and non-financial factors before and after Yunnan Baiyao's implementation of the diversification strategy, we find that Yunnan Baiyao's adoption of the diversification strategy has contributed to the firm's financial performance to a certain extent. At the same time, the company also faces a series of risks and challenges.

Keywords: Diversification Strategy, Corporate Performance, Dynamic Capabilities

1 Introduction

Nowadays, in a very competitive economic market, companies need some new motivation to help them improve. Diversification strategy is one of the important strategies for enterprises to cope with competition and changes in the process of operation, and more and more enterprises are implementing this strategy to make their operation more adaptable to the changes of market and customer demands, so as to improve their competitiveness and market share. However, when adopting this strategy, companies must correctly grasp the market demand, grasp the capital advantage, enhance their dynamic capabilities, and avoid neglecting their core business areas to ensure the stability and sustainability of their overall development. This paper will use Yunnan Baiyao as a case study to explore the impact of a company's implementation of a diversification strategy on its financial performance and to analyze the role of a company's dynamic capabilities on this strategy.

2 Literature review

Current status of theoretical research on diversification strategies:

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2.1 Status of foreign research

In 1962, M. Gort (1962) in his work "Diversification and Integration of American Industries," explained that diversification is the increase in the number of heterogeneous markets in which a firm is involved, that is, the increase in the number of industries in which it is involved [1]. This thesis was a major breakthrough in the field of business as it drew a more precise line of demarcation between diversification and integration.

In foreign countries, corporate diversification strategy has been adopted by American companies on a large scale. 1975 American scholar H.I. Ansoff published "Diversification Strategy" in the Harvard Business Review. For the study of diversification, he believed that diversification refers to new markets developed with new R&D of products. Product development strategy is different from diversification strategy, the former refers to adding new products to the original market, but diversification strategy refers to companies opening the door to new markets through new products [2]. Since such an approach is open and innovative, it can harvest a large number of customers, thus enabling companies to have higher revenue in the short term, so many companies are scrambling to implement this strategy.

2.2 Current status of domestic research

After the reform and opening up, due to the influence of the market economy system, private and private enterprises emerged one after another, and state-owned enterprises also began to appear on a large scale. In order to enhance their competitive advantages and avoid risks, diversification strategy has become the optimal strategic choice for entrepreneurs.

In the book "Enterprise Diversification", Rongping Kang and Yinbin Ke (2006) clarified that "enterprises not only engage in production and business activities in multiple industries, but also provide many different products to different markets", he distinguished between product segmentation and diversification and emphasized that industrial operation is the basic element to identify diversification [3].

In the 1990s, Dr. Yin Yisheng (2012) of Tsinghua University's School of Management defined the difference between diversification and product lines in the lecture series "Peculiar Polyglot Growth Strategy and Management", arguing that diversification is not just a way of doing business, but an opportunity that enables companies to grow rapidly, an act that tests their own corporate capabilities in all aspects, a way that allows them to broaden the originally involved The business scope is broadened [4].

Analysis by Nie Ruijie (2023), in general, for companies to adopt a diversification strategy, to a certain extent, the strategy can help companies reduce the risk of a certain business, improve the stability of the company, and also enable companies to expand business in different areas [5], thus improving the competitiveness and market share of the company. However, Song Kai-kai (2023) analyzed that excessive diversification may lead to over-diversification of resources, lower operational

efficiency, and less stable input and output results, resulting in a longer time for the company to realize profits [6].

3 Implementation of Yunnan Baiyao's diversification strategy

3.1 Yunnan Baiyao's Traditional Business and Market Competition

Yunnan Baiyao's traditional business mainly contains the production and sales of pharmaceutical products. The company's products cover many fields such as digestive system, respiratory system, pediatrics, dermatology and stomatology, including bronchitis oral liquid, pediatric cold and flu spirit and many other well-known brands.

In recent years for the development of the Chinese medicine industry has received a lot of attention, through the support of the state, the increase in social demand, the improvement of industry technology, industrial pattern adjustment, the Chinese medicine industry has been able to grow rapidly.

Politically, the government has given strong support to the TCM industry and in order to give it a legal status, the Chinese government promulgated the Outline of the Chinese Medicine Innovation Development Plan (2006-2020) in 2020. The TCM industry is the foundation of medicine that can represent Chinese characteristics, and its vigorous promotion is conducive to its internationalization and the promotion of national culture.

Economically, as the Chinese medicine industry has fewer side effects compared to Western medicine, the demand for Chinese medicine is increasing, and consumers are increasingly inclined to rely on their bodies as a way to cure their illnesses.

In society, the Chinese medicine industry has grown rapidly as people's health awareness has increased and their needs have become more diversified.

Technologically, in an era led by science and technology, TCM and modern science are integrated with each other, and the effective selection of quality methods and techniques of Western medicine at the technical level has enabled TCM to make great progress.

3.2 Key steps and major initiatives in the implementation of Yunnan Baiyao's diversification strategy

Based on the process of implementing Yunnan Baiyao's diversification strategy, it can be divided into four stages:

From 1999 to 2003 was the initial stage of Yunnan Baiyao's diversification strategy. Since Yunnan Baiyao was initially focused on pharmaceutical powders only, the product line was too homogeneous and had the risk of brand aging. Therefore, a multi-line development was adopted, followed by the return of brands such as Yunnan Baiyao capsules and Yunnan Baiyao aerosol to the production line.

The period from 2004 to 2010 was a period of rapid growth when the company implemented its diversification strategy. At this time, Yunnan Baiyao rose to prominence in the market with its innovation, a Band-Aid with medicinal properties. This was a crucial stage in Yunnan Baiyao's diversification path.

The implementation of the diversification strategy from 2011 to 2015 has reached a mature stage. During this time, the company has established a very influential brand image in the market and has transformed from a single pharmaceutical strategy to a strategy of developing an integrated approach to medicine and health.

Since 2016, Yunnan Baiyao has been on a steady rise. As the company continues to expand its health industry, its products are gradually being marketed internationally, and its brand image is gradually "gaining ground" in the market, Yunnan Baiyao is already the first in the health industry.

4 Theoretical basis and research hypothesis

4.1 The relationship between dynamic capabilities and corporate performance of Yunnan Baiyao

Dynamic capabilities are the ability of firms to integrate, build, and reconfigure internal and external capabilities to adapt to rapidly changing environments, a concept introduced by Teece et al. (1997). Eisenhardt et al. (2000) argue that dynamic capabilities are organizational and strategic practices that are inextricably linked to the rise, collision, differentiation, evolution, and demise of markets [7], so that firms can make themselves available to new resource allocations [8]. However, Ge Baoshan et al. (2009) also found a positive relationship between dynamic capabilities and firm performance by exploring the issue of dynamic capabilities and own resource development [9]. Therefore, the following hypothesis is proposed.

Hypothesis 1: Stronger dynamic capabilities contribute more to the positive effect of diversification strategy on the performance of the firm (Yunnan Baiyao).

4.2 The relationship between the degree of diversification and corporate performance of Yunnan Baiyao

Nowadays, diversification strategy has been widely used in the business activities of various types of enterprises, such as state-owned enterprises and private enterprises, but the issue of whether adopting diversification strategy is beneficial to enterprises has been controversial. Ma Wenli (2019) believe that corporate performance increases with the increase of diversification under relevant diversification strategy and decreases with the increase of diversification under non-relevant diversification strategy [10]; some scholars believe that adopting diversification strategy may reduce corporate performance because adopting diversification strategy may lead to the loss of corporate resources, over-diversification of operation and decrease of management ability [11], for example Wang Zhenping (2020); while Zhao xingxin, Sun Tong, Wang Qidong and Wu Yao (2013) believe that there is an inverted U-shaped relationship between diversification strategy and firm performance [12], as firms enhance (or weaken) their performance by influencing the benefits or costs of technological diversification [13].

In general, the adoption of a diversification strategy within a certain range can improve a company's risk diversification and sustainability, which in turn can have a

positive impact on the company's financial performance. Therefore, the following hypothesis is proposed.

Hypothesis 2: Diversification strategy positively affects the financial performance of the firm (Yunnan Baiyao): dynamic capability as a moderating variable

5 Yunnan Baiyao case study analysis

5.1 Changes in the dynamic capabilities of the company after the implementation of its diversification strategy

According to Zott's research, this paper can classify dynamic capability into three dimensions: enterprise resource integration capability, change and innovation capability, and enterprise learning and absorption capability. In this paper, we combine the specific measures of dynamic capability by Sun Tong et al. and reflect the dynamic capability of enterprises from two perspectives: total asset turnover ratio and R&D expense ratio (Fig. 1).

D1 Total Asset Turnover = Sales Revenue/Total Assets.

D2 R&D expense ratio = R&D expenses / sales revenue.

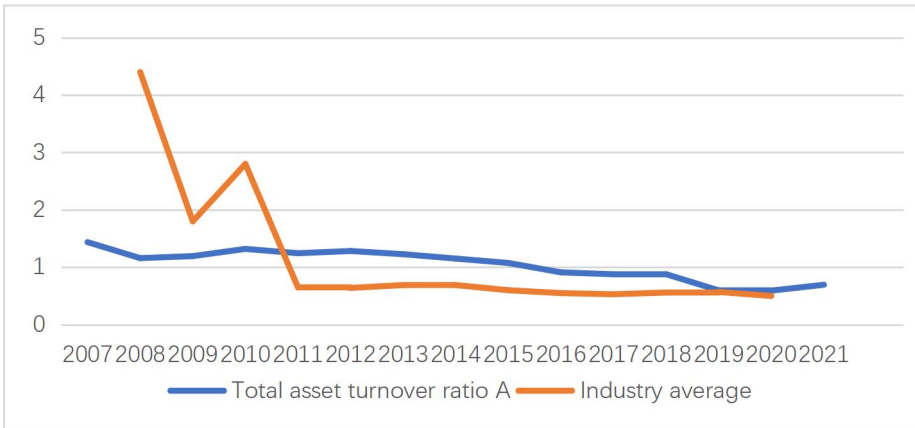


Fig. 1. Yunnan Baiyao and industry average total asset turnover ratio

Table 1. Yunnan Baiyao 2011-2020 total assets turnover rate

	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020
Total assets turnover ratio	1.24	1.28	1.23	1.15	1.08	0.91	0.88	0.88	0.60	0.59
Industry average	0.65	0.64	0.69	0.69	0.60	0.55	0.53	0.56	0.57	0.50

Data source: CSMAR database

According to the data in Table 1, the industry average total asset turnover rate is slowly decreasing, and the total asset turnover rate of Yunnan Baiyao has also decreased, but the industry average fluctuates around 0.6 and is always lower than that of Yunnan Baiyao. From 2011 to 2012, when Yunnan Baiyao's diversification strategy was in full swing, the total asset turnover ratio peaked, which shows that increased diversification has a positive impact on the company's ability to integrate resources, but Yunnan Baiyao's ability to integrate resources has yet to be improved in recent years.

Table 2. Yunnan Baiyao Operating Growth Rate, Industry Average, Net Profit Growth Rate and R&D Expense Ratio, 2017-2020

	2017	2018	2019	2020
Operating income growth rate	8.50%	9.84%	11.07%	10.38%
Industry average	15.56%	20.33%	14.32%	10.36%
Net profit growth rate	6.88%	5.02%	26.85%	32.13%
R&D expense ratio	-	0.41%	0.59%	0.55%

Data source: CSMAR database

According to the data in Table 2, from 2017 to 2020, Yunnan Baiyao's average R&D expense ratio exceeds 0.5%, indicating that the company is more focused on product development, staff training, etc. The company's ability to innovate and change and learn and absorb is always at a medium to high level. The growth rate of the company's gross operating income during this period reflects that Yunnan Baiyao is also strengthening its diversification strategy. This suggests that the dynamic capability of the company (Yunnan Baiyao) can effectively contribute to the performance of the company even at a level above good. That is, hypothesis one holds.

Taken together, the profitability and operating capacity of the company is improving after the transformation by adopting a comprehensive diversification strategy, and it can effectively provide some cash flow support for other businesses, indicating that the dynamic capacity of the company has been in a good state during the continuous implementation of the diversification strategy, and the strategy has contributed to the performance of the company.

5.2 The relationship between dynamic capabilities and diversification strategies and firm performance

Harreld, O'Reilly III, and Tushman (2007) found that dynamic capabilities can strengthen firms' implementation of diversification strategies, using IBM as an example [14]. Hu, Gang and Cao, Xing (2014) explored the relationship between dynamic capabilities and corporate diversification and found that dynamic capabilities significantly contribute to corporate diversification [15]; Su, Rujer and Chang, Yuhao

(2019) and others showed that with high levels of dynamic capabilities, corporate diversification can significantly improve the level of corporate performance [16]. Therefore, dynamic capabilities can not only act as a moderating variable to make the impact of diversification on firm performance more facilitated under high levels of dynamic capabilities, but also can have a positive impact on the implementation of diversification strategies.

According to Zott et al. (2003), there is a correlation between three attributes of dynamic capabilities and firm performance [17], namely, as proposed by Li Xingwang, Wang Yingjun (2004), a firm's ability to integrate resources, its ability to change and innovate, and its ability to learn and absorb [18]. For different situations firms use painful competitive strategies as well as inconsistent when it comes to innovation. C.K. Chang (2001) and others analyze data showing that under the influence of innovative factors in business management, innovation in the way firms organize and manage their processes will enhance the influence of dynamic capabilities on financial and managerial performance [19]. In this case study, Yunnan Baiyao's diversification strategy has been strengthened, and the company's dynamic capabilities have remained at the forefront of the industry, resulting in improved corporate performance.

6 Research findings and insights

6.1 Main conclusions

Yunnan Baiyao has evolved from innovating with a single powder product (before the implementation of the strategy) to focusing on producing integrated pharmaceutical and health products (after the diversification strategy), which is a significant innovation and strategic change for the company. Yunnan Baiyao's improved profitability and stable operations after the implementation of the diversification strategy demonstrate that Yunnan Baiyao still has good sustainable development capability after the implementation of the diversification strategy. Moreover, the analysis of this paper shows that Yunnan Baiyao's dynamic capabilities (the ability to integrate resources, change and innovate, and learn and absorb) are stable and strengthening, and its financial performance level is always above the industry. Overall, with Yunnan Baiyao's strong dynamic capabilities, the company's diversification strategy can contribute to the company's performance.

6.2 Insights

Overall, the implementation of the diversification strategy has contributed positively to Yunnan Baiyao's financial performance. For the long term, Yunnan Baiyao's growth has been slowing down in recent years, and the positive effects of diversification are showing signs of diminishing slightly, which needs to be taken into account. In order to maintain improved performance in the future, Yunnan Baiyao should enhance its ability to integrate its resources.

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