



# The Impact of Diversification Strategies and Operational Capabilities on Financial Performance in Thai Professional Service Firms

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**Abstract:** The professional service sector plays a crucial role in the world economy, especially in emerging countries. This research explores the impact of diversification strategies and operational capabilities on financial performance in Thai professional firms. Financial data of 96 companies in the service sector listed on the Stock Exchange of Thailand (SET) was collected. Partial Least Squares (PLS) regression was selected as an analysis method. The results find that service diversification strategy, but not international diversification strategy, has a significant effect on a firm's financial performance. The empirical findings support the importance of diversification strategies. The result also shows that operational capabilities have a significant negative impact on a firm's financial performance. This study contributes to previous literature in a few ways. The first contribution lies in explaining the direct effect of service and international diversification strategies and operational capabilities on a firm's financial performance. Second, this study advances service and management literature by exploring professional service firms in an emerging country, Thailand. The professional service sector plays an important role in Thailand and other emerging countries' economies.

**Keywords:** Firm performance, professional service firms, diversification strategy, operational capability

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## INTRODUCTION

The professional service sector has been developing fast and is high in competition (Heirati, O'Cass, Schoefer, & Siahtiri, 2016). The service firms refer to the firms that operate in a variety of industries, including health care, media and publishing, hotel, tourism & leisure, and transportation & logistics. These firms have special characters as they deliver intensive knowledge and customized services (Aarikka-Stenroos & Jaakkola, 2012). In fact, the professional service firms contribute to an increasing Gross Domestic Product (GDP) and decreasing unemployment ratio (Sahli & Nowak, 2007). They are gaining recognition as contributors to world business growth and become an important source of employment in the global economy (Ostrom et al., 2010; Alejandro, Javalgi, Gross, Joseph, & Granot, 2011). Specifically, professional service firms provide a source of profitability and economic contribution in many emerging countries (Menicucci, 2018). Many professional service firms' managers in both developed and developing countries attempt to develop and implement various business strategies to improve their firms' financial performance (Durand, Grant, & Madsen, 2016; Hoskisson, Shi, Yi, & Jin, 2013).

When competition intensifies and business environment changes rapidly, firms are required to change their business strategies in an effort to create superior firm performance, e.g., through operational capabilities and diversification strategies (Nath, Nachiappan, & Ramanathan, 2010). Superior firm's operational capability is a driver to increase a

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firm's performance. Capacities to operate can assist the firm's process in gaining economic advantages to meet their business achievement (Ramanathan, Ramanathan, & Zhang, 2016). The marketing and strategic management literature show significant relationships among operational capabilities, marketing strategies, and business success, which can, in turn, generate superior firm's financial performance (Park & Jang, 2013). However, the studies of the operational capabilities and marketing strategies (e.g., diversification strategy) have been examined separately in literature (Nath et al., 2010). Marketing strategies, such as diversification strategy, help organizations to match varieties of customer needs and, therefore, deliver better customer services. Operational capabilities enhance management to respond better to customers' demands. Several studies have explored how firms formulate and implement marketing strategies to increase competitive advantages in their markets. Yet surprisingly, while previous research examines relationships between marketing capability and firm's performance (Kamboj & Rahman, 2015; Nath et al., 2010; Song, Nason, & Benedetto, 2008), very few pay attention to operational capabilities and their contributions to the firm's performance (Ayuningrat, Noermijati., & Hadiwidjojo, 2016; Ramanathan et al., 2016).

Management literature has explored the pieces of evidence of diversification strategy on competitive advantage (Eckardt & Skaggs, 2018) broadly. Prior studies also demonstrate that diversification strategies play an important role in contributing to a firm's financial performance (Menicucci, 2018; Nath et al., 2010; Piyachat, 2017).

Also, very little is known about a performance driver at the firm level in emerging countries, especially in the professional service sector (Bresciani, Thrassou, & Vrontis, 2015; Santoro, 2015). Thailand is considered to be the Asian Emerging Market (Asian Development Bank, 2015); therefore, it can represent other emerging countries due to various comprehensive and modern professional service firms (Freeman, Daniel, & Murad, 2011). Professional service sector is recognized as the major sector in Thailand's economy with a 55 per cent share on GDP (World Bank, 2018) and an influence on GDP, foreign exchange earnings, and employment.

This study investigates Thai professional service firms to answer the question-'what factors drive professional service firms' better financial performance?'. To answer the research question, relationships between financial performance and various aspects of the business, including service and international diversification strategies and operational capabilities, are investigated.

This study contributes to previous literature in a few ways. The first contribution lies in explaining the direct effect of service and international diversification strategies and operational capabilities on a firm's financial performance. Second, this study advances service and management literature by exploring professional service firms in an emerging country, Thailand. Professional service sector plays an important role in Thailand and other emerging countries' economies. Third, this study contributes to practitioners in professional service firms. The study demonstrates relationships between several diversification strategies, which can be used by professional service firms' managers as a guideline when allocating firm's limited resources.

## LITERATURE REVIEW

Integration of strategic management, operation, and marketing functions has been increasingly recognized as a driver to a firm's performance (Balasubramanian & Bhardwaj, 2004; Ho & Zheng, 2004; Malhotra & Sharma, 2002; Sawhney & Piper, 2002). Research also suggests that resources and capabilities generate competitive advantages and lead to above-normal rates of return, known as the Resource-Based View (RBV) theory (J. Barney, 1991; Ortega, 2010). Resources include both tangible assets (financial and physical elements) and intangible assets (e.g., human and technology) (Amit & Schoemaker, 1993; Grant, 1991).

Capabilities are referred to as the ability of a firm to employ its resources to achieve the desired outcome (Amit & Schoemaker, 1993). Capabilities are "intermediate goods" produced by a firm employing organizational mechanisms to offer improved productivity to its resources (Amit & Schoemaker, 1993). Capabilities are organizational tangible or intangible mechanisms that firms accumulated over time, so they cannot be easily acquired (Teece, Pisano, & Shuen, 1997).

According to the RBV, firms have diverse nature of resources and various degrees of capabilities, depending on the firm's structure, size, experience, and strategy (Day & Wensley, 1988; Peteraf, 1993; Prahalad & Hamel, 1990). Superior resources can help firms achieve their competitive advantage (Peteraf, 1993; Song, Benedetto, & Nason, 2007; Wasike, 2017).

In the RBV, operational capabilities have an impact on the firm's performance (Kamboj & Rahman, 2015) and are recognized as a source of competitive advantage (Nath et al., 2010). In addition, deployment of appropriated strategies

plays a positive role in improving the firm's performance and generating competitive advantage (Han, 2012; Porter, 1985; Yeung & Lau, 2005). Competitive business strategies refer to "actions that are developed by a firm to establish its strategy" (J. B. Barney, 2002). They can reflect firms' strategic orientation, such as diversification strategy (Menicucci, 2018; Ortega, 2010, 2010; Yeung & Lau, 2005). Diversification strategies are referred to when a firm decides to enter or not to enter a new geographic market (Hoopes, 1999; Goerzen & Beamish, 2003; Narasimhan & Kim, 2002).

Operational capabilities refer to embedded non-transferable firm-specific resources which can promote capabilities and productivities of the other resources possessed by the firm (Makadok, 2001). The operational capabilities may capture a firm's capacity to apply resources (e.g., employees, managers, and board of directors) by deploying the firm's processes in order to drive the desired outcome, such as non-financial performance and firm's financial performance (Amit & Schoemaker, 1993). Superior firm performance can be influenced by how a firm manages its cost of operation (Nath et al., 2010).

### ***Hypotheses Development***

**Diversification strategies:** Diversification is a firm entrance into new lines of business activities (Nath et al., 2010). It has widely developed on the reason, cost, timing of diversification, and its effect on profitability (Chakrabarti, Singh, & Mahmood, 2006; Montgomery & Wernerfelt, 1988). Key reasons for diversification are to increase target market, utilize unused productive capacity, reduce business portfolio risk, and build up capability.

Previous research shows that diversification has a positive influence on a firm's performance as it assists the firms to increase profitability and imply its experience in different organizations (Rumelt, 1974). However, some researchers suggest that diversification has a negative effect on the firm's performance (Montgomery & Wernerfelt, 1988). Diversification also increases the cost of operation, causes managerial conflict and complexities, and restrains firms from responding to main external forces (Chakrabarti et al., 2006; Grant, Jammie, & Thomas, 1988). Research also investigates the impact of diversification strategies, such as service and international diversification (Berger & Ofek, 1995; Bettis & Mahajan, 1985; Ghoshal, 1987; Kim, Hwang, & Burgers, 1993).

The concept of RBV describes that diversification strategy enhances the firm's performance if the resources, like market knowledge transferred between partners, are rare, valuable, and inimitable (Prahalad & Hamel, 1990). Related diversification strategy increases a firm's performance through better application of resources and capabilities, while the unrelated diversification process exceeds a variety of resource utilization, surpasses management capabilities, and reduces the firm's performance (Tallman & Li, 1996). Extended literature shows that there are mixed relationships between diversification and firm's performance, either positive or negative (Datta, Rajagopalan, & Rasheed, 1991; Geringer, Tallman, & Olsen, 2000; Narasimhan & Kim, 2002).

Based on the above arguments on the impact of diversification strategies on a firm's financial performance, it is then hypothesized that

**H1:** *Service diversification positively relates to a firm's performance.*

**H2:** *International diversification positively relates to a firm's performance.*

**Operational capabilities:** Previous research has emphasized operational capabilities as a key component of firm's proficiencies in order to foster production-related goals achievement, such as quality of the product, cost control and management, production flexibility, and speed and delivery reliability (Boyer & Lewis, 2009; Swink & Hegarty, 1998; White, 1996; Terjesen, Patel, & Covin, 2010). Superior operational capabilities are acknowledged as a driver to gain competitive advantages and enhance financial performance outcomes (Terjesen et al., 2010; Sabara, Soemarno, Leksono, & Tamsil, 2019; Peng, Schroeder, & Shah, 2007).

Specifically, operational capabilities refer to the cost of labor and cost of operation. Cost of labor includes salary, wages, and other benefits a firm pays to its employees and managers. The higher the employee and management benefit, the better service a firm can provide to its customers (Dutta, Narasimhan, & Rajiv, 1999). When a firm pays more to acquire high-quality employees and management, it can have better performance.

To advance the literature, this study also investigates the relationship between the cost of operation and a firm's performance. It claims that a professional service firm can gain competitive benefit by effectively managing marketing strategic cost, such as reducing the cost of sales. Previous literature indicates that the role of the cost of operation is a condition for the firm's success (Yu, Ramanathan, & Nath, 2014; Hausman, Montgomery, & Roth, 2002).

Thus, based on the argument and previous literature about operational capabilities, it is hypothesized that

**H3:** *Operational capabilities positively relate to a firm's performance.*

A conceptual framework is developed on the basis of previous literature and RBV theory. Figure 1 depicts diversification strategies and operational capabilities as drivers to achieve superior firm performance.

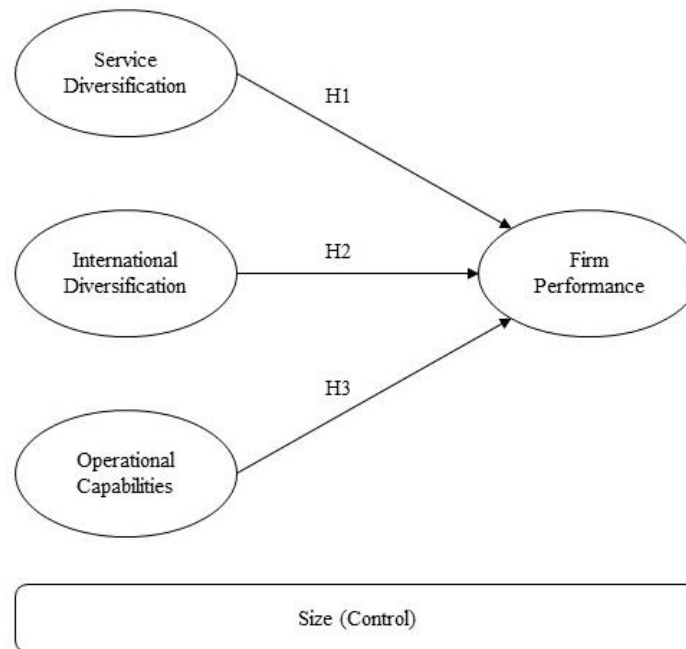


Figure 1 *Conceptual Framework*

## RESEARCH METHOD

### *Data Collection*

Samples are 96 companies in the service sector, listed on the SET. To test the hypotheses, indicators were obtained from the information stated in firms' financial statements, including notes to financial statements over the year of 2016 from Thomson Reuters Datastream and hand-collected data from the financial statement.

Data for service diversification and international diversification were hand-collected from companies' financial statement. Data for operational capabilities and the firm's performance were collected from DataStream.

This study focuses on the service sector according to SET industry group and sector classification structure. Service sector comprises of commerce, health care, media & publishing, professional services, tourism & leisure, and transportation & logistics.

### *Construct Measurement*

To examine the hypothesized relationships, there are four related constructs: (i) service diversification, (ii) international diversification, (iii) operational capabilities, and (iv) firm's performance.

**Service diversification:** was measured by the extent to which the companies approach their customers in their home country. The number of branches in Thailand is used as a measurement indicator for service diversification strategy.

**International diversification:** was measured by the extent to which the companies approach their customers in countries other than their home country. The number of branches in other countries outside of Thailand is used as a measurement indicator for international diversification strategy.

**Operational capabilities:** are represented as the non-transferred firm-specific resources, such as employees, managers, and operation procedures. Cost of operation in companies' financial statements - selling & administrative expenses and salary expenses, was used as a measurement indicator for operational capabilities.

The dependent variable is a firm's performance of a year after ( $t+1$ ). There is a lag effect, so it is believed that the performance effect shows better in the following year. Two dimensions, Return on Assets (ROA) and Return on Equity (ROE), were used as measurement indicators for a firm's performance.

Firm size is controlled in this study because larger firms are considered to have better strategic positions and capabilities to generate better firm performance. Firm size was measured by using the number of both total assets and total equities.

The descriptive statistics of all indicators are presented in Table 1.

Table 1 *DESCRIPTIVE STATISTICS*

	Mean	Standard Deviation	Kurtosis	Skewness
Service diversification	1.363	2.186	1.507	1.547
International diversification	0.332	1.084	12.850	3.650
Operational capabilities				
Salary expenses	13.123	1.486	0.067	0.367
Selling & administration expenses	13.352	1.598	1.434	0.910

The measurement model was further assessed for reliability and validity of the construct measures, with the exception of service diversification and international diversification, which were measured by only a single indicator. All other indicators were assessed for Cronbach's alpha, rho\_A, composite reliability, and Average Variance Extracted (AVE). As for reliability and validity, Table 2 confirmed that all constructs met the criterion.

Table 2 *RELIABILITY AND VALIDITY*

	Cronbach's Alpha	rho_A	Composite Reliability	AVE
Operational capabilities	0.941***	0.941***	0.971***	0.944***
Firm performance (t+1)	0.841***	0.841***	0.926***	0.862***

1-tailed;  $p < 0.1^*$ ;  $p < 0.05^{**}$ ;  $p < 0.01^{***}$

As for discriminant validity, the Fornell-Larcker criterion was applied. All constructs meet the criteria (Table 3).

Table 3 *FORNELL-LARCKER CRITERION*

	Service Diversification	Foreign Diversification	Operational Capabilities	Firm Performance (t+1)
Service diversification	1.000			
Foreign diversification	0.367	1.000		
Operational capabilities	0.557	0.398	0.972	
Firm performance (t+1)	0.217	0.200	0.078	0.929

The Heterotrait-Monotrait (HTMT) was used to further confirm discriminant validity between pair. Table 4 confirmed that all HTMT scores were below the discriminant validity benchmark.

Table 4 *HTMT*

	Service Diversification	Foreign Diversification	Operational Capabilities
Foreign diversification	0.367		
Operational capabilities	0.574	0.411	
Firm performance (t+1)	0.237	0.219	0.087

### Data Analysis

PLS regression was selected as a method to empirically examine and analyze relationships among the proposed constructs of interest. PLS-SEM is based on the non-parametric bootstrapping procedure in order to calculate outer weights, outer loaders, path coefficients, etc. and define their statistical significance (Hair Jr, Hult, Ringle, & Sarstedt, 2016). PLS is free from normal distribution assumption and suitable for small datasets (Chin, 1998), and also consistent with prior service marketing and hospitality research examining consumer behavior (Assaker & Hallak, 2013; Battour, Battor, & Ismail, 2012).

### RESULTS

The structural model shown in Figure 1 was tested for hypothesized relationships. The results of the PLS analysis and bootstrapping are presented in Table 5.

Table 5 *STRUCTURAL MODEL RESULTS*

H1: Service diversification -> Firm performance(t+1)	0.259**
H2: International diversification-> Firm performance(t+1)	0.176
H3: Operational capabilities -> Firm performance(t+1)	-0.478**
Controls:	
Size -> Service diversification	0.393***
Size -> Foreign diversification	0.294***
Size -> Operational Capabilities	0.841***

1-tailed;  $p < 0.1^*$ ;  $p < 0.05^{**}$ ;  $p < 0.01^{***}$

As predicted, service diversification has a significant positive effect on the firm's performance ( $\beta = 0.259$ ,  $p < 0.05$ ). However, the predicted relationship between foreign diversification and a firm's performance is rejected ( $\beta = 0.176$ , n.s.). Surprisingly, operational capabilities are confirmed to have a significant effect on a firm's performance, but negatively.

As the rationale to control the firm's size, the results show that a firm's size has significant positive effects on service diversification, foreign diversification, and operational capabilities.

### CONCLUSION

The results confirm that service diversification is significant in influencing financial performance of professional service firms in Thailand (H1). Service diversification strategy assists the firms to expand their service portfolio and reduce risk of operation.

However, this study finds that international diversification does not have a significant impact on the financial performance of professional service firms (H2). One possible explanation is that international diversification strategy does not assist Thai professional service firms in leveraging their capabilities and gaining benefits in local markets. This finding is in line with previous diversification literature, indicating that not all firms improve their performance through diversification strategy (Chakrabarti et al., 2006; Nath et al., 2010).

Both service and international diversification strategies need integration of comprehensive understanding of service initiation, local markets' culture, and alliance resources exchange (Fang, Wade, Delios, & Beamish, 2007; Chatterjee &

Wernerfelt, 1991).

The relationship between operational capability and financial performance is significant, but negatively (H3). This is different from the study result of (Nath et al., 2010; Ramanathan et al., 2016). The result may be explained that Thai professional service firms do not rely their performance on operational capabilities.

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