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# The Evolution and Restructuring of Diversified Business Groups in Emerging Markets: The Lessons from Chaebols in Korea

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**Abstract.** This paper proposes an evolutionary model of business groups in emerging economies by tracing the evolution and restructuring of business groups in Korea. Underlying our model are two theoretical premises: (1) the value-creation potential of business group diversification depends on the quality of the economic institutions supporting the economy; and (2) the strategy-structure fit is a key determinant of diversified business groups' performance. Combining these two premises, we link business group evolution with institutional context, sources of competitive advantages, diversification strategy, and structure. To illustrate our theoretical arguments, we provide an overview of the evolution of chaebols in Korea and examine the restructuring of two major business groups, LG and Hyundai Motor. We conclude by discussing implications for management, public policy, and future research.

**Keywords:** chaebols, business groups, evolutionary model of institutions, restructuring

Diversified business groups are significant players of the competitive landscape in many emerging economies. While traditional studies generally considered business groups as a departure from economic efficiency, recent research has provided a new understanding of the importance of this organizational form (Ghemawat and Khanna, 1998; Granovetter, 1994; Guillén, 2000; Khanna and Palepu, 1997, 1999). These studies suggest that business groups act as substitutes for imperfect capital, labor, and product markets in many countries, thereby enjoying competitive advantages that are not available to independent firms (Leff, 1976).

Because business groups in Korea, called chaebols, are a major case in point, our paper will focus on the evolution of chaebols and how they have changed and restructured over time. In the early phase of Korean economic development, when external markets were poorly developed, the chaebols' ability to transfer and share financial resources, human resources, and management know-how across subsidiaries played a crucial role in their rapid growth. By 1996, the 30 largest chaebols accounted for 40% of Korea's total output (Ungson, Steers and Park, 1997). Leading chaebols, such as Samsung, Hyundai, LG, and Daewoo, had

over 80 affiliated companies each participating in a wide range of industries, including semiconductors, consumer electronics, construction, shipbuilding, automobiles, trading, and financial services. By successfully transforming from exporters of cheap products to major global players in the past two decades, chaebols have been regarded as drivers behind the unprecedented success of the Korean economy (Amsden, 1989; Chang and Hong, 2000, 2002).

However, the perception of such large and diverse business groups has changed quite dramatically in the more recent period. Since the Asian currency crisis in 1997, chaebols in Korea have been described as excessively diversified and poorly managed organizations and accordingly seen as globally non-competitive. As a result, some scholars argued for the break-up of chaebols to improve national competitiveness. The government forced many chaebols to restructure their business portfolios (Bremner and Moon, 2002). In fact, the 1997 financial crisis mentioned early has brought vast changes to many chaebols. Of the largest 30 chaebols in 1996, about half of them have gone through bankruptcy proceedings or bank-sponsored restructuring programs. Daewoo, which was ranked number four in 1996, has literally been broken up and no longer exists. Other chaebols have also voluntarily taken their own restructuring efforts, often on a large scale.

The rise and fall of chaebols and other Asian business groups in general poses an intriguing research question. To examine this question, we propose an evolutionary model of business groups in emerging economies by tracing the evolution and restructuring of chaebols. Underlying our model are two theoretical premises. First, beyond strategic considerations in past research (e.g., Hoskisson and Hitt, 1990), the value-creation potential of diversification depends on the nature of economic and societal institutions supporting the country's economy. Different institutional settings offer different types of value-creation opportunities that can be exploited through different types of diversification strategies (Khanna and Palepu, 1997; Wan and Hoskisson, 2003). Thus, as institutions evolve with economic development, we argue, so do sources of potential value-creation of diversified business groups. Second, the strategy-structure fit is a key determinant of the performance of diversified business groups. Related diversification and unrelated diversification strategies pursue different economic benefits and necessitate different organizational arrangements (e.g., Hill and Hoskisson, 1987; Hoskisson, Hill and Kim, 1993; Keats and O'Neill, 2001). Thus, appropriate corporate structure of business groups varies according to the shifting nature of relationships between subsidiaries. Combining these two premises, we explore business group evolution through the development of institutional context, sources of competitive advantages, and diversification strategy and structure of business groups.

The paper is organized as follows. We first review the literature on business groups from institutional and organizational perspectives. Next, we combine the two perspectives to offer a model delineating evolutionary paths of strategy and structure of diversified business groups. We use this model to examine the evolution of chaebols within the Korean institutional context prior to the financial crisis. In the post-financial crisis period, we then analyze the structural adjustments of chaebols, which are illustrated by examining the restructuring paths of LG and Hyundai Motor groups. We conclude with implications for management and public policy, and offer suggestions for future research.

## 1. Theoretical perspectives

### *1.1. Institutional perspective*

Institutional economists claim that institutions—by defining the rules of the game and incentive structure of economies—affect economic performance (North, 1990). As such, the institutional contexts of a country define value-creating opportunities as well as constraints on firm action. Information and contracting problems associated with weak market institutions limit the firm's ability to expand through market relationships. Such market failures, however, present value-creating opportunities for an internal market that rests on the diversified business portfolio. The internal market helps to overcome the problems of contracting in the external markets. The logic of diversified firms as a response to market failures has been applied to explain the rise of U.S. conglomerates in the 1960s and diversified business groups in emerging markets.

Williamson (1975) provides a comprehensive explanation for rapidly growing conglomerates in many countries, including the U.S. during the 1960s. He argued that the emergence of conglomerates is primarily attributed to information asymmetry and governance inefficiencies in external capital markets. The information asymmetries and governance inefficiencies imply that external capital markets are limited in their abilities to achieve an efficient allocation of resources and discipline under-performing firms effectively. Headquarters in conglomerate firms perform roles analogous to those of investors in external capital markets (Williamson, 1975). They not only allocate scarce resources among divisions, but also evaluate and control them using return on investment criteria and resource allocation schemes based on profit maximization. Therefore, headquarters as internal investors may have advantages over investors in external capital markets, especially if the external capital market is underdeveloped. Headquarters possess rich information concerning the status of each division through internal information and auditing systems. Headquarters can mandate changes in strategy and operating policies, manipulate reward systems, or simply replace uncooperative, under-performing divisional managers without incurring extensive costs, particularly when compared to the costs associated with hostile takeovers. Because of these advantages, the internal capital market of the conglomerate firm can improve capital allocation and manage divisions more effectively than the external capital market can if each division were an independent firm. Indeed, there is growing evidence that U.S. conglomerates created value in the 1960s at the time that external capital markets were less developed (Hubbard and Palia, 1999; Klein, 2001).

Business groups in developing countries may play a similar role to conglomerates. Business groups are often seen as organizational solutions to problems arising from market failure and inadequate institutional development in capital, labor, and product markets (Encaoua and Jacquemin, 1982; Khanna and Palepu, 1997, 1999; Leff, 1978). In many countries with underdeveloped market institutions, vertical integration and diversification is necessary to secure access to intermediate products and services, leading to the emergence of business groups with diversified business portfolios. The diversified portfolio constitutes the backbone of the internal market for sharing scarce resources across subsidiaries. For this reason, Leff described business groups as an "institutional innovation for overcoming—and reaping

the benefits from—imperfect markets in the less developed countries." (1978: 668). As such, Khanna and Palepu (2000b) claim that there is no a priori theoretical reason to focus on capital market imperfections in searching for a reason for the existence of business groups; groups might also alleviate failures in product markets, labor markets, and in cross-border markets for technology.

The benefits associated with business group membership have been the focus of a number of empirical studies. For instance, Zeile (1996) found that group-affiliated firms are more dominant in the industries that are subject to market failures than others in Korea. Chang and Choi (1988) and Chang and Hong (2000, 2002) confirmed performance-enhancing effects of group affiliation in Korea. Khanna and Palepu (2000a) compared group-affiliated firms with unaffiliated firms in India and found that group affiliation was disadvantageous at lower levels of group diversification. In the case of highly diversified groups, however, group-affiliated firms outperformed unaffiliated firms. Khanna and Palepu (2000b) presented similar findings from the longitudinal analysis of Chilean firms.

In summary, if external markets are non-existent or poorly performing, it is possible to create value through internal markets of diversified business groups. With the advancement of external markets, however, it may become increasingly difficult for internal markets to accumulate and allocate resources more efficiently than for external markets (Guillén, 2000). Thus, the economic rationale of business groups is determined by the relative efficiency of internal versus external markets and is a function of institutional development (Khanna and Palepu, 1997, 2000a, 2000b). As external markets develop and become increasingly efficient over time, the relative importance of internal markets declines, and costs of building and maintaining internal capital markets come to outweigh associated benefits (Berger and Ofek, 1995; Lang and Stulz, 1994). However, to understand the trade-offs between internal and external markets, a consideration of different organizational forms is in order.

### *1.2. Organizational perspective*

Related and unrelated diversification strategies aim at different economic benefits and impose conflicting organizational requirements on firms (Hill and Hoskisson, 1987; Hoskisson, Hill and Kim, 1993). Related diversified firms tend to realize economies of scope, which require the M-form structure emphasizing cooperation among divisions (cooperative M-form structure). Unrelated diversified firms are appropriate to realize the economic benefits from internal capital markets, which require the M-form structure emphasizing competition among divisions (competitive M-form structure) (Hill, Hitt and Hoskisson, 1992). The inner working of business groups resembles the M-form structure with more hierarchical control and coordination than the holding company form involving legally independent firms. Thus, organizational challenges for managing diversified business groups might be similar to those facing the diversified M-form firm.

If the conglomerate seeks the economic benefits from the internal capital market, it should have the M-form structure with the following characteristics (Williamson, 1975): divisions should have full autonomy so that divisional managers can be held accountable for divisional performance; the evaluation of divisions should be based on objective financial criteria and be linked to divisional performance; and finally, cash flows should be allocated between

divisions by the headquarters to high yield uses on a competitive basis, rather than returned to source divisions. As such, the headquarters serves as an investor, and divisions can be analogous to individual firms in external capital markets.

In the cooperative M-form, coordination between divisions is necessary to realize economies of scope through transferring skills and sharing resources among divisions (Hoskisson, Hill and Kim, 1993). Galbraith (1995) suggests that some degree of centralization is required to achieve such coordination. Mintzberg (1983) also contends that when various divisions share specific functions such as R&D and distribution, the headquarters should manage these functions centrally. Also, to facilitate coordination between divisions, incentive systems for divisional managers should be linked to corporate as well as divisional performance (Gupta and Govindarajan, 1986; Kerr, 1985). Williamson (1975) labeled such a centralized M-form as "corrupted" and less efficient than a pure M-form. However, studies by Hill (1988), and Markides and Williamson (1994) found that the centralized M-form is more effective at realizing synergies inherent in related diversification than the pure M-form (or the competitive M-form structure mentioned above).

The radical differences between competitive and cooperative M-form structures imply that it may be difficult for diversified firms to simultaneously realize economies of scope and the economic benefits from internal capital markets (Hoskisson, Hill and Kim, 1993). The realization of economies of scope requires related business structures while the realization of the economic benefits from internal capital markets necessitates unrelated business structures. This strategy-structure contingency argument is supported by prior theory and research (e.g., Hill, 1988; Hill, Hitt, and Hoskisson, 1992; Hoskisson, 1987; Hoskisson and Hitt, 1994). Next, we integrate institutional and organization perspectives, discuss the rationale of business group diversification, and suggest the evolutionary paths of diversified groups.

### *1.3. Integrated framework*

In the early stage of economic development, market institutions are poorly developed. Because capital, labor, and product markets entail quite limited amounts of resources to trade, it is exceedingly difficult to mobilize large amounts of resources. Furthermore, the lack of specialized intermediaries supporting market transactions—which are available in developed countries—makes external markets suffer from information and incentive problems, further deteriorating efficiency of market transactions (Khanna and Palepu, 1997). On the other hand, the early stage of economic development generates abundant market opportunities. Firms in emerging economies, lacking indigenous technological capabilities, tend to compete on cost advantages while relying on foreign firms for necessary technologies. However, weak market institutions continue to present barriers to mobilizing financial and human resources necessary for launching new ventures. Thus, the firms that have the ability to mobilize generic resources rather than industry-specific capabilities (e.g., technological and marketing) are able to preempt markets and enjoy first mover advantages.

In the absence of efficiently functioning external markets, business groups with diversified business portfolios provide advantages, vis-à-vis independent firms, by mobilizing financial and human resources across subsidiaries. By performing the roles of internal markets for

transferring and sharing scarce resources across subsidiaries, business groups can overcome imperfections arising from weak market institutions, thereby becoming a dominant organizational form in emerging markets. In building and exploiting internal markets, unrelated diversification, as opposed to related diversification, tends to lead to two major benefits.

First, the ability to organize necessary resources for new market entry is generic in regard to basic applications (Guillén, 2000). Mobilizing financial and human resources, which are generic in nature, can be applied to entries into unrelated as well as those into related industries. In the absence of technological and marketing capabilities that may be used to exploit related industries, business groups are open to business opportunities, regardless of the degree of relatedness to existing businesses (Amsden and Hikino, 1994). When entering into the new industry, business groups often become the first local companies to enjoy first-mover advantages in regard to learning and accumulating basic skills and capabilities. Thus, groups emphasize industry-level attractiveness in their search for new business rather than emphasizing firm-level capabilities (Hoskisson et al., 2000).

Second, unrelated business portfolios provide stability and flexibility in operating internal markets (Khanna and Palepu, 2000a, 2000b). If internal capital markets, for example, are based on few affiliated companies operating in related businesses, their capabilities associated with financial economies of mobilizing capital and smoothing out business fluctuation tend to be limited. The same logic applies to internal labor markets. Internal labor markets, resting on many affiliates including a wide range of industries, provide more flexibility in exploiting new business opportunities and dealing with business downturns. Thus, in the absence of efficiently working external markets, the benefits of internal markets increase with the extent of unrelated diversification.

**Proposition 1.** *Under weak market institutions, unrelated diversification, as opposed to related diversification, increases benefits of internal markets.*

The benefits of internal markets do not come without costs. To run their internal markets, groups need to create coordinating mechanisms to transfer and share information and resources, and to enforce explicit and implicit intra-group trade. The resulting linkages make it difficult to evaluate the performance of individual subsidiaries. Thus, evaluating each subsidiary based on its objective financial criteria in isolation could be misleading. With ample new business opportunities to exploit, performance and prospect of the group usually take priority over those of individual subsidiaries. Accordingly, strategies in the best interest of individual subsidiaries may be not optimal for the entire group and group-level strategies take on significance. These features of running internal markets call for some degree of centralization and coordination by group headquarters. For these reasons, business groups would likely adopt the organizational arrangements more closely aligned to those of cooperative M-form structures.

Although there are benefits associated with unrelated business portfolios managed by the cooperative M-form in emerging economies, this ability to combine resources is a rare capability in the absence of well-functioning market mechanisms. Indeed, neither have all the firms in emerging markets been able to grow into business groups, nor have all the business groups been equally successful in leveraging their internal markets. The ability

to combine resources is embedded in routines, systems, structure, and culture of the group and often reflects the early history of the group. This ability creates scope economies and gives rise to unrelated business portfolios.

**Proposition 2.** *Under weak market institutions, unrelated diversified business groups managed by the cooperative M-form have competitive advantages over other types of business groups.*

However, the significance of internal market capabilities tends to decline over time as market institutions evolve (Peng, 2003). Internal markets compete against external markets on the basis of effectiveness and efficiency in raising and allocating resources. If there are no external markets, internal markets are the sole alternative. With the development of external markets, however, it becomes progressively difficult for internal markets to create more value than external markets do (Hoskisson et al., 2000; Khanna and Palepu, 2000a, 2000b).

The decline in the benefits of internal markets may also come from the competitive landscape. With new business opportunities associated with the industrial vacuum depleted, business groups start to enter the markets that other groups are already in, and, as a consequence, competition often occurs between business groups. Also, market liberalization often includes lifting of restrictions on foreign direct investments and allows foreign competitors to enter markets populated by domestic firms alone. As business groups move into the high-end segments of the global markets following their initial success in low-end market segments, they begin to compete head-to-head against foreign firms. As a result, the advantage of mobilizing resources through internal markets loses much of its relevance. Instead, competitive advantage is more determined by industry-specific capabilities such as technological and marketing skills (Guillén, 2000).

The shift in competition toward industry-specific capabilities has crucial implications for diversified business groups. The decreased significance of internal market capabilities makes sharing generic resources less meaningful and individual businesses become less dependent on each other. Furthermore, as the benefits of internal market capabilities decline, so do benefits associated with centralization and coordination by group headquarters. Interventions by group headquarters may unduly reduce strategic autonomy and flexibility of subsidiaries, thereby inhibiting them from accumulating core competencies and pursuing long-term strategies. As a consequence, unrelated diversified groups managed by the cooperative M-form create a strategy-structure misfit. Instead, unrelated diversified business groups managed by the competitive M-form and related diversified business groups managed by the cooperative M-form emerge as efficient organizational forms.

**Proposition 3a.** *With advancement in market institutions, unrelated diversified business groups managed by the cooperative M-form lose their competitive advantage.*

**Proposition 3b.** *With advancement in market institutions, unrelated diversified business groups managed by the competitive M-form and related diversified business groups managed by the cooperative M-form emerge as efficient organizational forms.*

There are basically two different paths for unrelated diversified groups managed by the cooperative M-form to remedy the strategy-structure misfit. The first path is to shift towards the competitive M-form structure to create an unrelated diversified group under the control of the competitive M-form structure. This path involves major restructuring and reorientation in organizational arrangements while business portfolios remain intact to a large extent. It would require that the group headquarters delegate much decision authority to subsidiaries, put emphasis on autonomy, and emphasize performance accountability of individual subsidiaries. Alternatively, business groups can restructure business portfolios to realize scope economies based on specialized capabilities while maintaining the cooperative M-form structure. This can take the form of designating core businesses, and then liquidating, spinning off, and divesting unrelated businesses. The resulting diversified group has a related business portfolio under the control of the cooperative M-form. Next, we will illustrate our arguments through the evolution and restructuring of Korean business groups.

**Proposition 3.** *With advancement in market institutions, unrelated diversified business groups managed by the cooperative M-form can improve competitiveness by reorganizing into the competitive M-form structure or by reducing the level of scope and thereby refocusing into related business portfolios.*

## 2. Evolution of the chaebol

### *2.1. From the 1960s to the late 1980s*

Industrialization in Korea started with the launching of the first five-year economic development plan in 1962. Lacking adequate resources, experience, and market institutions, the government opted to seek rapid growth by pursuing initiatives to jump-start the industrialization process. The government designated "strategic sectors" for the concentration of scarce resources. To boost these primary sectors rapidly, the government provided negotiated access to foreign technology, low-interest funds, and subsidies. The government's strategy of targeting certain industries offered both risks and opportunities to firms. Although operating in new industries entailed high risk, firms were able to gain access to scarce resources such as foreign technology and capital by entering into strategic sectors.

In the early stage of economic development, it was almost impossible to raise large amounts of funds through domestic sources due to the underdeveloped nature of domestic capital markets. Only the government could borrow abroad and channel these funds into strategic or export-oriented sectors at below-market interest rates. Banks, which were nationalized in 1961, also played a significant role as a conduit for funneling financial resources into strategic or export-oriented sectors. Firms that diversified into strategic sectors in response to the government's initiative could readily secure funds, diversify and renew their business portfolios, and emerge as chaebols. By contrast, firms sticking to their core businesses failed to renew their business portfolios and grow into chaebols (Korea Economic Research Institute, 1995).

Once diversified, chaebols came to build and exploit internal capital markets. When the chaebol ventured into a new subsidiary, much of the equity capital came from other member

firms; in turn, the new subsidiary assumed equity of other subsidiaries. The resulting cross-shareholdings among subsidiaries enabled chaebols to make the most of the use of internal capital. Because the chaebol engaged in intensive selling and purchasing of intermediate and final products among its member firms, it could channel funds into a particular subsidiary by manipulating transfer prices (Chang and Hong, 2000). Chaebols also invested in non-banking financial institutions to enlarge their internal capital markets. Although chaebols were prohibited from owning commercial banks, they diversified into non-banking financial institutions (e.g., insurance and investment companies), which were not only very lucrative businesses, but were also critical for the chaebol "to get around the nationalized banking system, allowed the chaebol flexibility with day-to-day cash-flow problems and with lending within the chaebol" (Kim, 1997a:189) Given the relative underdevelopment of external capital markets, such internal financing capabilities were essential to funding the rapid growth of business groups.

Chaebol members also had advantages over single-business firms in obtaining financial resources outside. Banks usually preferred financially strong member companies to guarantee debt repayment. The bank treated group members as divisions of an M-form firm. The availability of debt repayment from other group members, along with large diversified business portfolios of the group as a whole, made group members attractive debtors. Furthermore, because of their ability to create new businesses, chaebols and their member companies demonstrated sanguine prospects by growing in size and business scope.

The size and diversified business portfolio of chaebols were helpful at securing high-quality human resources, too. In the hierarchical Korean society, working for large companies per se conferred prestige upon employees (Han, 1995). Business groups generated many opportunities for promotions and career development by continuously expanding into promising industries (Amsden, 1989). In the absence of well-developed external labor markets, prospective employees sought to start and develop their careers at the business groups whose internal labor markets were expected to grow and diversify into promising areas.

The lack of external labor markets made it difficult to hire junior and senior managers from outside, which was a barrier to starting new businesses. Business groups could overcome this barrier by transferring managers across subsidiaries (Amsden, 1989). A study by the Korea Economic Research Institute (1995) based on a sample of the five largest business groups showed that, in launching new ventures, managerial positions were normally filled by transferring managers from other member companies. This was true even when new ventures were unrelated to existing businesses. Indeed, the transfer of managers facilitated the diffusion of technologies and management know-how within the group (Amsden, 1997; Kim, 1997b). In sum, internal labor market capabilities enabled business groups to continually accumulate and utilize human capital (Hoskisson, Yiu and Kim, 2000).

During the early stage of economic development, markets for intermediate products were also poorly developed, which could be another barrier to starting new businesses. LG Chairman Koo Cha-Kyung explained the group's successive moves into new business fields in the following way (Aguilar and Cho, 1985:3):

> My father and I started a cosmetic cream factory in the late 1940s. At the time, no company could supply us with plastic caps of adequate quality for cream jars, so we

> had to start a plastics business. Plastic caps alone were not sufficient to run the plastic molding plant, so we added combs, toothbrushes, and soap boxes. This plastics business also led us to manufacture electric fan blades and telephone cases, which in turn led us to manufacture electrical and electronic products and telecommunication equipment. The plastics business also took us into oil refining, which needed a tanker shipping company. The oil refining company alone was paying an insurance premium amounting to more than half the total revenue of the then largest insurance company in Korea. Thus, an insurance company was started. This natural step-by-step evolution through related businesses resulted in the Lucky-Goldstar group as we see it today.

LG's early business expansion was characterized as (1) vertical integration to procure necessary parts and services of its own and (2) related diversification to utilize overcapacity. The above pattern is observed at other groups: some of the diversification moves by chaebols—which are now regarded as unrelated—started as vertical integration to secure intermediate products or as related diversification to utilize excess capacity. This gives further credence to the necessity of using the cooperative M-form structure postulated earlier.

In the course of industrialization, new business opportunities proliferated. Modern industries simply did not exist in many business areas, and demand surpassed supply in most domestic markets. Competent entrepreneurs—if arranged with necessary resources—could succeed with almost any business. The basis of competition was who could mobilize the necessary resources for new entry more rapidly rather than who could produce more competitive products. At this stage of evolution, business groups were the only organizational form with such entrepreneurial capabilities. With internal markets for capital, labor, and intermediate products, business groups were able to organize necessary resources and preempt new market opportunities rapidly. Lacking advanced technological and marketing capabilities, business groups were willing to exploit new business opportunities, regardless of relatedness between existing businesses and new ventures (Han, 1995). Still, important scope economies existed among subsidiaries in that they shared key inputs such as financial and human resources through internal markets.

In summary, the early rapid growth of chaebols was made possible through their efforts to overcome problems stemming from weak economic institutions. Since capital, labor, and intermediate product markets were non-existent or weakly developed, groups had no choice but to generate these resources internally. By establishing their diversified business portfolios, groups could build internal markets, which allowed further diversification in response to emerging business opportunities. Indeed, the internal markets served as a mechanism of converting factor-market imperfections into product-market preemption.

The strong leadership of the founders contributed to the rapid growth of major chaebols (Shin, 1995). Without the entrepreneurial spirit and business savvy of these founders, these companies could not have responded to emerging opportunities rapidly and grown into major chaebols. As groups grew in size and business scope later, it became difficult for chairpersons to process all the relevant information and make decisions accordingly. In response, groups established the headquarters to assist the central control of chairpersons. Samsung group, for instance, established its headquarters, called "Secretarial Office," in 1959. Its major responsibilities included the allocation of financial and human resources

and the coordination of decisions between affiliates. It also served as a group think tank that engaged in long-range planning for the group. The headquarters made a great contribution to crafting and orchestrating the rapid growth of the Samsung group (Korea Economic Research Institute, 1995).

The group's ability to mobilize resources was a major source of scope economies in Korea prior to the late 1980s (Amsden, 1989). In fact, business groups adopted organizational arrangements similar to the cooperative M-form. Centralization and coordination provided by the cooperative M-form structure were essential for mobilizing scarce resources, financial and human, across affiliates in response to emerging opportunities. For example, in entering into the shipbuilding industry, the Hyundai group claimed that shipbuilding was related to its then core business, construction, in terms of "building things." Synergies arising from "building things" sounds like an oversimplification. However, accumulated experience in project feasibility studies, project task force formation, access to foreign technical assistance, training, equipment purchase, new plant design and construction, and operation of project start-ups in the construction business helped Hyundai to set up its new shipbuilding business (Amsden and Hikino, 1994). In the process, the group headquarters played a key role in coordinating the transfer and sharing of resources and expertise between the two group-affiliated companies.

In summary, in the early period of development, chaebols took advantage of the abundance of new business opportunities while exploiting their ability of overcoming factor market imperfections through internal markets. Although the resulting business portfolio was unrelated in technology and markets, individual businesses were related in sharing the group's internal market capabilities, which was facilitated by the cooperative M-form structure. Thus, in the early stage of industrialization, chaebols had a relatively good strategy-structure fit.

### 2.2. *From the late 1980s to present*

In the late 1970s, the Korean government set out to support massive investments in heavy industries with the same determination and tools it had applied to other sectors earlier. However, by the 1980s, the domestic heavy industries experienced serious financial problems, which invoked skepticism about the government's capability of leading economic development. In addition, major trading partners asked for economic liberalization including reduction of the government's support to industry sectors and reduced import barriers. In response, during the fifth economic development plan (1982–1986), the government emphasized the development of market-based systems, shifting the government's role from a "development" to a "regulatory" approach (Kim, 1997a).

To promote market competition, many restrictions on foreign direct investment and new market entry were lifted. In the early period with abundant new business opportunities, competition occurred on the basis of the ability of overcoming factor market imperfections and starting new businesses. In pursuing business opportunities, companies preferred creating and preempting new markets to entering into existing markets and competing head-on against incumbents. Indeed, major groups concentrated on different businesses in the 1960s: Samsung rested heavily on textile and sugar industries, Hyundai on construction, and LG

on electrical/electronic industries. However, once the first mover advantages into new business opportunities were depleted, groups gradually moved into the existing markets and competed fiercely against each other. As a result of the emergence of competition between groups, the ability to mobilize generic resources (e.g., financial and human resources) lost its significance as a source of competitive advantage. Instead, more industry-specific resources (technological and marketing capabilities) became defining sources of competitive advantage in domestic markets.

Global competition also amplified the significance of securing industry-specific capabilities such as technological and marketing expertise. With initial success in exporting low-end product segments, chaebols started to move into the higher-end segments of the global industry, which required industry-specific capabilities. At the same time, the challenges from less developed countries such as China and other Southeast Asian countries, along with the sharp increase in labor costs, made it difficult for group members to continue to compete on the basis of low prices. The competitive landscape, domestic and global, indicated a shift of competitive basis from generic to industry-specific capabilities.

Factor markets also improved, but at a slower rate than product markets. The government initiated liberalization in the 1980s in financial services aimed to substantially reduce its role in the allocation of credit and to gradually build an autonomous financial services sector. As such, loans associated with government policy with preferential interest rates, which had been used as an inducement for companies to invest in strategic sectors, were gradually eliminated. Such loans had been the dominant source of capital for companies. For instance, government policy loans to these strategic sectors accounted for 63 percent of total bank loans and constituted a majority of the investments in heavy industries. The government also privatized commercial banks that it had owned and used as a method of supporting companies investing in strategic sectors for the past two decades. However, chaebols were prohibited from acquiring commercial banks.

Financial liberalization and subsequent development of the financial services sector made financial resources less scarce than before. However, information imperfections and weak governance remained barriers to the development of capital markets. Business groups maintained their position of being reliable debtors by providing debt guarantees through cross-collateralization among group subsidiaries and projecting a “too-big-to-fail” image to lenders. Also, by expanding non-banking financial operations, they sought to broaden their internal capital market capabilities, which continued to play a key role in financing growth.

In terms of human resources, the number of colleges and universities increased substantially, raising the supply of managerial human capital. External labor markets for managerial talent formed upon the entry of foreign companies. While local companies were reluctant to recruit managers from outside, foreign companies were eager to do so. Although the market for managerial talent emerged initially on a small scale, such labor markets in general remained inflexible.

More fundamental changes to institutional environments were fostered by the financial crisis in late 1997. Viewing reckless expansion of chaebols to be a major contributor to the financial crisis, the government initiated the “chaebol reform policy”. The reform policy included the elimination of debt guarantees between affiliates, the reduction of debt-to-equity ratios to below 200 percent, the ban on cross-shareholdings between affiliates, and the

ban on unfair trade between affiliates (Jang, 2002). All these initiatives were intended to restrict activities that were central to internal capital market operation, which had been a driver behind the early growth of groups. As a consequence, groups' internal capital market capabilities declined substantially after the crisis.

Chaebols also have restructured themselves voluntarily since the financial crisis. Groups, for the first time in their history, engaged in massive layoffs and the psychological contract of lifetime employment started to disappear in Korea. Managers are focusing on maintaining "employability" rather than life time commitment and are willing to move to another company to increase their market value. Many engineers and managers voluntarily left large firms to pursue better career opportunities at entrepreneurial start-ups or foreign firms. The increased supply of human resources and development of external labor markets has reduced the relative importance of internal labor markets of chaebols (Bremner and Moon, 2002)

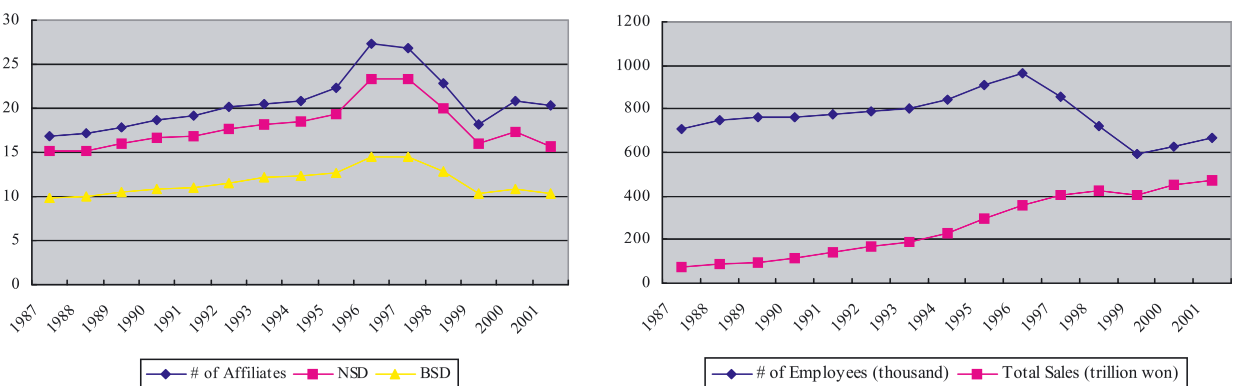
With the development of factor markets, along with shifts in competitive context, the significance of internal market capabilities declined. At the same time the importance of specialized resources, including technological and marketing skills, increased as sources of competitive advantage. These changes implied that the business portfolio, which was related earlier in sharing generic resources, became mixed related or unrelated.

Despite a shift in their business portfolios, business groups failed to rearrange their organizational arrangements. Business groups remained under tight control of chairpersons and headquarters. Chairpersons still got deeply involved in decision-making processes at subsidiaries with assistance of large staffs at the headquarters. Even if operating decisions were delegated to subsidiaries, strategic decisions were often centralized. Major decisions such as the launch of new businesses, overseas expansion, large-scale investments, and appointment of key executives were all within the founders' authority or at least such decisions needed to be referred to founders before finalization was possible (Shin, 1995). As such, the authority of subsidiary managers was quite limited and chaebols were managed in a top-down fashion.

In sum, chaebols, with unrelated business portfolios, remained organized following the logic of the cooperative M-form structure, creating probable inefficiencies in regard to strategy-structure fit (Hill, Hitt and Hoskisson, 1992). Furthermore, this strategy-structure misfit served as a stumbling block for the accumulation of specialized resources. Under the centralized organizational form, often dominated by founders or their family members, it is difficult for affiliated firms to have the strategic autonomy necessary to establish a long-term vision, build specialized resources, and develop business models. Given the widely diversified business portfolio, the headquarters has limited ability to pay attention to the individual needs of affiliated firms. Group culture emphasizing homogeneity within a business group could be another barrier to each affiliated firm to develop its own differentiated strategy and systems.

## 3. Future directions for chaebol restructuring

Figure 1 summarizes the key statistics of 30 Korean chaebols, designated annually by the Korean Fair Trade Commission for regulatory purposes as the largest chaebols. As shown in figure 1, chaebols kept expanding their business diversified scope until 1997 at the time that




| | 1987 | 1988 | 1989 | 1990 | 1991 | 1992 | 1993 | 1994 | 1995 | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **# of Affiliates** | 16.8 | 17.1 | 17.9 | 18.7 | 19.1 | 20.1 | 20.5 | 20.8 | 22.3 | 27.3 | 26.8 | 22.9 | 18.1 | 20.8 | 20.3 |
| **NSD** | 15.1 | 15.2 | 16.0 | 16.6 | 16.8 | 17.7 | 18.2 | 18.5 | 19.4 | 23.3 | 23.3 | 20.0 | 16.0 | 17.4 | 15.7 |
| **BSD** | 9.9 | 10.0 | 10.5 | 10.9 | 11.0 | 11.5 | 12.1 | 12.3 | 12.7 | 14.5 | 14.5 | 12.9 | 10.4 | 10.9 | 10.3 |
| **# of Employees (thousand)** | 710 | 748 | 765 | 765 | 775 | 786 | 800 | 841 | 911 | 967 | 858 | 723 | 596 | 629 | 670 |
| **Total Sales (trillion won)** | 75 | 87 | 95 | 116 | 143 | 170 | 191 | 226 | 294 | 354 | 402 | 427 | 402 | 455 | 472 |

*Figure 1*. Key statistics on the top 30 chaebols, 1987–2001 (figures include non-financial sectors only). NSD: Narrow Spectrum Diversification: Number of 4-digit SIC segments; BSD: Broad Spectrum Diversification: Number of 2-digit SIC segments.

the economic crisis occurred. Since then, they have restructured their business portfolios to improve their focus. For instance, the average number of four-digit Korean SIC codes was about 15 in 1987, grew into more than 23 in 1997, and fell to about 16 subsequently. During this period, the average number of two-digit Korean SIC codes shifted from 9.9 in 1987, to 14.5 in 1997, to 10.3 in 2001.

The reduction in business scope may under-represent the severity that chaebols have gone through since the financial crisis. Of the largest 30 chaebols as of 1996, about half of them have been bankrupt or under the bank-sponsored workout program, as summarized in Table 1. Finally, the "too-big-to-fail" myth has been dispelled and chaebols have been

*Table 1.* Restructuring of the top 30 chaebols in 1996[a].

| | Number of affiliates | | | NSD[b] | | | BSD[c] | | |
|---|---|---|---|---|---|---|---|---|---|
| Ranking | 1996 | 1999 | 2001 | 1996 | 1999 | 2001 | 1996 | 1999 | 2001 |
| 1. Hyundai | 57 | 35 | 12 | 39 | 27 | 11 | 26 | 20 | 11 |
| 2. Samsung | 80 | 45 | 63 | 57 | 36 | 44 | 27 | 20 | 20 |
| 3. LG | 49 | 43 | 51 | 38 | 33 | 37 | 22 | 17 | 19 |
| 4. Daewoo* | 30 | ** | ** | 25 | ** | ** | 15 | ** | ** |
| 5. SK | 46 | 39 | 62 | 28 | 25 | 39 | 17 | 14 | 21 |
| 6. Ssangyoung* | 25 | 22 | ** | 22 | 18 | ** | 17 | 13 | ** |
| 7. Hanjin | 24 | 18 | 21 | 19 | 13 | 15 | 15 | 11 | 13 |
| 8. Kia* | 28 | ** | ** | 17 | ** | ** | 12 | ** | ** |
| 9. Hanwha | 31 | 23 | 26 | 22 | 20 | 22 | 17 | 15 | 16 |
| 10. Lotte | 30 | 28 | 32 | 24 | 23 | 26 | 16 | 15 | 15 |
| 11. Kumho | 26 | 20 | 15 | 22 | 14 | 13 | 15 | 10 | 9 |
| 12. Halla* | 18 | ** | ** | 15 | ** | ** | 13 | ** | ** |
| 13. Dongah* | 19 | 16 | ** | 18 | 15 | ** | 13 | 10 | ** |
| 14. Doosan | 25 | 16 | 18 | 20 | 14 | 15 | 14 | 10 | 11 |
| 15. Daelim | 21 | 18 | 15 | 17 | 14 | 13 | 14 | 9 | 10 |
| 16. Hansol | 23 | 19 | 12 | 19 | 17 | 11 | 15 | 13 | 8 |
| 17. Hyosung | 18 | 13 | 15 | 16 | 12 | 12 | 12 | 11 | 11 |
| 18. Dongkuk | 17 | 14 | 6 | 13 | 11 | 5 | 10 | 8 | 4 |
| 19. Jinro* | 24 | 16 | ** | 20 | 12 | ** | 14 | 11 | ** |
| 20. Kolon | 24 | 17 | 29 | 21 | 16 | 24 | 14 | 12 | 14 |
| 21. Kohap* | 13 | 6 | ** | 12 | 6 | ** | 9 | 5 | ** |
| 22. Dongbu | 34 | 19 | 21 | 30 | 18 | 18 | 15 | 12 | 12 |
| 23. Dongyang | 24 | 25 | 16 | 18 | 16 | 10 | 13 | 11 | 7 |
| 24. Haitai* | 15 | ** | ** | 13 | ** | ** | 9 | ** | ** |
| 25. Newcore* | 18 | ** | ** | 11 | ** | ** | 7 | ** | ** |
| 26. Anam* | 21 | 14 | ** | 17 | 14 | ** | 12 | 9 | ** |
| 27. Hanil* | 7 | ** | ** | 6 | ** | ** | 4 | ** | ** |
| 28. Keopyung* | 22 | ** | ** | 18 | ** | ** | 13 | ** | ** |
| 29. Miwon | 25 | ** | 12 | 18 | ** | 11 | 13 | ** | 7 |
| 30. Shinho* | 25 | ** | ** | 21 | ** | ** | 13 | ** | ** |

*Groups that have gone through bankruptcy proceedings or bank-sponsored restructuring programs.
**The group was unlisted on the list of the top 30 chaebols in the respective year.
[a]Figures include non-financial sectors only.
[b]Narrow Spectrum Diversification: Number of 4-digit SIC segments.
[c]Broad Spectrum Diversification: Number of 2-digit SIC segments.

forced to undertake restructuring efforts. This has been supported by bank reforms. For instance, "like Japan, South Korea has provided big infusions to troubled banks, spending about $120 billion. But in contrast to Japan, Korea has forced big changes. Korea's bad bank loans have been reduced to an internationally acceptable level of 3.4 percent, from around 10 percent three years ago, the level where Japan is stuck today" (Brooke, 2002, Section C: 1). These changes meant closing 16 banks and a 25 percent of bank branches, and laying off 300,000 employees. As mentioned above, this restructuring resulted in chaebols with relatively narrow scopes of businesses.

However, to achieve a strategy-structure fit requires changes in internal organization besides changing the business scope. In many cases, chaebols have gone beyond business portfolio reshufflings and overhauled their ways of managing their group affiliates in an attempt to regain and improve their competitive advantages. To illustrate how these broad changes have affected chaebols, we provide an overview of restructuring efforts of two groups, LG and Hyundai Motor. The restructuring of LG and Hyundai Motor groups has many similarities and differences. LG and Hyundai (from which Hyundai Motor was spun off) were both large groups with highly diversified business portfolios as of the late 1997, having consistently ranked among the top four groups since the 1970s. However, they took quite different routes to restructuring, as illustrated below.

### *3.1. LG group*

When the financial crisis swept the Korean economy in the late 1997, LG was one of the top four chaebols with more than fifty affiliated firms, which competed in a wide range of businesses including electronics, telecommunication equipment, telecommunication services, chemicals, oil refining, trade, retailing, financial services, construction, home shopping, etc. Facing declining competitiveness in many of its businesses and a severe liquidity crisis, LG embarked on a group-wide restructuring initiative. Initially, it focused on improving cash flow. In 1998 and 1999, LG attracted a total of $3.65 billion in foreign capital, including a $1.6 billion investment from Philips in its LCD sector in 1999, which is record amount of foreign capital infusion for a single Korean company. Due to these strenuous efforts, LG reduced debt-to-equity ratio from 313% in late 1997 to 148% by the end of 1999, overcoming its cash flow crisis.

LG, however, intended to achieve much more than improving its financial structure. LG initiated an asset restructuring program of its business portfolio by pursuing a "select-and-focus" strategy. The basic principle of this strategy is to be more selective in choosing areas to compete and focusing resources in the select areas—rather than spreading itself too thin across many disparate areas. For this purpose, non-core businesses (defined as businesses with limited growth potential) were liquidated, sold off, or spun off; and core or related businesses were also consolidated. In 1999 alone, LG sold off four companies, spun off three companies, liquidated one company, and consolidated eight companies. In fact, LG reduced its business scope, measured by the number of two-digit SIC codes, from 21 in late 1997 to 16 by the end of 2000. Although LG reduced the unrelated component of its business portfolio to some degree, its business portfolio remained comparatively unrelated.

Besides reorganizing its business portfolio, LG has been experimenting with the holding company system to overhaul the ways in which the group manages its affiliated companies. A holding company, which refers to a corporation that owns enough voting stocks in another company to control management, is still an unfamiliar concept in Korea. In fact, it was not until April 1999 that the Korean government lifted a ban on the creation of holding companies. Although the holding company system can improve transparency and prevent the spread of a unit's financial distress into other units by eliminating cross-shareholdings and debt guarantees, it can also enable owners to leverage relatively small shareholdings to secure control over a large number of affiliates (Bethel and Liebeskind, 1998). In a bid to restrain such abuses, the government allowed the introduction of the holding company systems with some qualifications, including a 100-percent debt ratio ceiling for a holding company, minimum equity holdings of 30 percent in listed subsidiaries and a ban on ownership of financial service companies. This will allow for further restructuring if needed, because chaebol subsidiaries will be less interdependent due to less cross-shareholding and less debt guarantees that are based on assets beyond the focal subsidiary assets. Cross-shareholdings and debt guarantees created mutual interdependence among chaebol member firms. In the downturn, this mutual interdependence created situations of overall financial distress for the chaebol and not just for the specific subsidiary suffering from performance problems.

LG set up two holding companies, LG Chemical Investment (LGCI) and LG Electronic Investment (LGEI), for two flagship businesses in 2001 and 2002, respectively. These two holding companies were merged into LG Holdings in 2003, culminating LG's three-year efforts to reorganize all the affiliated companies under a single holding company. According to LG's restructuring plan, controlling shareholders will hold only the shares of the holding company that engages in management and restructuring the portfolio of invested assets (i.e., affiliated companies) while management of affiliated companies will be delegated to professional managers. If implemented, the holding company structure would generate effects similar to those of the competitive M-form structure: The top management of affiliates, as those of divisions, would have full autonomy and responsibility for their business decisions; the top management of the holding company, similar to those of the M-form headquarters, concentrates on evaluating affiliates and deciding on which businesses will be added to and which businesses will be divested from the business portfolio.

LG's move towards the holding company, along with the change of its business portfolio, represent restructuring efforts in line with the operational logic of managing a competitive M-form structure. Although it has discarded several unrelated lines of businesses and rationalized remaining lines of businesses, LG remains as an unrelated diversified group. As such, LG has shifted to a more decentralized system to better manage its unrelated business scope.

### 3.2. *Hyundai motor group*

When the financial crisis hit the Korean economy in the late 1997, Hyundai was one of the top four chaebols with more than sixty affiliates. It was extensively diversified, including automobile, construction, shipbuilding, semiconductors, electronics, financial services, chemicals, oil refining, retailing, etc. While other chaebols were busy in raising capital

to improve their financial structure during the financial crisis, Hyundai sought to expand its businesses further. It took over Kia Motors and LG Semiconductor to consolidate with their existing businesses, and launched a number of North Korean projects. All of these new outlays of capital, together with the lack of cash inflow, deteriorated Hyundai's financial situation. In 1999, liquidity problems of Hyundai Engineering & Construction, one of flagship companies, became public and spread to other affiliates interlinked by cross-shareholdings and debt guarantees. To ease its liquidity problems, Hyundai decided to spin off some of its major affiliates including automobile and heavy industries in addition to selling off businesses and attracting foreign investors. In August 2000, Hyundai Motor and other auto-related affiliates were separated from Hyundai, establishing Hyundai Motor group.

Chung Mong Koo, chairman of Hyundai Motor, took advantage of the spin-off to upgrade its capabilities, with the vision of joining the world's top 5 automakers by 2005. Hyundai Motor revamped quality control operations, improved its design capabilities, and increased R&D investments. Hyundai Motor exploited the 1998 acquisition of Kia Motors seeking to realize scale economies, improve supplier relationships, and consolidate its market positions. Hyundai Motor sold 10% of its stakes to Chrysler with the aim of building a strategic alliance. The partnership was expected to provide Hyundai Motor with access to advanced technology and foreign markets. Along with these efforts, Hyundai Motor group reconfirmed its independence from Hyundai group by refusing Hyundai group's request for financial assistance.

Hyundai Motor group has been expanding into interrelated lines of business. Hyundai Motor group, which consisted of 10 affiliates at the time of spin-off, now has 25 affiliates, and the number is expected to grow. However, these expansion efforts concentrated on reinforcing and complementing the automobile business rather than diversifying into unrelated areas. For instance, Hyundai Capital added auto-financing operations and planned to develop differentiated auto-related services. The acquisition of Diner Card was driven by Hyundai Motor group's desire to reinforce its financial services business. By bundling automobile sales and financial services, it hoped to improve customer relationships and create new sources of profit. In fact, Hyundai Motor group set up a long-term strategy to transform itself from a simple automobile manufacturer into a comprehensive automobile group providing the end-to-end service including auto purchase, insurance, financing, and information.

Until now, Hyundai Motor group seems to be successful in growing into an automobile group. With the bankruptcies of major local competitors such as Daewoo Motor, Ssangyong Motor, and Samsung Motor, it has been relatively easy to dominate the domestic market. However, it has also had noteworthy success in foreign markets, especially in the U.S. Owing to enhancements in quality, design, and performance, Hyundai automobiles received better responses from the U.S. customers. Industry analysts, for instance, recently ranked Santa Fe as America's top compact SUV. In the past three years, its market share in the U.S. has risen 70% from 1.4% to 2.4%, which does not include the 1.4% U.S. market share of Kia Motors, a Hyundai affiliate (Moon, Armstrong and Edmondson, 2003).

The break-up of Hyundai group and the resulting birth of Hyundai Motor group represent another route to reaching the strategy-structure fit in the diversified group. Hyundai Motor

group has built its businesses around the automobile businesses and sought to grow into a comprehensive automobile group. Its corporate strategy focuses on creating and leveraging synergies among affiliates and accordingly emphasizes cross-unit cooperation and coordination. In short, Hyundai Motor group is trying to organize its group following the logic of cooperative M-form.

In summary, LG and Hyundai have taken different paths in restructuring. LG is moving toward organizing unrelated businesses under the control of a holding company framework. By decentralizing decision-making authority to affiliates, the holding company system is expected to resolve problems arising from managing unrelated businesses in a top-down fashion. LG's restructuring has also invited growing interest among other chaebols. Several groups have already implemented the holding company structure to facilitate restructuring and major groups such as Doosan and Kolon are contemplating following LG's approach. These groups are likely to restructure following the logic of the competitive M-form structure. Alternatively, Hyundai Motor group, which was founded as a result of Hyundai's break-up, is an example of a chaebol that has pursued a cooperative structure in restructuring efforts. To transform into a comprehensive automobile group, Hyundai Motor group concentrated resources in the automobile and other related areas rather than pursuing unrelated businesses. Such chaebols as Hanjin and Hanwha have restructured in the similar fashion. They were initially forced to liquidate, divest, or spin off non-core business to relieve huge debt burden, and then refocused around core businesses emphasizing the cooperative M-form structure.

## 4. Discussion and conclusions

By combining institutional and organizational perspectives, this paper illustrates evolutionary paths of strategy and structure of diversified business groups. In the early days of industrialization in Korea, business groups constituted internal markets that mitigated institutional inefficiencies. While the ability of mobilizing through internal markets can be applied to a broad spectrum of seemingly unrelated opportunities, running internal markets requires coordination and integration by the group headquarters. The outcome is widely diversified business groups managed by the cooperative M-form structures. The chaebols are a good example in point. In the early course of industrialization, external markets were non-existent or weakly developed in Korea. The ability of building and operating internal markets efficiently was a valuable, rare, and inimitable resource that accounted for remarkable growth of chaebols and significant advances for the Korean economy at large.

With the advancement of institutional and competitive contexts, however, the significance of internal market capabilities declined, and major competition occurred between groups and/or between groups and foreign companies. As a result, the source of competitive advantage shifted toward industry-specific capabilities, and the business portfolio—which was once related in sharing generic resources through internal markets—became unrelated. As such, most diversified business groups experienced strategy-structure misfit unless they reorganized their organizational arrangements into competitive M-forms or refocused themselves into related businesses using the cooperative M-form structure.

However, many chaebols failed to make appropriate adjustments. The past success might simply blind top management to shifting institutional and competitive contexts, and concomitant needs for changes. Lacking well-developed market institutions made major portfolio restructurings exceedingly difficult. Implementing the competitive M-form structure goes beyond formally delegating decision-making authority to affiliated firms and requires accompanying changes in reward systems, management competencies, organizational processes, and culture. Such radical and concerted changes might explain why chaebols were reluctant to launch organizational restructuring efforts. As a consequence, chaebols maintained their unrelated business portfolios and cooperative M-form structures, thereby experiencing significant strategy-structure misfit.

It was the financial crisis of the late 1997 that forced management to re-examine strategy and structure of their business groups. With their viability as a going concern and as an organizational form being challenged, chaebol managers had little choice but to plan restructuring directions and methods. The financial crisis also provided the government with legitimacy to push the reforms in financial and corporate sectors in attempts to improve transparency and accountability in corporate governance and supporting institutions. Some reforms, such as the elimination of debt guarantees and the ban on cross-sharing holdings, were targeted specifically to chaebols. These government reforms have magnified strategy-structure misfit and needs for chaebol restructuring.

Following the financial crisis, chaebols have been under pressure to restructure their business portfolios. The prevailing view is to follow the "focus hypothesis." This hypothesis suggests that chaebols were the outcome of the government-driven economic development policy when the country had weak market institutions and chaebols lost economic vigor over time as market institutions developed. The prevailing mindset suggests that their future is bleak without reducing business scope and refocusing as the U.S. diversified firms did during the 1980s. Implicit in this view is that the best success formula for diversified business groups is related diversification supported by the cooperative M-form structure.

However, as discussed earlier, there are multiple ways of creating value with diversification strategy (Collis and Montgomery, 1998) and thus there is not one ideal strategy for diversified business groups. While there are benefits of trimming down excessive components in diversified business portfolios and improving financial structure, unrelated diversification per se may not be value destroying. Research demonstrates that diversified business groups in various economies make a positive impact on performance of affiliated firms (Khanna and Palepu, 2000a, 2000b; Khanna and Rivkin, 2001; Wan and Hoskisson, 2003). There is also empirical evidence of positive effects of group affiliation in Korea (Chang and Choi, 1988; Chang and Hong, 2000; Zeile, 1996). The real problem is that while chaebols pursued related linked and unrelated diversification strategies, they were managed primarily using the cooperative M-form structure. Chaebols need to be restructured to regain their strategy-structure fit. One direction is to adopt the competitive M-form, which readily fits the unrelated business portfolios. Another direction is to restructure their business portfolios to pursue related diversification strategy, which fits the cooperative M-form in place. LG and Hyundai Motor illustrate each direction, respectively.

The evolutionary model of diversified business groups also has implications for public policy. Instead of holding business groups responsible for macroeconomic problems, public

policy needs to work on improving the institutional context (Khanna and Palepu, 1999). If business groups move up into more competitive and high-end market segments while domestic institutional contexts remain under-developed, groups may be in a strategic quandary. To meet competitive challenges that have emerged as the economy has liberalized, business groups should develop industry-specific capabilities and the unrelated business portfolio supported by the cooperative M-form structure needs to be restructured. On the other hand, to meet institutional challenges associated with under-developed domestic institutions, business groups see the necessity of the unrelated business portfolio managed by the logic of the cooperative M-form structure. Collectively, the institutional and competitive contexts impose conflicting demands on business groups, which have damaging effects on global competitiveness of domestic firms moving into global markets. As such, strategies pursued to enhance domestic competitiveness do not translate directly into improved global competitiveness. Public policies should focus on improving the institutional context along with the expansion and globalization of the domestic economy, thereby mitigating strategic dilemmas firms face between addressing institutional challenges at home and competitive challenges abroad.

Subsequent to the financial crisis, many scholars and policy makers claim that the roles of group headquarters should be substantially reduced or totally eliminated. However, while the excessive control and intervention by group headquarters lead to inefficiencies, groups without headquarter operations would leave a void and create different problems. For instance, spillover effects of sharing group brand names can be negative. When a group or one of its member firms is perceived to commit socially irresponsible action, consumers often respond by campaigning to boycott products from all group members. To prevent such an occurrence requires the evaluation and control of group headquarters. The key issue is to redefine the roles of group headquarters by considering the nature of the group's business portfolios, resources, and group-level strategies. However, the relationship between strategy and structure of business groups has seldom been examined in a systematic way. Survey research methods supported by in-depth interviews, as implemented in Hill, Hitt and Hoskisson (1992) in a developed market setting, may be necessary to pursue this line of inquiry.

We propose two modes of restructuring that business groups can take with shifting institutional environments. Indeed, the financial crisis in Korea provides an appropriate setting to study antecedents and consequences of business group restructuring. As illustrated in the LG and Hyundai Motor cases, different groups have taken different approaches to restructuring. In addressing antecedents and consequences of business groups restructuring, such heterogeneity among business groups should be taken more seriously. Contrary to the treatment of business groups as a homogenous entity in popular press and academic literature, business groups differ from each other along various dimensions. Samsung and LG have substantially more diversified business portfolios than other groups. Some groups operate a wider range of internal markets and possess greater group-level resources than others. Some groups share group brand among member firms to a greater extent than others. These differences are expected to influence direction taken in restructuring efforts and associated consequences. These issues await further conceptualization and systematic data analysis.

By tracing strategy and structure of the chaebol over an extended period of time, we propose an evolutionary model of business groups that provides the linkages among institutional contexts and organizational arrangements. The evolutionary model can offer important implications for other emerging economies. For instance, business groups in China, partly modeled after the chaebols, have been crucial to China's reforms and have become a crucial part of their emerging economy (Keister, 2000). With weak market institutions, business groups in China can create value by performing the roles of internal markets, which favor unrelated diversification and the cooperative M-form structure. From a public policy perspective, promoting the formation of business groups, as China's government did, would constitute a better way of overcoming the shortage of key resources such as capital, human resources, and entrepreneurial talent. However, as market institutions evolve and competition increases, unrelated diversified business groups under the control of the cooperative M-form may turn into core rigidities. As institutional and competitive contexts evolve, so should strategy and structure of business groups. Similarly, as domestic firms move upward towards high-end segments of global markets, domestic market institutions should evolve accordingly. Otherwise, domestics firms would be pulled into different directions at the same time. Thus, building domestic institutions along economic development is crucial to enhancing national competitiveness. To ascertain the generalizability of our model based on the chaebol and deepen our understanding of the evolution of business groups at large, we suggest that more studies in other countries be undertaken.

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