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NEW VENTURES AND FIRST DIVERSIFICATION (SUMMARY)

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SUMMARY

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Principal Topic

Though diversification is one of the central themes in strategic management research (Rumelt, Schendel & Teece, 1994), the patterns of diversification that occur at early stages of firm formation have not been directly studied. Studies sampled on large and mature firms might suffer from the sample selection and survivor bias (Heckman, 1979) because small, young and private firms are neglected. In order to address this limitation, this study examines how organizational age affects decisions by organizations to enter new product-markets. Using organizational learning framework, this study integrates the internal and external drivers of diversification, argues new ventures diversify in a different way than established firms because their unique learning modes. In our view, new ventures are more likely to conduct trial-and-error learning to build competency, and use other firm’s experience to alleviate uncertainty.

Method

This study uses a naturally occurring experiment to compare the patterns of diversification for newly formed and established firms in a newly created market niche, the market for generic drugs. The Waxman-Hatch Act of 1984 decreased protections for patent based drugs, creating opportunities for established firms and new entrants in the generic pharmaceutical industry. The data contains the population of firms (n=284) that produced generic drugs in the U.S. during 1984-2004. In this study, each new product-market entry is viewed as a result of the focal firm’s strategic choice among all available alternatives. We measure diversification across two types of relatedness: technology relatedness (drug forms) and market relatedness (therapeutic classes). We capture environmental factors by technology and market density. Data is analyzed using a conditional logit model (McFadden, 1974).

Results and Implications

Our study demonstrates firms at different stages exhibit different patterns of diversification. New ventures are less likely to enter product-markets that relate to their prior experience, and more likely to enter markets with higher density, as compared to mature firms. The results provide insights into the unique behavior pattern of young firms, indicate the fallacy of using the experience of successful firms as way to reason backwards and make inferences (either descriptive or prescriptive) about the early steps in firm strategy.

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