Lecture 5

Corporate level strategy

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Case for next discussion

- Virgin
  - look at the corporation's history
  - identify the businesses
  - identify the reasons to diversify
  - outline the strategy for each business, and the corporate-level strategy

Learning objectives

- Define corporate level ***strategy*** and discuss its purpose
- Discuss different ***levels*** of diversification with different corporate level strategies
- Explain three primary ***reasons*** why firms diversify
- Describe how firms ***create value*** in different diversification strategies
- Discuss ***over diversification***

Opening case

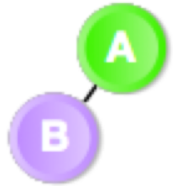
- Foster's Group
  - beer for mass market
  - diversification on vine (premium)

Key term

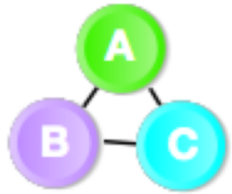
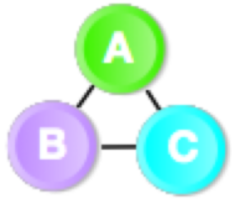
- Corporate level strategy specifies actions a firm takes to gain a competitive advantage by ***selecting*** and ***managing*** a group of different businesses competing in different market products.
- Expected to increase the firm's value.

FIGURE 7.1 Levels and types of diversification

Low Levels of Diversification

Single business:	95% or more of revenue comes from a single business.	
Dominant business:	Between 70% and 95% of revenue comes from a single business.	

Moderate to High Levels of Diversification

Related constrained:	Less than 70% of revenue comes from the dominant business, and all businesses share product, technological, and distribution linkages.	
Related linked (mixed related and unrelated):	Less than 70% of revenue comes from the dominant business, and there are only limited links between businesses.	

Very High Levels of Diversification

Unrelated:	Less than 70% of revenue comes from the dominant business, and there are no common links between businesses.	

Source: Adapted from R. P. Rumelt, 1974, *Strategy, Structure and Economic Performance*, Boston: Harvard Business School.

Levels of diversification 2/3

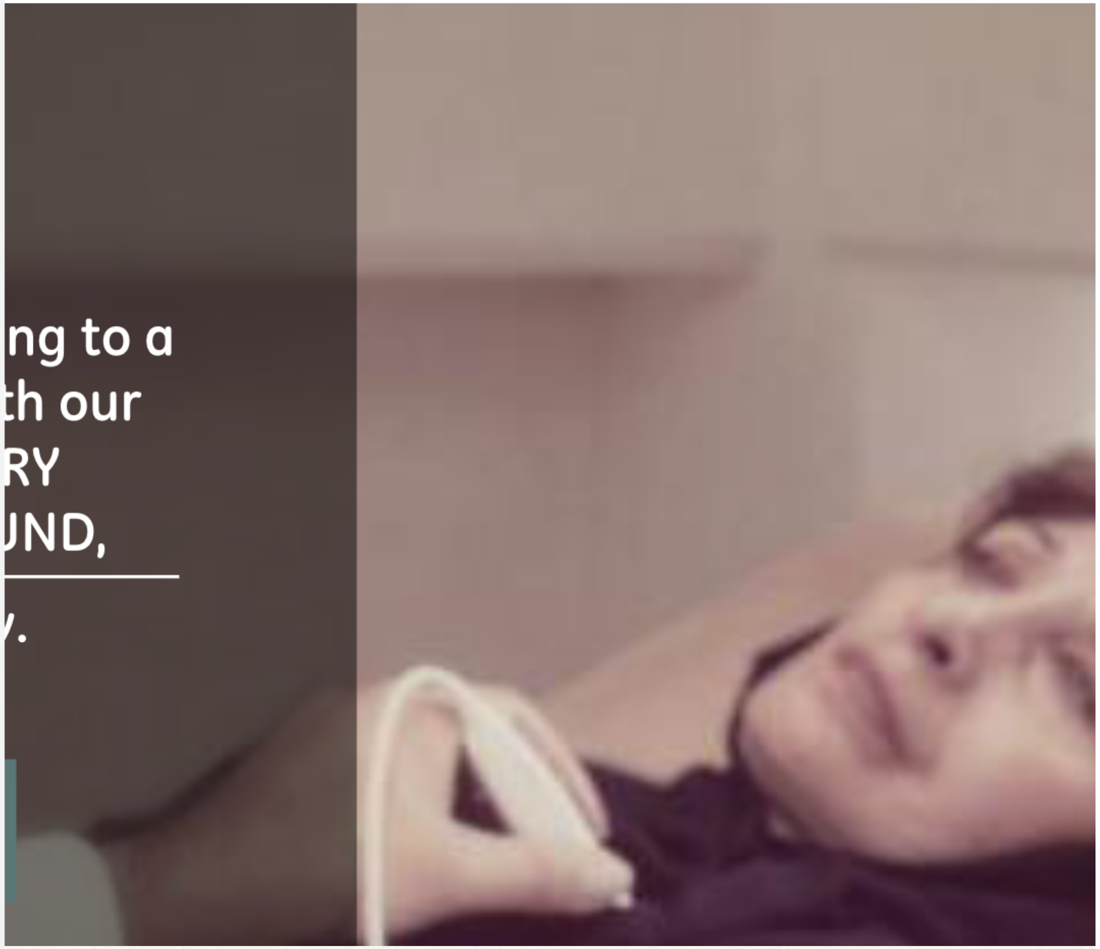
- A firm pursuing ***low levels*** of diversification uses either a single- (95% +) or a dominant-business corporate level strategy (70-95%).
- A firm generating more than 30% of its revenue outside the core business, and whose businesses are related to each other in some manner uses a ***related diversification*** corporate-level strategy (Procter&Gamble).

Levels of diversification 3/3

- The diversified company with a portfolio of businesses that have only a few links between them is using the ***related linked*** diversification strategy (GE).
- A highly diversified firm that has no relationships between its businesses follow an ***unrelated diversification*** strategy (SAMSUNG).

GE imagination at work

- Aviation
- Cities
- Food, Beverage & Consumer Goods
- Marine
- Healthcare
- Mining
- Oil & Gas
- Power & Energy
- >> Power Generation
- >> Transmission & Distribution
- Retail
- Transportation
- Water & Wastewater



36.0% M/S

LNG Ship

24.6% M/S

Home Entertainment System

26.6% M/S

BluRay Player

11.2% M/S

Microwave Oven

24.5% M/S

Small Battery

23.0% M/S

Smart Card IC (SIM Card)

26.6% M/S

Small- and Medium-sized Panel

60.2% M/S

PDP Panel

24.0% M/S

TMAH

Galaxy S4

The Samsung Galaxy S4 takes the smartphone to another level with its laundry list of must-have features and its colorful 5-inch Full HD Super AMOLED Display. The supercharged Galaxy S4 comes with a sharp-shooting 13-megapixel camera and plenty of processing power to make it the all-in-one smartphone that does whatever you need it to do.

27.2%

Mobile Phone market share

32.3%

Smartphone market share

18.1% M/S

Display Driver IC

Reasons for diversification 1/2

Table 7.1 Reasons for diversification

Value-Creating Diversification

- Economies of scope (related diversification)
  - Sharing activities
  - Transferring core competencies
- Market power (related diversification)
  - Blocking competitors through multipoint competition
  - Vertical integration
- Financial economies (unrelated diversification)
  - Efficient internal capital allocation
  - Business restructuring

Reasons for diversification 2/2

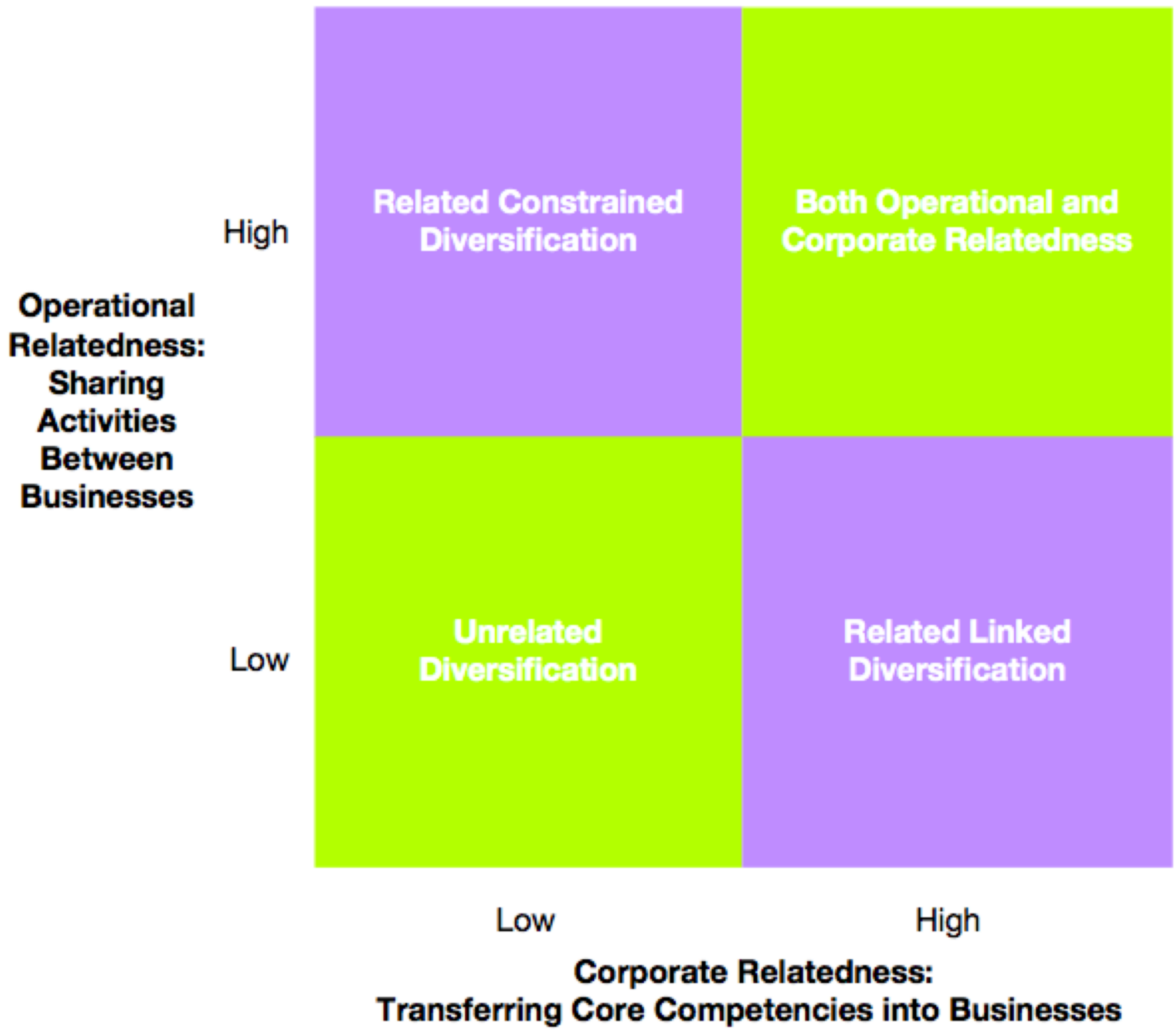
Value-Neutral Diversification

- Antitrust regulation
- Tax laws
- Low performance
- Uncertain future cash flows
- Risk reduction for firm
- Tangible resources
- Intangible resources

Value-Reducing Diversification

- Diversifying managerial employment risk
- Increasing managerial compensation

FIGURE 7.2 Value-creating diversification strategies: operations and corporate relatedness



Value-creating diversification 2/9

- *Economies of scope* are cost *savings* that the firm creates by:
    - successfully *sharing* some of its resources and capabilities, or
    - *transferring* one or more corporate-level core competencies that were developed in one business to another of its businesses.

Value-creating diversification 3/9

- Firms can create ***operational relatedness*** by sharing either a primary activity (eg. inventory delivery systems) or a support activity (eg. purchasing capacity).
  - expected higher performance of shared activities,
  - risky because creates links between outcomes.

Value creating diversification 4/9

- ***Corporate relatedness*** is created through corporate core competencies, i.e. complex sets of resources and capabilities that link different businesses, primarily through managerial and technological k***nowledge, experience and expertise***.
    - transferring competence to another business does not require the expense of developing it (HP printers and copiers),
    - resource intangibility is difficult for competitors to understand and imitate (Virgin marketing capacity).

Value creating diversification 5/9

- Transferring core competencies is ***not easy***:
  - original unit managers may be reluctant,
  - absorption issues may arise,
  - reliance on outsourcing may lower the potential for transferability in the future.

Value creating diversification 6/9

- *Market power* exists when a firm is able to sell its products above the existing competitive level or to reduce its costs of its primary or support activities below the competitive level, or both.
  - *Acquisitions* may help to increase market power (Wrigley and Mars)
  - *Multipoint competition* exists when two diversified firms simultaneously compete in the same product areas or geographical markets (UPS, DHL, FedEx).

Value creating diversification 7/9

- ***Vertical integration*** is used to gain market power. It exists when a company produces its own inputs (backward integration) or owns its own source of product distribution (forward integration).

- Market power is ***gained when***: the firm develops the capability to save on its operations, avoid market costs, improve product quality, and protect its technology from imitation by rivals.

Value-creating diversification 8/9

- Vertical integration has ***costs***: may be less competitive than outside suppliers, involve bureaucratic costs, or reduce the firms flexibility.
- Many firms have actually sought to gain market power through ***decreasing*** vertical integration.
- Some ***firms seek both*** operational and corporate relatedness, as difficult to understand and imitate.

Value-creating diversification 9/9

- ***Unrelated diversification*** strategy can create value through financial economies i.e.
  - ***cost savings*** realized through improved allocation of financial resources based on investment inside or outside the firm.
  - ***asset restructuring*** allowing the firm to optimize the portfolio.

Value neutral diversification 1/5

- Incentives to diversify may come from the ***external*** environment, such as anti-competition regulation or tax law.
- While opposing mergers that create concentrated power, regulators support diversification.
- Some firms generate more cash from their operations than they can reinvest profitably in their operations (Apple, Google)

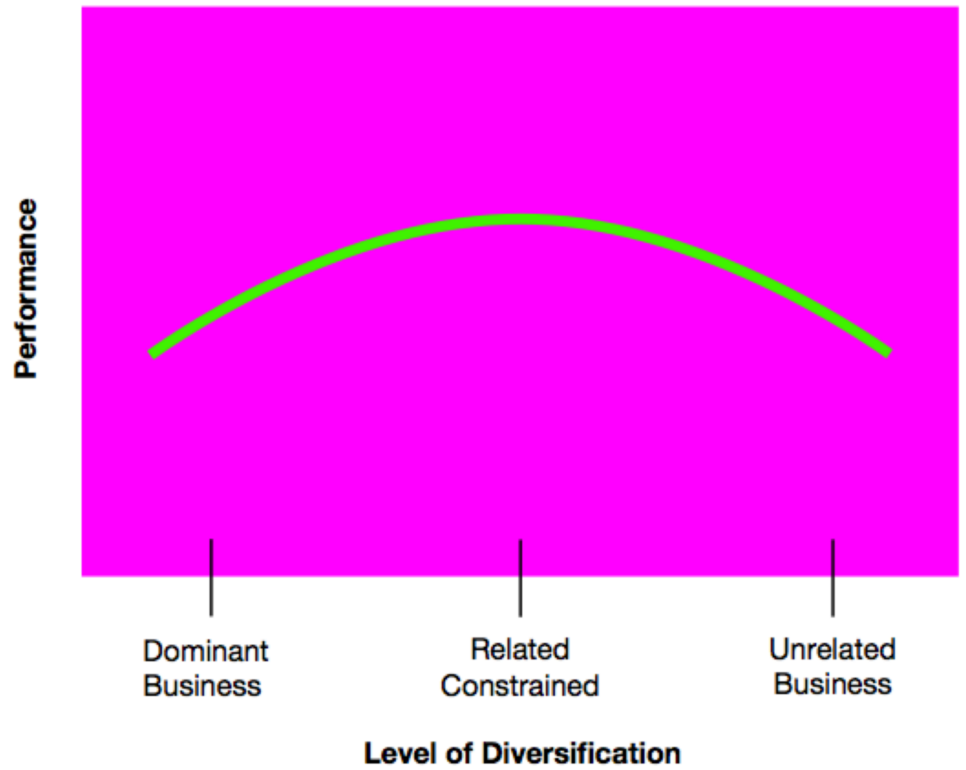
Value neutral diversification 2/5

- Within the ***internal*** environment key incentives to diversify are:
  - low performance,
  - uncertain future cash flows,
  - pursuit of synergy,
  - reduction of risk.

Value neutral diversification 3/5

- If high performance eliminates the need for diversification, then low performance may lead to diversification.

FIGURE 7.3 The curvilinear relationship between diversification and performance



Value neutral diversification 4/5

- As firm's product line matures and future cash flows are threatened, diversification may be an important ***defensive strategy***.
- ***Synergy*** exists when the value created by the business units working together exceeds the value created by the same units working independently.
- Synergy also increases the ***risk*** of corporate failure, because units are increasingly interdependent, and less flexible as a whole.

Value neutral diversification 5/5

- Resources constrain the capacity to diversify:
  - financial resources are visible to competitors and less likely to create long-term competitive advantage,
  - excess capacity may be used for related diversification,
  - intangible resources are more flexible in facilitating diversification.

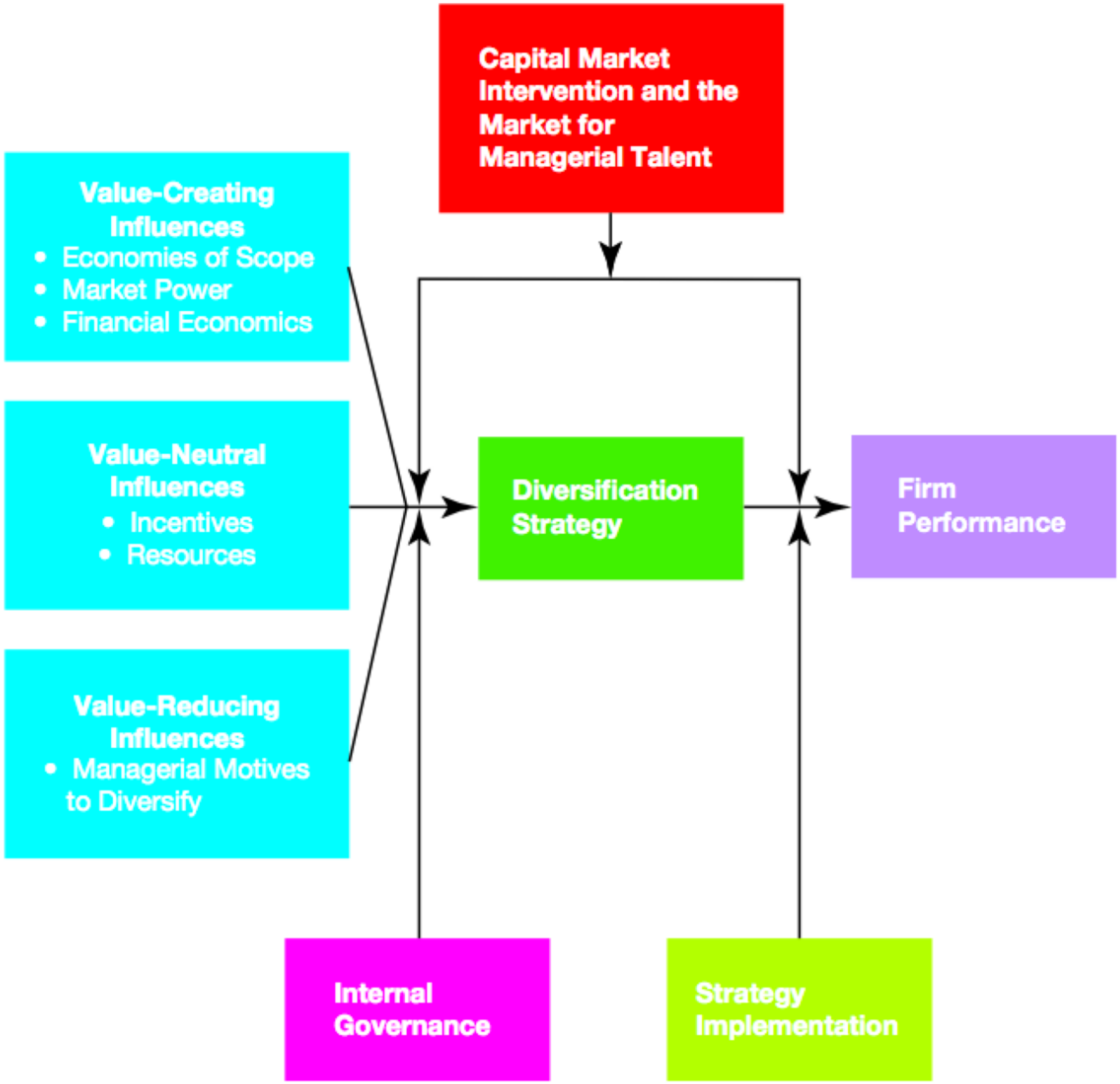
Value reducing diversification 1/2

- Managerial motives to diversify exist independently of value-neutral incentives and value-creating reasons.
- Two main motives:
  - desire for increased compensation,
  - reduced managerial risk.

Value reducing diversification 2/2

- Diversification and firm size are highly correlated. When the firm's size increases, so does ***compensation***.
- Over-diversification may lead to the point when the firm fails to earn average returns.
- ***Governance*** mechanisms may be useful to limit managerial tendencies to over-diversify.
- A positive ***reputation*** facilitates the development and use of managerial power.

FIGURE 7.4 Summary model of the relationship between diversification and firm performance



Source: Adapted from R. E. Hoskisson and M. A. Hitt, 1990, "Antecedents and performance outcomes of diversification: A review and critique of theoretical perspectives", *Journal of Management*, 16: 498.

Summary 2/3

- The primary reason a firm uses a corporate strategy to become more diversified is to create ***additional value***.
- Related diversification helps firms create more value through ***sharing*** activities or ***transferring*** competencies.
- Unrelated diversification depends on the efficient resource ***allocation*** and ***restructuring*** of target firm's assets.

Summary 3/3

- Diversification is sometimes pursued for ***value-neutral*** reasons both internal or external to the firm.
- Managerial motives to diversify may lead to ***over-diversification***.
- Managers need to take careful decisions in ***optimizing*** the level their firm's diversification.