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Business Strategy

Chapter 7

Corporate-level strategy

KNOWLEDGE OBJECTIVES

- Define corporate-level strategy and discuss its purpose.
- Describe different levels of diversification with different corporate level strategies.
- Explain three primary reasons firms diversify.
- Describe how strategy.
- Explain how firms can create value by using a related diversification strategy.
- Discuss the incentives and resources that encourage diversification.
- Describe motives that can encourage managers to overdiversify a firm.

Corporate Level Strategy

- A 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 product markets.

- Strategies firms use to diversify their operations from a single business competing in a single market into several product markets and, most commonly, into several businesses.

Corporate Level Strategy

TWO KEY ISSUES

1. In what product markets and businesses should the firm compete?

2. How should corporate headquarters manage those businesses?

Corporate Level Strategy

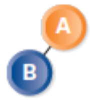
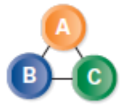
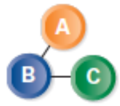
- A corporate-level strategy is expected to help the firm earn above-average returns by creating value.
- The degree to which corporate-level strategies create value beyond the sum of the value created by all of a firm's business units remains an important research question.

Diversification

- Diversification, a primary form of corporate-level strategies, concerns the scope of the markets and industries in which the firm competes as well as "how managers buy, create and sell different businesses to match skills and strengths with opportunities presented to the firm."

Levels of Diversification

Figure 6.1 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.

Low Levels of Diversification

- A firm is related through its diversification when its businesses share links across:
  - PRODUCTS (goods or services)
  - TECHNOLOGIES
  - DISTRIBUTION CHANNELS
- The more links among businesses, the more "constrained" is the relatedness of diversification
- "Unrelated" refers to the absence of direct links between businesses

Low Levels of Diversification

- A firm pursuing a low level of diversification uses either a single- or a dominant-business, corporate-level diversification strategy.

Low Levels of Diversification

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

Single Business Strategy

Corporate-level strategy in which the firm generates 95% or more of its sales revenue from its core business area

EXAMPLE: WRIGLEY

- Wm. Wrigley Jr. Company, the world's largest producer of chewing and bubble gums, historically used a single-business strategy while operating in few product markets
- 2005: Wrigley employed the dominant-business strategy, when it acquired the confectionary assets of Kraft Foods Inc., including Life Savers and Altoids.
- 2008- Wrigley was acquired by Mars, a privately held global confection company.

Dominant Business Diversification

Corporate-level strategy whereby firm generates 70-95% of total sales revenue within a single business area

EXAMPLE: UPS

United Parcel Service (UPS) uses this strategy.
UPS generates 60 percent of its revenue from its U.S. package delivery business and 22 percent from its international package business, with the remaining 18 percent coming from the firm's non-package business.

Related Constrained Diversification Strategy

- Less than 70% of revenue comes from the dominant business
- Direct links (i.e., share products, technology, and distribution linkages) between the firm's businesses

EXAMPLES:

Campbell Soup, Procter & Gamble, Merck & Company

Related Linked Diversification Strategy (mixed related and unrelated)

- Less than 70% of revenue comes from the dominant business
- Mixed: Linked firms sharing fewer resources and assets among their businesses (compared with related constrained), concentrating on the transfer of knowledge and competencies among the businesses

Example

EXAMPLE: GE

Very High Levels: Unrelated

- Less than 70% of revenue comes from dominant business
- No relationships between businesses

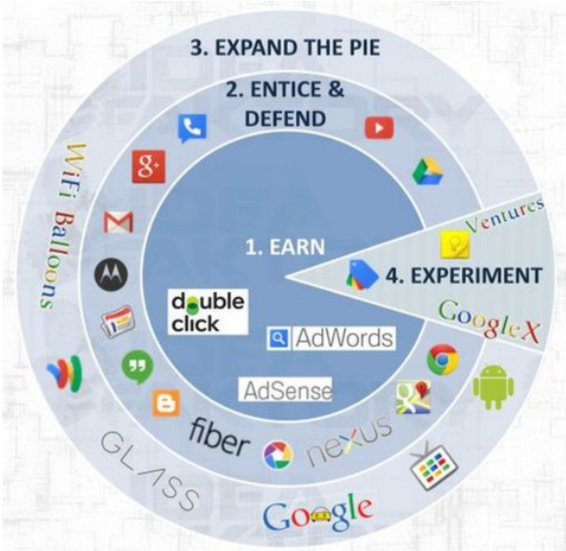
Example

EXAMPLES:

United Technologies, Textron, Samsung, and Hutchison Whampoa Limited (HWL)

From Google into Alphabet

- Alphabet Inc. is a conglomerate founded on October 2015 by the two founders of Google: Larry Page and Sergey Brin



- The establishment of Alphabet was prompted by a desire to make the core Google Internet services “cleaner and more accountable” while allowing greater autonomy to group companies

From Google into Alphabet

As Sergey and I wrote in the original founders letter 11 years ago, “Google is not a conventional company. We do not intend to become one.” As part of that, we also said that you could expect us to make “smaller bets in areas that might seem very speculative or even strange when compared to our current businesses.” From the start, we’ve always strived to do more, and to do important and meaningful things with the resources we have.
We did a lot of things that seemed crazy at the time. Many of those crazy things now have over a billion users, like Google Maps, YouTube, Chrome, and Android. And we haven’t stopped there. We are still trying to do things other people think are crazy but we are super excited about. …..

We are excited about…
- Getting more ambitious things done.
- Taking the long-term view.
- Empowering great entrepreneurs and companies to flourish.
- Investing at the scale of the opportunities and resources we see.
- Improving the transparency and oversight of what we’re doing.
- Making Google even better through greater focus.

And hopefully… as a result of all this, improving the lives of as many people as we can.

Larry Page

Reasons for Diversification

Table 6.1 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

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

VALUE-CREATING DIVERSIFICATION: RELATED CONSTRAINED AND RELATED LINKED DIVERSIFICATION

- With the related diversification corporate-level strategy, the firm builds upon or extends its **resources** and **capabilities** to create value.
- The company using the related diversification strategy wants to develop and exploit economies of scope between its businesses.

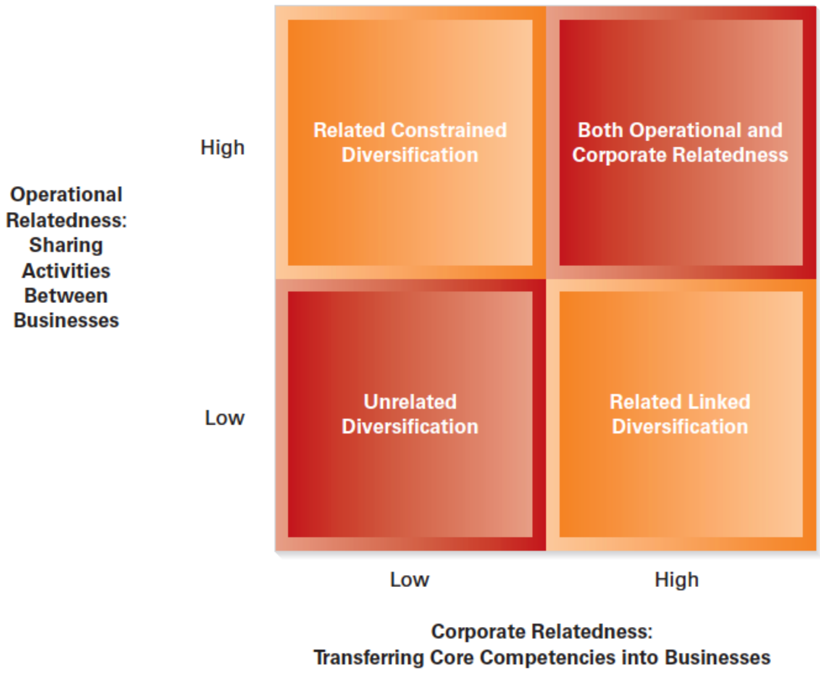
Economies of scope are cost savings that the firm creates by successfully sharing some of its resources and capabilities or transferring one or more corporate-level core competencies that were developed in one of its businesses to another of its businesses.

VALUE-CREATING DIVERSIFICATION: RELATED CONSTRAINED AND RELATED LINKED DIVERSIFICATION

- Operational relatedness in sharing activities
- Corporate relatedness in transferring skills or corporate core competencies among units

- The difference between sharing activities and transferring competencies is based on how the resources are jointly used to create economies of scope.

Value creating diversification strategies



Value-Creating Diversification Strategies: Operational and Corporate Relatedness

Operational relatedness in sharing activities

- Can gain economies of scope

- Share primary or support activities (in value chain), e.g., a primary activity such as inventory delivery systems, or a support activity such as purchasing

- Risky as ties create links between outcomes

- Related constrained share activities in order to create value

- Not easy, often synergies not realized as planned

CORPORATE RELATEDNESS: TRANSFERRING OF CORE COMPETENCIES (I)

- Complex sets of resources and capabilities linking different businesses through managerial and technological knowledge, experience, and expertise

- Two sources of value creation:

- Expense incurred in first business and knowledge transfer reduces resources required for second business
- Intangible resources difficult for competitors to understand and imitate, so immediate competitive advantage over competition

CORPORATE RELATEDNESS: TRANSFERRING OF CORE COMPETENCIES (II)

- One way managers facilitate the transfer of corporate-level core competencies is by moving key people into new management positions
- However, the manager of an older business may be reluctant to transfer key people who have accumulated knowledge and experience critical to the business's success
- Too much dependence on outsourcing can lower the usefulness of core competencies and thereby reduce their useful transferability to other business units in the diversified firm

MARKET POWER

- Relevant for:
  RELATED CONSTRAINED
  RELATED LINKED
- Exists when a firm is able to sell its products above the existing competitive level, to reduce costs of primary and support activities below the competitive level, or both
- Multipoint competition, when two or more diversified firms simultaneously compete in the same product areas or geographical markets.
- Vertical integration, when a company produces its own inputs (backward integration) or owns its own source of output distribution (forward integration).

MARKET POWER

- Related diversification strategy may include:

Vertical integration

- Backward integration: a firm produces its own inputs

- Forward integration: a firm operates its own distribution system for delivering its outputs

Virtual integration

SIMULTANEOUS OPERATIONAL RELATEDNESS AND CORPORATE RELATEDNESS

- The ability to simultaneously create economies of scope by sharing activities (operational relatedness) and transferring core competencies (corporate relatedness) is difficult for competitors to understand and learn how to imitate
- Involves managing two sources of knowledge simultaneously:
  - Operational forms of economies of scope
  - Corporate forms of economies of scope

- Such efforts often fail due to implementation difficulties

Unrelated Diversification

Firm create value through two types of FINANCIAL ECONOMIES

- Cost savings realized through improved allocations of financial resources based on investments inside or outside firm
  - Efficient internal capital market allocation
- Restructuring of acquired assets
  - Firm A buys firm B and restructures assets so it can operate more profitably, then A sells B for a profit in the external market

EFFICIENT INTERNAL CAPITAL MARKET ALLOCATION

- In a market economy, capital markets allocate capital efficiently
- **EQUITY** - investors take equity positions (ownership) with high expected future cash-flow values.
- **DEBT** - debt holders try to improve the value of their investments by taking stakes in businesses with high growth and profitability prospects

EFFICIENT INTERNAL CAPITAL MARKET ALLOCATION

INTERNAL CAPITAL MARKET

- In large diversified firms, capital distributions may generate gains from internal capital market allocations that

EXCEED

EXTERNAL CAPITAL MARKET

- the gains that would accrue to shareholders from capital being allocated by the external capital market

EFFICIENT INTERNAL CAPITAL MARKET ALLOCATION

CONGLOMERATE DISCOUNT

- This discount results from analysts not knowing how to value a vast array of large businesses with complex financial reports
- Stock markets apply a "Conglomerate Discount" of 20% on unrelated diversified firms, which means that investors believe that the value of conglomerates is 20% less than the value of the sum of their parts
- To overcome this discount, many unrelated diversifiers or conglomerates have sought to establish a brand for the parent company

EFFICIENT INTERNAL CAPITAL MARKET ALLOCATION

ACHILLES' HEEL

Financial economies are more easily duplicated by competitors than are gains from operational and corporate relatedness

- This issue is less of a problem in emerging economies, where the absence of a "soft infrastructure" (including effective financial intermediaries, sound regulations, and contract laws) supports and encourages use of the unrelated diversification strategy
- In emerging economies such as those in Korea, India, and Chile, research has shown that diversification increases the performance of firms affiliated with large diversified business groups

UNRELATED DIVERSIFICATION

RESTRUCTURING OF ASSETS

Restructuring creates financial economies

- A firm creates value by buying, restructuring, then selling the restructured firms' assets in the external market
- An economic downturn can present opportunities but also some risks

Resource allocation decisions may become complex, so success often requires:

- Focus on mature, low-technology businesses
- Focus on businesses not reliant on a client orientation

Value-Neutral Diversification: Incentives and Resources

- Different incentives to diversify exist, and the quality of the firm's resources may permit only diversification that is value neutral rather than value creating.

Value-Neutral Diversification: Incentives and Resources

INCENTIVES TO DIVERSIFY

External incentives

- Antitrust regulations
- Tax laws

Internal incentives

- Low performance
- Uncertain future cash flows
- Synergy and Firm Risk Reduction

External incentives
Antitrust regulations

•Antitrust laws in 1960s and 1970s discouraged mergers that created increased market power (vertical or horizontal integration)

- Mergers in the 1960s and 1970s thus tended to be unrelated (conglomerate)
- 1980s: Relaxation of antitrust enforcement results in more and larger horizontal mergers
- Late 1990s: Industry-specific deregulation spurred increased merger activity in banking, telecommunications, oil and gas, and electric utilities
- Early 2000s: Antitrust concerns seem to be emerging and mergers are more closely scrutinized

External incentives
Tax Laws

•High tax rates on dividends cause a corporate shift from dividends to buying and building companies in high-performance industries

- 1986 Tax Reform Act

Reduced individual ordinary income tax rate from 50 to 28 percent

Treated capital gains as ordinary income

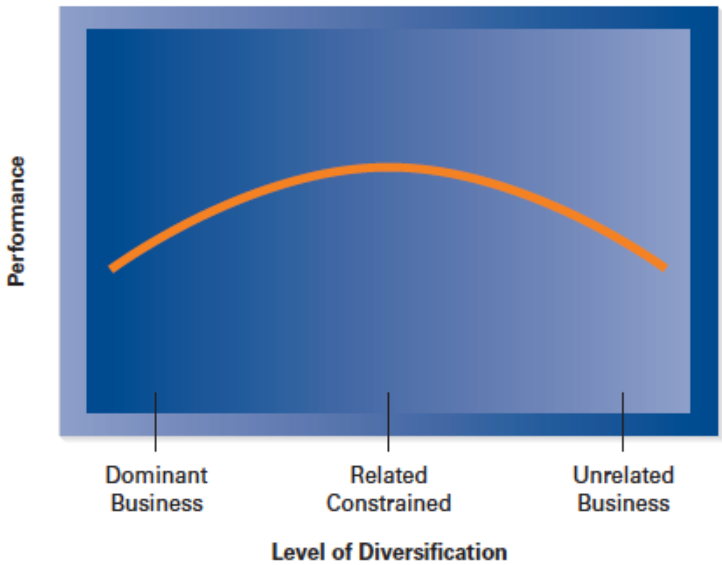
Thus created incentive for shareholders to prefer dividends to acquisition investments, as the 1986 Tax Reform Act diminished some of the corporate tax advantages of diversification

Internal incentives
Low performance

- High performance eliminates the need for greater diversification
- Low performance acts as incentive for diversification
- Firms plagued by poor performance often take higher risks (diversification is risky)

Internal incentives
Low performance

The Curvilinear Relationship between Diversification and Performance



Internal incentives
Uncertain future cash flows

- Diversification may be defensive strategy if the:
  - Product line matures
  - Product line is threatened
  - Firm is small and is in a mature or maturing industry

Internal incentives
Synergy and Firm Risk Reduction

- Synergy exists when the value created by businesses working together exceeds the value created by them working independently
  - … But synergy creates joint interdependence between business units
  - A firm may reduce the level of technological change by operating in more certain environments—resulting in more related types of diversification
  - A firm may become risk averse, constrain its level of activity sharing, and forgo potential benefits of synergy—resulting in more unrelated types of diversification

Resources and Diversification

A firm must have BOTH:

- Incentives to diversify
- The resources required to diversify: cash and tangible resources (e.g., plant and equipment)

Value creation is determined more by appropriate use of resources than by incentives to diversify

VALUE-REDUCING DIVERSIFICATION: MANAGERIAL MOTIVES TO DIVERSIFY

Top-level executives may diversify in order to diversity their own employment risk, as long as profitability does not suffer excessively

- Diversification adds benefits to top-level managers but not shareholders

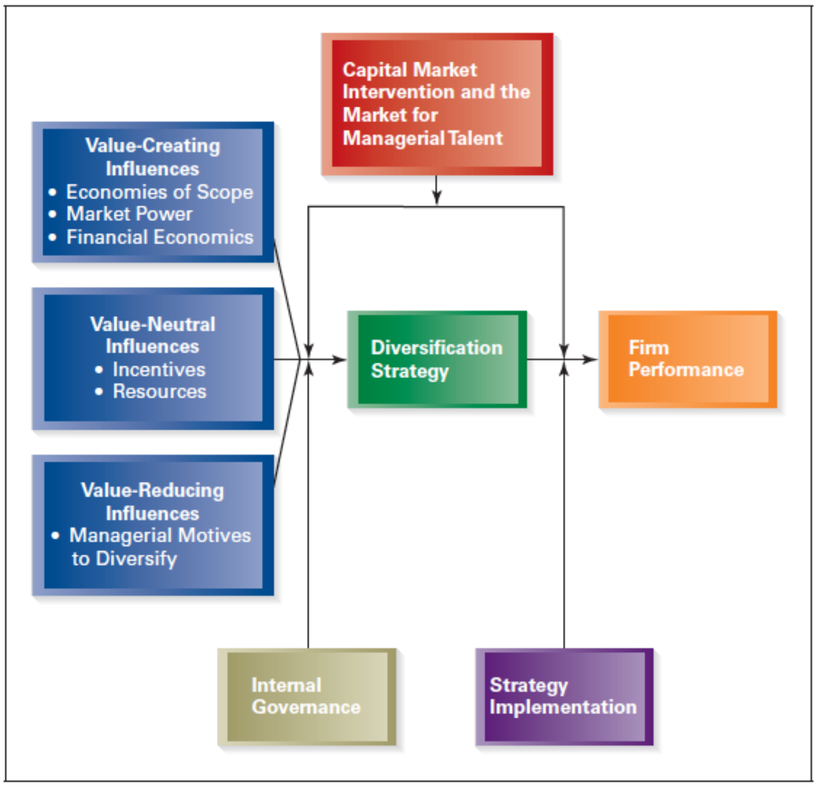
- This strategy may be held in check by governance mechanisms or concerns for one's reputation

VALUE-REDUCING DIVERSIFICATION: MANAGERIAL MOTIVES TO DIVERSIFY

MANAGERIAL MOTIVES TO DIVERSIFY

- Managerial risk reduction
- Desire for increased compensation

VALUE-REDUCING DIVERSIFICATION: MANAGERIAL MOTIVES TO DIVERSIFY



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

Boston Consulting Group matrix

In 1970 Bruce Henderson devised the concept of the growth share matrix as a tool to help companies allocate resources on the basis of the attractiveness of their market and their own level of competitiveness.

“The need for a portfolio of businesses become more obvious. Every company needs product in which to invest cash. Every company needs products that generate cash … Only a diversified company with a balanced portfolio can use its strengths to truly capitalize on its growth opportunities”

Bruce Henderson – BCG founder

Boston Consulting Group matrix

Market growth rate (cash use)	High	Low
High	**STAR** Cash flow limited (positive or negative)	**QUESTION MARK** Cash flow very negative
Low	**CASH COW** Cash flow very positive	**DOG** Cash flow limited (positive or negative)

Relative market share
(cash generation)

BCG highlight the importance of cash-flows balancing

Pitfalls:
- Rigidity of the analysis scheme and of the “prescriptions”
- Limited numbers of variables taken into account

Boston Consulting Group matrix revised

BCG 2014

The new competitive arena shows:

- **Increased speed of change**
- **Higher unpredictability (greater EBIT volatility)**
- **Reduced importance of market share**

Therefore the original BCG matrix should be updated to take into account:

- **Accelerate**: business shoud increase their clock-speed

- **Balance exploration and exploitation** by:

✓ Increasing the number of question marks
✓ Test question marks quickly and economically
✓ Milk cows efficiently
✓ Keep pets on a short leash

- **Select rigorously**

- **Manage and measure portfolio economics of sperimentation**