Diversification Strategy

OUTLINE

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Introduction: The Basic Issues

Diversification decisions involve two basic issues:

• Is the industry to be entered more attractive than the firm’s existing business?

• Can the firm establish a competitive advantage within the industry to be entered? (i.e. what synergy’s exist between the core business and the new business?)
The Trend Over Time: Diversified Companies among the Fortune 500

Since late 1970’s, diversification has declined.

Corporate Strategy & Diversification: A Time-Line of Management Thought & Practice

Quest for Growth
Financial problems of conglomerates
Shareholder activism
Leveraged Buyouts

Rise of conglomerates
Related diversification by industrial firms
Emphasis on “related” & “concentric” diversification
Refocusing on core businesses
Divestment

Licensing, JVs, & strategic alliances

Development of corporate planning systems

Financial Analysis
Diffusion of M-form structures
Analysis of economies of scope & “synergy”
Portfolio planning
Capital asset pricing mode
Core competences
Dominant logic

Value based management
Transaction cost analysis

Motives for Diversification

| GROWTH | --The desire to escape stagnant or declining industries has been one of the most powerful motives for diversification (tobacco, oil, defense).  
|        | --But, growth satisfies management not shareholder goals.  
| RISK   | --Growth strategies (esp. by acquisition), tend to destroy shareholder value  
| SPREADING | --Diversification reduces variance of profit flows  
| PROFIT | --For diversification to create shareholder value, the act of bringing different businesses under common ownership & must somehow increase their profitability.  

Diversification and Shareholder Value: Porter’s Three Essential Tests

If diversification is to create shareholder value, it must meet three tests:

1. The Attractiveness Test: diversification must be directed towards actual or potentially-attractive industries.

2. The Cost of Entry Test: the cost of entry must not capitalize all future profits.

3. The Better-Off Test: either the new unit must gain competitive advantage from its link with the corporation, or vice-versa. (i.e. synergy must be present)
Diversification and Performance: Empirical Evidence

- Diversification trends have been driven by *beliefs* rather than evidence: 1960s and 70s diversification believed to be profitable; 1980s and 90s diversification seen as value destroying.
- Empirical evidence inconclusive—no consistent findings on impact of diversification on profitability, or on related vs. unrelated diversification.
- Some evidence that high levels of diversification detrimental to profitability
- Diversifying acquisitions, on average, destroy shareholder value for acquirers
- Refocusing generates positive shareholder returns

Relatedness in Diversification

Synergy in diversification derives from two main types of relatedness:
- *Operational Relatedness*—synergies from sharing resources across businesses (common distribution facilities, brands, joint R&D)
- *Strategic Relatedness*—synergies at the corporate level deriving from the ability to apply common management capabilities to different businesses.

Problem of operational relatedness: the benefits in terms of economies of scope may be dwarfed by the administrative costs involved in their exploitation.
## The Determinants of Strategic Relatedness

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<th>CORPORATE MANAGEMENT TASKS</th>
<th>DETERMINANTS OF STRATEGIC SIMILARITY</th>
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| Resource Allocation        | -Similar sizes of capital investment projects  
                             -Similar time spans of investment projects  
                             -Similar sources of risk  
                             -Similar management capabilities required by different businesses |
| Strategy Formulation       | -Similar key success factors  
                             -Businesses are at similar stages of their industry life cycles  
                             -Similar competitive positions occupied by each business within its industry |
| Monitoring & Control of Business Units | -Similar performance goals & performance variables  
                                             -Similar time horizons for performance targets |

## Core Competence Tests

- Potential access to a wide variety of markets
- Makes a significant contribution to the perceived customer benefits
- Difficult to imitate
Competitive Advantage Tests

• What can our competitors do better than any of its competitors in its current market?
• What strategic assets do we need in order to succeed in the new market?
• Can we catch up to or leapfrog competitors at their own game?
• Will diversification break up strategic assets that need to be kept together?
• Will we be simply a player in the new market or will we emerge a winner?
• What can our company learn by diversifying, and are we sufficiently organized to learn it?

Summary