Industrial Economics
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CHAPTER 4
DIVERSIFICATION

DIVERSIFICATION

- Diversification is an act of an existing entity branching out into a new business opportunity.
- This corporate strategy enables the entity to enter into a new market segment which it does not already operate in.
- The decision to diversify can prove to be a challenging decision for the entity as it can lead to extraordinary rewards with risks.

DIVERSIFICATION

- Diversification can be understood as the corporate strategy that a company implements to increase the market share and sales volume by introducing new products in new markets or industry, which is distinct from its core business.

WHY DO FIRMS DIVERSIFY?

- **The following are the reasons why firms opt for diversification:**
- For growth in business operations
- To ensure maximum utilization of the existing resources and capabilities
- To escape from unattractive industry environments

Types of Diversification Strategies

- **<u>The following are the types of diversification strategies:</u>**
- **Horizontal Diversification**
- This strategy of diversification refers to an entity offering new services or developing new products that appeal to the firm's current customer base. For example, a dairy company producing cheese adds a new variety of cheese to its product line.
- Horizontal diversification allows these companies to leverage their brand, distribution channels, and customer loyalty in new but related product areas. This strategy reduces reliance on a single product or market and helps companies tap into new customer needs and trends.

TYPES OF DIVERSIFICATION STRATEGIES

- Here are some well-known examples of Horizontal Diversification:
- Apple Example:
- Apple expanded from computers to other consumer electronics, such as the iPod, iPhone, iPad, and Apple Watch.
- Purpose: This allowed Apple to leverage its brand reputation and customer loyalty to succeed across various electronics categories.
- Samsung Example:
- Samsung initially focused on consumer electronics, such as televisions, but diversified horizontally into mobile phones, home appliances, and computer components.
- Purpose: Samsung's horizontal expansion has helped it build a diversified electronics portfolio, reducing dependency on any one product line and capturing a broader market share.

TYPES OF DIVERSIFICATION STRATEGIES

- Vertical Diversification
- This form of diversification takes place when a company goes back to a previous or next stage of its production cycle. For example, a company involved in the reconstruction of houses starts selling construction materials and paints. It may be forward integration or backward integration.
- Example: A car manufacturer purchasing a tire company (backward integration) or opening its own retail dealerships (forward integration).
- Purpose: By controlling more of the supply chain, companies can reduce costs, improve supply chain efficiency, and ensure better quality control.

TYPES OF DIVERSIFICATION STRATEGIES

- IKEA Example:
- IKEA purchased forests to control its wood supply and invested in renewable energy sources to power its stores.
- Purpose: By managing its raw materials (wood supply) and energy sources, IKEA reduces supply chain disruptions, manages costs, and supports its sustainability goals.
- Ford Example:
- Henry Ford pioneered vertical integration by owning rubber plantations for tire production, steel mills, and parts manufacturing, and assembling everything in Ford factories.
- Purpose: By controlling raw materials and manufacturing processes, Ford lowered costs, improved production efficiency, and ensured a steady supply of parts for its cars.

TYPES OF DIVERSIFICATION STRATEGIES

- **Concentric Diversification**
- In this form of a diversification strategy, the entity introduces new products with an aim to fully utilize the potential of the prevailing technologies and marketing system. For example, a bakery making bread starts producing biscuits.

TYPES OF DIVERSIFICATION STRATEGIES

- **Conglomerate diversification**
- In this form of diversification, an entity launches new products or services that have no relation to the current products or distribution channels. A firm may adopt this strategy to appeal to an all-new group of customers. The high growth scope and return on investment in a new market segment may prompt a company to take this option

TYPES OF DIVERSIFICATION STRATEGIES

- **Here are a few examples of conglomerate diversification:**
- General Electric (GE):
- Originally focused on electrical appliances and machinery, GE expanded into various industries such as aviation, healthcare, and finance. This broad diversification helped GE reduce risk by not relying on a single market.
- Samsung: While Samsung started as a trading company and later became famous for its electronics, it diversified into industries like construction, heavy industries, insurance, and biopharmaceuticals.

TYPES OF DIVERSIFICATION STRATEGIES

- Geographic diversification in trading aims to reduce risk by spreading investments across various regions. This method minimizes the impact of economic downturns in a single market and can enhance returns by tapping into different economic cycles.
- Geographic diversification minimizes risks by spreading investments across various regions, increasing portfolio resilience against localized economic downturns.
- Investing in multiple markets enhances potential returns by accessing different economic cycles and reducing reliance on domestic performance.
- Effective geographic diversification requires thorough research and continuous monitoring of economic conditions, political stability, and market correlations to optimize risk and return

TYPES OF DIVERSIFICATION STRATEGIES

- Geographic diversification involves distributing investments across various different geographical regions to minimize risks associated with poor performance in a single market. This strategy allows traders to leverage the varying performance of different markets at different times. Investing in regions influenced by distinct factors helps traders guard against localized economic downturns.
- Geographic diversification spreading investments across multiple different geographic regions reduces the risk associated with a single market. This means that even if one market experiences a downturn, the impact on the overall portfolio is cushioned by the performance of investments in other regions.

TYPES OF DIVERSIFICATION STRATEGIES

- example of geographic diversification
- Apple Inc.Strategy: Apple manufactures components and assembles its products across multiple countries, including the U.S., China, South Korea, and Vietnam. It also has sales channels and stores worldwide, helping it reach diverse customer bases.
- Purpose: Geographic diversification of manufacturing and sales helps Apple manage supply chain risks and currency exchange fluctuations, while serving a global customer base.

ADVANTAGES AND DISADVANTAGES OF DIVERSIFICATION

- <u>The following are the advantages of diversification:</u>
- As the economy changes, the spending patterns of the people change. Diversification into a number of industries or product line can help create a balance for the entity during these ups and downs.
- There will always be unpleasant surprises within a single investment. Being diversified can help in balancing such surprises.
- Diversification helps to maximize the use of potentially underutilized resources.
- Certain industries may fall down for a specific time frame owing to economic factors. Diversification provides movement away from activities which may be declining.

ADVANTAGES AND DISADVANTAGES OF DIVERSIFICATION

- **<u>The following are the disadvantages of diversification:</u>**
- Entities entirely involved in profit-making segments will enjoy profit maximization. However, a diversified entity will lose out due to having limited investment in the specific segment. Therefore, diversification limits the growth opportunities for an entity.
- Diversifying into a new market segment will demand new skill sets. Lack of expertise in the new field can prove to be a setback for the entity.
- A mismanaged diversification or excessive ambition can lead to a company over expanding into too many new directions at the same time. In such a case, all old and new sectors of the entity will suffer due to insufficient resources and lack of attention.

ADVANTAGES AND DISADVANTAGES OF DIVERSIFICATION

- A widely diversified company will not be able to respond quickly to market changes. The focus on the operations will be limited, thereby limiting the innovation within the entity.

THIRD ASSIGNMENT

- Choose three major Egyptian companies (for example, Orascom Group, Emaar Misr, Arab African International Bank, The Egyptian General Petroleum Corporation (EGPC), or Juhayna Food Industries).
- For each company, explore the following:
- **Original Industry:** Describe the company's core business or primary sector before diversification.
- **Diversified Industries:** Identify and describe the unrelated industries the company expanded into.
- **Reason for Diversification:** Explain the motives behind their diversification strategy (e.g., reducing risk, accessing new markets, capitalizing on financial resources).
- **Impact of Diversification:** Analyze how diversification affected the company's financial performance, market position, and risk profile. Consider both positive and negative outcomes.