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# Corporate Strategy: Tools for Analysis and Decision-Making

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I

# Corporate advantage

*Mario had worked hard to become CEO of MoveIt, a large diversified producer of planes, trains, and tractors. Since he took over three years ago, things have gone well: revenues increased every year by at least 15 percent and profits are at an all-time high. But he has this nagging feeling that more is possible. At the same time, he does not know what that is. What should Mario strive for, and how can he know if he is doing a good job as CEO?*

**Corporate strategy** refers to the strategy that multi-business corporations use to compete as a collection of multiple businesses. It is qualitatively different from strategy for a single business firm, or "business strategy." The number of businesses, goals, the nature of competition, and, consequently, the concepts used in analysis, all differ between business and corporate strategy.

### Difference 1: Single vs. multi-businesses

Business strategy involves a **single business**, whereas corporate strategy involves **multiple businesses**. For instance, a corporation could have multiple businesses that make appliances, software, mining instruments, turbines, jet engines, and healthcare products. Each business has its own business strategy. The corporate strategy of the corporation cuts across and affects all these businesses.

The questions "what is a business?" and "how do we distinguish businesses from each other?" are inescapable if we think of corporate strategy as the strategy of multi-business firms. We find it useful to think of a business as uniquely identified in terms of its ***business model***. A business model comprises the set of choices about customers, products, and value chain activities that every business must make.[1] These choices are also sometimes referred to as the "who/what/how" choices: who are the customers, what are we selling them, and how do we produce what we are selling and get it into the hands of the customers? Two businesses are different if their business models differ from each other on at least one of these dimensions. Thus, a business selling furniture out of local warehouses to customers in the UK is a different business than one selling to customers in India (different "who"). A business offering sushi for lunch from a small restaurant to busy professionals is a different business than one offering hamburgers (different "what"). An online only bank is a different business than one that serves customers exclusively through its branch network (different "how").

Industries, in contrast, are usually distinguished from each other in terms of low cross-price elasticity of demand – a price change within one industry has negligible effects on the demand for goods in the other industry. For example, sushi and hamburgers belong to the same industry if a price increase for hamburgers leads to more sushi being sold. Thus a corporation may have multiple businesses within the same industry. Airlines that operate both a full service and a budget carrier are an instance of this. On the other hand, being in a different industry necessarily means being in a distinct business. To be "in" a business means owning at least some of the assets needed for the activities involved in that business.

## Difference 2: Competitive advantage vs. corporate advantage

The goal of business strategy is to maximize the net present value (NPV) of a business, i.e., its future cash flows appropriately discounted for their timing and riskiness (for a brief explanation of NPV see the appendix to this chapter). At the most basic level, this is achieved by ensuring that your buyers are willing to pay more for the outputs of a business than what your suppliers are willing to sell the inputs to you for. Willingness-to-pay (WTP) is the most that buyers will pay for a firm's product. The actual price (i.e., what the buyers pay the firm) will be equal to or less than the WTP, or a firm will sell nothing. Willingness-to-sell (WTS) is the least price for which suppliers will provide all inputs for a firm's product, including raw materials, capital, and labor. The firm's actual cost (i.e., what the firm pays its suppliers) will be at least as high (see Figure 1.1).

You have a **competitive advantage** over a competitor when your difference between buyers' WTP and suppliers' WTS sell is greater than your competitor's difference (between their buyers' WTP and

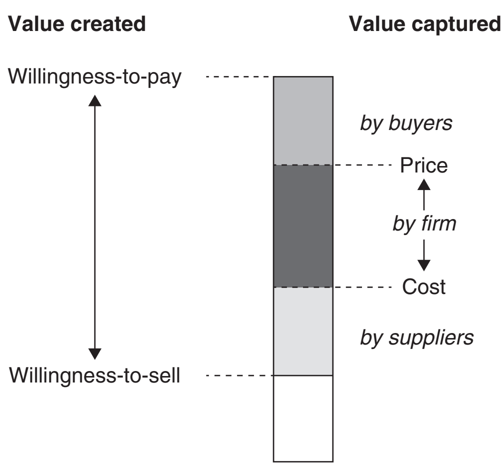


**Figure 1.1** Willingness-to-pay and willingness-to-sell

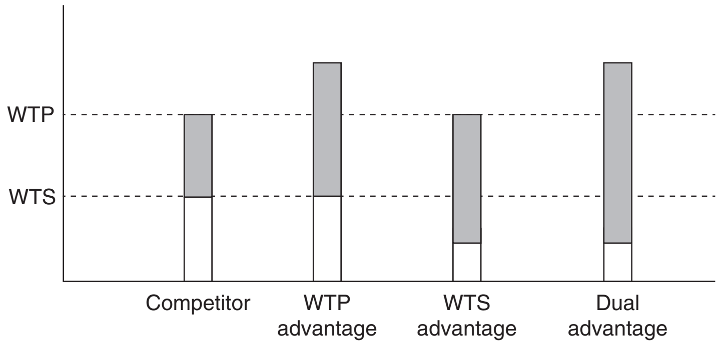


**Figure 1.2** Different types of competitive advantage

their suppliers' WTS). There are thus two ways of increasing competitive advantage (see Figure 1.2): by raising the price the customers are willing to pay you (pursuing a differentiation advantage) and/or by lowering the price suppliers are willing to sell to you for (pursuing a cost advantage).[2] It follows that which one you should pursue will depend on the alternatives available to your customers and suppliers (i.e., their bargaining power with you).

One might think that the goal of corporate strategy is to individually maximize the NPV of each of the businesses in the corporation. However, this is incorrect, as it obscures the possible linkages between the businesses when they belong to a corporation. **Corporate advantage** has traditionally been understood as in some sense doing better than the sum of the parts (i.e., individual businesses). Corporate advantage thus exists if the collection of businesses **owned together** is somehow more valuable (i.e., generates higher total NPV) than the sum of values of individual businesses owned in isolation from each other (see Box 1.1).

The goal of maximizing corporate advantage may or may not be consistent with maximizing the competitive advantage of each individual business. To maximize competitive advantage for each business, each business must outdo its rivals in creating a wedge

**Box 1.1 The corporate advantage test**

The corporate advantage test can be written as:

$$V[AB] > V(A) + V(B)$$

V(A) is the standalone NPV of business A and V(B) that of business B. This is the value when each is **owned separately**. V[AB] is the NPV of business A and business B when they are **owned jointly**.

between their customers' WTP and their suppliers' WTS. However, some businesses could give up competitive advantage in their business in order to enhance the competitive advantage of other businesses in the portfolio; there may optimally be winners and losers within a portfolio if the winners win more than the losers lose.

Various studies have decomposed the profitability of businesses into factors that arise from the business unit, corporate parent, or industry level. The results show that business unit level factors (such as the management or capabilities underlying the business) explain a big part of the variance in the returns of businesses, but that additionally the corporate level explains a substantial part (ahead of industry level factors). Furthermore, it is also understood that the impact of the business level is at least in part due to decisions taken at the corporate level (such as which businesses to enter).[3] The implication is clear: corporate strategy matters, over and above business strategy, and matters at least as much as the analysis of industry competition. No business within a multi-business corporation can consider its strategic analysis complete without understanding its role within the overall corporate strategy of the parent.

## Difference 3: Who is the competition?

The competition for a corporate strategist is different from that for a business strategist. For a business strategist, the competition is **anyone who can influence a business' cost or revenues adversely**. This includes direct rivals, but also buyers, suppliers, potential entrants, and companies that sell substitutes (famously captured in Michael Porter's "five forces" framework).[4]

For a corporate strategist, the competition is **anyone who can assemble a similar portfolio of businesses**. We distinguish between two types of such competitors: (1) investors (e.g., mutual funds) and (2) other corporate strategists (e.g., other multi-business corporations, their chief executive officers (CEOs), boards, internal and external advisors, chief strategy officers (CSOs), etc.).

Investors have cash flow rights over returns but typically no decision rights. They have only limited power to tell a corporation what corporate strategy decisions to take. On the other hand, corporate strategists have decision rights in the businesses through the administrative control exercised by corporate headquarters (HQ). Between these two groups is a grey zone. For example, activist shareholders can take a stake in a company and (publicly) pressure a CEO to divest a business. Private equity firms that traditionally focused on financial engineering and operational restructuring are now also engaged in exploiting linkages between businesses. A corporate strategist competes with all of them.

Identifying the competition helps the corporate strategist formulate an appropriate corporate strategy. Because investors have cash flow but no decision rights, their main strategy is **portfolio assembly**. In addition, corporate strategists can also use **business modification**. We discuss these next.

## Corporate advantage from portfolio assembly: the "selection" approach

More corporate advantage is better, but how much is necessary? A natural, minimal benchmark for a corporate strategist is a passive investor. A corporate strategist should at least be doing better than someone who has no decision power over the individual businesses. But how can an investor create corporate advantage at all, without such power?

The answer lies in the definition of the NPV of a portfolio of businesses A and B: V[AB] = Future cash flows discounted at a discount rate. A discount rate is used to assign a present value (PV) to the cash flows that occur in the future. It follows that value can be created in two ways: influencing cash flows or decreasing the discount rate.

Recall that by our definition an investor cannot influence the cash flows of the businesses. However, an investor may be able to spot bargains: the usual mantra is to "buy low and sell high." In other words, buy a business for less than what it can be resold for later. If successful, an investor may capture value by getting a bargain: more cash comes in than goes out.

Further, an investor can decrease the discount rate. A discount rate depends on three factors. First, a discount rate depends on the timing of the cash flows. Cash flows in the near future are worth more than those in the far future. Getting \$1,000 next week is more appealing than getting the same amount ten years from now. Second, a discount rate depends on the riskiness of the cash flows. Secure cash flows are worth more than risky cash flows. A \$1,000 payment in ten years promised by the US government is more attractive than the same \$1,000 payment in ten years promised by a stranger on a peer-to-peer (P2P) lending site. Third, a discount rate depends on who is the beneficiary of the cash flows. A diversified beneficiary might be willing to take on more risk than an undiversified beneficiary, so that the discount rate would be lower for a diversified than an undiversified beneficiary. For example, you may be unwilling to lend \$1,000 to one stranger on a P2P lending site, but you might be willing to lend \$100 each to ten different strangers.

In this last way, an investor can lower a discount rate through diversification. For instance, consider three equally valuable but different businesses, A, B, and C, each owned separately by Alexia, Barbara, and Charlie. Assume further that they have all their wealth invested in their own business and are passive investors (i.e., they don't interfere with their business). For each business, each year there's a 50 percent chance that the owner will get $300 and a 50 percent chance of $0. Thus, on average, each owner will get $150. One day they sit together and discuss combining their businesses into a single corporation ABC, with each obtaining a one-third stake. They are all in favor even though they agree that the businesses will be owned jointly but operated separately (the decision-making for each business is completely independent). The reason is that the risk has been lowered through diversification. Under the new structure, each owner will still get on average $150. But the annual payments are less likely to be as extreme as before (i.e., $300 or $0). In a given year, it is unlikely that all companies do well or all do poorly. Therefore the new investment is less risky than the old one. In other words, the discount rate is lower because the risk is diversified.

This logic underlies the classic investment advice: "don't put all your eggs in one basket." In fact, Alexia, Barbara, and Charlie favor this deal precisely because they had all their wealth tied up in a single business. They probably would not have done this deal had their wealth already been diversified into other assets.

In this example, the condition of corporate advantage is satisfied: V[ABC] > V(A) + V(B) + V(C). This is entirely due to a reduction in discount rates because the cash flows are unaffected. If we take as a benchmark the performance of a passive investor, who can create corporate advantage merely through **selection** of a good portfolio of businesses, then a corporate strategist (with the same portfolio, but who administratively controls her selected portfolio of businesses) must in this example at least do better than the V[ABC] achieved by the three owners.

## Corporate advantage from business modification: the "synergy" approach

It should be clear by now that a corporate strategist (i.e., a strategist in the corporate HQ of a multi-business firm, or anybody advising or assisting somebody playing that role) cannot rest content with the gains from risk diversification or bargain hunting if a typical investor can also access them. Rather, within the selected portfolio the corporate strategist must work on increasing the NPV of the portfolio of businesses. Unlike an investor, a corporate strategist can create value by changing the cash flows of the businesses (e.g., through increasing revenue or decreasing expenditures) as well as by decreasing the discount rates.

In Chapter 2, we will develop detailed frameworks for analyzing a central concept in corporate strategy: **synergy** between the businesses in a portfolio. For now, it suffices to note that we use synergy as an umbrella term to describe the various ways in which the cash flows and discount rates of businesses in a portfolio can be **modified through joint operation (i.e., collaboration and joint decision-making)** across them. Synergy is therefore the means through which corporate advantage is created relative to a typical investor who can **select** the same portfolio of investments (without exercising decision-making power over them, as she lacks the rights to do so).

In most mature capital markets, typical investors may be able to build the same or a more diversified portfolio than the corporate strategist, and typically with a lower cost of administrative overhead than that of a corporation. If the shareholders are already well diversified, then further diversification by the company will not reduce the discount rate. There are, however, situations in which the investor may simply not have access to the equivalent portfolio. She cannot buy shares in the relevant businesses or access mutual funds that do so, as has sometimes been the case in the emerging economies. In these situations, the corporate strategist may be able to get away with acting essentially as an investor with preferential access to investments, if she can merely select the portfolio and typical investors cannot. In other words, mere portfolio assembly may create sufficient corporate advantage in such cases, even if the returns and risks of the individual businesses are left unmodified.

So how much corporate advantage is enough for a corporate strategist? Ideally, a corporate strategist would maximize corporate advantage. But at a minimum, she should create no less value from the portfolio of businesses than any another actor would. What this minimum is varies by institutional context, and hence so does the appropriate path to achieve corporate advantage. When investors can replicate the portfolio of investments represented by a multi-business corporation, corporate advantage must necessarily rest on some form of synergy, which requires modification of the cash flows or the discount rates of businesses; otherwise assembling a portfolio of individually good but unlinked businesses may suffice. Thus corporate strategy in a developed and developing economy may look very different in the relative emphasis placed on portfolio assembly vs. modification, but we contend that both can be understood according to the same over-arching principles. Table 1.1 provides a summary of the different paths to corporate advantage.

To summarize, corporate strategy is the strategy of multi-business corporations and the goal is the pursuit of corporate advantage. Corporate advantage exists if joint ownership of businesses is more valuable than the same businesses owned separately. In Figure 1.3, this is the case if quadrant III and IV are more valuable than

TABLE 1.1 *Useful corporate strategies in different contexts*

| | Modification of businesses: "synergy" | | Assembly of portfolio: "selection" | |
|---|---|---|---|---|
| | Cash flows | Discount rate | Cash flows | Discount rate |
| **Context** | Increase cash flows (increase revenue or decrease expenses) | Reduce risk of business (systematic risk) | Buy under-valued businesses (unaltered cash flows are worth more than what is paid for them) | Reduce risk of portfolio (unsystematic risk) |
| Under-developed capital markets | ✓ | ✓ | ✓ | ✓ |
| Well-developed capital markets | ✓ | ✓ | X | X |

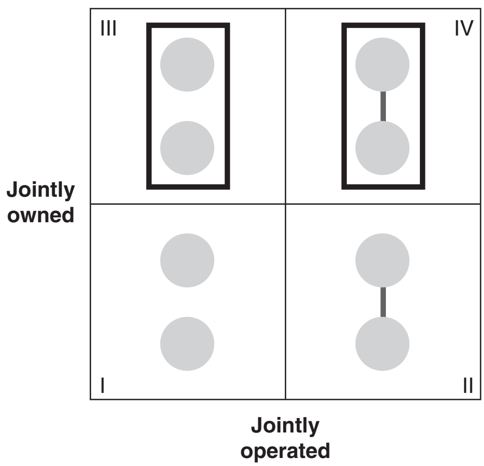


**Figure 1.3** Investors can jointly own business, corporate strategists can additionally jointly operate them

quadrants I and II, respectively. If an investor can easily select and assemble a portfolio similar to a corporate strategist (i.e., compare quadrant I to III) then a corporate strategist potentially can only do better through modification of businesses (i.e., compare quadrant

III and IV). Figure 1.3 further clarifies that synergies may also exist between businesses that are owned separately (i.e., if quadrant II does better than quadrant I). An important question for corporate strategy, which we address in Part II on the scope of the organization (Chapters 4–6), is when common ownership is necessary to realize synergies.

**Application: MoveIt**

Mario is CEO of MoveIt, which is active in three businesses: planes, trains, and tractors, as we saw at the beginning of the chapter. To assess Mario's performance, we look at whether MoveIt has corporate advantage, i.e., whether the business are worth more owned jointly than separately.

With the help of their investment bank, Mario prepares a sum-of-the-parts (SOTP) valuation (see Table 1.2). Such valuation is often done to assess the performance of multi-business organizations. It is a comparison between MoveIt and **focused peers**, i.e., companies who are active only in planes, only in trains, or only in tractors. Mario uses privately available data on earnings before interest, tax, depreciation, and amortization (EBITDA) per division of his own corporation and publicly available data on valuation multiples of focused peers (Enterprise value/EBITDA multiples). **Enterprise value** indicates how much a company is worth and equals market capitalization + debt – cash reserves.

TABLE 1.2 *SOTP valuation (in £ million except where noted otherwise)*

| Division | EBITDA (2016) | Enterprise value/ EBITDA of focused peers | Enterprise value | |
|---|---|---|---|---|
| | | | Total | £ per share |
| Planes | 70 | 11 | 770 | 6.16 |
| Trains | 60 | 17 | 1020 | 8.16 |
| Tractors | 50 | 9 | 450 | 3.60 |

TABLE 1.2 (*cont.*)

| Division | EBITDA (2016) | Enterprise value/ EBITDA of focused peers | Enterprise value | |
|---|---|---|---|---|
| | | | Total | £ per share |
| | | | | |
| HQ | | Costs | (67) | (0.54) |
| | | | | |
| Total | | | 2173 | 17.38 |
| | | | | |
| | | Net debt | (869) | (6.95) |
| | | | | |
| SOTP | | | 1304 (market capitalization) | 10.43 (share price) |

From this, Mario infers an enterprise value per division for his own company. Taking into account the costs of HQ, net debt, and the fact that 125 million shares are outstanding, the SOTP valuation of MoveIt suggests a price of £10.43 per share. This is an estimate of what the shares in a portfolio of investments in three standalone companies – 1 for planes, 1 for trains, and 1 for tractors – would be valued at if they had similar earnings to MoveIt's divisions. Arguably the estimate is even conservative, as the cost of HQ in such a portfolio of pure investments (assuming there are no centralized functions at HQ) may not be as high as it is for MoveIt. At the time of the analysis, the share price of MoveIt is £9.40, i.e., lower than the SOTP valuation. Can we conclude that MoveIt lacks corporate advantage because MoveIt trades at a discount relative to its focused peers?

While it may be tempting to think so, in fact such a conclusion must be tempered with a lot of caution. If we use an SOTP valuation to assess corporate advantage, then we need to make two critical assumptions (see Table 1.3). First, that the focused peers

TABLE 1.3 *Assumptions when using SOTP valuation to infer corporate advantage (in £ million)*

| MoveIt | EBITDA | Enterprise value/ EBITDA | Enterprise value |
|---|---|---|---|
| Jointly owned | 180 | 11.36 | 2044 |
| Separately owned | 180 (assumption 2: equal to jointly owned) | 12.07 (assumption 1: equal to focused peers) | 2173 |

whose multiples we use are truly comparable to MoveIt's divisions. Second, that the earnings of MoveIt's divisions would be unaffected if the divisions were split up and organized under separate rather than joint ownership. This assumption is particularly problematic. We want to know whether splitting up MoveIt into three separately owned businesses would increase or decrease earnings. Using a technique in which we begin by assuming that the earnings are unaffected cannot provide a good answer.

So what is the discount calculated using SOTP good for? First, it does highlight the fact that the capital markets discount the earnings from MoveIt relative to comparable earnings from standalone firms. Thus, a SOTP provides an insight into whether the capital markets appreciate a pound of earnings (or sales, cash flows, assets) of the multi-business firm more than those of standalone firms, but not into whether those earnings would be lower or higher. Perhaps Mario needs to explain to investors and analysts why the future prospects of his businesses are better than they think. Second, it gives us a **benchmark** rather than a measure. Mario must be confident that the EBITDA generated by the businesses in his portfolio are *at least* higher than the discount because they are in his portfolio, than when operated and owned independently. Obviously the larger the discount, the less plausible this argument is.

## Corporate advantage is a goal, not a measure

Despite our ability to define corporate advantage clearly, in practice it remains very difficult to measure. The most important difficulty for all techniques is the same. The notion of corporate advantage requires a comparison between something we can observe – the performance of a multi-business corporation – and a counterfactual that we cannot – the aggregate performance of the individual businesses **if** they had been operating in isolation from each other (see Figure 1.4). By coming into existence, the multi-business firm in effect destroys its own best benchmark. In contrast, competitive advantage is easier to measure because it involves comparing observables – the performance of different businesses.

We therefore think of corporate advantage ultimately as an imperfectly measurable but nonetheless useful benchmark for corporate strategists, to use as a conceptual touchstone when contemplating strategic decisions.

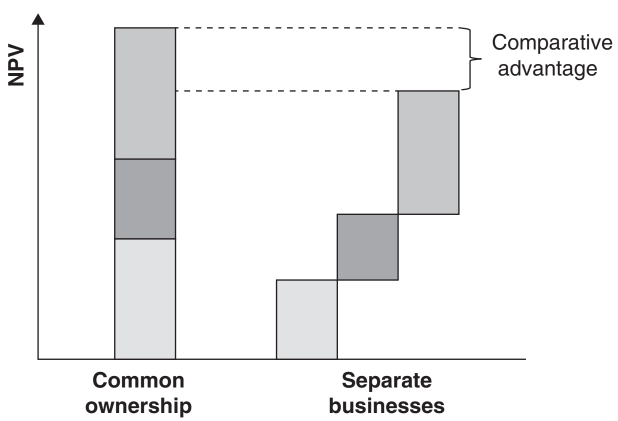


**Figure 1.4** Corporate advantage involves a comparison between what is and what could have been

## Frequently asked questions

**1. The goal for corporate strategy is variously described in terms of "pursue synergies," "make sure your assets are not worth more to another buyer," or "seek corporate advantage." How do these three ideas relate to each other?**

If an investor can replicate the portfolio of businesses that a corporate strategist controls, then corporate advantage exists relative to this investor only if the corporate strategist can extract synergies, i.e., modify the cash flows or discount rates of businesses. Therefore "seek corporate advantage" and "pursue synergies" mean the same thing if an investor can replicate the portfolio of businesses that a corporate strategist controls.

Different corporate strategists may generate different levels of corporate advantage for the same portfolio of businesses, so to compete with other potential controllers of the same portfolio; the goal of the corporate strategist is to maximize corporate advantage. However, even if you exploit such synergies in your portfolio to the fullest extent, this is not sufficient for you to be safe from being worth more to another buyer, because the assets they hold may generate large synergies with your assets. If the buyer is a non-synergistic buyer such as a private equity fund, then pursuing synergies to the fullest extent is sufficient for you to be safe from takeover. Note also that pursuing synergies to their full potential is not even necessary to be safe from takeover. Even if you have under-exploited synergies, the costs another player faces in taking over your assets may still make the assets worth less to them.

**2. Given a portfolio of businesses, when is risk reduction by a corporate strategist useful?**

Risk reduction is always useful for bondholders (because their loans become more secure) and for top managers and employees

TABLE 1.4 *Does risk reduction lead to a lower discount rate (and hence a higher NPV)?*

| | Lowering unsystematic risk (i.e., business specific) | Lowering systematic risk (i.e., market risk) |
|---|---|---|
| Diversified shareholders | X | ✓ |
| Undiversified shareholders | ✓ | ✓ |

(if their jobs become more secure). For shareholders, this depends on their alternatives. If the shareholders have no other investment opportunities, then any risk reduction by the strategist is beneficial. If the shareholder has unlimited other investment opportunities, then he can diversify away all the unsystematic risk (the risk that is unique to a business); then risk reduction by the strategist is only useful to the shareholder if it leads to lower systematic risk for the portfolio – the extent to which a company's returns vary with those of the broader capital market. In other words, whether risk diversification by a corporate strategist leads to a lower discount rate for shareholders depends on whether the shareholders themselves are diversified, and what sort of risk is being reduced (see Table 1.4).

## 3. Can diversification ever lead to lower systematic risk?

This would be the case if the combination of two businesses were less sensitive to the general economy than the same two businesses uncombined. Diversification by an investor does not lower systematic risk because this is defined as the risk that is undiversifiable (i.e., the risk that remains after diversifying). However, diversification by a corporate strategist with administrative control that allows the movement of cash between businesses can lower systematic risk if: (1) businesses have bankruptcy costs, i.e., the prospect of a near bankruptcy will discourage suppliers or customers from dealing with the organization (e.g. would you still buy a flight ticket if you suspected the airline might go bankrupt before you fly?) or will force the organization to forgo profitable investment opportunities (a product extension will be hugely profitable in two years but no funds are available for the upfront investments); (2) it is costly for businesses to hold enough financial slack to avoid all future bankruptcy costs; and (3) cash flows of businesses are imperfectly correlated (so that someone with administrative control can subsidize one business close to bankruptcy with funds from another business). Thus diversification by a corporate strategist can lower systematic risk for a portfolio containing businesses that face substantial bankruptcy costs, whose cash flows are not correlated, and in periods of financial downturn.[5]

## 4. What is the difference between "divisional," "holding," and "conglomerate" forms of multi-business corporations?

When the different businesses are **internal divisions** (as in the case of General Electric) the corporation is called a "multi-divisional corporation." This structure will typically have an integrated treasury function at corporate HQ that manages cash for the entire corporation. Another way to organize these different businesses is to structure each as a separate company, whose shares are held by a "**parent holding company**." For instance, Tata Sons is the parent holding company for the various businesses – software, steel, autos, and many others – that make up the companies in the Tata group. The term "**conglomerate**" is applied to either form when the collection of industries (and therefore businesses) the company is involved in appears so diverse as to show little coherence (at least in the eyes of the analyst covering the company). Thus BMW with two businesses – motorcycles and automobiles – is typically not described as a conglomerate, but General Electric is. Finally, the term "**business group**" is often used to describe a single family controlled conglomerate holding company structure; often some of the businesses in the portfolio will also be publicly listed, as is the case for instance in the Tata group in India or the Ayala group in the Philippines. More details about the structures of multi-business corporations can be found in Chapter 9.

## 5. With trends like "focus on the core" and outsourcing, aren't conglomerates a thing of the past?

No. Across the globe conglomerates defined as corporations with involvement in multiple industries (and therefore multiple businesses) are quite common.

**In developed economies** Rudolph and Schweltzer (2013) identified thousands of *publicly traded* conglomerates, which are defined as active in at least two out of 48 different industries, by region (Asia Pacific (Australia, Japan, Singapore, South Korea), Europe, and North America).[6] It is interesting that many conglomerates were identified even in the UK (1,588) and US (2,549), because in these countries, unlike in most other economies, inter-divisional dividends are taxed, making conglomerates less attractive.[7] The number of multi-business organizations in an economy must necessarily be at least as big as the number of multi-industry organizations. Basu (2010) found that in the US for the years 1999–2007, between 35 and 38 percent of the firms reported financial data for more than one industry they were operating in.[8]

**In developing economies** Khanna and Rivkin (2000) studied emerging economies (Argentina, Brazil, Chile, India, Indonesia, Israel, Mexico, Peru, the Philippines, South Africa, South Korea, Taiwan, Thailand, and Turkey). They found that for the firms for which data was available, a significant fraction in each country belonged to a business group (low: 23 percent, median: 48 percent, high: 64 percent).[9] A business group is "a set of firms which, though legally independent, are bound together by a constellation of formal and informal ties and are accustomed to taking coordinated action" (Khanna and Rivkin, 2000, 47–48). Typically, these business groups are highly diversified across multiple industries.

**6. How does strategy in multi-national corporations link to corporate strategy?**

We distinguish businesses in terms of their business models – their answers to the "who/what/how" (customers, products, activities) choices. By definition, multi-national corporations (MNCs) are active in multiple businesses because they serve customers across different countries (i.e., the "who"). Thus, MNCs are instances of multi-businesses organizations, and the frameworks developed in this book are applicable to them. There are of course additional complications because of differences in governance regimes and national cultures across businesses. We integrate the discussion of international aspects directly within the relevant chapters, rather than treating them in a separate chapter.

**7. Company A has two divisions B and C. Company A is listed. A SOTP valuation based on comparable focused firms suggests that it is trading at a 15 percent discount. You are senior partner in a private equity firm. Do you think you should take over A and unlock value by splitting it up into B and C? What else would you need to know?**

An SOTP valuation based on multiples makes two critical assumptions. First, that we have found truly comparable standalone listed firms for B and C (call them B´ and C´, respectively) in order to apply their Enterprise value to revenues/profits/assets multiple to B and C to impute a market value for them. Second, we assume that the profits or revenues of division B and C will not fall as a consequence of being unlocked from the current ownership structure, if we use multiples that use revenues or profits in the denominator. If either of these assumptions is not met, then we cannot be sure that we can create any value by breaking up the company. In addition, even if we could be sure that these assumptions were justified, the potential value unlocked must be compared to the costs of conducting the takeover and divestitures.

## 8. How does the corporate advantage test apply if the corporate strategist works in a privately held company rather than a listed one?

Whether the company is private or public should not in itself necessarily change the goal of the corporate strategist, which is to use the benefits of administrative control to maximize the value of the portfolio of businesses controlled.

However, the benchmark for how much corporate advantage is sufficient may vary with a few circumstances. First, wealthy owners may be content if the group realizes just risk diversification. Sound financial advice suggests that one should not put all one's eggs in one basket. Diversification of unsystematic risk can be easily done through a mutual fund if you have a $100,000 but might be harder if you have $75,000,000,000. Thus, the super-rich may treat their business group as their own mutual fund.

Second, the corporate advantage test focuses on economic value. The owners of private business groups may strive for additional goals besides purely financial ones, e.g., influence, status, power, and legacy.

Third, outside investors may sometimes not have access to the same investment opportunities as a corporation has (for example, the opportunity to invest in or buy a private company). In this case the benchmark for the corporate strategist may be lower.

**9. Holding company A has two subsidiaries, B and C, in which it owns 90 percent shares each. Both the subsidiaries are listed, as is A, the holding company. The two subsidiaries have a market valuation of 60 million dollars each, whereas the holding company is valued at $100 million. Is this structure creating corporate advantage?**

Based on its ownership of 90 percent of each of the companies, the holding company must be worth 0.9*60*2= $108 million if it simply transmits unchanged the value it derives from the two businesses to its shareholders. The fact that it is valued at $100 million suggests that there may be transmission losses and that shareholders may prefer to hold shares directly in the listed companies (rather than let the holding company act as a mutual fund manager).

However, this does not tell us anything about corporate advantage! Note that corporate advantage is based on a comparison between different ownership structures: common administrative control vs. separate autonomous entities. If both the business and the holding company are listed, we have information about the value of holding shares in the individual businesses and the value of holding shares in the holding company when those businesses are part of a holding company. We don't have information about the value of the businesses under separate ownership. Thus, in the example above, it may well be true that the two businesses would have been worth only $50 million each if they were not being managed by the holding company. (Incidentally, this kind of structure, with listing of both businesses and holding company, is rare but exists; the Ayala group in the Philippines is structured in this way.)

### 10. Is corporate strategy only relevant for a few big companies?

First of all, there are many big companies (see FAQ 5) and in many economies multi-business corporations are responsible for more than half of total output. However, corporate strategy is relevant even for single-business companies as they plan on new businesses to enter. The new businesses under consideration might be more or less related to the existing business.

### 11. I understand how business and corporate strategy are different. How are they related?

First, business strategy is about choosing a business model so that a company can generate competitive advantage in selling products and services to customers. By entering multiple businesses, a company may sacrifice profitability in one business but with the idea of making more in another business to compensate. So corporate strategy must reinforce business strategy for some (if not all) businesses, and increase the cumulative competitive advantage (i.e., the sum of competitive advantages for each business) of the portfolio. Second, competition for customers is affected if multi-business competitors meet in multiple markets. For instance, Siemens and General Electric sell both wind turbines and trains. They might compete less aggressively than if they met only in one market because the other could retaliate in multiple markets.[10]

## Notes

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9. Khanna, T. and Rivkin, J. W. (2001). Estimating the performance effects of business groups in emerging markets. *Strategic Management Journal*, *22*(1), 45–74.
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## Further reading

For early thinking on corporate strategy, conceptualized as the strategy through which multi-business firms compete, see:

Andrews, K. R. (1971). *The Concept of Corporate Strategy*. Homewood, IL: Richard D. Irwin, Inc.

Ansoff, H. I. (1965). *Corporate Strategy*. New York: McGraw-Hill.

For the early work on diversification, and in particular the possible advantages of related diversification, see:

Chandler, A. D., Jr. (1962). *Strategy and Structure: Chapters in the History of the American Industrial Enterprise*. Cambridge, MA: MIT Press.

Rumelt, R. (1974). *Strategy, Structure and Economic Performance*. Cambridge, MA: Harvard University Press.

Wrigley, L. (1970). *Divisional Autonomy and Diversification (DBA thesis)*. Boston, MA: Harvard Business School.

The argument for related diversification took its most popular form in the work of Prahalad and Hamel (1990), see:

Prahalad, C. K. and Hamel, G. (1990). The core competence of the corporation. *Harvard Business Review* 68(3), 79–91.

For other discussions of corporate advantage, see:

Collis, D. J. and Montgomery, C. A. (1997). *Corporate Strategy: Resources and the Scope of the Firm*. Chicago, IL: Irwin.

Goold, M., Campbell, A., and Alexander, M. (1994). *Corporate Level Strategy: Creating Value in the Multi-Business Company*. New York: John Wiley.

Porter, M. E. (1987). From competitive advantage to corporate strategy. *Harvard Business Review*, 65(3), 43–59.

## Appendix: NPV

Net present value (NPV) is the sum of all future cash flows discounted to the present. The formula is:

$$\text{NPV} = \sum\nolimits_0^t \frac{C_t}{(1+r)^t}$$

Where C is the net cash flow (inflows – outflows) in year $t$, and $r$ is the yearly discount rate. Cash flows occurring in the far future will be discounted more than those occurring in the near future. Specifically, for a given year the cash flows will be multiplied by $1/(1+r)^t$, which is called the **discount factor**. Table A1.1 shows an example of a NPV calculation. The NPV is 15,510, which means that future cash flows are as valuable as receiving 15,510 immediately.

TABLE A1.1 *NPV calculation with a discount rate of 7 percent*

| Year | Incoming cash flows | Outgoing cash flows | Net cash flows | Discount factor | Discounted cash flows |
|---|---|---|---|---|---|
| 0 | 0 | 10000 | *−10000* | 1.00 | *−10000* |
| 1 | 2000 | 5000 | *−3000* | 0.93 | *−2804* |
| 2 | 4000 | 3000 | *1000* | 0.87 | *873* |
| 3 | 6000 | 1000 | *5000* | 0.82 | *4081* |
| 4 | 8000 | 1000 | *7000* | 0.76 | *5340* |
| 5 | 10000 | 1000 | *9000* | 0.71 | *6417* |
| 6 | 10000 | 1000 | *9000* | 0.67 | *5997* |
| 7 | 10000 | 1000 | *9000* | 0.62 | *5605* |
| | | | | **NPV** | **15510** |