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STRATEGIC MANAGEMENT

An Integrated Approach

Theory & Cases

HILL • SCHILLING • JONES

CENGAGE

CHAPTER 10

Corporate-Level Strategy: Related and Unrelated Diversification

LEARNING OBJECTIVES (1 of 2)

- Differentiate between multibusiness models based on related and unrelated diversification
- Explain the five primary ways in which diversification can increase company profitability
- Discuss the conditions that lead managers to pursue related diversification versus unrelated diversification, and explain why some companies pursue both strategies

LEARNING OBJECTIVES (2 of 2)

- Describe the three methods companies use to enter new industries—internal new venturing, acquisitions, and joint ventures—and discuss the advantages and disadvantages associated with each of these methods

DIVERSIFICATION

- **Diversification** - Entering new industries, distinct from a company's core or original industry, to make new kinds of products for customers in new markets.
- **Diversified company** - A company that makes and sells products in two or more different or distinct industries.
- Diversification strategy "better off" test: The firm must be more valuable than it was before the diversification, and that value must not be fully capitalized by the cost of the diversification move.

INCREASING PROFITABILITY THROUGH DIVERSIFICATION

- Ways in which profitability can be increased
  - Transfer competencies between business units in different industries.
  - Leverage competencies to create business units in new industries.
  - Share resources between business units to realize synergies or economies of scope.
  - Utilize general organizational competencies that increase the performance.

TRANSFERRING COMPETENCIES (1 of 3)

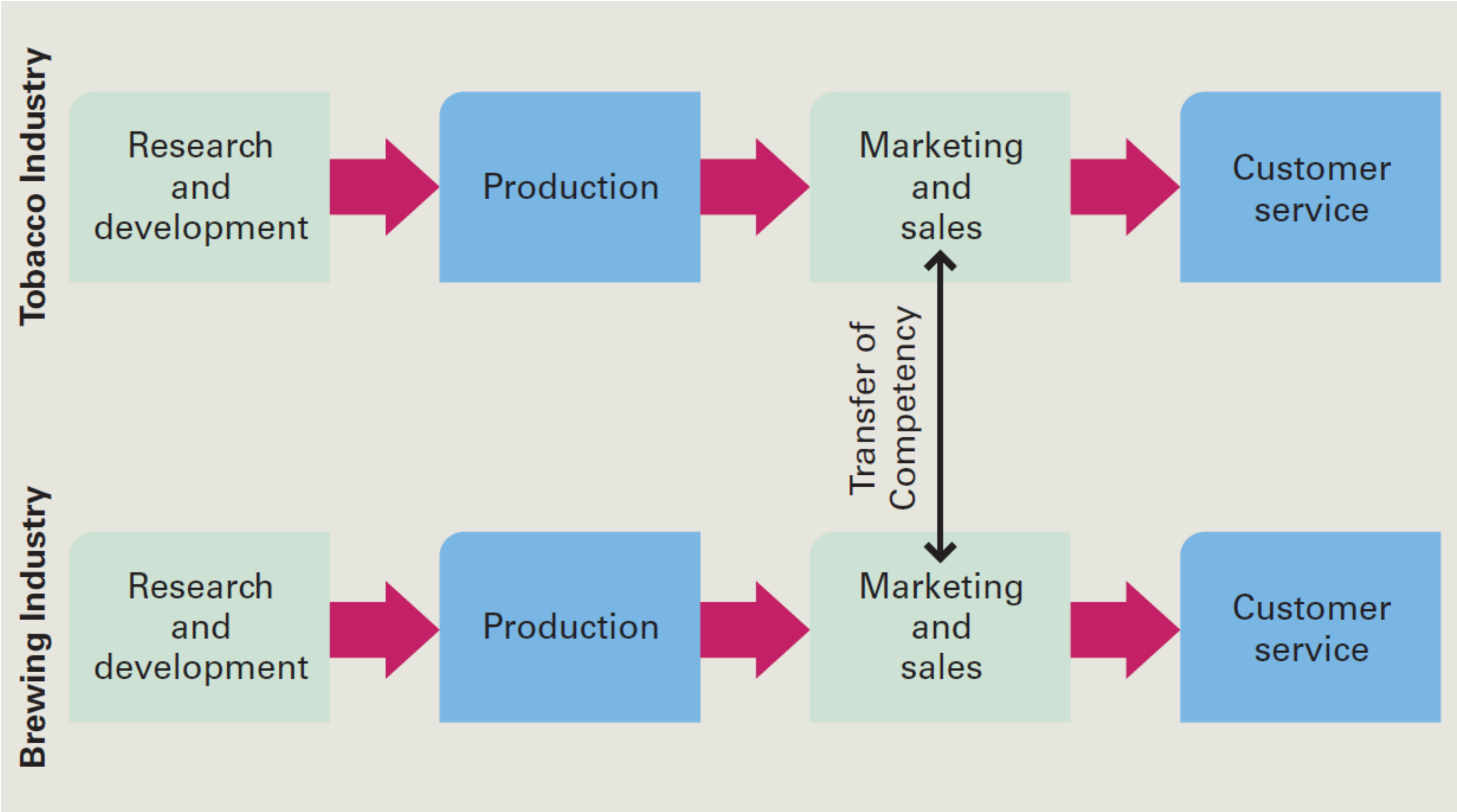
- **Transferring competencies** - Taking a distinctive competency developed by a business unit in one industry and implanting it in a business unit operating in another industry.
- **Commonality** - Skill or competency that, when shared by two or more business units, allows them to operate more effectively and create more value for customers.

TRANSFERRING COMPETENCIES (2 of 3)

- Increases profitability when they:
  - lower the cost structure of one or more of a diversified company's business units.
  - enable one or more of its business units to better differentiate their products.
- Distinctive competency being transferred must have real strategic value.
  - Competencies should involve value-chain activities to increase profitability.

TRANSFERRING COMPETENCIES (3 of 3)

Figure 10.1 Transfer of Competencies at Philip Morris



LEVERAGING COMPETENCIES

- **Leveraging competencies** - Taking a distinctive competency developed by a business unit in one industry and using it to create a new business unit in a different industry.
- Basis of the model
  - Company's competitive advantage in one industry is applied to create a differentiation or cost-based competitive advantage for a new business unit in a different industry.

SHARING RESOURCES AND CAPABILITIES

- **Economies of scope** - Synergies that arise when one or more of a diversified company's business units are able to lower costs or increase differentiation.
  - More effectively pool, share, and utilize expensive resources or capabilities.
- Sources of cost reductions
  - Sharing resources lowers the cost structure.
  - Marketing function creates the differentiation of products leading to a higher ROIC.

PRODUCT BUNDLING

- **Product bundling** - Providing products that are related to each other.
  - Allows companies to expand their range providing customers a complete package of related products.
- Goal: Bundling products offers customers:
  - lower prices.
  - convenience of a single supplier.
- Does not always require joint ownership.
  - Can be achieved through market contracts.

GENERAL ORGANIZATIONAL COMPETENCIES

- **General organizational competencies** - Help business units within a company perform at a higher level than it could if it operated as a separate or independent company.
  - Results from the skills of a company's top managers.
- Types
  - Entrepreneurial capabilities
  - Organizational design capabilities
  - Strategic capabilities

ENTREPRENEURIAL CAPABILITIES

- Required to take advantage of the free cash flow
- To promote entrepreneurship, a company must:
  - encourage managers to take risks.
  - give managers the time and resources to pursue novel ideas.
  - not punish managers when a new idea fails.
  - make sure that the company's free cash flow is not wasted in risky ventures that would generate a low return on investment.

CAPABILITIES IN ORGANIZATIONAL DESIGN

- **Organizational design skills** - Ability of the managers to create a structure, culture, and control systems that motivate and coordinate employees to perform at a high level.
- Major factors:
  - influences a company's entrepreneurial capabilities.
  - determines a company's ability to create functional competencies.
  - determines a diversified company's ability to profit from its multibusiness model.

SUPERIOR STRATEGIC MANAGEMENT CAPABILITIES (1 of 2)

- Required to manage different business units to perform better than they would if they were independent companies
- Ability to diagnose the underlying source of the problems of a poorly performing business unit
- **Turnaround strategy** - Managers of a diversified company identify inefficient, poorly managed companies in other industries they acquire and restructure them to improve their performance and the profitability of the total corporation.

SUPERIOR STRATEGIC MANAGEMENT CAPABILITIES (2 of 2)

- Ways to improve the performance of the acquired company
  - Top managers of the acquired company are replaced with a more aggressive team.
  - New top-management team sells off expensive assets.
  - New management team works to devise new strategies to improve the performance.
  - Introduce companywide pay-for-performance bonus system.
  - Establish “stretch” goals for employees at all levels.

RELATED DIVERSIFICATION

- **Related diversification** - Corporate-level strategy based on the goal of establishing a business unit in a new industry related to a company's existing business units.
  - By some form of commonality or linkage between their value-chain functions
- Basis of multibusiness model
  - Takes advantage of strong commonalities that can be modified to increase the competitive advantage.
  - Allows a company to use any general organizational competency it possesses.

UNRELATED DIVERSIFICATION (1 of 2)

- **Unrelated diversification** - Corporate-level strategy that uses general organizational competencies to increase the performance of all the company's business units.
  - Companies pursuing this are called conglomerates.
- **Internal capital market** - Corporate-level strategy whereby the firm's headquarters assesses the performance of business units and allocates money across them.
  - Cash generated by profitable but poor investments is cross-subsidized to promising units that need cash.

UNRELATED DIVERSIFICATION (2 of 2)

- Benefits of an internal capital market are limited by the efficiency of the external capital market.
- Reasons for efficiency of capital markets in U.S.
  - Reporting requirements mandated by the Securities and Exchange Commission (SEC)
  - Large numbers of research analysts
  - Extremely large and active investment community
  - Strong communication systems
  - Strong contract law

DISADVANTAGES OF DIVERSIFICATION (1 of 2)

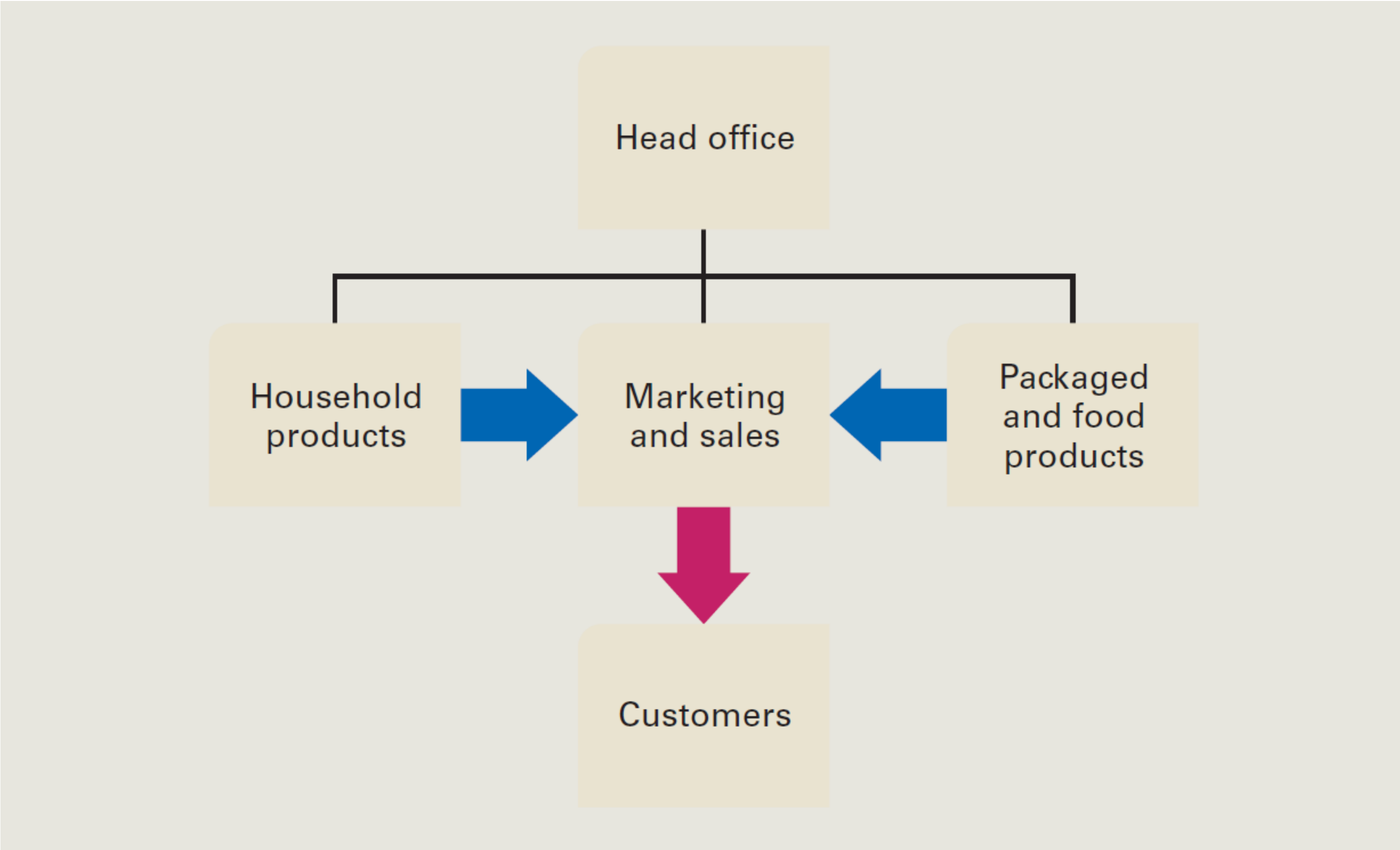
- Changes in the industry or company
  - Management
  - Technology
- Diversification for the wrong reasons
  - Risk pooling
  - Entry into a wrong business or at the wrong time or for the wrong reasons

DISADVANTAGES OF DIVERSIFICATION (2 of 2)

- **Bureaucratic costs** - Costs associated with solving the transaction difficulties between business units and corporate headquarters.
  - Factors responsible
    - Number of business units in a company’s portfolio
    - Degree to which coordination is required to realize the advantages of diversification

COORDINATING AMONG BUSINESSES

Figure 10.4 Coordination Among Related Business Units



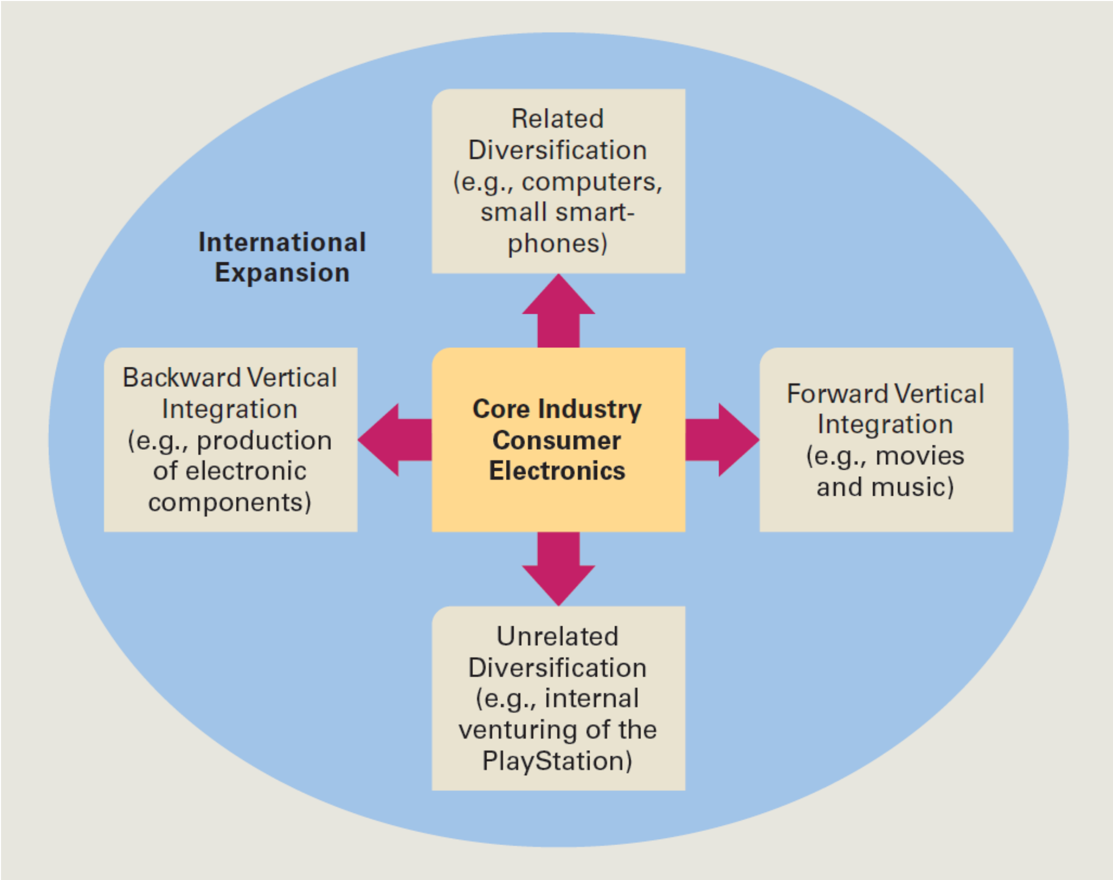
RELATED VERSUS UNRELATED DIVERSIFICATION

Related diversification	Unrelated diversification

▪ Company's competencies can be applied across a greater number of industries.
▪ Company has superior strategic capabilities that allow it to keep bureaucratic costs under close control.
	▪ Company's top managers are skilled at raising the profitability of poorly run businesses.
	▪ Company's managers use their strategic management competencies to:
	  ▪ improve the competitive advantage of their business units.
	  ▪ keep bureaucratic costs under control.

WEB OF CORPORATE-LEVEL STRATEGY

Figure 10.5 Sony's Web of Corporate-Level Strategy

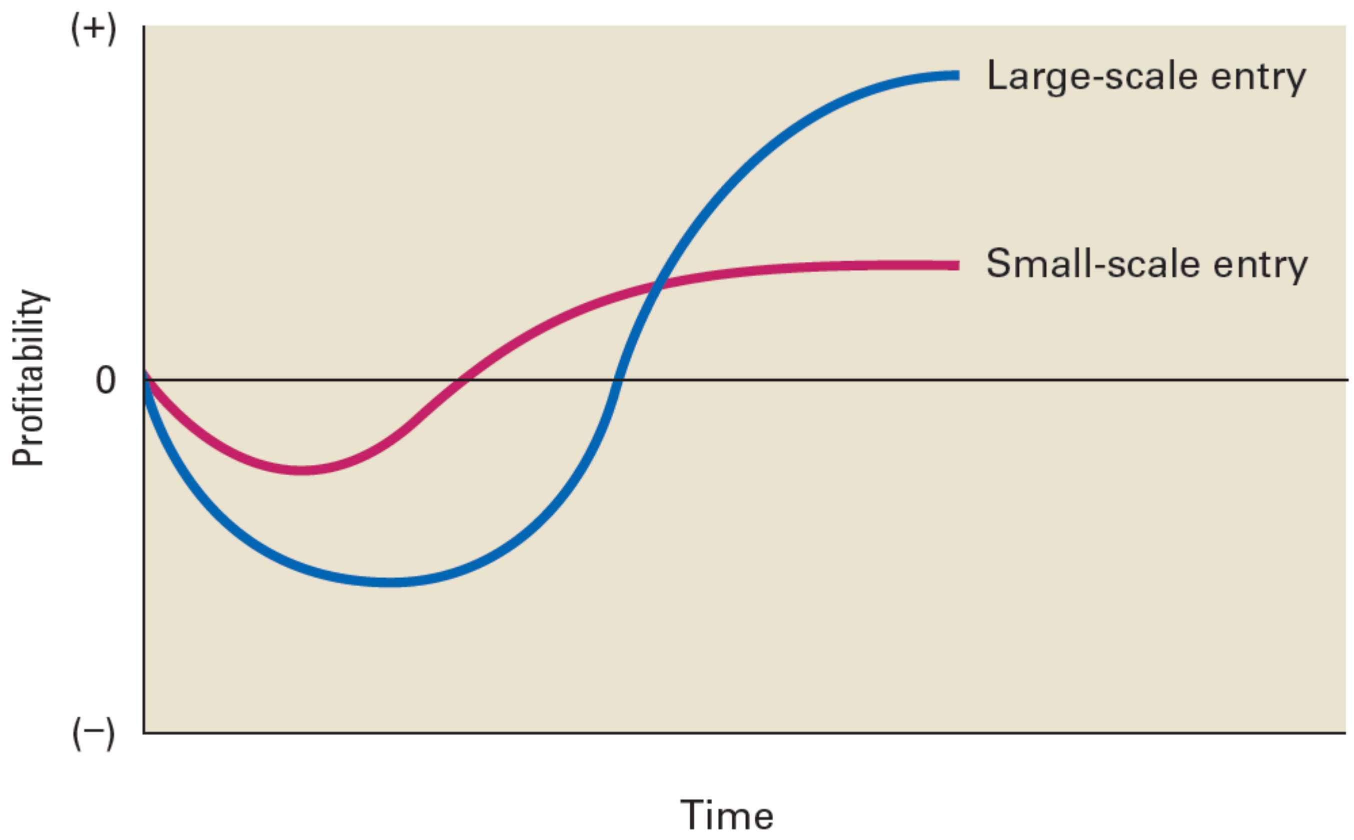


INTERNAL NEW VENTURING

- **Internal new venture** - Transferring resources and creating a new business unit in a new industry to innovate new kinds of products.
  - Used by companies that are:
    - technology-based and pursue related diversification.
    - venturing to enter a newly emerging industry.
- Pitfalls
  - Market entry on too small a scale
  - Poor commercialization of the new-venture product
  - Poor corporate management of new-venture division

SCALE OF ENTRY AND PROFITABILITY

Figure 10.6 Scale of Entry and Profitability



GUIDELINES FOR SUCCESSFUL INTERNAL NEW VENTURING (1 of 2)

- Understand and base new ventures on R&D.
- Give funding for research to business unit managers who can narrow down and then select the best set of research projects.
- Work with R&D scientists to continually develop and improve the business model and strategies.
- Fostering links between R&D and marketing to increase the commercial success of the new product.

GUIDELINES FOR SUCCESSFUL INTERNAL NEW VENTURING (2 of 2)

- Fostering links between R&D and manufacturing to ensure cost-effective manufacturing of the product.
- Construct efficient-scale manufacturing facilities and give marketing a large budget.
- Develop a future product campaign that will build market presence and brand loyalty quickly.

ACQUISITIONS (1 of 2)

- Principal way companies enter new industries to pursue vertical integration and diversification
  - Used by companies to move fast to establish a presence in an industry
- Less risky than internal new ventures
- Easy way to enter an industry that is protected by high barriers to entry

ACQUISITIONS (2 of 2)

Pitfalls

- Integrating the acquired company
- Overestimating economic benefits
- Expense of acquisitions
- Inadequate pre-acquisition screening
- Agency problems

Guidelines for success

- Target identification and pre-acquisition screening
- Bidding strategy
- Integration
- Learning from experience

JOINT VENTURES

- **Joint ventures** - Two or more companies agree to pool their resources to create new business.
  - Allows a company to share the risks and costs associated with establishing a business unit
- Resulting problems
  - Partner with superior skills will have to give away profits.
  - Different business models or time horizons leading to a conflict about how to run the joint venture.
  - Can lead to leaks of proprietary information.

RESTRUCTURING (1 of 2)

- Companies may exit industries and split their businesses to increase profitability.
- **Restructuring** - Reorganizing and divesting business units and exiting industries.
  - To refocus upon a company's core business and rebuild its distinctive competencies

RESTRUCTURING (2 of 2)

- Reasons
  - Investors feel these companies no longer have multibusiness models.
  - Complexity of the financial statements of highly diversified enterprises disguises the performance of individual business units.
  - Responds to declining financial performance brought about by over-diversification.
  - Diminishes the advantages of vertical integration or diversification from innovations in strategic management.

APPENDIX

NOTE TO INSTRUCTOR: Choose from the following questions (also found in the text at the end of the chapter) to conduct in-class discussions around key chapter concepts.

DISCUSSION:

- When is a company likely to choose (a) related diversification and (b) unrelated diversification?

DISCUSSION:

- What factors make it most likely that (a) acquisitions or (b) internal new venturing will be the preferred method to enter a new industry?

DISCUSSION:

- Imagine that IBM has decided to diversify into the telecommunications business to provide online cloud-computing data services and broadband access for businesses and individuals. What method would you recommend that IBM pursue to enter this industry? Why?

DISCUSSION:

- Under which conditions are joint ventures a useful way to enter new industries?

DISCUSSION:

- Identify Honeywell’s portfolio of businesses, which can be found at its website (www.honeywell.com). In how many different industries is Honeywell involved? Would you describe Honeywell as a related or an unrelated diversification company? Has Honeywell’s diversification strategy increased profitability over time?