From Competitive Advantage to Corporate Strategy

By Michael E. Porter

Corporate strategy, the overall plan for a diversified company, is both the darling and the stepchild of contemporary management practice—the darling because CEOs have been obsessed with diversification since the early 1960s, the stepchild because almost no consensus exists about what corporate strategy is, much less about how a company should formulate it.

A diversified company has two levels of strategy: business unit strategy and corporate strategy. Competitive strategy concerns how to create competitive advantage in each of the businesses in which a company competes. Corporate strategy concerns two different questions: what businesses the corporation should be in and how the corporate office should manage the array of business units.

Corporate strategy is what makes the corporate whole add up to more than the sum of its business unit parts.

The track record of corporate strategies has been dismal. I studied the diversification records of 33 large, prestigious U.S. companies over the 1950-1986 period and found that most of them had divested many more acquisitions than they had kept. The corporate strategies of most companies have dissipated instead of created shareholder value.

The need to rethink corporate strategy could hardly be more urgent. By taking over companies and breaking them up, corporate raiders thrive on failed corporate strategy. Fueled by junk bond financing and growing acceptability, raiders can expose any company to takeover, no matter how large or blue chip.

Recognizing past diversification mistakes, some companies have initiated large-scale restructuring programs. Others have done nothing at all. Whatever the response, the strategic questions persist. Those who have restructured must decide what to do next to avoid repeating the past; those who have done nothing must awake to their vulnerability. To survive, companies must understand what good corporate strategy is.

Concepts of Corporate Strategy

My study has helped me identify four concepts of corporate strategy that have been put into practice-portfolio management, restructuring, transferring skills, and sharing activities. While the concepts are not always mutually exclusive, each rests on a different mechanism by which the corporation creates shareholder value and each requires the diversified company to manage and organize itself in a different way. The first two require no connections among business units; the second two depend on them. While all four concepts of strategy have succeeded under the right circumstances, today some make more sense than others. Ignoring any of the concepts is perhaps the quickest road to failure.

PORTFOLIO MANAGEMENT

The concept of corporate strategy most in use is portfolio management, which is based primarily on diversification through acquisition. The corporation acquires sound, attractive companies with competent managers who agree to stay on. While acquired units do not have to be in the same industries as existing units, the best portfolio managers generally limit their range of businesses in some way, in part to limit the specific expertise needed by top management.

The acquired units are autonomous, and the teams that run them are compensated according to unit results. The corporation supplies capital and works with each to infuse it with professional management techniques. At the same time, top management provides objective and dispassionate review of business unit results. Portfolio managers categorize units by potential and regularly transfer resources from units that generate cash to those with high potential and cash needs.

In a portfolio strategy, the corporation seeks to create shareholder value in a number of ways. It uses its expertise and analytical resources to spot attractive acquisition candidates that the individual shareholder could not. The company provides capital on favorable terms that reflect corporate wide fund-raising ability. It introduces professional management skills and discipline. Finally, it provides high-quality review and coaching, unencumbered by conventional wisdom or emotional attachments to the business.

The logic of the portfolio management concept rests on a number of vital assumptions. If a company's diversification plan is to meet the attractiveness and cost-of-entry tests, it must find good but undervalued companies. Acquired companies must be truly undervalued because the parent does little for the new unit once it is acquired. To meet the better-off test, the benefits the corporation provides must yield a significant competitive advantage to acquired units. The style of operating through highly autonomous business units must both develop sound business strategies and motivate managers.

In most countries, the days when portfolio management was a valid concept of corporate strategy are past. In the face of increasingly well-developed capital markets, attractive companies with good managements show up on everyone's computer screen and attract top dollar in terms of acquisition premium. Simply contributing capital isn't contributing much. A sound strategy can easily be funded; small to medium-size companies don't need a munificent parent.

Other benefits have also eroded. Large companies no longer corner the market for professional management skills; in fact, more and more observers believe managers cannot necessarily run anything in the absence of industry-specific knowledge and experience. Another supposed advantage of the portfolio management concept—dispassionate review—rests on similarly shaky ground since the added value of review alone is questionable in a portfolio of sound companies.

The benefit of giving business units complete autonomy is also questionable. Increasingly, a company's business units are interrelated, drawn together by new technology, broadening distribution channels, and changing regulations. Setting strategies of units independently may well undermine unit performance. The companies in my sample that have succeeded in diversification have recognized the value of interrelationships and understood that a strong sense of corporate identity is as important as slavish adherence to parochial business unit financial results.

But it is the sheer complexity of the management task that has ultimately defeated even the best portfolio managers. As the size of the company grows, portfolio managers need to find more and more deals just to maintain growth. Supervising dozens or even hundreds of disparate units and under chain-letter pressures to add more, management begins to make mistakes. At the same time, the inevitable costs of being part of a diversified company take their toll and unit performance slides while the whole company's ROI turns downward. Eventually, a new management team is in-stalled that initiates wholesale divestments and pares down the company to its core businesses. The experiences of Gulf & Western, Consolidated Foods (now Sara Lee), and ITT are just a few comparatively recent examples. Reflecting these realities, the U.S. capital markets today reward companies that follow the portfolio management model with a "conglomerate discount"; they value the whole less than the sum of the parts.

In developing countries, where large companies are few, capital markets are undeveloped, and professional management is scarce, portfolio management still works. But it is no longer a valid model for corporate strategy m advanced economies. Nevertheless, the technique is in the limelight today in the United Kingdom, where it is supported so far by a newly energized stock market eager for excitement. But this enthusiasm will wane, as well it should. Portfolio management is no way to conduct corporate strategy.

RESTRUCTURING

Unlike its passive role as a portfolio manager, when it serves as banker and reviewer, a company that bases its strategy on restructuring becomes an active restructurer of business units. The new businesses are not necessarily related to existing units. All that is necessary is unrealized potential.

The restructuring strategy seeks out undeveloped, sick, or threatened organizations or industries on the threshold of significant change. The parent intervenes, frequently changing the unit management team, shifting strategy, or infusing the company with new technology. Then it may make follow-up acquisitions to build .a critical mass and sell off unneeded or unconnected parts and thereby reduce the effective acquisition cost. The result is a strengthened company or a transformed industry. As a coda, the parent sells off the stronger unit once results are clear because the parent is no longer adding value and top management decides that its attention should be directed elsewhere.

When well implemented, the restructuring concept is sound, for it passes the three tests of successful diversification. The restructurer meets the cost-of-entry test through the types of company it acquires. It limits acquisition premiums by buying companies with problems and lackluster images or by buying into industries with as yet unforeseen potential. Intervention by the corporation clearly meets the better-off test. Provided that the target industries are structurally attractive, the restructuring model can create enormous shareholder value. Some restructuring companies are Loew's, BTR, and General Cinema. Ironically, many of today's restructurers are profiting from yesterday's portfolio management strategies.

To work, the restructuring strategy requires a corporate management team with the insight to spot undervalued companies or positions in industries ripe for transformation. The same insight is necessary to actually turn the units around even though they are in new and unfamiliar businesses.

These requirements expose the restructurer to considerable risk and usually limit the time in which the company can succeed at the strategy. The most skillful proponents understand this problem, recognize their mistakes, and move decisively to dispose of them. The best companies realize they are not just acquiring companies but restructuring an industry. Unless they can integrate the acquisitions to create a whole new strategic position, they are just portfolio managers in disguise. Another important difficulty surfaces if so many other companies join the action that they deplete the pool of suitable candidates and bid their prices up.

Perhaps the greatest pitfall, however, is that companies find it very hard to dispose of business units once they are restructured and performing well. Human nature fights economic rationale. Size supplants shareholder value as the corporate goal. The company does not sell a unit even though the company no longer adds value to the unit. While the transformed units would be better off in another company that had related businesses, the restructuring company instead retains them. Gradually, it becomes a portfolio manager. The parent company's ROI declines as the need for reinvestment in the units and normal business risks eventually offset restructuring's one-shot gain. The perceived need to keep growing intensifies the pace of acquisition; errors result and standards fall. The restructuring company turns into a conglomerate with returns that only equal the average of all industries at best.

TRANSFERRING SKILLS

The purpose of the first two concepts of corporate strategy is to create value through a company's relationship with each autonomous unit. The corporation's role is to be a selector, a banker, and an intervenor.

The last two concepts exploit the interrelationships between businesses. In articulating them, however, one comes face-to-face with the often ill-defined concept of synergy. If you believe the text of the countless corporate annual reports, just about anything is related to just about anything else! But imagined synergy is much more common than real synergy. GM's purchase of Hughes Aircraft simply because cars were going electronic and Hughes was an electronics concern demonstrates the folly of paper synergy. Such corporate relatedness is an ex post facto rationalization of a diversification undertaken for other reasons.

Even synergy that is clearly defined often fails to materialize. Instead of cooperating, business units often compete. A company that can define the synergies it is pursuing still faces significant organizational impediments in achieving them.

But the need to capture the benefits of relationships between businesses has never been more important. Technological and competitive developments already link many businesses and are creating new possibilities for competitive advantage. In such sectors as financial services, computing, office equipment, entertainment, and health care, interrelationships among previously distinct businesses are perhaps the central concern of strategy.

To understand the role of relatedness in corporate strategy, we must give new meaning to this often ill-defined idea. I have identified a good way to start—the value chain.[5] Every business unit is a collection of discrete activities ranging from sales to accounting that allow it to compete.

I call them value activities. It is at this level, not in the company as a whole, that the unit achieves competitive advantage.

I group these activities in nine categories. *Primary* activities create the product or service, deliver and market it, and provide after-sale support. The categories of primary activities are inbound logistics, operations, outbound logistics, marketing and sales, and service. *Support* activities provide the input and infrastructure that allow the primary activities to take place. The categories are company infrastructure, human resource management, technology development, and procurement.

The value chain defines the two types of interrelationships that may create synergy. The first is a company's ability to transfer skills or expertise among similar value chains. The second is the ability to share activities. Two business units, for example, can share the same sales force or logistics network

The value chain helps expose the last two (and most important) concepts of corporate strategy. The transfer of skills among business units in the diversified company is the basis for one concept. While each business unit has a separate value chain, knowledge about how to perform activities is transferred among the units. For example, a toiletries business unit, expert in the marketing of convenience products, transmits ideas on new positioning concepts, promotional techniques, and packaging possibilities to a newly acquired unit that sells cough syrup. Newly entered industries can benefit from the expertise of existing units and vice versa.

These opportunities arise when business units have similar buyers or channels, similar value activities like government relations or procurement, similarities in the broad configuration of the value chain (for example, managing a multisite service organization), or the same strategic concept (for example, low cost). Even though the units operate separately, such similarities allow the sharing of knowledge.

Of course, some similarities are common; one can imagine them at some level between almost any pair of businesses. Countless companies have fallen into the trap of diversifying too readily because of similarities; mere similarity is not enough.

Transferring skills leads to competitive advantage only if the similarities among businesses meet three conditions:

1. The activities involved in the businesses are similar enough that sharing expertise is meaningful. Broad similarities (marketing intensiveness, for example, or a common core process technology such as bending metal) are not a sufficient basis for diversification. The resulting **ability** to transfer skills is likely to have little impact on competitive advantage.
2. The transfer of skills involves activities important to competitive advantage. Transferring skills in peripheral activities such as government relations or real estate in consumer goods units may be beneficial but is not a basis for diversification.
3. The skills transferred represent a significant source of competitive advantage for the receiving unit. The expertise or skills to be transferred are both advanced and proprietary enough to be beyond the capabilities of competitors.

The transfer of skills is an active process that significantly changes the strategy or operations of the receiving unit. The prospect for change must be specific and identifiable. Almost guaranteeing that no shareholder value will be created, too many companies are satisfied with vague prospects or faint hopes that skills will transfer. The transfer of skills does not happen by accident or by osmosis. The company will have to reassign critical personnel, even on a permanent basis, and the participation and support of high-level management in skills transfer is essential. Many companies have been defeated at skills transfer because they have not provided their business units with any incentives to participate.

Transferring skills meets the tests of diversification if the company truly mobilizes proprietary expertise across units. This makes certain the company can offset the acquisition premium or lower the cost of overcoming entry barriers.

The industries the company chooses for diversification must pass the attractiveness test. Even a close fit that reflects opportunities to transfer skills may not overcome poor industry structure. Opportunities to transfer skills, however, may help the company transform the structures of newly entered industries and send them in favorable directions.

The transfer of skills can be one-time or ongoing. If the company exhausts opportunities to infuse new expertise into a unit after the initial post-acquisition period, the unit should ultimately be sold. The corporation is no longer creating shareholder value. Few companies have grasped this point, however, and many gradually suffer mediocre returns. Yet a company diversified into well-chosen businesses can transfer skills eventually in many directions. If corporate management conceives of its role in this way and creates appropriate organizational mechanisms to facilitate cross-unit interchange, the opportunities to share expertise will be meaningful.

By using both acquisitions and internal development, companies can build a transfer-of-skills strategy. The presence of a strong base of skills sometimes creates the possibility for internal entry instead of the acquisition of a going concern. Successful diversifiers that employ the concept of skills transfer may, however, often acquire a company in the target industry as a beachhead and then build on it with their internal expertise. By doing so, they can reduce some of the risks of internal entry and speed up the process. Two companies that have diversified using the transfer-of-skills concept are 3M and Pepsico.

SHARING ACTIVITIES

The fourth concept of corporate strategy is based on sharing activities in the value chains among business units. Procter & Gamble, for example, employs a common physical distribution system and sales force in both paper towels and disposable diapers. McKesson, a leading distribution company, will handle such diverse lines as pharmaceuticals and liquor through superwarehouses.

The ability to share activities is a potent basis for corporate strategy because sharing often enhances competitive advantage by lowering cost or raising differentiation. But not all sharing leads to competitive advantage, and companies can encounter deep organizational resistance to even beneficial sharing possibilities. These hard truths have led many companies to reject synergy prematurely and retreat to the false simplicity of portfolio management.

A cost-benefit analysis of prospective sharing opportunities can determine whether synergy is possible. Sharing can lower costs if it achieves economies of scale, boosts the efficiency of utilization, or helps a company move more rapidly down the learning curve. The costs of General Electric's advertising, sales, and after-sales service activities in major appliances are low because they are spread over a wide range of appliance products. Sharing can also enhance the potential for differentiation. A shared order-processing system, for instance, may allow new features and services that a buyer will value. Sharing can also reduce the cost of differentiation. A shared service network, for example, may make more advanced, remote servicing technology economically feasible. Often, sharing will allow an activity to be wholly reconfigured in ways that can dramatically raise competitive advantage.

Sharing must involve activities that are significant to competitive advantage, not just any activity. P&G's distribution system is such an instance in the diaper and paper towel business, where products are bulky and costly to ship. Conversely, diversification based on the opportunities to share only corporate overhead is rarely, if ever, appropriate.

Sharing activities inevitably involves costs that the benefits must outweigh. One cost is the greater coordination required to manage a shared activity. More important is the need to compromise the design or performance of an activity so that it can be shared. A salesperson handling the products of two business units, for example, must operate in a way that is usually not what either unit would choose were it independent. And if compromise greatly erodes the unit's effectiveness, then sharing may reduce rather than enhance competitive advantage.

Many companies have only superficially identified their potential for sharing. Companies also merge activities without consideration of whether they are sensitive to economies of scale. When they are not, the coordination costs kill the benefits. Companies compound such errors by not identifying costs of sharing in advance, when steps can be taken to minimize them. Costs of compromise can frequently be mitigated by redesigning the activity for sharing. The shared salesperson, for example, can be provided with a remote computer terminal to boost productivity and provide more customer information. Jamming business units together without such thinking exacerbates the costs of sharing.

Despite such pitfalls, opportunities to gain advantage from sharing activities have proliferated because of momentous developments in technology, deregulation, and competition. The infusion of electronics and information systems into many industries creates new opportunities to link businesses. The corporate strategy of sharing can involve both acquisition and internal development. Internal development is often possible because the corporation can bring to bear clear resources in launching a new unit. Start-ups are less difficult to integrate than acquisitions. Companies using the shared-activities concept can also make acquisitions as beachhead landings into a new industry and then integrate the units through sharing with other units. Prime examples of companies that have diversified via using shared activities include P&G, Du Pont, and IBM. The fields into which each has diversified are a cluster of tightly related units. Marriott illustrates both successes and failures in sharing activities over time.

Following the shared-activities model requires an organizational context in which business unit collaboration is encouraged and reinforced. Highly autonomous business units are inimical to such collaboration. The company must put into place a variety of what I call horizontal mechanisms—a strong sense of corporate identity, a clear corporate mission statement that emphasizes the importance of integrating business unit strategies, an incentive system that rewards more than just business unit results, cross-business-unit task forces, and other methods of integrating.

A corporate strategy based on shared activities clearly meets the better-off test because business units gain ongoing tangible advantages from others within the corporation. It also meets the cost-of-entry test by reducing the expense of surmounting the barriers to internal entry. Other bids for acquisitions that do not share opportunities will have lower reservation prices. Even widespread opportunities for sharing activities do not allow a company to suspend the attractiveness test, however. Many diversifiers have made the critical mistake of equating the close fit of a target industry with attractive diversification. Target industries must pass the strict requirement test of having an attractive structure as well as a close fit in opportunities if diversification is to ultimately succeed.

Choosing a Corporate Strategy

Each concept of corporate strategy allows the diversified company to create shareholder value in a different way. Companies can succeed with any of the concepts if they clearly define the corporation’s role and objectives, have the skills necessary for meeting the concept’s prerequisites, organize themselves to manage diversity in a way that fits the strategy, and find themselves in an appropriate capital market environment. The caveat is that portfolio management is only sensible in limited circumstances.

A company’s choice of corporate strategy is partly a legacy of its past. If its business units are in unattractive industries, the company must start from scratch. If the company has few truly proprietary skills or activities it can share in related diversification, then its initial diversification must rely on other concepts. Yet corporate strategy should not be a once-and-for-all choice but a vision that can evolve. A company should choose its long-term preferred concept and then proceed pragmatically toward it from its initial starting point.

Both the strategic logic and the experience of the companies I studied over the last decade suggest that a company will create shareholder value through diversification to a greater and greater extent as its strategy moves from portfolio management toward sharing activities. Because they do not rely on superior insight or other questionable assumptions about the company’s capabilities, sharing activities and transferring skills offer the best avenues for value creation.

Each concept of corporate strategy is not mutually exclusive of those that come before, a potent advantage of the third and fourth concepts. A company can employ a restructuring strategy at the same time it transfers skills or shares activities. A strategy based on shared activities becomes more powerful if business units can also exchange skills. A company can often pursue the two strategies together and even incorporate some of the principles of restructuring with them. When it chooses industries in which to transfer skills or share activities, the company can also investigate the possibility of transforming the industry structure. When a company bases its strategy on interrelationships, it has a broader basis on which to create shareholder value than if it rests its entire strategy on transforming companies in unfamiliar industries.

My study supports the soundness of basing a corporate strategy on the transfer of skills or shared activities. The data on the sample companies' diversification programs illustrate some important characteristics of successful diversifiers. They have made a disproportionately low percentage of unrelated acquisitions, *unrelated* being defined as having no clear opportunity to transfer skills or share important activities. Even successful diversifiers such as 3M, IBM, and TRW have terrible records when they have strayed into unrelated acquisitions. Successful acquirers diversify into fields, each of which is related to many others. Procter & Gamble and IBM, for example, operate in 18 and 19 interrelated fields, respectively, and so enjoy numerous opportunities to transfer skills and share activities.

Companies with the best acquisition records tend to make heavier-than-average use of start-ups and joint ventures. Most companies shy away from modes of entry besides acquisition. My results cast doubt on the conventional wisdom regarding start-ups. While joint ventures are about as risky as acquisitions, start-ups are not. Moreover, successful companies often have very good records with start-up units, as 3M, P&G, Johnson & Johnson, IBM, and United Technologies illustrate. When a company has the internal strength to start up a unit, it can be safer and less costly to launch a company than to rely solely on an acquisition and then have to deal with the problem of integration. Japanese diversification histories support the soundness of start-up as an entry alternative.

My data also illustrate that none of the concepts of corporate strategy works when industry structure is poor or implementation is bad, no matter how related the industries are. Xerox acquired companies in related industries, but the businesses had poor structures and its skills were insufficient to provide enough competitive advantage to offset implementation problems.

AN ACTION PROGRAM

To translate the principles of corporate strategy into successful diversification, a company must first take an objective look at its existing businesses and the value added by the corporation. Only through such an assessment can an understanding of good corporate strategy grow. That understanding should guide future diversification as well as the development of skills and activities with which to select further new businesses. The following action program provides a concrete approach to conducting such a review. A company can choose a corporate strategy by:

1. **Identifying the interrelationships among already existing business units.**

A company should begin to develop a corporate strategy by identifying all the opportunities it has to share activities or transfer skills in its existing portfolio of business units. The company will not only find ways to enhance the competitive advantage of existing units but also come upon several possible diversification avenues. The lack of meaningful interrelationships in the portfolio is an equally important finding, suggesting the need to justify the value added by the corporation or, alternately, a fundamental restructuring**.**

2. **Selecting the core businesses that will be the foundation of the corporate strategy.**

Successful diversification starts with an understanding of the core businesses that will serve as the basis for corporate strategy. Core businesses are those that are in an attractive industry, have the potential to achieve sustainable competitive advantage, have important interrelationships with other business units, and provide skills or activities that represent a base from which to diversify.

The company must first make certain its core businesses are on sound footing by upgrading management, internationalizing strategy, or improving technology. My study shows that geographic extensions of existing units, whether by acquisition, joint venture, or start-up, had a substantially lower divestment rate than diversification.

The company must then patiently dispose of the units that are not core businesses. Selling them will free resources that could be better deployed elsewhere. In some cases disposal implies immediate liquidation, while in others the company should dress up the units and wait for a propitious market or a particularly eager buyer.

3. Creating horizontal organizational mechanisms to facilitate interrelationships among the core businesses and lay the groundwork for future related diversification.

Top management can facilitate interrelationships by emphasizing cross-unit collaboration, grouping units organizationally and modifying incentives, and taking steps to build a strong sense of corporate identity.

4. Pursuing diversification opportunities that allow shared activities.

This concept of corporate strategy is the most compelling, provided a company's strategy passes all three tests. A company should inventory activities in existing business units that represent the strongest foundation for sharing, such as strong distribution channels or world-class technical facilities. These will in turn lead to potential new business areas. A company can use acquisitions as a beachhead or employ start-ups to exploit internal capabilities and minimize integrating problems.

5. **Pursuing diversification through the transfer of skills if opportunities for sharing activities are limited or exhausted.**

Companies can pursue this strategy through acquisition, although they may be able to use start-ups if their existing units have important skills they can readily transfer.

Such diversification is often riskier because of the tough conditions necessary for it to work. Given the uncertainties, a company should avoid diversifying on the basis of skills transfer alone. Rather it should also be viewed as a stepping-stone to subsequent diversification using shared activities. New industries should be chosen that will lead naturally to other businesses. The goal is to build a cluster of related and mutually reinforcing business units. The strategy's logic implies that the company should not set the rate of return standards for the initial foray into a new sector too high.

6. Pursuing a strategy of restructuring if this fits the skills of management or no good opportunities exist for forging corporate interrelationships.

When a company uncovers under managed companies and can deploy adequate management talent and resources to the acquired units, then it can use a restructuring strategy. The more developed the capital markets and the more active the market for companies, the more restructuring will require a patient search for that special opportunity rather than a headlong race to acquire as many bad apples as possible. Restructuring can be a permanent strategy, as it is with Loew's, or a way to build a group of businesses that supports a shift to another corporate strategy.

7. **Paying dividends so that the shareholders can be the portfolio managers.**

Paying dividends is better than destroying shareholder value through diversification based on shaky underpinnings. Tax considerations, which some companies cite to avoid dividends, are hardly legitimate reason to diversify if a company cannot demonstrate the capacity to do it profitably.