Chapter **8**

Corporate Strategy: Vertical Integration and Diversification

Chapter Outline

Learning Objectives

LO 8-1 Define corporate strategy and describe the three dimensions along which it is assessed.

LO 8-2 Explain why firms need to grow, and evaluate different growth motives.

LO 8-3 Describe and evaluate different options firms have to organize economic activity.

LO 8-4 Describe the two types of vertical integration along the industry value chain: backward and forward vertical integration.

LO 8-5 Identify and evaluate benefits and risks of vertical integration.

LO 8-6 Describe and examine alternatives to vertical integration.

LO 8-7 Describe and evaluate different types of corporate diversification.

LO 8-8 Apply the core competence–market matrix to derive different diversification strategies.

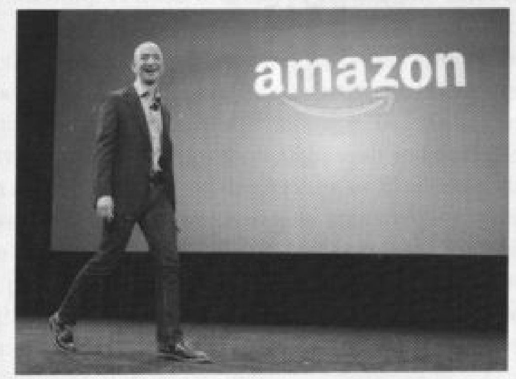
LO 8-9 Explain when a diversification strategy creates a competitive advantage and when it does not.

CHAPTER**CASE 8** /

How Amazon.com Became the Everything Store

TWENTY YEARS AGO JEFF BEZOS STARTED Amazon.com to sell books online from a garage in a Seattle suburb. He furnished his makeshift office with discarded wood doors for desks. Today, Amazon has become the largest online retailer worldwide, with some 230 million items available, 30 times the number sold by Walmart, the world's largest traditional retailer. Yet, wood doors turning into desks remain a staple at Amazon, where strict cost control is paramount to this day.

Amazon.com is also now a widely diversified technology company; see Exhibit 8.1 for Amazon's key strategic initiatives and stock market valuation over the years. Besides offering every imaginable product online, it sells its own line of Kindle e-book readers, Fire tablets, Fire TV, and Fire phone. The Kindle e-reader has transformed the publishing industry. Amazon holds a two-thirds market share in e-books and now sells more e-books than print books.



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Via its Prime Instant Video and Music services, Amazon streams content such as movies, TV shows, and music. Prime members pay an annual $99 fee for unlimited free two-day shipping when buying items on Amazon's site, and they receive the streamed content for free. The estimated 40 million Prime members are Amazon's most loyal customers: They spend roughly $1,300 per year, three times more than non-Prime members. With Amazon Web Services (AWS), the company is now the largest cloud computing service provider globally. It also diversified geographically by establishing country-specific sites not only in the United States, but also in Canada, Brazil, Mexico, Germany, France, Italy, Spain, The Netherlands, the UK, China, India, Japan, and Australia.

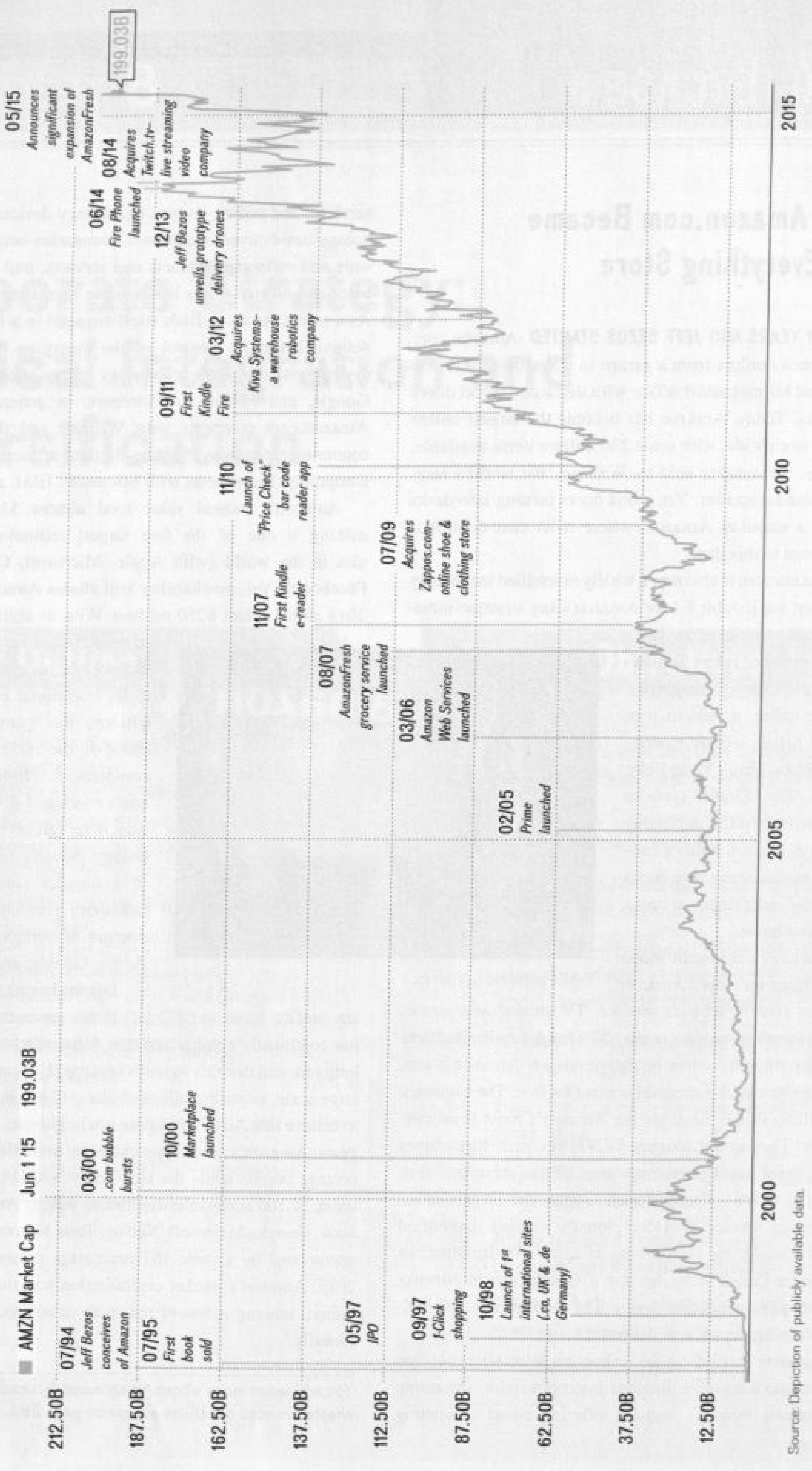
Amazon started as an online book retailer but has grown into a massive discount Internet vendor, streaming multimedia from its website, offering cloud computing services, and selling its own technology devices. As technology has evolved, traditional boundaries between hardware and software, products and services, and online and brick-and-mortar stores has become increasingly blurred. As a result, Amazon finds itself engaged in a fierce competitive battle for control of the emerging digital ecosystem, pitted against technology giants such as Apple, Google, and Facebook. Moreover, in general retailing Amazon.com competes with Walmart and the Chinese ecommerce company Alibaba. In data services and cloud computing, it competes with Microsoft, IBM, and others.

Amazon's annual sales total almost $100 billion, making it one of the five largest technology companies in the world (with Apple, Microsoft, Google, and Facebook). Yet, profitability still eludes Amazon.com; in 2014 alone, it lost $250 million. With its ability to diversify into business activities that are not necessarily related to its traditional core competencies, the company faces some of the most formidable competitors. Indeed, Amazon's continued diversification into other areas of the technology industry has been part of a broader convergence of industries previously the sole domain of companies such as Apple, Google, and Facebook.

Despite having yet to deliver any profits, Amazon CEO Jeff Bezos seems undaunted. He has continually emphasized that Amazon's focus is on the long run, and that this requires continued diversification and large scale, requiring billion-dollar outlays. Investors seem to believe that Amazon's future is a bright one. In the last 10 years, Amazon's stock appreciated by more than 1,100 percentage points, while the tech-heavy NASDAQ composite index of 100 companies (including Apple, Amazon, Facebook, Google, Microsoft, Netflix, Tesla Motors, and Yahoo) appreciated by a mere 187 percentage points. In summer 2015, Amazon's market capitalization had surpassed $200 billion, making it one of the most valued tech companies globally.[1]

You will learn more about Amazon.com by reading this chapter; related questions appear on page 283.

EXHIBIT 8.1 / Amazon's Strategic Initiatives and Stock Market Valuation, 1994–2015



Source: Depiction of publicly available data.

OVER TIME AMAZON.COM has morphed from a mere online book retailer into the "everything store."[2] In the process, it transformed into the world's largest online retailer. From books it diversified into consumer electronics, media content, cloud computing services, and other business endeavors. Jeff Bezos decided to compete in a number of different industries, some related to Amazon's core business of online retailing, some unrelated.

How does a business decide exactly *where to compete*? Answers to this important question—in terms of products and services offered, or of geographic markets—are captured in a firm's *corporate strategy*, which we cover in the next three chapters. In this chapter, we define corporate strategy and then look at two fundamental corporate strategy topics: vertical integration and diversification. We conclude the chapter with "Implications for the Strategist," providing a practical application of dynamic corporate strategy at Nike and adidas.

8.1 What Is Corporate Strategy?

LO 8-1

Define corporate strategy and describe the three dimensions along which it is assessed.

Strategy formulation centers around the key questions of *where* and *how* to compete. *Business strategy* concerns the question of *how to compete* in a *single product market*. As discussed in Chapter 6, the two generic business strategies that firms can pursue their quest for competitive advantage are to increase differentiation (while containing cost) *or* lower costs (while maintaining differentiation). If trade-offs can be reconciled, some firms might be able to pursue a blue ocean strategy by increasing differentiation *and* lowering costs. As firms grow, they are frequently expanding their business activities through seeking new markets both by offering new products and services and by competing in different geographies. When this happens, managers must formulate a corporate strategy. To gain and sustain competitive advantage, therefore, any corporate strategy must align with and strengthen a firm's business strategy, whether it is a differentiation, cost-leadership, or blue ocean strategy.

Corporate strategy comprises the decisions that senior management makes and the goal-directed actions it takes in the quest for competitive advantage in several industries and markets simultaneously.[3] It provides answers to the key question of *where to compete*. Corporate strategy determines the boundaries of the firm along three dimensions: vertical integration (along the industry value chain), diversification (of products and services), and geographic scope (regional, national, or global markets).

corporate strategy The decisions that senior management makes and the goal-directed actions it takes to gain and sustain competitive advantage in several industries and markets simultaneously.

Executives must determine their corporate strategy by answering three questions:

1. *In what stages of the industry value chain should the company participate (vertical integration)?* The industry value chain describes the transformation of raw materials into finished goods and services along distinct vertical stages.
2. *What range of products and services should the company offer (diversification)?*
3. *Where should the company compete geographically* in terms of regional, national, or international markets (geographic scope)?

In most cases, underlying these three questions is an implicit desire for growth. The need for growth is sometimes taken so much for granted that not every manager understands all the reasons behind it. A clear understanding will help executives pursue growth for the right reasons and make better decisions for the firm and its stakeholders.

WHY FIRMS NEED TO GROW

LO 8-2

Explain why firms need to grow, and evaluate different growth motives.

Several reasons explain *why firms need to grow*. These can be summarized as follows:

1. Increase profits.
2. Lower costs.

3. Increase market power.
4. Reduce risk.
5. Motivate management.

Let's look at each reason in turn.

INCREASE PROFITS. Profitable growth allows businesses to provide a higher return for their shareholders, or owners, if privately held. For publicly traded companies, the stock market valuation of a firm is determined to some extent by expected future revenue and profit streams. If firms fail to achieve their growth target, their stock price often falls. With a decline in a firm's stock price comes a lower overall market capitalization, exposing the firm to the risk of a hostile takeover. Moreover, with a lower stock price, it is more costly for firms to raise the required capital to fuel future growth by issuing stock.

LOWER COSTS. Firms are also motivated to grow in order to lower their cost. As discussed in detail in Chapter 6, a larger firm may benefit from *economies of scale,* thus driving down average costs as their output increases. Firms need to grow to achieve minimum efficient scale, and thus stake out the lowest-cost position achievable through economies of scale.

INCREASE MARKET POWER. Firms might be motivated to achieve growth to increase their market share and with it their market power. When discussing an industry's structure in Chapter 3, we noted that firms often consolidate industries through horizontal mergers and acquisitions (buying competitors) to change the industry structure in their favor (we'll discuss mergers and acquisitions in detail in Chapter 9). Fewer competitors generally equates to higher industry profitability. Moreover, larger firms have more bargaining power with suppliers and buyers (see the discussion of the five forces in Chapter 3).

REDUCE RISK. Firms might be motivated to grow in order to diversify their product and service portfolio through competing in a number of different industries. The rationale behind these diversification moves is that falling sales and lower performance in one sector (e.g., GE's oil and gas unit) might be compensated by higher performance in another (e.g., GE's health care unit). Such conglomerates attempt to achieve *economies of scope* (as first discussed in Chapter 6).

MANAGERIAL MOTIVES. Research in behavioral economics suggests that firms may grow to achieve goals that benefit its managers more than their stockholders.[4] As we will discuss in detail when presenting the *principal-agent problem* later in the chapter, managers may be more interested in pursuing their own interests such as empire building and job security—plus managerial perks such as corporate jets or executive retreats at expensive resorts—rather than increasing shareholder value. Although there is a weak link between CEO compensation and firm performance, the CEO pay package often correlates more strongly with firm size.[5]

Finally, we should acknowledge that promising businesses can fail because they grow unwisely—usually too fast too soon, and based on shaky assumptions about the future. There is a small movement counter to the need for growth, seen both in small businesses and social activism. Sometimes small-business owners operate a business for convenience, stability, and lifestyle; growth could threaten those goals. In social entrepreneurship, business micro-solutions are often operated outside of capital motives, where the need to solve a social problem outweighs the need of the firm to insure longevity beyond the solution of the problem.

THREE DIMENSIONS OF CORPORATE STRATEGY

All companies must navigate the three dimensions of vertical integration, diversification, and geographic scope. Although many managers provide input, the responsibility for corporate strategy ultimately rests with the CEO. Jeff Bezos, Amazon's CEO, determined in *what stages of the industry value chain Amazon would participate* (question 1). With its prevalent delivery lockers in large metropolitan areas and its first brick-and-mortar retail store opened in New York City, Amazon moved forward in the industry value chain to be closer to its end customer. With its offering of Amazon-branded electronics and more recently groceries, it also moved backward in the industry value chain toward manufacturing and production.

Bezos also chooses *what range of products and services to offer,* and which not (question 2). ChapterCase 8 discusses Amazon's diversification over time. Finally, Bezos also decided to customize certain country-specific websites despite the instant global reach of ecommerce firms. With this strategic decision, he decided where to compete globally in terms of different geographies beyond the United States. In short, Bezos determined *where Amazon competes geographically* (question 3).

Where to compete in terms of industry value chain, products and services, and geography are the fundamental corporate strategic decisions. The underlying strategic management concepts that will guide our discussion of vertical integration, diversification, and geographic competition are *core competencies, economies of scale, economies of scope,* and *transaction costs.*

- *Core competencies* are unique strengths embedded deep within a firm (as discussed in Chapter 4). Core competencies allow a firm to differentiate its products and services from those of its rivals, creating higher value for the customer or offering products and services of comparable value at lower cost. According to the *resource-based view of the firm,* a firm's boundaries are delineated by its knowledge bases and core competencies.[6] Activities that draw on what the firm knows how to do well (e.g., Google's core competency in developing proprietary search algorithms) should be done in-house, while non-core activities such as payroll and facility maintenance can be outsourced. In this perspective, the internally held knowledge underlying a core competency determines a firm's boundaries.
- *Economies of scale* occur when a firm's average cost per unit decreases as its output increases (as discussed in Chapter 6). Anheuser-Busch InBev, the largest global brewer (producer of brands such as Budweiser, Bud Light, Stella Artois, and Beck's), reaps significant economies of scale. Given its size, it is able to spread its fixed costs over the millions of gallons of beer it brews each year, in addition to the significant buyer power its large market share affords. Larger market share, therefore, often leads to lower costs.
- *Economies of scope* are the savings that come from producing two (or more) outputs or providing different services at less cost than producing each individually, though using the same resources and technology (as discussed in Chapter 6). Leveraging its online retailing expertise, for example, Amazon benefits from economies of scope: It can offer a large range of different product and service categories at a lower cost than it would take to offer each product line individually.
- *Transaction costs* are all costs associated with an economic exchange. The concept is developed in transaction cost economics, a strategic management framework, and enables managers to answer the question of whether it is cost-effective for their firm to expand its boundaries through vertical integration or diversification. This implies taking on greater ownership of the production of needed inputs or of the channels by which it distributes its outputs, or adding business units that offer new products and services.

We continue our study of corporate strategy by drawing on transaction cost economics to explain vertical integration, meaning the choices a firm makes concerning its boundaries. Later, we will explore managerial decisions relating to diversification, which directly affect the firm's range of products and services in multi-industry competition. The third question of geographic scope will receive attention later, especially in Chapter 10.

LO 8-3

Describe and evaluate different options firms have to organize economic activity.

8.2 The Boundaries of the Firm

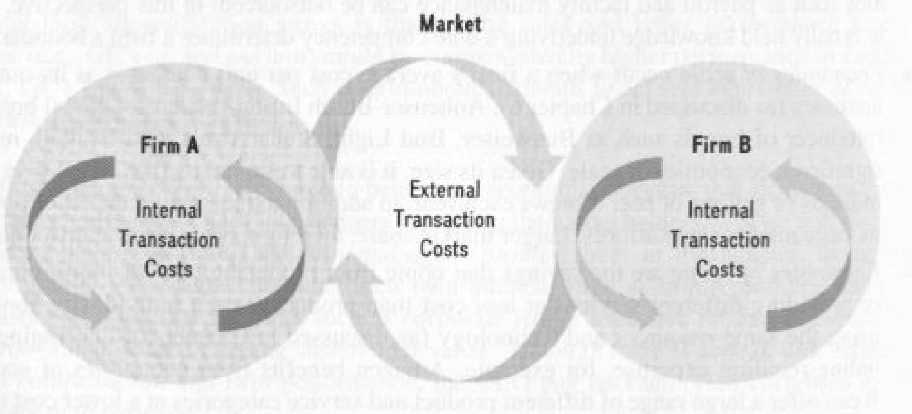
Determining the boundaries of the firm so that it is more likely to gain and sustain a competitive advantage is the critical challenge in corporate strategy.[7] A theoretical framework in strategic management called **transaction cost economics** explains and predicts the boundaries of the firm. Insights gained from transaction cost economics help managers decide what activities to do in-house versus what services and products to obtain from the external market. This stream of research was first initiated by Nobel Laureate Ronald Coase, who asked a fundamental question: Given the efficiencies of free markets, why do firms even exist? The key insight of transaction cost economics is that different *institutional arrangements*—markets versus firms—have different costs attached.

Transaction costs are all internal and external costs associated with an economic exchange, whether it takes place within the boundaries of a firm or in markets.[8] Exhibit 8.2 visualizes the notion of transaction costs. It shows the respective internal transactions costs within Firm A and Firm B, as well as the external transactions that occur when Firm A and Firm B do business with one another.

The total costs of transacting consist of external and internal transaction costs, as follows:

- When companies transact in the open market, they incur **external transaction** costs: the costs of searching for a firm or an individual with whom to contract, and then negotiating, monitoring, and enforcing the contract.
- Transaction costs can occur within the firm as well. Considered **internal transaction** costs, these include costs pertaining to organizing an economic exchange within a firm—for

EXHIBIT 8.2 / Internal and External Transaction Costs



transaction cost economics A theoretical framework in strategic management to explain and predict the boundaries of the firm, which is central to formulating a corporate strategy that is more likely to lead to competitive advantage.

transaction costs All internal and external costs associated with an economic exchange, whether within a firm or in markets.

external transaction costs Costs of searching for a firm or an individual with whom to contract, and then negotiating, monitoring, and enforcing the contract.

internal transaction costs Costs pertaining to organizing an economic exchange within a hierarchy; also called *administrative costs*.

example, the costs of recruiting and retaining employees; paying salaries and benefits; setting up a shop floor; providing office space and computers; and organizing, monitoring, and supervising work. Internal transaction costs also include administrative costs associated with coordinating economic activity between different business units of the same corporation such as transfer pricing for input factors, and between business units and corporate headquarters including important decisions pertaining to resource allocation, among others. Internal transaction costs tend to increase with organizational size and complexity.

FIRMS VS. MARKETS: MAKE OR BUY?

Transaction cost economics allows us to explain which activities a firm should pursue in-house ("make") versus which goods and services to obtain externally ("buy"). These decisions help determine the boundaries of the firm. In some cases, costs of using the market such as search costs, negotiating and drafting contracts, monitoring work, and enforcing contracts when necessary may be higher than integrating the activity within a single firm and coordinating it through an organizational hierarchy. When the costs of pursuing an activity in-house are less than the costs of transacting for that activity in the market $(C_{in\text{-}house} < C_{market})$, then the firm should *vertically integrate* by owning production of the needed inputs or the channels for the distribution of outputs. In other words, when *firms* are more efficient in organizing economic activity than are *markets*, which rely on contracts among many independent actors, firms should vertically integrate.[9]

For example, rather than contracting in the open market for individual pieces of software code, Google hires programmers to write code in-house. Owning these software development capabilities is valuable to the firm because its costs, such as salaries and employee benefits to in-house computer programmers, are less than what they would be in the open market. More importantly, Google gains economies of scope in software development resources and capabilities and reduces the monitoring costs. Skills acquired in writing software code for its different Internet-based service offerings are transferable to new offerings. Programmers working on the original proprietary software code for the Google search engine leveraged these skills in creating a highly profitable online advertising business (AdWords and AdSense).[10] Although some of Google's software products are open source, such as the Android operating system, many of the company's Internet services are based on closely guarded and proprietary software code. Google, like many leading high-tech companies such as Amazon, Apple, Facebook, and Microsoft, relies on proprietary software code and algorithms, because using the open market to transact for individual pieces of software would be prohibitively expensive. Also, the firms would need to disclose the underlying software code to outside developers, thus negating the value-creation potential.

Firms and markets, as different institutional arrangements for organizing economic activity, have their own distinct advantages and disadvantages, summarized in Exhibit 8.3.

EXHIBIT 8.3 / Organizing Economic Activity: Firms vs. Markets

	Firm	Markets
Advantages	• Command and control - Fiat - Hierarchical lines of authority • Coordination • Transaction-specific investments • Community of knowledge	• High-powered incentives • Flexibility
Disadvantages	• Administrative costs • Low-powered incentives • Principal–agent problem	• Search costs • Opportunism - Hold-up • Incomplete contracting - Specifying & measuring performance - Information asymmetries • Enforcement of contracts

The advantages of firms include:

- The ability to make *command-and-control decisions* by fiat along clear hierarchical lines of authority.
- *Coordination* of highly complex tasks to allow for specialized division of labor.
- *Transaction-specific investments,* such as specialized robotics equipment that is highly valuable within the firm, but of little or no use in the external market.
- Creation of a *community of knowledge,* meaning employees within firms have ongoing relationships, exchanging ideas and working closely together to solve problems. This facilitates the development of a deep knowledge repertoire and ecosystem within firms. For example, scientists within a biotech company who worked together developing a new cancer drug over an extended time period may have developed group-specific knowledge and routines. These might lay the foundation for innovation, but would be difficult, if not impossible, to purchase on the open market.[11]

The disadvantages of organizing economic activity within firms include:

- *Administrative costs* because of necessary bureaucracy.
- *Low-powered incentives,* such as hourly wages and salaries. These often are less attractive motivators than the entrepreneurial opportunities and rewards that can be obtained in the open market.
- The *principal–agent problem.*

principal–agent problem
Situation in which an agent performing activities on behalf of a principal pursues his or her own interests.

The **principal–agent problem** is a major disadvantage of organizing economic activity within firms, as opposed to within markets. It can arise when an agent such as a manager, performing activities on behalf of the principal (the owner of the firm), pursues his or her own interests.[12] Indeed, the *separation of ownership and control* is one of the hallmarks of a publicly traded company, and so some degree of the principal–agent problem is almost inevitable.[13] For example, a manager may pursue his or her own interests such as job security and managerial perks (e.g., corporate jets and golf outings) that conflict with the principal's goals—in particular, creating shareholder value. One potential way to overcome the principal–agent problem is to give stock options to managers, thus making them owners. We will revisit the principal–agent problem, with related ideas, in Chapters 11 and 12.

The advantages of markets include:

- *High-powered incentives.* Rather than work as a salaried engineer for an existing firm, for example, an individual can start a new venture offering specialized software. High-powered incentives of the open market include the entrepreneur's ability to capture the venture's profit, to take a new venture through an initial public offering (IPO), or to be acquired by an existing firm. In these so-called *liquidity events,* a successful entrepreneur can make potentially enough money to provide financial security for life.[14]
- *Increased flexibility.* Transacting in markets enables those who wish to purchase goods to compare prices and services among many different providers.

The disadvantages of markets include:

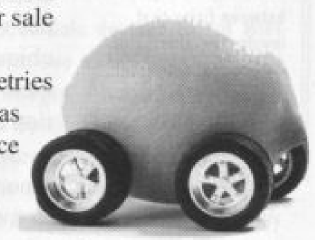
- *Search costs.* On a very fundamental level, perhaps the biggest disadvantage of transacting in markets, rather than owning the various production and distribution activities within the firm itself, entails non-trivial *search costs.* In particular, a firm faces search costs when it must scour the market to find reliable suppliers from among the many firms competing to offer similar products and services. Even more difficult can be the search to find suppliers when the specific products and services needed are not offered by firms currently in the market. In this case, production of supplies would require transaction-specific investments, an advantage of firms.

- *Opportunism by other parties. Opportunism* is behavior characterized by self-interest seeking with guile (we'll discuss this in more detail later).
- *Incomplete contracting.* Although market transactions are based on implicit and explicit contracts, all contracts are incomplete to some extent, because not all future contingencies can be anticipated at the time of contracting. It is also difficult to specify expectations (e.g., What stipulates "acceptable quality" in a graphic design project?) or to measure performance and outcomes (e.g., What does "excess wear and tear" mean when returning a leased car?). Another serious hazard inherent in contracting is *information asymmetry* (which we discuss next).
- *Enforcement of contracts.* It often is difficult, costly, and time-consuming to enforce legal contracts. Not only does litigation absorb a significant amount of managerial resources and attention, but also it can easily amount to several million dollars in legal fees. Legal exposure is one of the major hazards in using markets rather than integrating an activity within a firm's hierarchy.

information asymmetry
Situation in which one party is more informed than another because of the possession of private information.

Frequently, sellers have better information about products and services than buyers, which creates **information asymmetries**, situations in which one party is more informed than another, because of the possession of private information. When firms transact in the market, such unequal information can lead to a *lemons problem.* Nobel Laureate George Akerlof first described this situation using the market for used cars as an example.[15] Assume only two types of cars are sold: good cars and bad cars (lemons). Good cars are worth $8,000 and bad ones are worth $4,000. Moreover, only the seller knows whether a car is good or is a lemon. Assuming the market supply is split equally between good and bad cars, the probability of buying a lemon is 50 percent. Buyers are aware of the general possibility of buying a lemon and thus would like to hedge against it. Therefore, they split the difference and offer $6,000 for a used car. This discounting strategy has the perverse effect of crowding out all the good cars because the sellers perceive their value to be above $6,000. Assuming that to be the case, all used cars offered for sale will be lemons.

The important take-away here is *caveat emptor*—buyer beware. Information asymmetries can result in the crowding out of desirable goods and services by inferior ones. This has been shown to be true in many markets, not just for used cars, but also in e-commerce (e.g., eBay), mortgage-backed securities, and even collaborative R&D projects.[16]



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ALTERNATIVES ON THE MAKE-OR-BUY CONTINUUM

The "make" and "buy" choices *anchor each end of a continuum* from markets to firms, as depicted in Exhibit 8.4. Several alternative hybrid arrangements are available between these two extremes.[17] Moving from transacting in the market ("buy") to full integration ("make"), alternatives include short-term contracts as well as various forms of strategic alliances (long-term contracts, equity alliances, and joint ventures) and parent–subsidiary relationships.

SHORT-TERM CONTRACTS. When engaging in *short-term contracting,* a firm sends out *requests for proposals* (*RFPs*) to several companies, which initiates competitive bidding for contracts to be awarded with a short duration, generally less than one year.[18] The benefit to this approach lies in the fact that it allows a somewhat longer planning period than individual market transactions. Moreover, the buying firm can often demand lower prices due to the competitive bidding process. The drawback, however, is that firms responding to the RFP have no incentive to make any transaction-specific investments (e.g., buy new machinery

EXHIBIT 8.4 / Alternatives on the Make-or-Buy Continuum

to improve product quality) due to the short duration of the contract. This is exactly what happened in the U.S. automotive industry when GM used short-term contracts for standard car components to reduce costs. When faced with significant cost pressures, suppliers reduced component quality in order to protect their eroding margins. This resulted in lower-quality GM cars, contributing to a competitive advantage vis-à-vis competitors, most notably Toyota but also Ford, which used a more cooperative, longer-term partnering approach with their suppliers.[19]

strategic alliances Voluntary arrangements between firms that involve the sharing of knowledge, resources, and capabilities with the intent of developing processes, products, or services.

STRATEGIC ALLIANCES. As we move toward greater integration on the make-or-buy continuum, the next organizational forms are strategic alliances. **Strategic alliances** are voluntary arrangements between firms that involve the sharing of knowledge, resources, and capabilities with the intent of developing processes, products, or services.[20] Alliances have become a ubiquitous phenomenon, especially in high-tech industries. Moreover, strategic alliances can facilitate investments in transaction-specific assets without encountering the internal transaction costs involved in owning firms in various stages of the industry value chain.

Strategic alliances is an umbrella term that denotes different hybrid organizational forms—among them, long-term contracts, equity alliances, and joint ventures. Given their prevalence in today's competitive landscape as a key vehicle to execute a firm's corporate strategy, we take a quick look at strategic alliances here and then study them in more depth in Chapter 9.

licensing A form of long-term contracting in the manufacturing sector that enables firms to commercialize intellectual property.

franchising A long-term contract in which a franchisor grants a franchisee the right to use the franchisor's trademark and business processes to offer goods and services that carry the franchisor's brand name.

Long-Term Contracts. We noted that firms in short-term contracts have no incentive to make transaction-specific investments. *Long-term contracts,* which work much like short-term contracts but with a duration generally greater than one year, help overcome this drawback. Long-term contracts help facilitate transaction-specific investments. **Licensing**, for example, is a form of long-term contracting in the manufacturing sector that enables firms to commercialize intellectual property such as a patent. The first biotechnology drug to reach the market, Humulin (human insulin), was developed by Genentech and commercialized by Eli Lilly based on a licensing agreement.

In service industries, **franchising** is an example of long-term contracting. In these arrangements, a franchisor such as McDonald's, Burger King, 7-Eleven, H&R Block, or Subway grants a franchisee (usually an entrepreneur owning no more than a few outlets) the right to use the franchisor's trademark and business processes to offer goods and services that carry the franchisor's brand name. Besides providing the capital to finance the expansion of the chain, the franchisee generally pays an up-front (buy-in) lump sum to the franchisor plus a percentage of revenues.

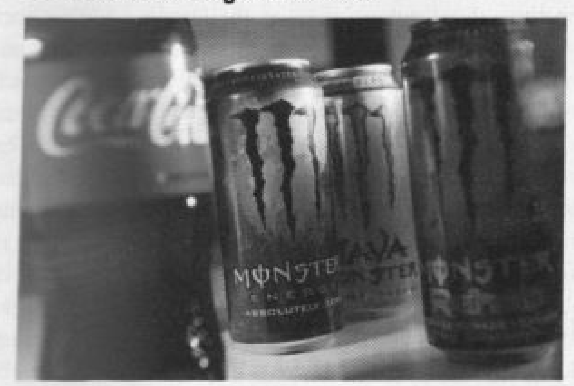
Equity Alliances. Yet another form of strategic alliance is an *equity alliance*—a partnership in which at least one partner takes partial ownership in the other partner. A partner purchases an ownership share by buying stock or assets (in private companies), and thus making an equity investment. The taking of equity tends to signal greater commitment to the partnership. Strategy Highlight 8.1 describes how soft drink giant Coca-Cola formed an equity alliance with energy-drink maker Monster.

Why is the Coca-Cola Co. forming an equity alliance with Monster Beverage Corporation and not just entering a short- or long-term contract, such as a distribution and profit-sharing agreement? One reason is that an equity investment in Monster might give Coca-Cola an inside look into the company. Gaining more information could be helpful if Coca-Cola decides to acquire Monster in the future. Gaining such private information might not be possible with a mere contractual agreement. Buying time is also helpful so Coca-Cola Co. can see how the wrongful death lawsuits play out, and thus limit the potential downside to Coke's wholesome brand image (as mentioned in Strategy Highlight 8.1).

Moreover, in strategic alliances based on a mere contractual agreement, one transaction partner could attempt to *hold up* the other by demanding lower prices or threatening to

Strategy Highlight 8.1

Is Coke Becoming a Monster?



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While Americans are drinking ever more nonalcoholic beverages, the demand for longtime staples such as the full-calorie Coke or Pepsi are in free fall. More health-conscious consumers are moving away from sugary drinks at the expense of Coke and Pepsi, the two archrivals among regular colas. Unlike in the 1990s, however, Americans are not replacing them with diet sodas, but rather with bottled water and energy drinks. Indeed, Coca-Cola was slow to catch the trend toward bottled water and other more healthy choices such as vitamin water. Protecting its wholesome image, the conservative Coca-Cola Co. shunned energy drinks. The makers of energy drinks, such as 5-hour Energy, Red Bull, Monster, Rockstar, and Amp Energy, have faced wrongful death lawsuits. PepsiCo, on the other hand, was much more aggressive in moving into the energy-drink business with Amp Energy (owned by PepsiCo) and Rockstar (distributed by PepsiCo).

Albeit late to the party, Coca-Cola decided to not miss out completely on energy drinks, one of the fastest-growing segments in nonalcoholic beverages. After years of deliberation, in 2014 the Coca-Cola Co. formed an equity alliance with Monster Beverage Corporation, spending $2 billion for a 16.7 percent stake in the edgy energy-drink company. This values the privately held Monster Beverage at roughly $12 billion. What might have finally persuaded Coca-Cola to make this decision? Not only was Monster now number one with 40 percent market share of the over $6 billion energy-drink industry, but the company also had settled a number of wrongful death lawsuits out of court. Meanwhile, however, the U.S. Food and Drug Administration is still investigating some 300 "adverse event" reports allegedly linked to the consumption of energy drinks, including 31 deaths. While the Coca-Cola Co. insists that it completed its due diligence before concluding that energy drinks are safe, it hedges its bets with a minority investment in Monster rather than an outright acquisition. This allows the market leader in nonalcoholic beverages to benefit from the explosive growth in energy drinks, while limiting potential exposure of Coca-Cola's wholesome image and brand.[21]

walk away from the agreement (with whatever financial penalties might be included in the contract). This might be a real concern for Monster because Coca-Cola, with about $50 billion in annual sales, is about 20 times larger than Monster with $2.5 billion in revenues. To assuage Monster's concerns, with its equity investment, Coca-Cola made Monster a **credible commitment**—a long-term strategic decision that is both difficult and costly to reverse.

credible commitment A long-term strategic decision that is both difficult and costly to reverse.

Joint Ventures. In a **joint venture**, which is another special form of strategic alliance, two or more partners create and jointly own a new organization. Since the partners contribute equity to a joint venture, they make a long-term commitment, which in turn facilitates transaction-specific investments. Dow Corning, owned jointly by Dow Chemical and Corning, is an example of a joint venture. Dow Corning focuses on silicone-based technology and employs roughly 10,000 people with $5 billion in annual revenues. That success shows that some joint ventures can be quite large.[22] Hulu, which offers web-based streaming video of TV shows and movies, is also a joint venture, owned by NBC, Fox, and Disney-ABC. Logging 5 million users in 2015, Hulu is a smaller competitor to Netflix with some 50 million users in the United States.

joint venture A stand-alone organization created and jointly owned by two or more parent companies.

PARENT–SUBSIDIARY RELATIONSHIP. The *parent–subsidiary relationship* describes the most-integrated alternative to performing an activity within one's own corporate family. The corporate parent owns the subsidiary and can direct it via command and control. Transaction costs that arise are frequently due to political turf battles, which may include the capital budgeting process and transfer prices, among other areas. For example, although GM owns its European carmakers (Opel in Germany and Vauxhall in the United Kingdom), it had problems bringing some of their know-how and design of small fuel-efficient cars back into the United States. This failure put GM at a competitive disadvantage vis-à-vis the Japanese competitors when they were first entering the U.S. market with more fuel-efficient cars. In addition, the Japanese carmakers were able to improve the quality and design of their vehicles faster, which enabled them to gain a competitive advantage, especially in an environment of rising gas prices.

The GM versus Opel and Vauxhall parent–subsidiary relationship was burdened by political problems because managers in Detroit did not respect the engineering behind the small, fuel-efficient cars that Opel and Vauxhall made. They were not interested in using European know-how for the U.S. market and didn't want to pay much or anything for it. Moreover, Detroit was tired of subsidizing the losses of Opel and Vauxhall, and felt that its European subsidiaries were manipulating the capital budgeting process.[23] In turn, the Opel and Vauxhall subsidiaries felt resentment toward their parent company: GM had threatened to shut them down as part of its bankruptcy restructuring, whereas they instead hoped to be divested as independent companies.[24]

Having laid a strong theoretical foundation by fully considering transaction cost economics and the boundaries of the firm, we now turn our attention to the firm's position along the vertical industry value chain.

8.3 Vertical Integration along the Industry Value Chain

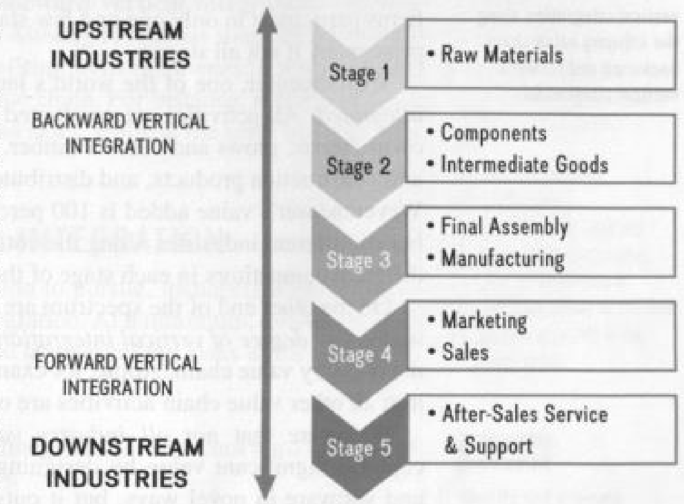
The first key question when formulating corporate strategy is: In what stages of the industry value chain should the firm participate? Deciding whether to make or buy the various activities in the industry value chain involves the concept of vertical integration. **Vertical integration** is the firm's ownership of its production of needed inputs or of the channels by which it distributes its outputs. Vertical integration can be measured by a firm's value

vertical integration The firm's ownership of its production of needed inputs or of the channels by which it distributes its outputs.

added: What percentage of a firm's sales is generated within the firm's boundaries?[25] The degree of vertical integration tends to correspond to the number of industry value chain stages in which a firm directly participates.

Exhibit 8.5 depicts a generic **industry value chain**. Industry value chains are also called *vertical value chains*, because they depict the transformation of raw materials into finished goods and services along distinct vertical stages. Each stage of the vertical value chain typically represents a distinct *industry* in which a number of different firms are competing. This is also why the expansion of a firm up or down the *vertical* industry value chain is called *vertical* integration.

EXHIBIT 8.5 / Backward and Forward Vertical Integration along an Industry Value Chain



To explain the concept of vertical integration along the different stages of the industry value chain more fully, let's use your cell phone as an example. This ubiquitous device is the result of a globally coordinated industry value chain of different products and services:

industry value chain Depiction of the transformation of raw materials into finished goods and services along distinct vertical stages, each of which typically represents a distinct *industry* in which a number of different firms are competing.

- The raw materials to make your cell phone, such as chemicals, ceramics, metals, oil for plastic, and so on, are commodities. In each of these commodity businesses are different companies, such as DuPont (U.S.), BASF (Germany), Kyocera (Japan), and ExxonMobil (U.S.).
- *Intermediate goods and components* such as integrated circuits, displays, touchscreens, cameras, and batteries are provided by firms such as ARM Holdings (UK), Jabil Circuit (U.S.), Intel (U.S.), LG Display (Korea), Altek (Taiwan), and BYD (China).
- *Original equipment manufacturing firms (OEMs)* such as Flextronics (Singapore) or Foxconn (China) typically assemble cell phones under contract for consumer electronics and telecommunications companies such as BlackBerry (Canada), Ericsson (Sweden), Microsoft (U.S., with its acquired Nokia business unit), Samsung (South Korea), and others. If you look closely at an iPhone, for example, you'll notice it says, "Designed by Apple in California. Assembled in China."
- Finally, to get wireless data and voice service, you pick a *service provider* such as AT&T, Sprint, T-Mobile, or Verizon in the United States; América Móvil in Mexico; Oi in Brazil; Orange in France; T-Mobile or Vodafone in Germany; NTT Docomo in Japan; Airtel in India; or China Mobile in China, among others.

In 2015, Google launched a low-cost wireless service in the United States. Called ProjectFi, the wireless service plans offered by Google cost $20 a month for talk and text, including Wi-Fi and international coverage. Each gigabyte of data costs $10 per month. Google's goal is that by providing lower-priced wireless services more people will connect to the Internet, which means more demand for its core online search business and ad-supported YouTube video service. On the downside, initially it is available only with Google phones such as the Nexus 6.[26]

All of these companies—from the raw-materials suppliers to the service providers—make up the global industry value chain that, as a whole, delivers you a working cell phone. Determined by their corporate strategy, each firm decides where in the industry value chain to participate. This in turn defines the vertical boundaries of the firm.

LO 8-4

Describe the two types of vertical integration along the industry value chain: backward and forward vertical integration.

TYPES OF VERTICAL INTEGRATION

Along the industry value chain, there are varying degrees of vertical integration. Some firms participate in only one or a few stages of the industry value chain, while others comprise many if not all stages.

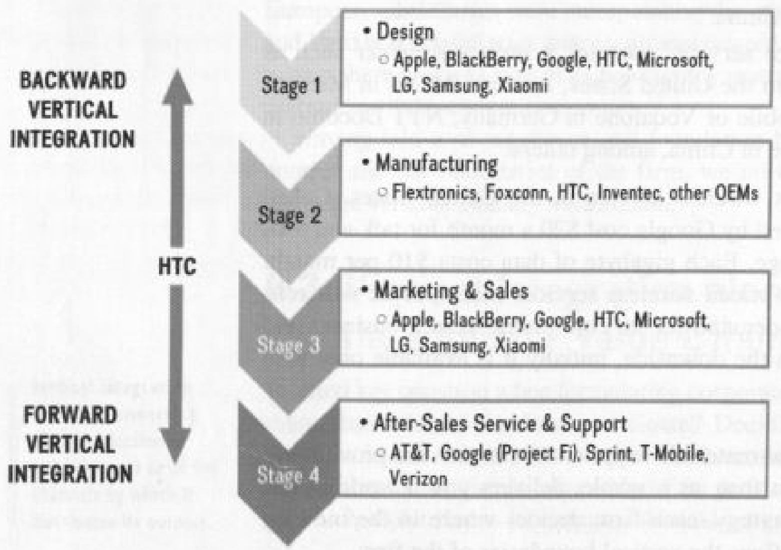
Weyerhaeuser, one of the world's largest paper and pulp companies, is *fully vertically integrated:* All activities are conducted within the boundaries of the firm. Weyerhaeuser owns forests, grows and cuts its timber, mills it, manufactures a variety of different paper and construction products, and distributes them to retail outlets and other large customers. Weyerhaeuser's value added is 100 percent. Weyerhaeuser, therefore, competes in a number of different industries along the entire vertical value chain. As a consequence, it faces different competitors in each stage of the industry value chain.

On the other end of the spectrum are firms that are more or less *vertically disintegrated with a low degree of vertical integration.* These firms focus on only one or a few stages of the industry value chain. Apple, for example, focuses only on design, marketing, and retailing; all other value chain activities are outsourced.

Be aware that *not all industry value chain stages are equally profitable.* Apple captures significant value by designing mobile devices through integration of hardware and software in novel ways, but it outsources the manufacturing to generic OEMs. The logic behind these decisions can be explained by applying Porter's five forces model and the VRIO model. The many small cell phone OEMs are almost completely interchangeable and are exposed to the perils of perfect competition. However, Apple's competencies in innovation, system integration, and marketing are valuable, rare, and unique (non-imitable) resources, and Apple is organized to capture most of the value it creates. Apple's continued innovation through new products and services provides it with a string of temporary competitive advantages.

Exhibit 8.6 displays part of the value chain for smartphones. In this figure, note HTC's transformation from a no-name OEM manufacturer in stage 2 of the value chain to a player in the design, manufacture, and sale of smartphones (stages 1 and 3). It now offers a lineup of innovative and high-performance smartphones under the HTC label.[27]

EXHIBIT 8.6 / HTC's Backward and Forward Integration along the Industry Value Chain in the Smartphone Industry



Firms regularly start out as OEMs and then vertically integrate along the value chain in either a backward and/or forward direction. With these moves, former contractual partners to brand-name phone makers such as Apple and Samsung then become their competitors. OEMs are able to vertically integrate because they acquire the skills needed to compete in adjacent industry value chain activities from their alliance partners, which need to share the technology behind their proprietary phone to enable large-scale manufacturing.

Over time, HTC was able to upgrade its capabilities from merely manufacturing smartphones to also designing products.[28] In doing so, HTC engaged in **backward vertical integration**—moving ownership of activities upstream to the originating inputs of the value chain. Moreover, by moving downstream into sales and increasing its branding activities, HTC has also engaged in **forward vertical integration**—moving ownership of activities closer to the end customer. Although HTC has long benefited from *economies of scale* as an OEM, it is now also benefiting from *economies of scope* through participating in different stages of the industry value chain. For instance, it now can share competencies in product design, manufacturing, and sales, while at the same time attempting to reduce transaction costs.

backward vertical integration
Changes in an industry value chain that involve moving ownership of activities upstream to the originating (inputs) point of the value chain.

forward vertical integration
Changes in an industry value chain that involve moving ownership of activities closer to the end (customer) point of the value chain.

BENEFITS AND RISKS OF VERTICAL INTEGRATION

LO 8-5

Identify and evaluate benefits and risks of vertical integration.

To decide the degree and type of vertical integration to pursue, managers need to understand the possible benefits and risks of vertical integration. At a minimum, executives need to proceed with caution, and carefully consider the countervailing risks at the same time they consider the benefits.

BENEFITS OF VERTICAL INTEGRATION. Vertical integration, either backward or forward, can have a number of benefits, including[29]

- Lowering costs.
- Improving quality.
- Facilitating scheduling and planning.
- Facilitating investments in specialized assets.
- Securing critical supplies and distribution channels.

As noted earlier, HTC started as an OEM for brand-name mobile device companies such as Motorola and Nokia and telecom service providers AT&T and T-Mobile. It backwardly integrated into smartphone design by acquiring One & Co., a San Francisco–based design firm.[30] The acquisition allowed HTC to secure scarce design talent and capabilities that it leveraged into the design of smartphones with superior quality and features, enhancing the differentiated appeal of its products. Moreover, HTC can now design phones that leverage its low-cost manufacturing capabilities.

Likewise, forward integration into distribution and sales allows companies to more effectively plan for and respond to changes in demand. HTC's forward integration into sales enables it to offer its products directly to wireless providers such as AT&T, Sprint, and Verizon. HTC even offers unlocked phones directly to the end consumer via its own website. With ownership and control of more stages of the industry value chain, HTC is now in a much better position to respond if, for example, demand for its latest phone should suddenly pick up.

PepsiCo's corporate strategy highlights several benefits to vertical integration. In 2009, PepsiCo forwardly integrated by buying its bottlers in order to obtain more control over its quality, pricing, distribution, and in-store display. This $8 billion purchase reversed a 1999 decision in which PepsiCo sold its bottlers in order to focus on marketing. CEO Indra Nooyi revised PepsiCo's strategic intent to broaden its menu of offerings to include noncarbonated beverages such as flavored water enhanced with vitamins and fruit juices. With an integrated value chain, Nooyi hoped to improve decision making and enhance flexibility to bring these innovative products to market faster, while reducing costs by more than $400 million.[31]

Because of the strategic interdependence of companies in an oligopoly (as studied in Chapter 3), it came as no surprise that only a few months later, in 2010, Pepsi's archrival Coca-Cola responded with its own forward integration move and purchased its bottlers for $12 billion. Coca-Cola also indicated that more control of manufacturing and distribution was the key driver behind this deal. Moreover, Coca-Cola pegged the expected cost savings at $350 million. Like PepsiCo, Coca-Cola's forward integration represented a major departure from its decade-old business model of large independent bottlers and distributors.[32]

Vertical integration allows firms to increase operational efficiencies through improved coordination and the fine-tuning of adjacent value chain activities. Keeping the downstream value chain activities independent worked well for PepsiCo and Coca-Cola during the 1980s and 1990s, when consumption of soda beverages was on the rise. However, independent bottlers are cost-effective only when doing large-volume business of a few, limited product offerings. With Pepsi's and Coca-Cola's more diversified portfolio of noncarbonated and healthier drinks, the costs of outsourcing bottling and distribution to independent bottlers increased significantly. Some of the independent bottlers even lacked the specialized equipment needed to produce the niche drinks now in demand. In addition, the independent bottlers' direct store-delivery system adds significant costs. To overcome this problem, the soft drink giants had begun to deliver some of their niche products such as Pepsi's Gatorade and SoBe Lifewater and Coca-Cola's Powerade and Glacéau directly to warehouse retailers such as Sam's Club and Costco. By owning the bottlers, both companies can deliver all products through one channel, thus lowering the overall cost of distribution.

Given the increase in costs of using independent bottlers (or the market), the forward integration of PepsiCo and Coca-Cola is in line with predictions derived from transaction cost economics. Controlling the delivery part of the value chain also enhances the soft drink giants' bargaining power when negotiating product price, placement, and promotion. Looking at Porter's five forces model, PepsiCo and Coca-Cola are reducing the bargaining power of buyers and thus shifting the industry structure in their favor. End consumers are likely to benefit from the forward integration in the form of a wider variety of niche drinks. With all these benefits taken together, vertical integration can increase differentiation and reduce costs, thus strengthening a firm's strategic position as the gap between value creation and costs widens.

Vertical integration along the industry value chain can also facilitate *investments in specialized assets.* What does this mean? **Specialized assets** have a high opportunity cost: They have significantly more value in their intended use than in their next-best use.[33] They can come in several forms:[34]

specialized assets Unique assets with high opportunity cost: They have significantly more value in their intended use than in their next-best use. They come in three types: site specificity, physical-asset specificity, and human-asset specificity.

- *Site specificity*—assets required to be co-located, such as the equipment necessary for mining bauxite and aluminum smelting.
- *Physical-asset specificity*—assets whose physical and engineering properties are designed to satisfy a particular customer, such as bottling machinery for Coca-Cola and PepsiCo. Since the bottles have different and often trademarked shapes, they require unique molds. Cans, in contrast, do not require physical-asset specificity because they are generic.
- *Human-asset specificity*—investments made in human capital to acquire unique knowledge and skills, such as mastering the routines and procedures of a specific organization, which are not transferable to a different employer.

Investments in specialized assets tend to incur high opportunity costs because making the specialized investment opens up the threat of opportunism by one of the partners. *Opportunism* is defined as self-interest seeking with guile.[35] Backward vertical integration is often undertaken to overcome the threat of opportunism and to secure key raw materials.

In an effort to secure supplies and reduce the costs of jet fuel, Delta was the first airline to acquire an oil refinery. In 2012, it purchased a Pennsylvania-based facility from ConocoPhillips. Delta estimates that this backward vertical integration move not only will allow it to provide 80 percent of its fuel internally, but will also save it some $300 million in costs annually. Fuel costs are quite significant for airlines; for Delta, they are almost 40 percent of its total operating cost.[36]

RISKS OF VERTICAL INTEGRATION. It is important to note that the risks of vertical integration can outweigh the benefits. Depending on the situation, vertical integration has several risks, some of which directly counter the potential benefits, including[37]

- Increasing costs.
- Reducing quality.
- Reducing flexibility.
- Increasing the potential for legal repercussions.

A higher degree of vertical integration can lead to increasing costs for a number of reasons. In-house suppliers tend to have higher cost structures because they are not exposed to market competition. Knowing there will always be a buyer for their products reduces their incentives to lower costs. Also, suppliers in the open market, because they serve a much larger market, can achieve economies of scale that elude in-house suppliers. Organizational complexity increases with higher levels of vertical integration, thereby increasing administrative costs such as determining the appropriate transfer prices between an in-house supplier and buyer. Administrative costs are part of internal transaction costs and arise from the coordination of multiple divisions, political maneuvering for resources, the consumption of company perks, or simply from employees slacking off.

The knowledge that there will always be a buyer for their products not only reduces the incentives of in-house suppliers to lower costs, but also can reduce the incentive to increase quality or come up with innovative new products. Moreover, given their larger scale and greater exposure to more customers, external suppliers often can reap higher learning and experience effects and so develop unique capabilities or quality improvements.

A higher degree of vertical integration can also reduce a firm's strategic flexibility, especially when faced with changes in the external environment such as fluctuations in demand and technological change.[38] For instance, when technological process innovations enabled significant improvements in steelmaking, mills such as U.S. Steel and Bethlehem Steel were tied to their fully integrated business models and were thus unable to switch technologies, leading to the bankruptcy of many integrated steel mills. Non-vertically integrated mini-mills such as Nucor and Chaparral, on the other hand, invested in the new steelmaking process and grew their business by taking market share away from the less flexible integrated producers.[39]

U.S. regulators such as the Federal Trade Commission (FTC) and the Justice Department (DOJ) tend to allow vertical integration, arguing that it generally makes firms more efficient and lowers costs, which in turn can benefit customers. However, due to monopoly concerns, vertical integration has not gone entirely unchallenged.[40] The FTC, for example, carefully reviewed PepsiCo's plan to reintegrate its two largest bottlers, which gives the firm full control of about 80 percent of its North American distribution. Before engaging in vertical integration, therefore, managers need to be aware that this corporate strategy can increase the potential for legal repercussions.

WHEN DOES VERTICAL INTEGRATION MAKE SENSE?

U.S. business saw a number of periods of higher than usual vertical integration, and looking back may reveal useful lessons on how a company can make better decisions around its corporate strategy.[41]

In the early days of automobile manufacturing, Ford Motor Company was frustrated by shortages of raw materials and the limited delivery of parts suppliers. In response, Henry Ford decided to own the whole supply chain, so his company soon ran mining operations, rubber plantations, freighters, blast furnaces, glassworks, and its own part manufacturer. In Ford's River Rogue plant, raw materials entered on one end, new cars rolled out the other end. But over time, the costs of vertical integration caught up, both financial costs that undid earlier cost savings and operational costs that hampered the manufacturer's flexibility to respond to changing conditions. Indeed, Ford experienced diseconomies of scale (see Exhibit 6.5) due to its level of vertical integration and the size of its mega-plants.

In the 1970s, the chipmakers and the manufacturers of electronic products tried to move into each others' business. Texas Instruments went downstream into watches and calculators. Bowmar, which at first led the calculator market, tried to go upstream into chip manufacturing and failed. The latter 2000s saw a resurgence of vertical integration. In 2009, General Motors was trying to reacquire Delphi, a parts supplier that it had sold in 1997. In 2010, the major soft drink companies purchased bottling plants (as discussed above).

Rita McGrath suggested that the siren call of vertical integration looms large for companies seeking to completely change the customer's experience: "An innovator who can figure out how to eliminate annoyances and poor interfaces in the chain can build an incredible advantage, based on the customers' desire for that unique solution."[42] So what should company executives do as they contemplate a firm's corporate strategy? As far back as the 1990s, the consulting firm McKinsey was counseling clients that firms had to consider carefully *why* they were looking at integrating along their industry value chain. McKinsey identified the main reason to vertically integrate: failure of vertical markets. **Vertical market failure** occurs when transactions within the industry value chain are too risky, and alternatives to integration are too costly or difficult to administer. This recommendation corresponds with the one derived from transaction cost economics earlier in this chapter. When discussing research on vertical integration, *The Economist* concluded, "Although reliance on [external] supply chains has risks, owning parts of the supply chain can be riskier—for example, few clothing-makers want to own textile factories, with their pollution risks and slim profits." The findings suggest that when a company vertically integrates two or more steps away from its core competency, it fails two-thirds of the time.[43]

vertical market failure When the markets along the industry value chain are too risky, and alternatives too costly in time or money.

The risks of vertical integration and the difficulty of getting it right bring us to look at alternatives that allow companies to gain some of the benefits without the risks of full ownership of the supply chain.

LO 8-6

Describe and examine alternatives to vertical integration.

ALTERNATIVES TO VERTICAL INTEGRATION

Ideally, one would like to find alternatives to vertical integration that provide similar benefits without the accompanying risks. Taper integration and strategic outsourcing are two such alternatives.

taper integration A way of orchestrating value activities in which a firm is backwardly integrated but also relies on outside-market firms for some of its supplies and/or is forwardly integrated but also relies on outside-market firms for some of its distribution.

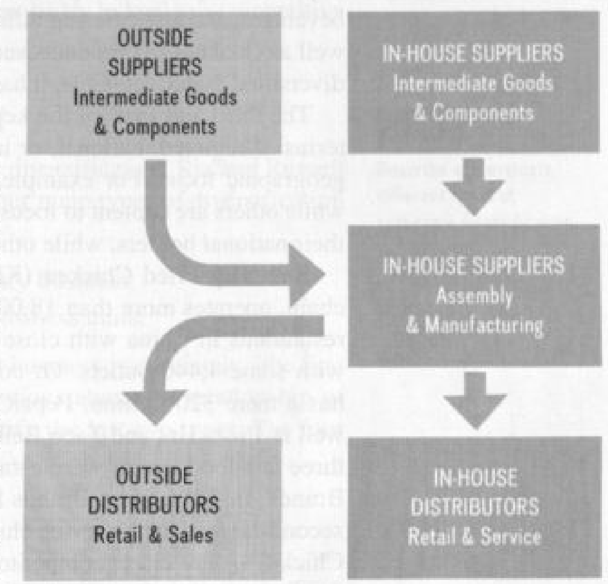
TAPER INTEGRATION. One alternative to vertical integration is **taper integration**. It is a way of orchestrating value activities in which a firm is backwardly integrated, but it also relies on outside-market firms for some of its supplies, and/or is forwardly integrated but also relies on outside-market firms for some if its distribution.[44] Exhibit 8.7 illustrates the concept of taper integration along the vertical industry value chain. Here, the firm sources intermediate goods and components from in-house suppliers as well as outside suppliers. In a similar fashion, a firm sells its products through company-owned retail outlets and through independent retailers. Both Apple and Nike, for example, use taper integration: They own retail outlets but also use other retailers, both the brick-and-mortar type and online.

Taper integration has several benefits:[45]

- It exposes in-house suppliers and distributors to market competition so that performance comparisons are possible. Rather than hollowing out its competencies by relying too much on outsourcing, taper integration allows a firm to retain and fine-tune its competencies in upstream and downstream value chain activities.[46]

- Taper integration also enhances a firm's flexibility. For example, when adjusting to fluctuations in demand, a firm could cut back on the finished goods it delivers to external retailers while continuing to stock its own stores.
- Using taper integration, firms can combine internal and external knowledge, possibly paving the path for innovation.

EXHIBIT 8.7 / Taper Integration along the Industry Value Chain



Based on a study of 3,500 product introductions in the computer industry, researchers have provided empirical evidence that taper integration can be beneficial.[47] Firms that pursued taper integration achieved superior performance in both innovation and financial performance when compared with firms that relied more on vertical integration or strategic outsourcing.

STRATEGIC OUTSOURCING. Another alternative to vertical integration is **strategic outsourcing**, which involves moving one or more internal value chain activities outside the firm's boundaries to other firms in the industry value chain. A firm that engages in strategic outsourcing reduces its level of vertical integration. Rather than developing their own human resource management systems, for instance, firms outsource these non-core activities to companies such as PeopleSoft (owned by Oracle), EDS (owned by HP), or Perot Systems (owned by Dell), which can leverage their deep competencies and produce scale effects.

strategic outsourcing Moving one or more internal value chain activities outside the firm's boundaries to other firms in the industry value chain.

In the popular media and in everyday conversation, you may hear the term *outsourcing* used to mean sending jobs out of the country. Actually, when outsourced activities take place outside the home country, the correct term is *offshoring* (or *offshore outsourcing*). By whatever name, it is a *huge* phenomenon. For example, Infosys, one of the world's largest technology companies and providers of IT services to many Fortune 100 companies, is located in Bangalore, India. The global offshoring market is estimated to be $1.5 trillion and is expected to grow at a compound annual growth rate of 15 percent. Banking and financial services, IT, and health care are the most active sectors in such offshore outsourcing.[48] More recently, U.S. law firms began to offshore low-end legal work, such as drafting standard contracts and background research, to India.[49] We discuss *global strategy* in detail in Chapter 10.

8.4 Corporate Diversification: Expanding Beyond a Single Market

Early in the chapter, we listed three questions related to corporate strategy and, in particular, the boundaries of the firm. We discussed the first question of defining corporate strategy in detail:

1. *In what stages of the industry value chain should the firm participate?*

Our exploration was primarily in terms of firm boundaries based on the desired extent of vertical integration. We now turn to the second and third questions that determine corporate strategy and the boundaries of the firm:

2. What range of products and services should the firm offer?
3. Where should the firm compete in terms of regional, national, or international markets?

The second question relates to the firm's *degree of diversification:* What range of products and services should the firm offer? In particular, why do some companies compete in a single product market, while others compete in several different product markets? Coca-Cola, for example, focuses on soft drinks and thus on a *single* product market. Its archrival PepsiCo competes directly with Coca-Cola by selling a wide variety of soft drinks and other beverages, and also offering different types of chips such as Lay's, Doritos, and Cheetos, as well as Quaker Oats products such as oatmeal and granola bars. Although PepsiCo is more diversified than Coca-Cola, it has reduced its level of diversification in recent years.

The third and final of the key questions concerns the question of *where to compete* in terms of regional, national, or international markets. This decision determines the firm's geographic focus. For example, why do some firms compete beyond state boundaries, while others are content to focus on the local market? Why do some firms compete beyond their national borders, while others prefer to focus on the domestic market?

Kentucky Fried Chicken (KFC), the world's largest quick-service chicken restaurant chain, operates more than 18,000 outlets in 115 countries.[50] Interestingly, KFC has more restaurants in China with close to 5,000 outlets than in the United States, its birthplace, with some 4,440 outlets. Of course, China has 1.4 billion people and the United States has a mere 320 million. PepsiCo CEO Nooyi was instrumental in spinning out KFC, as well as Pizza Hut and Taco Bell, to reduce PepsiCo's level of diversification. In 1997, the three fast-food chains were established as an independent company under the name Yum Brands. In 2014, Yum Brands had annual revenues of $13 billion. Compare the world's second-largest quick-service chicken restaurant, the privately held Chick-fil-A.[51] KFC and Chick-fil-A are direct competitors in the United States, both specializing in chicken in the fast food market. But Chick-fil-A operates only in the United States; by 2014 it had some 2000 locations across 42 states and earned $5 billion in sales.

Why are KFC and Chick-fil-A pursuing different corporate strategies? Although both companies were founded roughly in the same time period (KFC in 1930 and Chick-fil-A in 1946), one big difference between KFC and Chick-fil-A is the ownership structure. KFC is a publicly traded stock company, as part of Yum Brands; Chick-fil-A is privately owned. Public companies are often expected by shareholders to achieve profitable growth as fast as possible to result in an appreciation of the stock price and thus an increase in shareholder value (see the discussion in Chapter 5). In contrast, private companies generally grow slower than public companies because their growth is mostly financed through retained earnings and debt rather than equity. Before an initial public offering, private companies do not have the option to sell shares (equity) to the public to fuel growth. This is one explanation why KFC focuses on international markets, especially China, where future expected growth continues to be high, while Chick-fil-A focuses on the domestic U.S. market.

Answers to questions about the number of markets to compete in and where to compete geographically relate to the broad topic of **diversification**. A firm that engages in diversification increases the variety of products and services it offers or markets and the geographic regions in which it competes. A *non-diversified company* focuses on a single market, whereas a *diversified company* competes in several different markets simultaneously.[52]

There are various general diversification strategies:

- A firm that is active in several different product markets is pursuing a **product diversification strategy**.
- A firm that is active in several different countries is pursuing a **geographic diversification strategy**.
- A company that pursues *both* a product *and* a geographic diversification strategy simultaneously follows a **product–market diversification strategy**.

Because shareholders expect continuous growth from public companies, managers frequently turn to product and geographic diversification to achieve it. It is therefore not

diversification
An increase in the variety of products and services a firm offers or markets and the geographic regions in which it competes.

product diversification strategy
Corporate strategy in which a firm is active in several different product markets.

geographic diversification strategy
Corporate strategy in which a firm is active in several different countries.

product–market diversification strategy
Corporate strategy in which a firm is active in several different product markets *and* several different countries.

surprising that the vast majority of the Fortune 500 companies are diversified to some degree. Achieving performance gains through diversification, however, is not guaranteed. Some forms of diversification are more likely to lead to performance improvements than others. We now discuss which diversification types are more likely to lead to a competitive advantage, and why.

TYPES OF CORPORATE DIVERSIFICATION

LO 8-7
Describe and evaluate different types of corporate diversification.

To understand the different types and degrees of corporate diversification, Richard Rumelt developed a helpful classification scheme that identifies four main types of diversification by looking at two variables:

- The *percentage of revenue* from the dominant or primary business.
- The *relationship of the core competencies* across the business units.

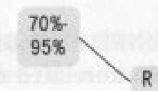
Just knowing the percentage of revenue of the dominant business immediately, (the first variable), lets us identify the first two types. Asking questions about the relationship of core competencies across business units allows us to identify the last two types. The four main types of business diversification are

1. Single business.
2. Dominant business.
3. Related diversification.
4. Unrelated diversification: the conglomerate.

Please note that related diversification (type 3) is divided into two subcategories. We discuss each type of diversification below.

SINGLE BUSINESS. A *single-business firm* derives more than 95 percent of its revenues from one business. The remainder of less than 5 percent of revenue is not (yet) significant to the success of the firm. For example, although Google is active in many different businesses, it obtains more than 95 percent of its revenues ($70 billion in 2014) from online advertising.[53]

DOMINANT BUSINESS. A *dominant-business firm* derives between 70 and 95 percent of its revenues from a single business, but it pursues at least one other business activity that accounts for the remainder of revenue. The dominant business shares competencies in products, services, technology, or distribution. In the schematic figure shown here, and those to follow the remaining revenue (*R*), is generally obtained in other strategic business units (SBU) within the firm.*



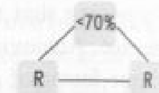
RELATED DIVERSIFICATION. A firm follows a **related diversification strategy** when it derives less than 70 percent of its revenues from a single business activity and obtains revenues from other lines of business linked to the primary business activity. The rationale behind related diversification is to benefit from economies of scale and scope: These multi-business firms can pool and share resources as well as leverage competencies across different business lines. The two variations of this type, which we explain next, relate to how much the other lines of business benefit from the core competencies of the primary business activity.

related diversification strategy
Corporate strategy in which a firm derives less than 70 percent of its revenues from a single business activity and obtains revenues from other lines of business that are linked to the primary business activity.

* This remaining revenue is by definition less than that of the primary business. Note also that the areas of the boxes in this and following graphics are not scaled to specific percentages.

related-constrained diversification strategy A kind of related diversification strategy in which executives pursue only businesses where they can apply the resources and core competencies already available in the primary business.

Related-Constrained Diversification. A firm follows a **related-constrained diversification strategy** when it derives less than 70 percent of its revenues from a single business activity and obtains revenues from other lines of business related to the primary business activity. Executives engage in such a new business opportunity only when they can leverage their existing competencies and resources. Specifically, the choices of alternative business activities are limited—constrained—by the fact that they need to be related through common resources, capabilities, and competencies.



ExxonMobil's strategic move into natural gas is an example of related diversification. In 2009, ExxonMobil bought XTO Energy, a natural gas company, for $31 billion.[54] XTO Energy is known for its core competency to extract natural gas from unconventional places such as shale rock—the type of deposits currently being exploited in the United States. ExxonMobil hopes to leverage its core competency in the exploration and commercialization of oil into natural gas extraction. The company is producing nearly equal amounts of crude oil and natural gas, making it the world's largest producer of natural gas. The company believes that roughly 50 percent of the world's energy for the next 50 years will continue to come from fossil fuels, and that its diversification into natural gas, the cleanest of the fossil fuels in terms of greenhouse gas emissions, will pay off. ExxonMobil's strategic scenario may be right on the mark. Because of major technological advances in hydraulic fracking to extract oil and natural gas from shale rock by companies such as XTO Energy, the United States has emerged as the world's richest country in natural gas resources and the third-largest producer of crude oil, just behind Saudi Arabia and Russia.[55]

related-linked diversification strategy A kind of related diversification strategy in which executives pursue various businesses opportunities that share only a limited number of linkages.

Related-Linked Diversification. If executives consider new business activities that share only a limited number of linkages, the firm is using a **related-linked diversification strategy**. Amazon.com, featured in the ChapterCase, began business by selling only one product: books. Over time, it expanded into CDs and later gradually leveraged its online retailing capabilities into a wide array of product offerings. As the world's largest online retailer, and given the need to build huge data centers to service its peak holiday demand, Amazon decided to leverage spare capacity into cloud computing, again benefiting from economies of scope and scale. Amazon now also offers its Kindle line of tablet computers and proprietary content, as well as instant video streaming via its Prime service. Amazon follows a related-linked diversification strategy.

unrelated diversification strategy Corporate strategy in which a firm derives less than 70 percent of its revenues from a single business and there are few, if any, linkages among its businesses.

conglomerate A company that combines two or more strategic business units under one overarching corporation; follows an unrelated diversification strategy.

UNRELATED DIVERSIFICATION: THE CONGLOMERATE.

A firm follows an **unrelated diversification strategy** when less than 70 percent of its revenues comes from a single business and there are few, if any, linkages among its businesses. A company that combines two or more strategic business units under one overarching corporation and follows an unrelated diversification strategy is called a **conglomerate**. Some research evidence suggests that an unrelated diversification strategy can be advantageous in emerging economies.[56]

This arrangement helps firms gain and sustain competitive advantage because it allows the conglomerate to overcome institutional weaknesses in emerging economies, such as a lack of capital markets and well-defined legal systems and property rights. Companies such as LG (representing a uniquely South Korean form of organization, the *chaebol*), Berkshire Hathaway, and the Japanese Yamaha group are all considered conglomerates due to their unrelated diversification strategy. Strategy Highlight 8.2 features the Tata group of India, a conglomerate that follows an unrelated diversification strategy.

Exhibit 8.8 summarizes the four main types of diversification—single business, dominant business, related diversification (including its subcategories related-constrained and related-linked diversification), and unrelated diversification.

EXHIBIT 8.8 / Four Main Types of Diversification

Revenues from Primary Business	Type of Diversification	Competencies (in products, services, technology or distribution)	Examples	Graphic
>95%	Single Business	Single business leverages its competencies.	Coca-Cola Google Facebook	>95%
70%–95%	Dominant Business	Dominant and minor businesses share competencies.	Harley-Davidson Nestlé UPS	70%-95% R
<70%	Related Diversification			
	Related-Constrained	Businesses generally share competencies.	ExxonMobil Johnson & Johnson Nike	<70% R R
	Related-Linked	Some businesses share competencies.	Amazon Disney GE	<70% R R
	Unrelated Diversification (Conglomerate)	Businesses share few, if any, competencies.	Berkshire Hathaway Yamaha Tata	<70% R R

Note: *R* = Remainder revenue, generally in other strategic business units (SBU) within the firm.

Source: Adapted from R.P. Rumelt (1974), *Strategy, Structure, and Economic Performance* (Boston, MA: Harvard Business School Press).

LEVERAGING CORE COMPETENCIES FOR CORPORATE DIVERSIFICATION

LO 8-8 Apply the core competence–market matrix to derive different diversification strategies.

In Chapter 4, when looking inside the firm, we introduced the idea that competitive advantage can be based on core competencies. Core competencies are unique strengths embedded deep within a firm. They allow companies to increase the perceived value of their product and service offerings and/or lower the cost to produce them.[58] Examples of core competencies are:

- Walmart's ability to effectively orchestrate a globally distributed supply chain at low cost.
- Infosys' ability to provide high-quality information technology services at a low cost by leveraging its global delivery model. This implies taking work to the location where it makes the best economic sense, based on the available talent and the least amount of acceptable risk and lowest cost.

core competence–market matrix A framework to guide corporate diversification strategy by analyzing possible combinations of existing/new core competencies and existing/new markets.

To survive and prosper, companies need to grow. This mantra holds especially true for publicly owned companies, because they create shareholder value through profitable growth. Managers respond to this relentless growth imperative by leveraging their existing core competencies to find future growth opportunities. Gary Hamel and C.K. Prahalad advanced the **core competence–market matrix**, depicted in Exhibit 8.9, as a way to guide

Strategy Highlight 8.2

The Tata Group: Integration at the Corporate Level

Tata Nano GenX, starting at $3,100
© Sam Panthaky/AFP/Getty Images

Range Rover, starting at $85,000
© Graeme Lamb/Alamy RF

Founded in 1868 as a trading company by then 29-year-old entrepreneur Jamsetji Nusserwanji Tata, the Tata group today has roughly 500,000 employees and $100 billion in annual revenues. A widely diversified multinational conglomerate, headquartered in Mumbai, India, it is active in industries as wide ranging as tea, hospitality, steel, IT, communications, power, and automobiles. Some of its strategic business units are giants in their own right. The Tata group includes Asia's largest software company (TCS) and India's largest steelmaker. It also owns the renowned Taj Hotels Resorts & Palaces.

In 2008, Tata Motors attracted attention in the automotive world when it bought Jaguar and Land Rover from Ford for $2.3 billion. In 2009, Tata Motors attracted even more attention when it unveiled its Tata Nano, the world's lowest-priced car. It accommodates passengers just over 6 feet tall, goes from zero to 60 mph in 30 seconds, and gets 67 mpg, beating the Toyota Prius for fuel consumption. The Tata Nano, clearly a no-frills car, exemplifies a focused low-cost strategy. It lacks a radio, glove compartment, and operable rear hatch, and its top speed is a little over 60 mph. Nonetheless, being about 50 percent cheaper than the next-lowest-cost car, Tata Motors hopes to find tens of millions of customers in the Indian and Chinese markets. Initial sales were disappointing, however. Apparently low cost alone was not sufficient to lure new buyers into the market. The first Nano models might have provided too little along the value dimension. Tata responded in 2015 with the Nano GenX, which has more options and customizability in an attempt to appeal to younger consumers, including an automatic transmission, Bluetooth compatibility and USB ports for the car's audio system, and a special feature designed to allow the car to creep forward with the engine at idle when the brake is released—a valuable feature in countries such as China and India where massive traffic jams are the norm.

The Tata group is attempting to carve out different strategic positions in its different segments of the automotive industry. Moreover, the Tata group hopes to integrate distinctly different business strategies at the corporate level. In particular, the luxury division of Tata Motors, with the Jaguar and Land Rover brands, is pursuing a focused differentiation strategy; the Nano car division is pursuing a focused cost-leadership strategy. Although their respective strategic profiles are basically the opposite of one another (differentiation versus low-cost), both business-level strategies are aimed at a specific segment of the market. Jaguar and Land Rover are luxury brands in their respective categories and appeal to affluent buyers; the Nano is clearly a lowest-cost offering, focused on a very specific market niche. Indeed, the Nano focuses on *non-consumption:* Buyers of the Nano will not be replacing other vehicles. They will be first-time car buyers moving up from bicycles and mopeds. Ratan Tata, then chairman of the Tata group, conceived of the Nano while seeing a family of four cramped on a moped in heavy rains.

By offering the Nano, Tata Motors is still hoping to bring millions of new car buyers from emerging countries into the market and thus increase the size of the automobile market. The Nano GenX is an attempt to offer more features and compete in the space occupied by competitors Maruti Suzuki and Hyundai. Taken together, Tata's corporate strategy is attempting to integrate different strategic positions, pursued by different strategic business units, each with its own profit and loss responsibility.[57]

managerial decisions in regard to diversification strategies. The first task for managers is to identify their existing core competencies and understand the firm's current market situation. When applying an existing or new dimension to core competencies and markets, four quadrants emerge, each with distinct strategic implications.

The lower-left quadrant combines existing core competencies with existing markets. Here, managers must come up with ideas of how to leverage existing core competencies to improve the firm's current market position. Bank of America is one of the largest banks in the United States and has at least one customer in 50 percent of U.S. households.[59] Developed from the Bank of Italy and started in San Francisco, California, in 1904, it became the Bank of America and Italy in 1922. Over the next 60 years it grew in California and then nationally into a major banking powerhouse. And then in 1997, in what was the largest bank acquisition of its time, NationsBank bought Bank of America.

You could say that acquisitions were a NationsBank specialty. While still the North Carolina National Bank (NCNB), one of its unique core competencies was identifying, appraising, and integrating acquisition targets. In particular, it bought smaller banks to supplement its organic growth throughout the 1970s and '80s, and from 1989 to 1992, NCNB purchased over 200 regional community and thrift banks to further improve its market position. It then turned its core competency to national banks, with the goal of becoming the first nationwide bank. Known as NationsBank in the 1990s, it purchased Barnett Bank, BankSouth, FleetBank, LaSalle, CountryWide Mortgages, and its eventual namesake, Bank of America. This example illustrates how NationsBank, rebranded as Bank of America since 1998, honed and deployed its core competency of selecting, acquiring, and integrating other commercial banks to grow dramatically in size and geographic scope and emerge as one of the leading banks in the United States. As a key vehicle of corporate strategy, we study acquisitions in more detail in Chapter 9.

The lower-right quadrant of Exhibit 8.9 combines existing core competencies with new market opportunities. Here, managers must strategize about how to redeploy and recombine existing core competencies to compete in future markets. At the height of the financial crisis in the fall of 2008, Bank of America bought the investment bank Merrill Lynch for $50 billion.[60] Although many problems ensued for Bank of America

EXHIBIT 8.9 The Core Competence–Market Matrix

Source: Adapted from G. Hamel and C.K. Prahalad (1994), *Competing for the Future* (Boston, MA: Harvard Business School Press).

following the Merrill Lynch acquisition, it is now the bank's investment and wealth management division. Bank of America's corporate managers applied an existing competency (acquiring and integrating) into a new market (investment and wealth management). The combined entity is now leveraging economies of scope through cross-selling when, for example, consumer banking makes customer referrals for investment bankers to follow up.[61]

The upper-left quadrant combines new core competencies with existing market opportunities. Here, managers must come up with strategic initiatives to build new core competencies to protect and extend the company's current market position. For example, in the early 1990s, Gatorade dominated the market for sports drinks, a segment in which it had been the original innovator. Some 25 years earlier, medical researchers at the University of Florida had created the drink to enhance the performance of the Gators, the university's football team, thus the name Gatorade. Stokely-Van Camp commercialized and marketed the drink, and eventually sold it to Quaker Oats. PepsiCo brought Gatorade into its lineup of soft drinks when it acquired Quaker Oats in 2001.

By comparison, Coca-Cola had existing core competencies in marketing, bottling, and distributing soft drinks, but had never attempted to compete in the sports-drink market. Over a 10-year R&D effort, Coca-Cola developed competencies in the development and marketing of its own sports drink, Powerade, which launched in 1990. In 2014, Powerade held about 25 percent of the sports-drink market, making it a viable competitor to Gatorade, which still holds about 70 percent of the market.[62]

Finally, the upper-right quadrant combines new core competencies with new market opportunities. Hamel and Prahalad call this combination "mega-opportunities"—those that hold significant future-growth opportunities. At the same time, it is likely the most challenging diversification strategy because it requires building new core competencies to create and compete in future markets.

Salesforce.com, for example, is a company that employs this diversification strategy well.[63] In recent years, Salesforce experienced tremendous growth, the bulk of it coming from the firm's existing core competency in delivering customer relationship management (CRM) software to its clients. Salesforce's product distinguished itself from the competition by providing software as a service via cloud computing: Clients did not need to install software or manage any servers, but could easily access the CRM through a web browser (a business model called *software as a service,* or *SaaS*). In 2007, Salesforce recognized an emerging market for *platform as a service* (*PaaS*) offerings, which would enable clients to build their own software solutions that are accessed the same way as the Salesforce CRM. Seizing the opportunity, Salesforce developed a new competency in delivering software development and deployment tools that allowed its customers to either extend their existing CRM offering or build completely new types of software. Today, Salesforce's Force.com offering is one of the leading providers of PaaS tools and services.

Taken together, the core competence–market matrix provides guidance to executives on how to diversify in order to achieve continued growth. Once managers have a clear understanding of their firm's core competencies (see Chapter 4), they have four options to formulate corporate strategy:

Four Options to Formulate Corporate Strategy via Core Competencies

1. Leverage existing core competencies to improve current market position.
2. Build new core competencies to protect and extend current market position.
3. Redeploy and recombine existing core competencies to compete in markets of the future.
4. Build new core competencies to create and compete in markets of the future.

CORPORATE DIVERSIFICATION AND FIRM PERFORMANCE

LO 8-9 Explain when a diversification strategy creates a competitive advantage and when it does not.

Corporate managers pursue diversification to gain and sustain competitive advantage. But does corporate diversification indeed lead to superior performance? To answer this question, we need to evaluate the performance of diversified companies. The critical question to ask when doing so is whether the individual businesses are worth more under the company's management than if each were managed individually.

The diversification-performance relationship is a function of the underlying type of diversification. A cumulative body of research indicates an inverted U-shaped relationship between the type of diversification and overall firm performance, as depicted in Exhibit 8.10.[64] High and low levels of diversification are generally associated with lower overall performance, while moderate levels of diversification are associated with higher firm performance. This implies that companies that focus on a single business, as well as companies that pursue unrelated diversification, often fail to achieve additional value creation. Firms that compete in single markets could potentially benefit from economies of scope by leveraging their core competencies into adjacent markets.

Firms that pursue unrelated diversification are often unable to create additional value. They experience a **diversification discount** in the stock market: The stock price of such highly diversified firms is valued at less than the sum of their individual business units.[65] For the last decade or so, GE experienced a diversification discount, as its capital unit contributed 50 percent of profits on one-third of the conglomerate's revenues. The presence of the diversification discount in GE's depressed stock price was a major reason GE's CEO, Jeffrey Immelt, decided in 2015 to spin out GE Capital. On the day of the announcement, GE's stock price jumped 11 percent, adding some $28 billion to GE's market capitalization. This provides some idea of the diversification discount that firms pursuing unrelated diversification may experience.[66] Through this restructuring of the corporate portfolio, GE is now better positioned to focus more fully on its core competencies in industrial engineering and management processes.

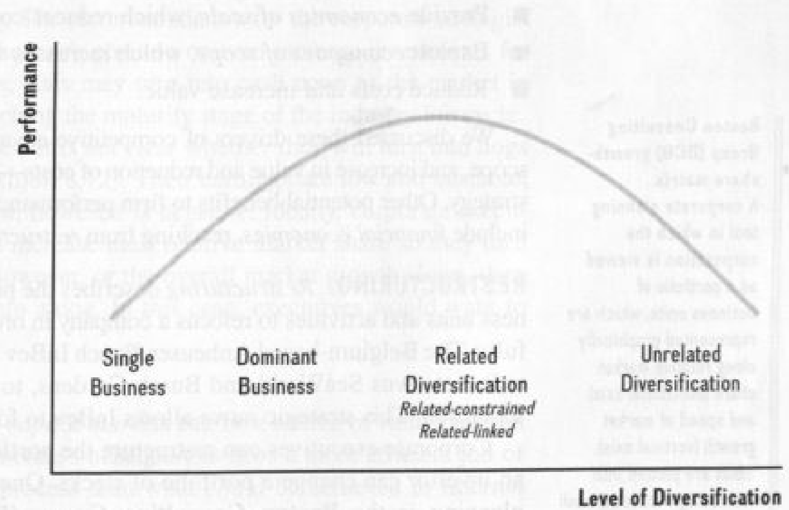
diversification discount Situation in which the stock price of highly diversified firms is valued at less than the sum of their individual business units.

diversification premium Situation in which the stock price of related-diversification firms is valued at greater than the sum of their individual business units.

The presence of the diversification discount, however, depends on the institutional context. Although it holds in developed economies with developed capital markets, some research evidence suggests that an unrelated diversification strategy can be advantageous in emerging economies as mentioned when discussing the Tata group in Strategy Highlight 8.2.[67] Here, unrelated diversification may help firms gain and sustain competitive advantage because it allows the conglomerate to overcome institutional weaknesses in emerging economies such as a lack of a functioning capital market.

In contrast, companies that pursue related diversification are more likely to improve their performance. They create a **diversification premium**: The stock price of related-diversification firms is valued at greater than the sum of their individual business units.[68]

EXHIBIT 8.10 / The Diversification-Performance Relationship



Source: Adapted from L.E. Palich, L.B. Cardinal, and C.C. Miller (2000), "Curvilinearity in the diversification-performance linkage: An examination of over three decades of research," *Strategic Management Journal* 21: 155–174.

EXHIBIT 8.11 /

Vertical Integration and Diversification: Sources of Value Creation and Costs

Corporate Strategy	Sources of Value Creation (*V*)	Sources of Costs (*C*)
Vertical Integration	• Can lower costs (but can go other way too) • Can improve quality (but can go other way too) • Can facilitate scheduling and planning (but can go other way too)	• Can increase costs (but can go other way too) • Can reduce quality (but can go other way too) • Can reduce flexibility (but can go other way too)
	• Facilitating investments in specialized assets • Securing critical supplies and distribution channels	• Increasing potential for legal repercussions
Related Diversification	• Economies of scope • Economies of scale • Financial economies ■ Restructuring ■ Internal capital markets	• Coordination costs • Influence costs
Unrelated Diversification	• Financial economies ■ Restructuring ■ Internal capital markets	• Influence costs

Why is this so? At the most basic level, a corporate diversification strategy enhances firm performance when its value creation is greater than the costs it incurs. Exhibit 8.11 lists the sources of value creation and costs for different corporate strategies, for vertical integration as well as related and unrelated diversification. For diversification to enhance firm performance, it must do at least one of the following:

- Provide *economies of scale*, which reduces costs.
- Exploit *economies of scope*, which increases value.
- Reduce costs *and* increase value.

We discussed these drivers of competitive advantage—economies of scale, economies of scope, and increase in value and reduction of costs—in depth in Chapter 6 in relation to business strategy. Other potential benefits to firm performance when following a diversification strategy include *financial economies*, resulting from *restructuring* and using *internal capital markets*.

RESTRUCTURING. *Restructuring* describes the process of reorganizing and divesting business units and activities to refocus a company in order to leverage its core competencies more fully. The Belgium-based Anheuser-Busch InBev sold Busch Entertainment, its theme park unit that owns SeaWorld and Busch Gardens, to a group of private investors for roughly $3 billion. This strategic move allows InBev to focus more fully on its core business.[69]

Corporate executives can restructure the portfolio of their firm's businesses, much like an investor can change a portfolio of stocks. One helpful tool to guide corporate portfolio planning is the **Boston Consulting Group (BCG) growth-share matrix**, shown in Exhibit 8.12.[70] This matrix locates the firm's individual SBUs in two dimensions: relative market share (horizontal axis) and speed of market growth (vertical axis). The firm plots its SBUs into one of four categories in the matrix: dog, cash cow, star, and question mark.

Boston Consulting Group (BCG) growth-share matrix A corporate planning tool in which the corporation is viewed as a portfolio of business units, which are represented graphically along relative market share (horizontal axis) and speed of market growth (vertical axis). SBUs are plotted into four categories (dog, cash cow, star, and question mark), each of which warrants a different investment strategy.

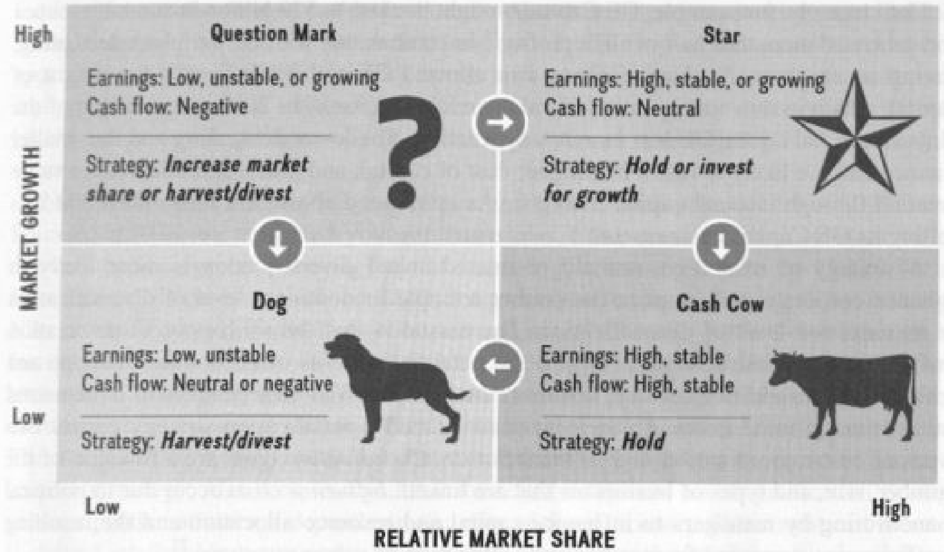


EXHIBIT 8.12 /

Restructuring the Corporate Portfolio: The Boston Consulting Group Growth-Share Matrix

Each category warrants a different investment strategy. All four categories shape the firm's corporate strategy.

SBUs identified as *dogs* are relatively easy to identify: They are the underperforming businesses. Dogs hold a small market share in a low-growth market; they have low and unstable earnings, combined with neutral or negative cash flows. The strategic recommendations are either to *divest* the business or to *harvest* it. This implies stopping investment in the business and squeezing out as much cash flow as possible before shutting it or selling it.

Cash cows, in contrast, are SBUs that compete in a low-growth market but hold considerable market share. Their earnings and cash flows are high and stable. The strategic recommendation is to invest enough into cash cows to hold their current position and to avoid having them turn into dogs (as indicated by the arrow).

A corporation's *star* SBUs hold a high market share in a fast-growing market. Their earnings are high and either stable or growing. The recommendation for the corporate strategist is to invest sufficient resources to hold the star's position or even increase investments for future growth. As indicated by the arrow, stars may turn into cash cows as the market in which the SBU is situated slows after reaching the maturity stage of the industry life cycle.

Finally, some SBUs are *question marks:* It is not clear whether they will turn into dogs or stars (as indicated by the arrows in Exhibit 8.12). Their earnings are low and unstable, but they might be growing. The cash flow, however, is negative. Ideally, corporate executives want to invest in question marks to increase their relative market share so they turn into stars. If market conditions change, however, or the overall market growth slows, then a question-mark SBU is likely to turn into a dog. In this case, executives would want to harvest the cash flow or divest the SBU.

INTERNAL CAPITAL MARKETS. *Internal capital markets* can be a source of value creation in a diversification strategy if the conglomerate's headquarters does a more efficient job of allocating capital through its budgeting process than what could be achieved in external capital markets. Based on private information, corporate managers are in a position to discover which of their strategic business units will provide the highest return on invested capital. In addition, internal capital markets may allow the company to access capital at a lower cost.

Until recently, for example, GE Capital brought in close to $70 billion in annual revenues and generated more than half of GE's profits.[71] In combination with GE's triple-A debt rating, having access to such a large finance arm allowed GE to benefit from a lower cost of capital, which in turn was a source of value creation in itself. In 2009, at the height of the global financial crises, GE lost its AAA debt rating. The lower debt rating and the smaller finance unit are likely to result in a higher cost of capital, and thus a potential loss in value creation through internal capital markets. (As mentioned above, GE announced that it is selling its GE Capital business unit.)

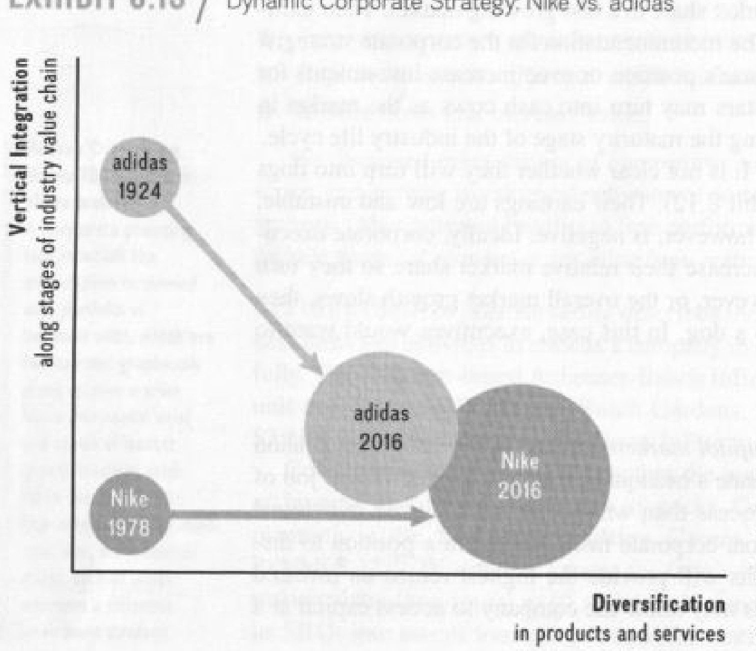
A strategy of related-constrained or related-linked diversification is more likely to enhance corporate performance than either a single or dominant level of diversification or an unrelated level of diversification. The reason is that the sources of value creation include not only restructuring, but also the potential benefits of economies of scope and scale. To create additional value, however, the benefits from these sources of incremental value creation must outweigh their costs. A related-diversification strategy entails two types of costs: coordination and influence costs. *Coordination costs* are a function of the number, size, and types of businesses that are linked. *Influence costs* occur due to political maneuvering by managers to influence capital and resource allocation and the resulting inefficiencies stemming from suboptimal allocation of scarce resources.[72]

8.5 Implications for the Strategist

An effective corporate strategy increases a firm's chances to gain and sustain a competitive advantage. By formulating corporate strategy, executives make important choices along three dimensions that determine the boundaries of the firm:

- **The degree of vertical integration**—in what stages of the industry value chain to participate.
- **The type of diversification**—what range of products and services to offer.
- **The geographic scope**—where to compete.

EXHIBIT 8.13 / Dynamic Corporate Strategy: Nike vs. adidas



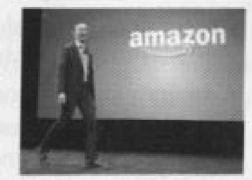
Since a firm's external environment never remains constant over time, *corporate strategy needs to be dynamic over time.* As firms grow, they tend to diversify and globalize to capture additional growth opportunities. Exhibit 8.13 shows the dynamic nature of corporate strategy through decisions made by two top competitors in the sports footwear and apparel industry: Nike and adidas.

Adidas was founded in 1924 in Germany. It began its life in the laundry room of a small apartment. Two brothers focused on one product: athletic shoes. Initially, adidas was a fairly integrated manufacturer of athletic shoes. The big breakthrough for the company came in 1954 when the underdog West Germany won the soccer World Cup in adidas cleats. As the world markets globalized and became more competitive in the decades after World War II, adidas not only vertically disintegrated to focus mainly on the design of athletic shoes but also diversified into sports apparel. Adidas' annual revenues are $20 billion. It is a diversified company active across the globe in sports shoes (40 percent of revenues), sports apparel (50 percent of revenues), and sports equipment (10 percent of revenues). The change in adidas' corporate strategy from a small, highly integrated single business to a disintegrated and diversified global company is shown in Exhibit 8.13.

Nike is the world's leader in sports shoes and apparel with annual sales of $30 billion. Founded in 1978, and thus much younger than adidas, Nike was vertically disintegrated from the very beginning. After moving beyond importing Japanese shoes to the United States, Nike focused almost exclusively on R&D, design, and marketing of running shoes. Although Nike diversified into different lines of business, it stayed true to its vertical disintegration by focusing on only a few activities (see Exhibit 8.13). Nike is a global company and its revenues come from sports shoes (50 percent) and apparel (25 percent), as well as sports equipment and other businesses, such as affiliate brands Cole Haan, Converse, Hurley, and Umbro. The changes in the strategic positions shown in Exhibit 8.13 highlight the dynamic nature of corporate strategy. Also, keep in mind that the relationship between diversification strategy and competitive advantage depends on the *type of diversification.* There exists an inverted U-shaped relationship between the level of diversification and performance improvements. On average, related diversification (either related-constrained or related-linked such as in the Nike and adidas example) is most likely to lead to superior performance because it taps into multiple sources of value creation (economies of scale and scope; financial economies). To achieve a net positive effect on firm performance, however, related diversification must overcome additional sources of costs such as coordination and influence costs.

In the next chapter, we discuss strategic alliances in more depth as well as mergers and acquisitions, both are critical tools in executing corporate strategy. In Chapter 10, we take a closer look at geographic diversification by studying how firms compete for competitive advantage around the world.

CHAPTERCASE 8 / Consider This...



AMAZON.COM CONTINUES TO diversify at a relentless pace. Besides offering same-day delivery of groceries in some metropolitan areas and testing drones for even faster distribution, Amazon now plans to capture a large piece of the over $10 billion college bookstore market. In a pilot project, Amazon initiated a student-centered program at three large universities: Purdue University, the University of California, Davis, and the University of Massachusetts Amherst. The goal of Amazon Campus is co-branded university-specific websites that offer textbooks, paraphernalia such as the ubiquitous logo sweaters and baseball hats, as well as ramen noodles!

As part of this new campus initiative, Amazon offers its Prime membership to students at a 50 percent discount ($49 a year) and guarantees unlimited next-day delivery of any goods ordered online, besides all the other Prime membership benefits (free streaming of media content, loaning one e-book a month for free, discounts on hardware, etc.). To accomplish next-day delivery, Amazon is building fashionable delivery centers on campus, university co-branded such as "amazon@purdue." Once a package arrives, students receive a text message and can then retrieve it via code-activated lockers or from Amazon employees directly. The on-campus delivery facilities also serve as student return centers.

Amazon's new campus initiative allows it to bind a younger generation of shoppers ever closer into its web of products, services, and content. Next-day delivery makes students less likely to shop at traditional campus bookstores. Amazon also has a history of selling textbooks at a discount in comparison to old-line campus bookstores. All course materials automatically qualify for next-day delivery and do not require a Prime membership. The Amazon Campus initiative is predicted to save students $200 to $400 a year on textbooks and other supplies.

Questions

1. Amazon.com continues to spend billions on seemingly unrelated diversification efforts. Do you believe these efforts contribute to Amazon gaining and sustaining a competitive advantage? Why or why not?
2. Amazon.com is now over 20 years old and makes some $100 billion in annual revenues. As an investor, would it concern you that Amazon.com has yet to deliver any profits? Why or why not? How much longer do you think investors will be patient with Jeff Bezos as he continues to pursue billion-dollar diversification initiatives?
3. One of the most profitable business endeavors that Amazon pursues is its cloud service offering, AWS. In 2014, AWS revenues were an estimated $6 billion, but bringing in $1 billion in profits. What is Amazon's core business? Is AWS related to Amazon's core business? Why or why not? Some investors are pressuring Jeff Bezos to spin out AWS as a standalone company. Do you agree with this corporate strategy recommendation? Why or why not? Hint: Do you believe AWS would be more valuable within Amazon or as a standalone company?

TAKE-AWAY CONCEPTS

This chapter defined corporate strategy and then looked at two fundamental corporate strategy topics—vertical integration and diversification—as summarized by the following learning objectives and related take-away concepts.

LO 8-1 / Define corporate strategy and describe the three dimensions along which it is assessed.

- Corporate strategy addresses "where to compete." Business strategy addresses "how to compete."
- Corporate strategy concerns the boundaries of the firm along three dimensions: (1) industry value chain, (2) products and services, and (3) geography (regional, national, or global markets).
- To gain and sustain competitive advantage, any corporate strategy must support and strengthen a firm's strategic position, regardless of whether it is a differentiation, cost-leadership, or blue ocean strategy.

LO 8-2 / Explain why firms need to grow, and evaluate different growth motives.

- Firm growth is motivated by the following: increasing profits, lowering costs, increasing market power, reducing risk, and managerial motives.
- Not all growth motives are equally valuable.
  - Increasing profits and lowering expenses are clearly related to enhancing a firm's competitive advantage.
  - Increasing market power can also contribute to a greater competitive advantage, but can also result in legal repercussions such as antitrust lawsuits.
- Growing to reduce risk has fallen out of favor with investors, who argue that they are in a better position to diversify their stock portfolio in comparison to a corporation with a number of unrelated strategic business units.
  - Managerial motives such as increasing company perks and job security are not legitimate reasons a firm needs to grow.

LO 8-3 / Describe and evaluate different options firms have to organize economic activity.

- Transaction cost economics help managers decide what activities to do in-house ("make") versus what services and products to obtain from the external market ("buy").
- When the costs to pursue an activity in-house are less than the costs of transacting in the market ($C_{in\text{-}house} < C_{market}$), then the firm should vertically integrate.
- Principal–agent problems and information asymmetries can lead to market failures, and thus situations where internalizing the activity is preferred.
- A principal–agent problem arises when an agent, performing activities on behalf of a principal, pursues his or her own interests.
- Information asymmetries arise when one party is more informed than another because of the possession of private information.
- Moving from less integrated to more fully integrated forms of transacting, alternatives include short-term contracts, strategic alliances (including long-term contracts, equity alliances, and joint ventures), and parent–subsidiary relationships.

LO 8-4 / Describe the two types of vertical integration along the industry value chain: backward and forward vertical integration.

- Vertical integration denotes a firm's addition of value—what percentage of a firm's sales is generated by the firm within its boundaries.
- Industry value chains (vertical value chains) depict the transformation of raw materials into finished goods and services. Each stage typically represents a distinct industry in which a number of different firms compete.
- Backward vertical integration involves moving ownership of activities upstream nearer to the originating (inputs) point of the industry value chain.
- Forward vertical integration involves moving ownership of activities closer to the end (customer) point of the value chain.

LO 8-5 / Identify and evaluate benefits and risks of vertical integration.

- Benefits of vertical integration include securing critical supplies and distribution channels, lowering costs, improving quality, facilitating scheduling and planning, and facilitating investments in specialized assets.
- Risks of vertical integration include increasing costs, reducing quality, reducing flexibility, and increasing the potential for legal repercussions.

LO 8-6 / Describe and examine alternatives to vertical integration.

- Taper integration is a strategy in which a firm is backwardly integrated but also relies on outside-market firms for some of its supplies, and/or is forwardly integrated but also relies on outside-market firms for some if its distribution.
- Strategic outsourcing involves moving one or more value chain activities outside the firm's boundaries to other firms in the industry value chain. Offshoring is the outsourcing of activities outside the home country.

LO 8-7 / Describe and evaluate different types of corporate diversification.

- A single-business firm derives 95 percent or more of its revenues from one business.
- A dominant-business firm derives between 70 and 95 percent of its revenues from a single business, but pursues at least one other business activity.
- A firm follows a related diversification strategy when it derives less than 70 percent of its revenues from a single business activity, but obtains revenues from other lines of business that are linked to the primary business activity. Choices within a related diversification strategy can be related-constrained or related-linked.
- A firm follows an unrelated diversification strategy when less than 70 percent of its revenues come from a single business, and there are few, if any, linkages among its businesses.

LO 8-8 / Apply the core competence–market matrix to derive different diversification strategies.

- When applying an existing/new dimension to core competencies and markets, four quadrants emerge, as depicted in Exhibit 8.9.
- The lower-left quadrant combines existing core competencies with existing markets. Here, managers need to come up with ideas of how to leverage existing core competencies to improve their current market position.
- The lower-right quadrant combines existing core competencies with new market opportunities.