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# To Diversify or Not To Diversify

by Constantinos C. Markides



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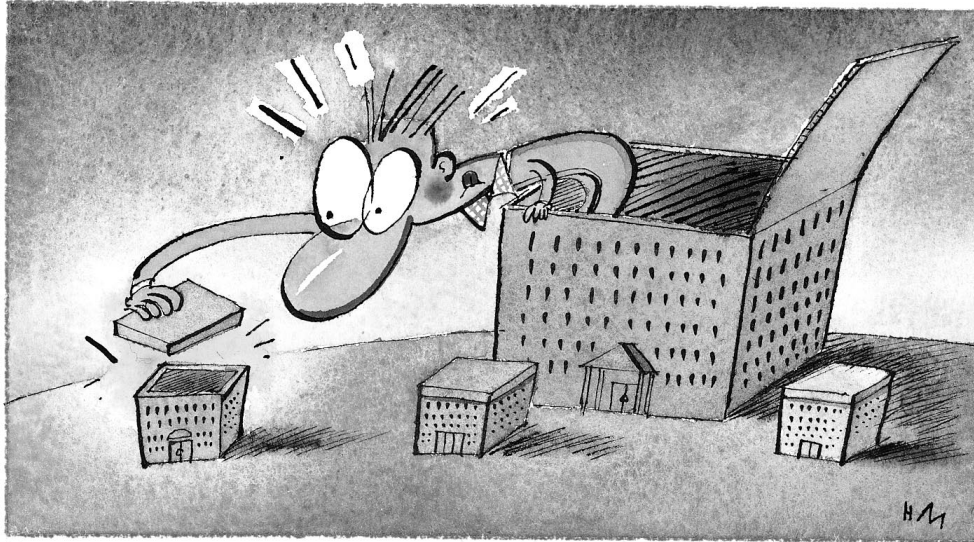
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*By answering six questions, managers can reduce the gamble in this high-stakes game.*

# TO DIVERSIFY OR NOT TO DIVERSIFY



BY CONSTANTINOS C. MARKIDES

ONE OF THE MOST CHALLENGING DECISIONS A COMPANY can confront is whether to diversify: the rewards and risks can be extraordinary. Success stories abound—think of General Electric, Disney, and 3M—but so do stories of such infamous and costly failures as Quaker Oats' entry into (and exit from) the fruit juice business with Snapple, and RCA's forays into computers, carpets, and rental cars.

What makes diversification such an unpredictable, high-stakes game? First, companies usually face the decision in an atmosphere not conducive to thoughtful deliberation. For example, an attractive company comes into play, and a competitor is interested in

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buying it. Or the board of directors strongly urges expanding into new markets. Suddenly, senior managers must synthesize mountains of data—including internal-rate-of-return calculations, market forecasts, and competitive assessments—under intense time pressure. To complicate matters, diversification as a corporate strategy goes in and out of vogue on a regular basis. In other words, there is

## Before diversifying, managers must think not about what their company does but about what it does better than its competitors.

little conventional wisdom to guide managers as they consider a move that could greatly increase shareholder value or seriously damage it.

But diversification doesn't need to be quite such a roll of the dice. Yes, it always will involve uncertainty; all major business decisions do. And indeed, there is a wealth of good advice about how to approach diversification.<sup>1</sup> But my research suggests that if managers consider the following six questions, they can push their thinking still further to reduce the gamble of diversification. Answering the questions will not lead to an easy go-no-go decision, but the exercise can help managers assess the likelihood of success.

The issues the questions raise, and the discussion they provoke, are meant to be coupled with the detailed financial analysis typical of the diversification decision-making process. Together, these tools can turn a complex and often pressured decision into a more structured and well-reasoned one.

Thus, when managers consider whether or not to diversify, they should ask themselves the following questions:

### **What can our company do better than any of its competitors in its current market?**

Just as it is important to take stock of the pantry before going shopping, so is it crucial for a company to identify its unique and unassailable competitive strengths before attempting to apply them elsewhere. The first step, then, is to determine the exact nature of those strengths—which I refer to in general terms as *strategic assets*.

How is such an assessment usually done? Incompletely, I'm afraid. The problem is that most companies confuse identifying strategic assets with

defining their business. A business is generally defined by using one of three frameworks: product, customer function, or core competencies.<sup>2</sup> Thus, depending on its approach, Sony could decide that it is in the business of electronics, entertainment, or "pocket-ability."

When facing the decision to diversify, however, managers need to think not about what their company *does* but about what it *does better* than its competitors. In one sense, pinpointing strategic assets is a market-driven approach to business definition. It forces an organization to identify how it might add value to an acquired company or in a new market—be it with excellent distribution, creative employees, or superior knowledge about information transfer. In other words, the de-

cision to diversify is made not on the basis of a broad or vague business definition, such as "We're in the entertainment business." Rather, it is made on the basis of a realistic identification of strategic assets: "Our excellent distribution capabilities could radically improve the performance of the acquired company."

Consider the case of Blue Circle Industries, a British company that is one of the world's leading cement producers. In the 1980s, Blue Circle decided to diversify on the basis of an unclear definition of its business. It was, the company's managers determined, in the business of making products related to home building. So Blue Circle expanded into real estate, bricks, waste management, gas stoves, bathtubs—even lawn mowers. According to one retired executive, "Our move into lawn mowers was based on the logic that you need a lawn mower for your garden—which, after all, is next to your house." Not surprisingly, few of Blue Circle's diversification forays proved successful.

Blue Circle's less focused, business-definition approach to diversification didn't answer the more relevant question: What are our company's strategic assets, and how and where can we make the best use of them?

One company that did ask that question—and reaped the rewards—is the United Kingdom's Boddington Group. In 1989, Boddington's then chairman, Denis Cassidy, assessed the company's competitive situation. At the time, Boddington was a vertically integrated beer producer that owned a brewery, wholesalers, and pubs throughout the country. But consolidation was changing the beer industry, making it hard for small players like Boddington to make a profit. The company had sur-

vived up to that point because its main strategic asset was in retailing and hospitality: it excelled at managing pubs. So Cassidy decided to diversify in that direction.

Quickly, the company sold off the brewery and acquired resort hotels, restaurants, nursing homes, and health clubs while keeping its large portfolio of pubs. "The decision to abandon brewing was a painful one, especially because the brewery has been a part of us for more than 200 years," Cassidy says. "But given the changes taking place in the business, we realized we could not play the brewing game with the big boys. We decided to build on our excellent skills in retailing, hospitality, and property management to start a new game." Boddington's diversification resulted in the creation of enormous shareholder value—especially when compared with the strategies adopted by regional brewers that decided to remain in the business. It also illustrates what happens when a company moves beyond a business-definition approach and instead launches a diversification effort based on its strategic assets.

#### **What strategic assets do we need in order to succeed in the new market?**

Once a company has identified its strategic assets, it can consider this second question. Although the question seems straightforward enough, my research suggests that many companies make a fatal error. They assume that having *some* of the necessary strategic assets is sufficient to move forward with diversification. In reality, a company usually must have *all* of them.

The diversification misadventures of a number of oil companies in the late 1970s highlight how dangerous it is to go up against a royal flush when all you have is a pair of jacks. Companies such as British Petroleum and Exxon broke into the mineral business believing they could exploit their competencies in exploration, extraction, and management of large-scale projects. Ten years later, the companies had dropped out of the game. The reason: in addition to the oil companies' capabilities, the mineral business required low-cost extraction capabilities and access to deposits, which the oil companies lacked.

Consider as well the experience of the Coca-Cola Company, long heralded for its intimate knowledge of consumers, its marketing and branding expertise, and its superior distribution capabilities. Based on those strategic assets, Coca-Cola decided in the early 1980s to acquire its way into the wine business, in which such strengths were imperative. The

company quickly learned, however, that it lacked a critical competence: knowledge of the wine business. Having 90% of what it took to succeed in the new industry was not enough for Coke, because the 10% it did not have—the ability to make quality wine—was the most critical component of success.

As in poker, the lesson for companies considering diversification is the same: you have to know when to hold them and when to fold them. If a company is holding only a pair of strategic assets in an industry in which most players have a better hand, there's no point in putting money on the table—unless, that is, the next question can be answered in the affirmative.

#### **Can we catch up to or leapfrog competitors at their own game?**

What if Coke had known in advance that it lacked an important strategic asset in the wine-making business? Should it have summarily abandoned its diversification plans?

Not necessarily. Companies considering diversification need to answer another pair of questions: If we are missing one or more critical factors for success in the new market, can we purchase them, develop them, or make them unnecessary by changing the competitive rules of the industry? Can we do that at a reasonable cost?

Consider the diversification history of Sharp Corporation. In the early 1950s, the company decided to leverage its existing strengths in the manufacturing and retailing of radios by moving first into televisions and then into microwave ovens. Sharp licensed the television technology from RCA and acquired the microwave oven technology by working with Litton, the U.S. innovator in that technol-

## To diversify, a company must have all the necessary strategic assets, not just some of them.

ogy. Similarly, Sharp diversified into the electronic calculator business in the 1960s by buying the necessary technology from Rockwell.

The Walt Disney Company has diversified following a similar strategy, expanding from its core animation business into theme parks, live entertainment, cruise lines, resorts, planned residential communities, TV broadcasting, and retailing by buying or developing the strategic assets it needed along the way. For example, Disney's cross-promo-

tional relationships with McDonald's and Mattel gave it an edge in retailing, and its close working relationship with the Florida state government gave the company the expertise it needed in the theme park business.

We can return to Sharp to illustrate how companies lacking crucial strategic assets can build them in-house. In 1969, Sharp invested \$21 million – about one-quarter of the company's equity at the time – to build a large-scale-integrated-circuit factory and a central R&D lab to facilitate entry into the semiconductor business. In the 1990s, it has made even bigger investments in order to bring the company up to speed in the liquid-crystal-display industry. Between 1990 and 1992 alone, Sharp invested \$540 million in liquid-crystal-display factories and earmarked an additional \$550 million for future investments.

A final option for companies lacking the right strategic assets to play in a new market is to rewrite that market's rules of competition, thereby making the missing assets obsolete. One case in point is Canon, which wanted to diversify from its core business of cameras into photocopiers in the early 1960s. Canon boasted strong competencies in photographic technology and dealer management. But it faced formidable competition from Xerox, which dominated the high-speed-copier market, targeting large businesses through its well-connected direct sales force. In addition, Xerox leased rather than sold its machines – a strategic choice that had worked well for the company in its earlier battles with IBM, Kodak, and 3M.

After studying the industry, Canon decided to play the game differently: The company targeted

tering the business. It was, however, a radically different business because of the way Canon had transformed it.

Not all companies have the skill, financial strength, and managerial foresight to pull off what Canon did. But, together with Sharp and Disney, Canon provides an excellent example for companies considering diversification without all the required strategic assets in hand. Those assets must be obtained one way or another; otherwise, moving forward into new markets is likely to backfire.

### **Will diversification break up strategic assets that need to be kept together?**

If managers have cleared the hurdles that the preceding questions raise, they then need to ask whether the strategic assets they intend to export are indeed transportable to the new industry. Too many companies mistakenly assume that they can break up clusters of competencies or skills that, in fact, work only because they are together, reinforcing one another in a particular competitive context. Such a misjudgment can doom a diversification move.

An academic exercise conducted several times with managers attending London Business School's executive education program illustrates precisely how easy it is to fall into the trap of breaking up strategic assets that are best left together.<sup>3</sup> The executives were asked to decide which new business McDonald's should enter: frozen foods, theme parks, or photo processing. Forty percent of the executives suggested that because the company's main competencies were finding good real-estate locations and offering family entertainment, it

should enter the theme park business. Thirty percent singled McDonald's out for its management of distribution outlets and its skill in making products of consistent quality, and suggested that the photo-processing business would be an appropriate diversification move. The remaining 30% pointed to competencies in distribution, food retailing, and relationships with suppliers,

and concluded that the frozen-food business made the most sense.

Interestingly, few executives voiced concern about the risks of unbundling competencies and applying them in different combinations in new markets. Yet in reality, the success of McDonald's in the fast-food business can be attributed to the synergy that exists between those competencies – which support and reinforce one another – and to

## **Managers need to ask whether their strategic assets are transportable to the industry they have targeted.**

small and midsize businesses, as well as the consumer market. Then it sold its machines outright through a network of dealers rather than through a direct sales force, and it further differentiated its products from those of Xerox by focusing on quality and price rather than speed. As a result, whereas IBM and Kodak failed to make any significant inroads into photocopiers, Canon emerged as the market leader (in unit sales) within 20 years of en-



## The Critical Questions for Diversification Success

Most managers tackle the decision to diversify by using financial analysis. That's necessary but not sufficient. The six questions explored in this article are designed to help managers identify the strategic risks – and opportunities – that diversification presents.

### **What can our company do better than any of its competitors in its current market?**

Managers often diversify on the basis of vague definitions of their business rather than on a systematic analysis of what sets their company apart from its competitors. By determining what they can do better than their existing competitors, companies will have a better chance of succeeding in new markets.

### **What strategic assets do we need in order to succeed in the new market?**

Excelling in one market does not guarantee success in a new and related one. Managers considering diversification must ask whether their company has every strategic asset necessary to establish a competitive advantage in the territory it hopes to conquer.

### **Can we catch up to or leapfrog competitors at their own game?**

All is not necessarily lost if managers find that they lack a critical strategic asset. There is always the po-

tential to buy what is missing, develop it in-house, or render it unnecessary by changing the competitive rules of the game.

### **Will diversification break up strategic assets that need to be kept together?**

Many companies introduce their time-tested strategic assets in a new market and still fail. That is because they have separated strategic assets that rely on one another for their effectiveness and hence are not able to function alone.

### **Will we be simply a player in the new market or will we emerge a winner?**

Diversifying companies are often quickly outmaneuvered by their new competitors. Why? In many cases, they have failed to consider whether their strategic assets can be easily imitated, purchased on the open market, or replaced.

### **What can our company learn by diversifying, and are we sufficiently organized to learn it?**

Savvy companies know how to make diversification a learning experience. They see how new businesses can help improve existing ones, act as stepping-stones to industries previously out of reach, or improve organizational efficiency.

the fit between the collection of those competencies and the competitive demands of the fast-food market. Indeed, I find it useful to think of inter-related competencies as organisms living in a symbiotic relationship within a particular environment. You cannot separate them and move them elsewhere and expect them to flourish as usual, just as you cannot take the engine out of an airplane and expect it to fly.

To put it in more practical terms, if a company plans to break apart, recombine, and relocate its strategic assets, it also must be prepared to create a hospitable new environment for them. Consider the story of Swatch, the popular mass-market watch made by the Société Suisse de Microélectronique et d'Horlogerie (SMH).

Until the 1980s, SMH was primarily in the business of selling expensive watches to wealthy individuals through jewelers and specialist distributors. Its primary strategic assets were patented knowledge of ultrathin, precision-movement technology, knowledge of process automation, and a

reputation for Swiss quality. That cluster, however, was inadequate for competing in the mass market, which required large-scale distribution, cutting-edge designs, and additional purchasing skills.

To overcome that problem, SMH acquired design skills from scratch by establishing the Swatch Design Lab in Milan, which employs artists, designers, and architects from all over the world. At the same time, it developed the required purchasing skills in-house. To gain better distribution, SMH entered into a joint venture with another company, Bhamco. Finally, it combined its new strategic assets with its existing competence in precision-movement technology.

By now, the whole world knows of Swatch's success as a product, but what happened before it hit the market is perhaps even more impressive. The company's managers knew which strategic assets were necessary, created or bought those that were missing, and then combined them with the existing strategic assets, creating a symbiotic, self-reinforcing organization. The company's move into

the mass-market watch business, then, stands as an unusual case of core competencies being recombined for success in a new market.

**Will we be simply a player in the new market or will we emerge a winner?**

Even if companies storm into new markets with all the required competencies—put together in the right combination—they still can fail to gain a foothold. Why? To achieve a sustainable advantage, diversifying companies need to create something unique. A company's competitive advantage will be short-lived, and diversification will fail, if competitors in the new industry can imitate the company's moves quickly and cheaply, purchase the necessary strategic assets in the open market, or find an effective substitute for them. In other words, there is no point rushing into a new market unless you have a way to beat the existing players at their own game.

Take the experience of Japanese consumer-goods giant Kao. Kao's chemical division had developed a technology that enabled the company to alter or smooth the surfaces of products such as clothes and magnetic tapes. In the late 1980s, Kao introduced the technology into its detergent division, where it quickly was a major success, allowing the company to create a new kind of laundry detergent. (The detergent, called Attack, was protected by 91 patents.) Within two years, Kao's market share in the laundry detergent business increased from 30% to 56%.

Hoping to build on that success, Kao then transferred the same technology to its floppy-disk division. The effort was not as successful. Simply put, the technology changed and improved the laundry detergent business, but it was old news in the floppy-disk business: competitors either had something similar to it already or had another technology that did the job. Kao had tried to enter a market with a strategic asset that didn't buy it a competitive advantage. The company could play in the floppy-disk industry, but it couldn't win.

How can managers assess whether their company's strategic assets have a strong likelihood of catapulting it to market leadership? A three-part acid test can help.

First, managers should ask if the strategic assets they intend to introduce into a new market are rare. For example, Laker Airways soared in the packaged-vacation business from 1966 to 1976 on the basis of its low-cost, low-price strategy. But in the mid-1970s, when Laker tried to diversify into the transatlantic scheduled-airline business,

it bumped into British Airways and the large U.S.-based airlines, and discovered that its low-cost competencies were not unique. British Airways, for example, used its reservations systems and skills in predicting the volume of passengers on flights to offer similar bargains. Laker went bankrupt in 1982.

Second, managers should ask, Can the strategic asset be imitated? 3M, for example, continues to di-

## Like good chess players, forward-thinking managers will think two or three moves ahead.

versify profitably on the strength of a competence that is very hard to copy: an organizational culture that fosters creativity, innovation, and entrepreneurship. Despite the numerous companies paying lip service to those ideals, very few can build and sustain success in the way 3M has.

Third, managers need to ask whether the strategic asset they plan to export can be substituted. Even if competitors can't copy a strategic asset, they may be able to create something similar enough that duplication doesn't matter. Dell Computer was able to substitute IBM's dealers and sales force by selling directly to the consumer. First Direct bank was able to substitute Barclay's extensive branch network in the British banking industry by reaching customers over the phone. In contrast, try as they might, Pepsi and other soft-drink makers cannot replicate or substitute Coca-Cola's strong brand name; hence the company's apparently unsailable competitive edge.

Of course, no company will intentionally diversify into an industry in which it will lose money. But managers considering a new market venture must decide how much money they want to make. For shareholders, being a contender is not enough. They seek winners, and winning is about unique and competitively meaningful strategic assets.

**What can our company learn by diversifying, and are we sufficiently organized to learn it?**

Forward-thinking managers not only will be concerned with success in new markets, but, like good chess players, also will be thinking two or three moves ahead. They will ask themselves a final question when considering a diversification move: What will we learn by entering a new business, and will it serve as a strategic stepping-stone to help us enter yet other businesses? Often, companies can



use what they have learned from one diversification move to enter a third market more quickly and cheaply. For example, by diversifying into the copier business, Canon learned how to build a marketing organization targeted to business customers and how to develop and manufacture a reliable electrostatic-printing engine. As a result, when Canon diversified into the laser printer business—which required the same competencies—it was able to move with speed and ease.

Managers also should examine whether a diversification move will allow them to learn competencies that can be reapplied in their existing businesses. For example, when Canon entered the laser printer business, it developed the capabilities required to support the design, manufacture, and service of sophisticated electronics. The company then took this knowledge and applied it to its photocopier business, vastly improving the electronic controls that allow its machines to count copies and sense paper jams.

Last, managers should ask themselves if their organization is doing all it can to transfer relevant information and competencies from one line of business to another. For such a flow to take place, companies need to have processes that facilitate and promote learning across different functions and divisions. An excellent example of this dynamic at work is Denmark's Lan & Spar Bank. CEO Peter Schou explains that the bank's key diversification moves—such as its recent entry into the direct-banking business—have been supported and fully harvested because 17 employee working groups from throughout the organization meet regularly to share new business ideas and information. In addition,

certain people in the company are continually transferred from one area to another to act as “integrators” and “messengers” of new information. By moving knowledge around inside the company in this way, Lan & Spar has taken full advantage of diversification. Indeed, even though the company ranks fortieth in Denmark in terms of the size of deposits, it has ranked number one in industry profitability in five of the last seven years.

The lessons that can be learned from a company's diversification moves can be significant, but, as we have seen, there are five other important questions for managers to ask before taking the leap into a new market. Those questions should help managers walk the fine line between being so inwardly focused that they miss excellent growth opportunities and so outwardly focused that they spend shareholders' capital on hopeless ventures.

Diversification will never be an easy game, and managers must study their cards carefully. It takes smart players to know when it's best to raise their bets and when it's best to fold.

1. See Michael E. Porter, “From Competitive Advantage to Corporate Strategy,” HBR May-June 1987; David J. Collis and Cynthia A. Montgomery, “Competing on Resources: Strategy in the 1990s,” HBR July-August 1995; and Andrew Campbell, Michael Goold, and Marcus Alexander, “Corporate Strategy: The Quest for Parenting Advantage,” HBR March-April 1995.

2. See Theodore Levitt, “Marketing Myopia,” HBR July-August 1960; C.K. Prahalad and Gary Hamel, “The Core Competence of the Corporation,” HBR May-June 1990.

3. The original experiment was conducted by David Aaker and Kevin Lane Keller, and their results are presented in “Consumer Evaluations of Brand Extensions,” *Journal of Marketing*, January 1990, p. 27. The results presented here are based on a series of experiments that I carried out with 120 executives attending the Accelerated Development Programme at London Business School between 1993 and 1996.

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