



# Book Diversification Strategy

## How to grow a business by diversifying successfully

Graham Kenny  
Kogan Page, 2009  
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## Recommendation

When a company fails, diversification is more likely to get the blame than concentration. Running multiple businesses is supposedly more dangerous than operating just one. But focus is overrated. With proper management, business diversity can deliver excellent investment returns. So says corporate strategy planner Graham Kenny whose book lists seven steps that “successful diversifiers” follow. Blending practical information with meaty, real-life examples, Kenny illustrates how notable conglomerates, such as General Electric, exercise the discipline that successful diversification demands. Although the book lacks some of the finer details you’d need to apply Kenny’s diversification program, *BooksInShort* recommends this clear volume to business managers who want a research-based framework for assessing diversification opportunities.

## Take-Aways

- Focused companies have been in vogue for decades, but firms that fail to diversify their business may leave their shareholders feeling poorer.
- General Electric, Bidvest, ITC and Wesfarmers are highly successful diversified firms. But Warren Buffett’s Berkshire Hathaway does not optimize its position as a diversifier.
- Effective diversified companies follow seven steps:
- First, they create a central headquarters to provide basic support for each division.
- Second, they choose division managers who are capable of leading.
- Third, successful diversified corporations use appropriate evaluation measures, such as return on equity, to assess their overall performance.
- Fourth, they offer compensation packages that give top executives incentives to balance short- and long-term business considerations.
- Fifth, they “align the corporate culture” among the mother company’s various divisions.
- Sixth, they “secure competitive advantage” by creating value for all their stakeholders, not just their shareholders.
- And seventh, they make smart acquisitions and seize new business opportunities.

## Summary

### Diversification Versus Concentration

Many business executives consider diversification risky. Concentrating on a core business has been a fashionable style of management for decades. It won many followers after the 1982 publication of *In Search of Excellence*, an influential, widely read book by Tom Peters and Robert Waterman, who urged companies to focus, to do only what they do best and to “stick to their knitting.” Investment analysts are more likely to cite excess diversification than excess concentration among the

reasons why companies fail. But, alternatively, branching out can breathe new life into a company, and avoiding diversification can have adverse consequences. Firms that fail to diversify their business are likely to leave their shareholders feeling poorer.

“Diversification is the variation between businesses within a company.”

However, succeeding in multiple lines of business can be difficult. The diversification process is fraught with change and challenge. Misguided diversification often stems from business acquisitions that are overpriced or poorly planned. And many diversified companies lack the managerial expertise to oversee two or more different businesses from one headquarters.

“The prevailing view is that focused firms are the norm...This simply isn’t true...Far from being freaks, diversified businesses are normal.”

Effective business diversification usually improves the financial performance of a company by leading to lower costs or to a higher-quality product or service. However, David Jones, a high-end Australian department store, did not achieve either result when it attempted to diversify into retail food stores in the mid-1990s. High-priced, high-quality merchandise distinguishes David Jones from other retailers. However, it tried to expand into the food trade without really understanding the business. David Jones exited its Foodchain business after numerous blunders, including poor store locations, inappropriate opening hours, ineffective product range and pricing errors.

## Diversification Done Right: Four Case Studies

Some companies clearly are better “diversifiers” than others. Four highly diverse conglomerates, General Electric, ITC Limited, Wesfarmers and Bidvest, are particularly worthy of emulation. They take a disciplined approach to diversification that discourages poorly conceived expansions into unfamiliar businesses. Research shows that these four multiline, multinational companies consistently earned annual returns on equity (ROE) of more than 14% for at least the 10 consecutive years prior to 2006. The best gauge of a company’s economic power is ROE, or annual net income divided by shareholders’ equity, because its formulation does not include volatile movements in share prices.

“Diversification has become the leper of management: something you certainly don’t touch.”

Bidvest, founded in South Africa in 1988, is the youngest of the four companies. It carved its path to growth and diversity through a series of acquisitions. By 2006, the firm held a mixed portfolio of business interests in freight logistics, commercial cleaning services, private security, financial services, auto sales and food wholesaling. Bidvest also diversified itself geographically by expanding into Australia, Europe and New Zealand.

“Managers and boards are frightened to stray from ‘core business,’ even though this concept proves illusive in practice.”

Incorporated in 1910, the Imperial Tobacco Company of India Limited never settled for serving only smokers. Now called ITC Limited, it has become a leading firm in India with far-reaching business interests, including hotel operations, retailing, information technology sales, paper-product manufacturing, agricultural production and packaged food distribution.

“There is no such thing as a perfect measure, [but] ROE is widely viewed as a sound metric for assessing overall corporate performance.”

In 1892, Thomas Edison’s General Electric Company merged with the Thomson-Houston Electric Company to create a combined entity, General Electric. GE went on to become an American corporate icon. A sprawling multinational conglomerate, GE sells products that range from jet engines, railroad equipment and medical imaging systems to refrigerators, freezers, washers and dryers. GE also sells financial services such as auto loans and private-label credit card accounts, and it distributes television programming through its ownership of NBC Universal.

“First-class corporate governance and proper dealings are important to all of them.”

A group of farmers formed Wesfarmers in 1914 as a cooperative venture that provided goods and services to residents of rural areas in the state of Western Australia. By 2006, Wesfarmers ranked among the 20 largest companies headquartered in Australia based on the market value of its stock. Wesfarmers became a five-division corporation with a wide spectrum of enterprises, from supermarkets to coal mining to the sale of chemicals, fertilizers, insurance and industrial safety products.

## Seven Steps to Successful Diversification

The success of these companies confirms the potential power of diversification. All four firms took similar actions to build their business portfolios and adhered to seven essential steps to manage the issues that diversification commonly entails. In fact, if the financial performance of any of these four companies worsens in the future, the reason probably will stem from failure to follow one or more of these seven steps:

1. **“Establish a supportive corporate center”** – Assemble a corporate headquarters staff that adds value to the company’s divisions but does not provide detailed operational direction. The home office should primarily supply basic support, including regulatory compliance, corporate governance, accounting and financial reporting. In addition to these functions, some central offices also handle corporate planning, human resources and investor relations.
2. **“Select capable division managers”** – Bidvest follows a policy of hiring division managers who perform as if they were “owner-managers” of their divisions. Michael Chaney, former chief executive officer of Wesfarmers, hired division managers who offered “emotional intelligence,” not just technical competence. Jack Welch, former CEO of GE, sought “integrity, intelligence and maturity” when he recruited division managers. Welch warned against hiring people who pretend to be more capable than they are.
3. **“Install appropriate performance measures”** – Diversified companies commonly use ROE and comparable gauges of financial performance to determine how their divisions are performing. For example, GE has used both ROE and “return on total capital,” or “profit before tax and interest divided by shareholders’ equity plus long-term borrowings,” to rate the operations of its divisions. “Return on capital employed” is one of the measures of success at Wesfarmers’ divisions. Bidvest uses a similar calculation called “return on funds employed.”
4. **“Set effective incentives”** – Compensation for top executives and division managers should include bonus payments that have the potential to exceed their annual salary. The way firms remunerate their managers ought to encourage them to balance short- and long-term business considerations. Paying long-term

incentives in stock, for example, can inspire sustainable business diversification and discourage thoughtless conglomeration.

5. **“Align the corporate culture”** – The corporate and division-level cultures of a diversified company should exalt common priorities regarding business expansion, divisional autonomy, corporate integrity, return on investment, and so on. Leaders of these companies must respect the cultural differences among their divisions while ensuring that the cultures of those divisions and the home office mesh well.
6. **“Secure competitive advantage”** – Successful diversified companies quell their competition by building strategies based on service to shareholders and other constituents. For example, both GE and Wesfarmers put their strategic focus on satisfying stakeholders, including their workers and customers, not just their shareholders. Setting operational strategies – such as capacity utilization, product branding and other internal business functions – at the corporate level is less effective and less likely to make a company more competitive.
7. **“Buy well and integrate”** – Bidvest, GE, ITC and Wesfarmers are “good shoppers” for acquisitions. They calculate their risks, avoid overpaying and address integration issues before they complete buyouts. These four companies diversify not to avoid risk but to seize business opportunities. Wesfarmers’ Chaney believes firms should reject narrow operational goals like “being the world’s biggest something.”

## Failed Diversification: The Case of Burns Philp

Prior to the 1970s, Australia-based Burns Philp focused primarily on South Pacific shipping and trading. By the early 1980s, Burns Philp had grown substantially more complex through diversification into additional businesses. In 1983, it reported 175 separate enterprises, ranging from travel agencies, hotels and retail hardware stores to cement distributors, mining ventures, film processors and distributors of drink-dispensing machines. A new CEO diagnosed excess diversification as a drag on profitability, so Burns Philp restructured between 1984 and 1996, selling some businesses, acquiring others and narrowing its line of products.

“Rapid growth by diversification is usually achieved through acquisition.”

The restructuring focused the company on three products: antibiotics, spices and yeast. Its yeast production process gave Burns Philp a technological advantage over its competitors, but the strategy of concentrating antibiotics and spices was unsuccessful. Burns Philp bought an Italian antibiotics company, and then unexpectedly paid an amount equal to nearly half the acquisition price to build a new antibiotics factory, replacing an existing plant because it posed an unforeseen environmental threat. Burns Philp had failed to conduct adequate due diligence before buying the Italian firm. In the US spice market, Burns Philp crumbled under pressure from competitors that increased the “slotting fees” they paid supermarket operators to gain the best positions on store shelves. Burns Philp acquired businesses in Canada, China, Germany, Ireland, Italy, New Zealand, Portugal and the US, among other countries. But its failure to plan for differences in foreign cultures, particularly in Italy and the US, led to administrative chaos at headquarters and contributed to its financial fragility. The company ultimately surrendered its own independence: Rank Group acquired Burns Philp in 2006.

## Diversification and Financial Structuring

The financial structure of a company can affect the benefits of diversification. For example, American billionaire and master diversifier Warren Buffett is CEO of US-based Berkshire Hathaway, which has interests in insurance, manufacturing, retailing and publishing, among many other industries. Originally an insurance business, Berkshire diversified by acquiring large equity stakes in other types of firms. This approach evolved from the insurance business, which involved collecting premiums and investing the money in stocks and bonds.

“You can’t dabble in diversification. Those who do get their fingers burnt.”

Despite other measurable successes, however, Berkshire Hathaway’s return on equity averaged 7.8% during the same 10-year period when returns on equity at Bidvest, GE, ITC and Wesfarmers averaged more than 14%. This is largely because Berkshire focuses on increasing net worth per share, not return on equity. Berkshire pays no dividends, a policy that increases retained earnings and cash. By holding large amounts of cash, Berkshire deepens its capacity to buy businesses without borrowing money, but depresses its return on equity.

## Diversified Companies, Focused Divisions

In 2003, a news periodical in India published an article calling ITC a “focused conglomerate,” thus acknowledging that ITC and other parent companies with multiple divisions are families of focused businesses. Specializing in one product or service is a proven way to gain advantages over unfocused competitors. But focus at the division level is rewarding only if the division’s strategic mission addresses all the major stakeholders. In this respect, diversified companies can learn from successful companies that dominate a single market niche. Quick-service restaurant chain McDonald’s, for example, is a powerful, focused company that has long addressed the needs of such stakeholders as its customers and suppliers.

“Successful diversified firms are masters at keeping it simple and at establishing systems and procedures that ensure it remains that way.”

The obvious importance of specialization has led some researchers to question the value of business diversification, but few question its popularity. Even a small real estate firm engaged in property sales and leasing has two distinct businesses. Indeed, diversified companies probably outnumber focused ones. So for many corporate leaders, the challenge is not whether to diversify but how to improve their management of different businesses under the same umbrella.

## About the Author

**Graham Kenny** is the managing director of Strategic Factors, an Australian firm specializing in strategic planning and performance measurement.

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