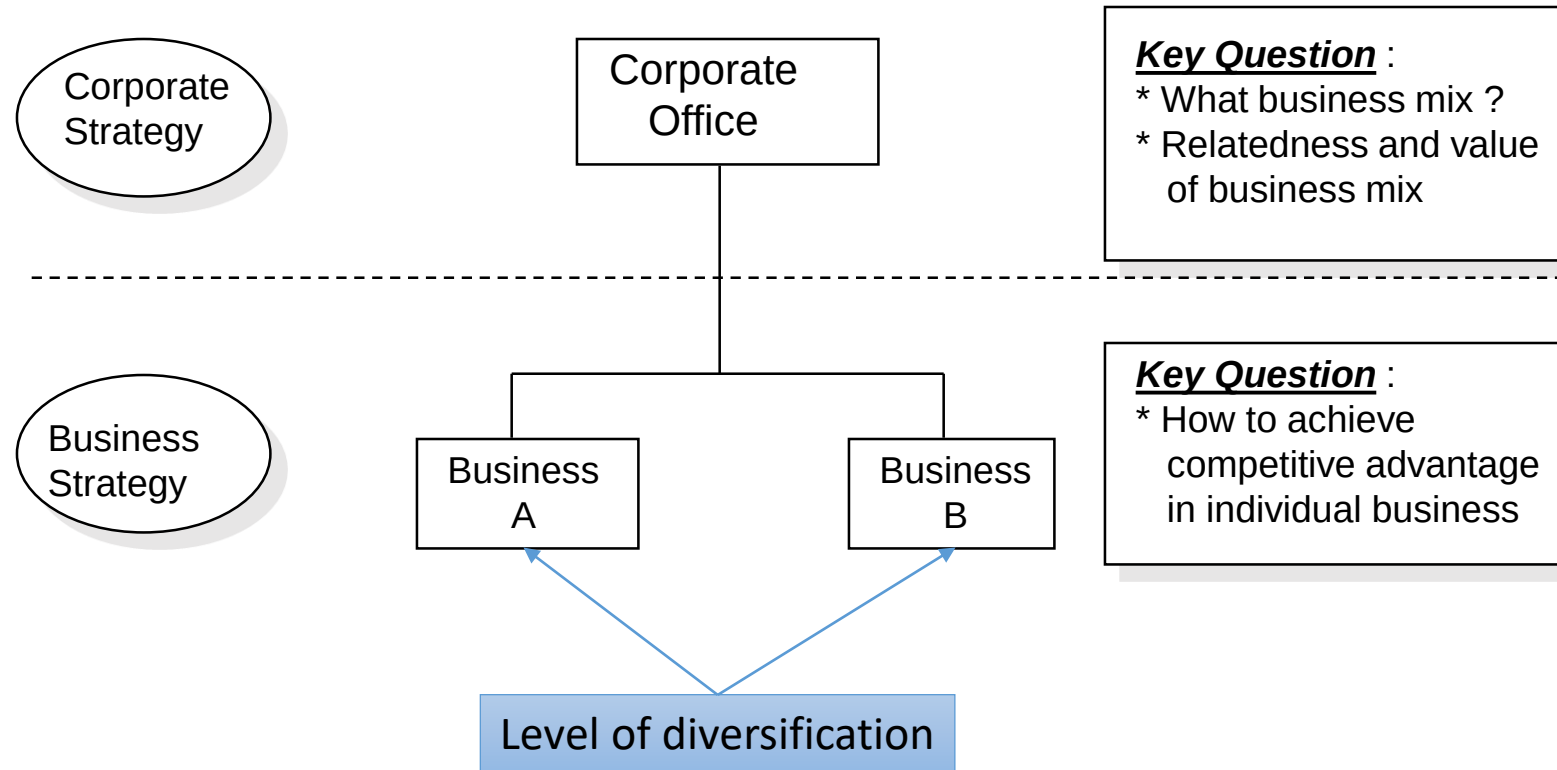


Agenda

- **Diversification**
- Alliance
- M&A

Levels of Strategy



Johnson & Johnson



Levels and types of diversification

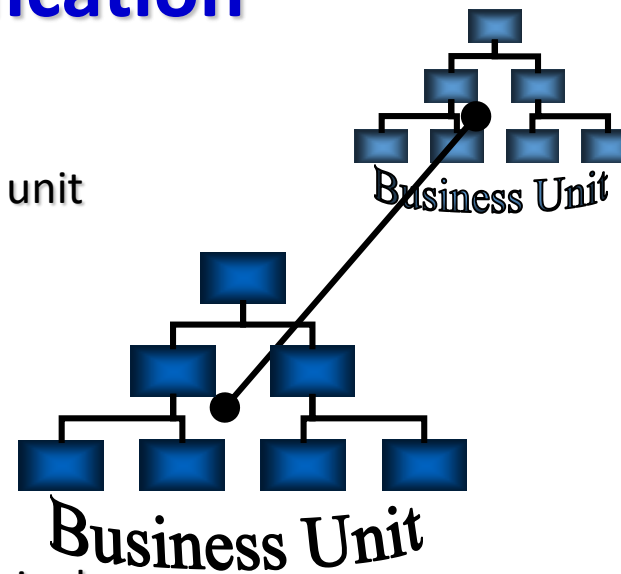
Low Levels of Diversification

Single Business

> 95% of business from a single business unit

Dominant Business

Between 70 and 95% of business from a single business unit

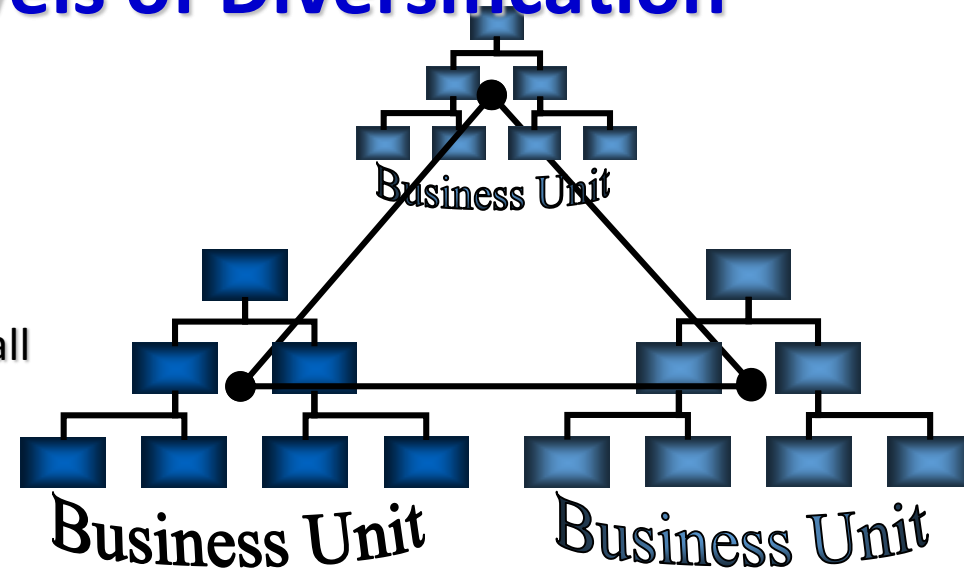


Levels and types of diversification

Moderate to High Levels of Diversification

Related Constrained

<70% of revenues from dominant business; all businesses share product, technological and distribution linkages

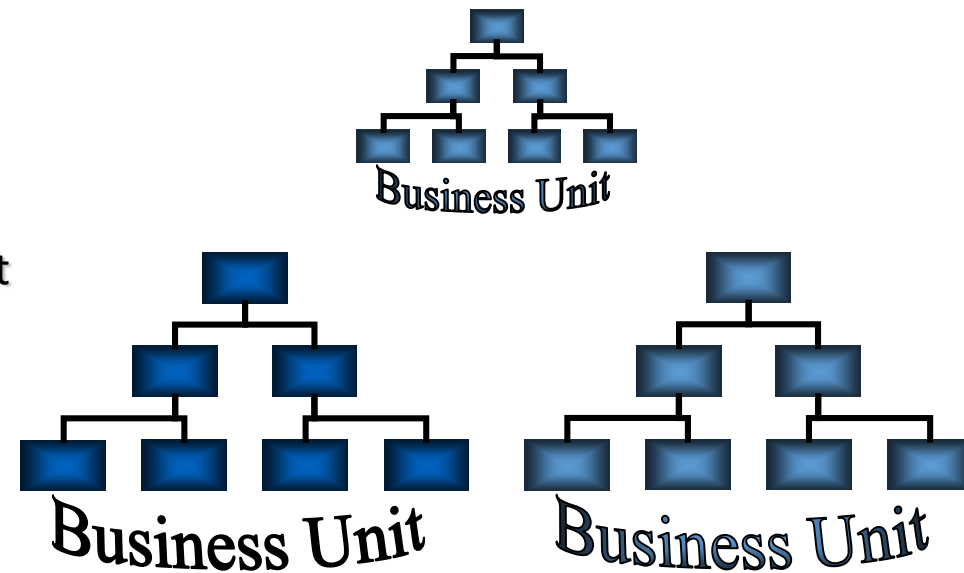


Levels and types of diversification

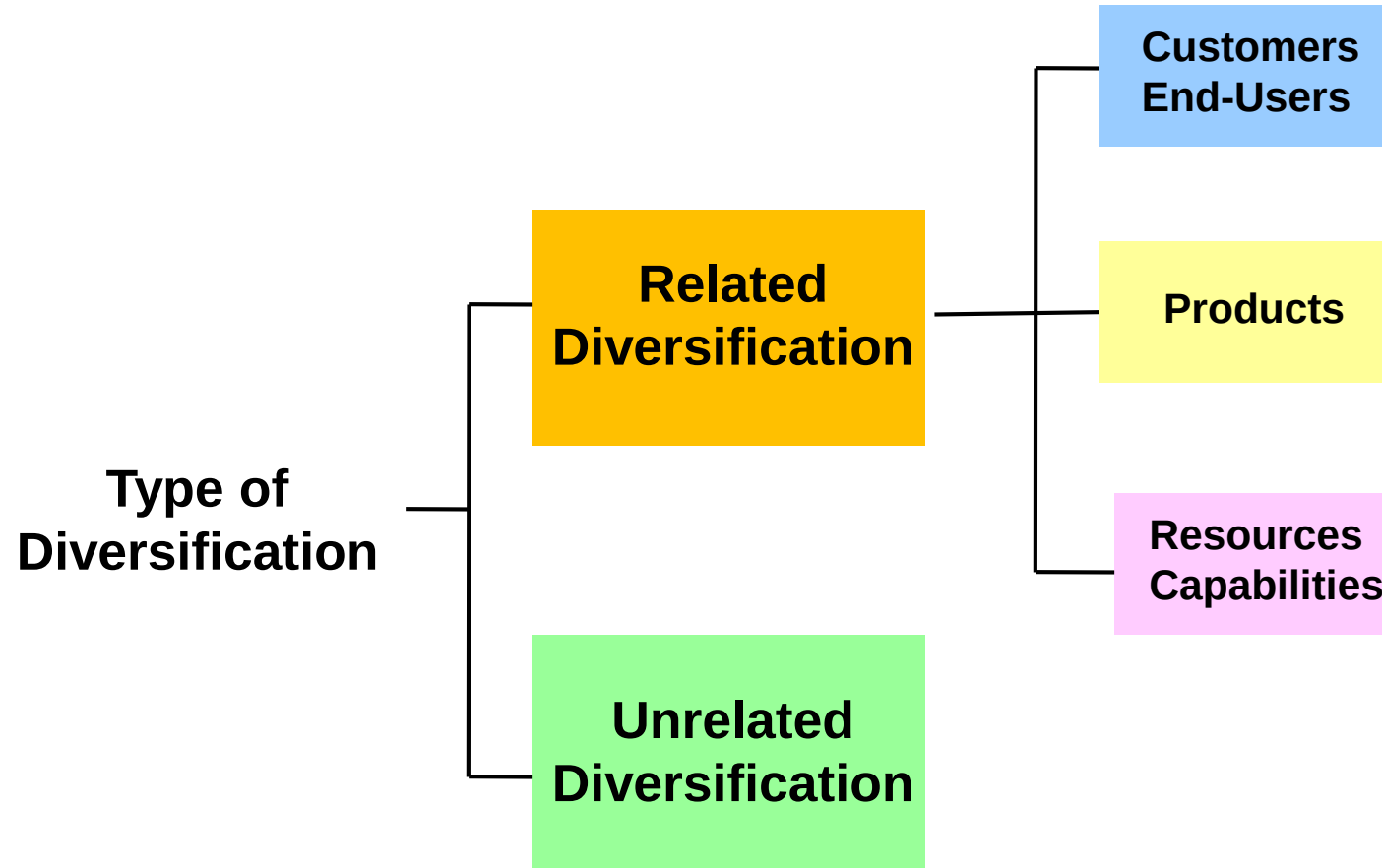
Very High Levels of Diversification

Unrelated

< 70% of revenue comes from the dominant business, and there are no common links between businesses



Types of Diversification



Types of Related Diversification

- Relatedness in terms of **end-users/customers**
 - Philip Morris' presence in beer and tobacco
- Relatedness in terms of **products**
 - Coca-Cola produces Coke and Sprite
- Relatedness in terms of **operating resources/skills**
 - Disney's presence in theme parks and cruise lines

What are the value enhancing economic rationales for related diversification?

Adding Value by Diversification

Related diversification most effectively adds value by either of two mechanisms:

- **1. Economies of scope:** cost savings attributed to transferring the capabilities and competencies developed in one business to a new business
- **2. Market power:** when a firm is able to manipulate the price of a product in the marketplace by manipulating the level of supply, demand or both.

Capture cross-business strategic fit

- **1. Leverage the use of a common brand name**
- **2. Sharing facilities or resources to reduce costs**
- **3. Transfer skills and capabilities**

1. A Common Brand

- Target common customers or draw upon common core competencies

For example:

Apple's reputation for being innovative and having stylish designs were competitive assets that facilitated the company's diversification into digital music players, smartphones, and tablet computers.

2. Sharing Activities

- Sharing activities can lower costs if it:
 - achieves economies of scope
 - boosts efficiency of utilization
 - helps move more rapidly down the learning curve
- Must involve activities that are crucial to competitive advantage
 - Think about activities in a company's value chain

2. Sharing Activities

Assumptions

- Strong sense of corporate identity
- Clear corporate mission that emphasizes the importance of integrating business units
- Incentive system that rewards more than just business unit performance

3. Transferring Core Competencies

- Exploits interrelationships among divisions
- Start with value chain analysis
 - identify ability to transfer skills or expertise among similar value chains
 - exploit ability to transfer activities

3. Transferring Core Competencies

Assumptions

- Activities involved in the businesses are similar enough that sharing expertise is meaningful
- Transfer of skills involves activities which are important to competitive advantage
- The skills transferred represent significant sources of competitive advantage for the receiving unit

Google



Technological
knowhow



Innovation
capabilities



What are the value enhancing economic rationales (motives) for unrelated diversification?

Adding Value by Diversification

Unrelated diversification most effectively adds value by either of two mechanisms:

- 1. Efficient internal capital market allocation

Efficient Internal Capital Market Allocation

- Firms pursuing this strategy frequently diversify by acquisition:
 - acquire sound, attractive companies
 - acquired units are autonomous
 - portfolio managers transfer resources from units that generate cash to those with high growth potential and substantial cash needs
 - add professional management & control to sub-units
 - sub-unit managers compensation based on unit results

Efficient Internal Capital Market Allocation

Assumptions

- Managers have more detailed knowledge of firm relative to outside investors
- Firm can reduce risk by allocating resources among diversified businesses

Adding Value by Diversification

Unrelated diversification most effectively adds value by either of two mechanisms:

- 2. Restructuring

Restructuring

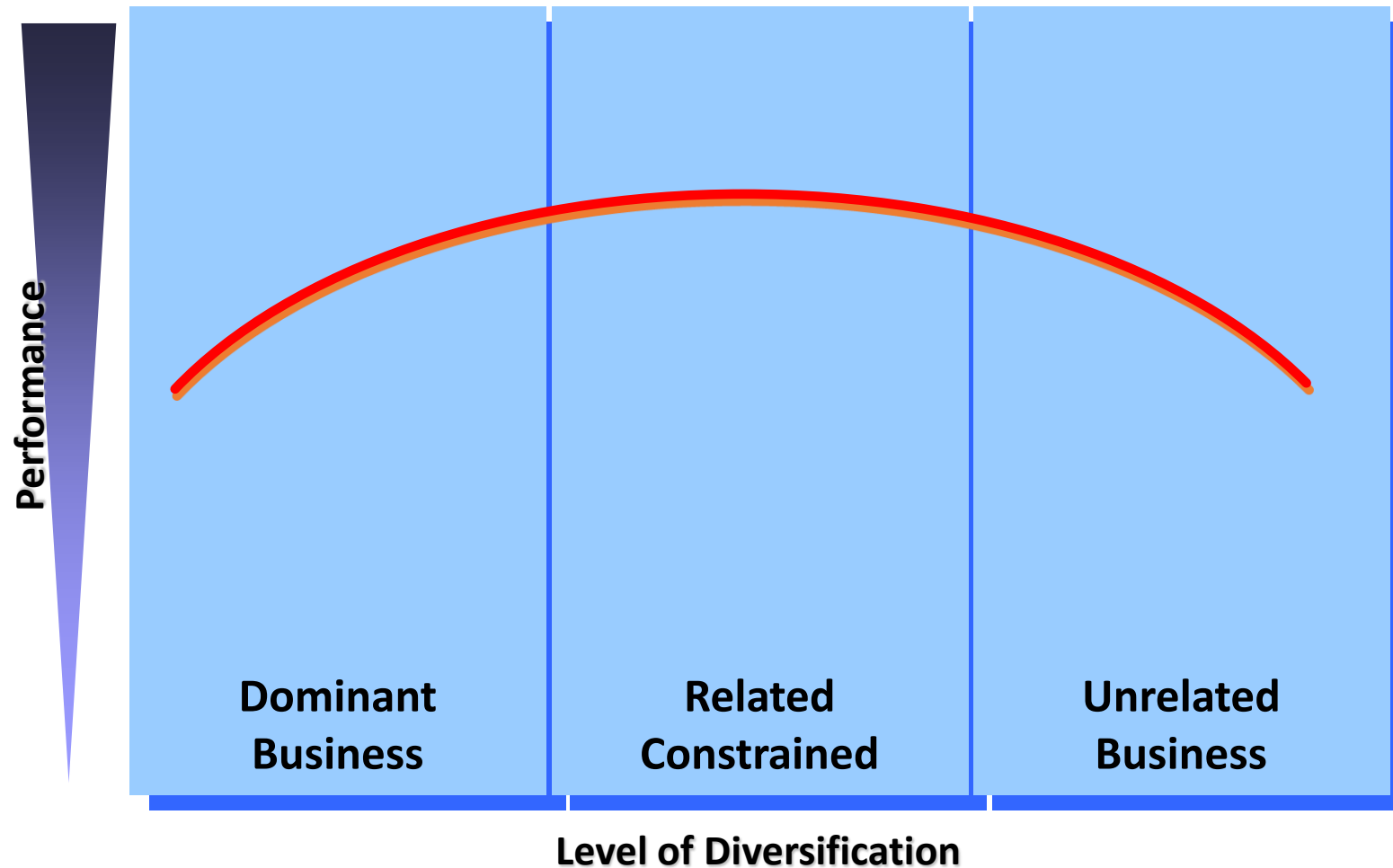
- Seek out undeveloped, sick or threatened organizations or industries
- Parent company (acquirer) intervenes and frequently:
 - changes sub-unit management team
 - shifts strategy
 - infuses firm with new technology
 - enhances discipline by changing control systems
 - divests part of firm
- Frequently sell unit after making one-time changes since parent no longer adds value to ongoing operations

Restructuring

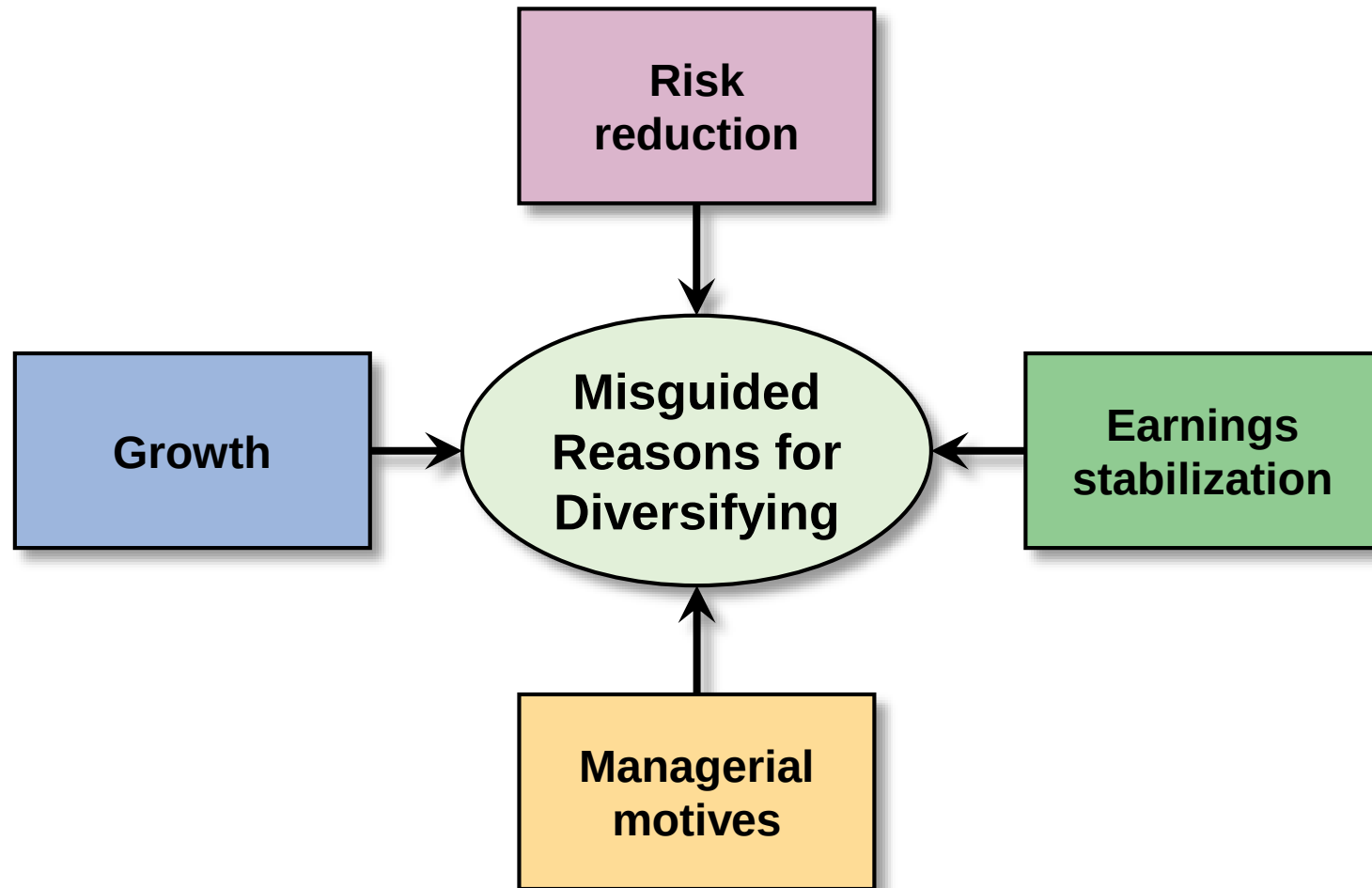
Assumptions

- Requires keen management insight in selecting firms with depressed values or unforeseen potential

Relationship (Not causality) Between Diversification and Performance



Misguided Reasons for Pursuing Unrelated Diversification



How to achieve the optimal level of diversification?

Increase diversification

- Start from scratch
- Mergers and acquisitions
- Strategic alliances

Reduce diversification

- Restructuring

Three Tests of Evaluating Diversification

- The industry attractiveness test
- The cost-of-entry test
- The better-off test

1. Attractiveness Test

- The industry the company is diversifying into has to offer opportunities that are equal to or better than the company's current businesses.

2. Better-off Test

- The new mix of businesses must perform better under the umbrella of the company than they would perform if operating separately
 - For example: company A diversifies by purchasing company B in another industry. If A and B's consolidated profits in the years to come prove no greater than what each would have earned on its own, then A's diversification won't provide its shareholders with added value.

3. Cost of Entry Test

- The cost of entry must not exceed the potential benefits of the diversification
 - The more attractive an industry's prospects are for growth and good long-term profitability, the more expensive it can be to enter
 - Take acquisition as an example:

price of target + payment to agencies + cost of integration < profits from operating the target's business

- Example: x-box analysis

Microsoft's Diversification into the Video Games/Console Business

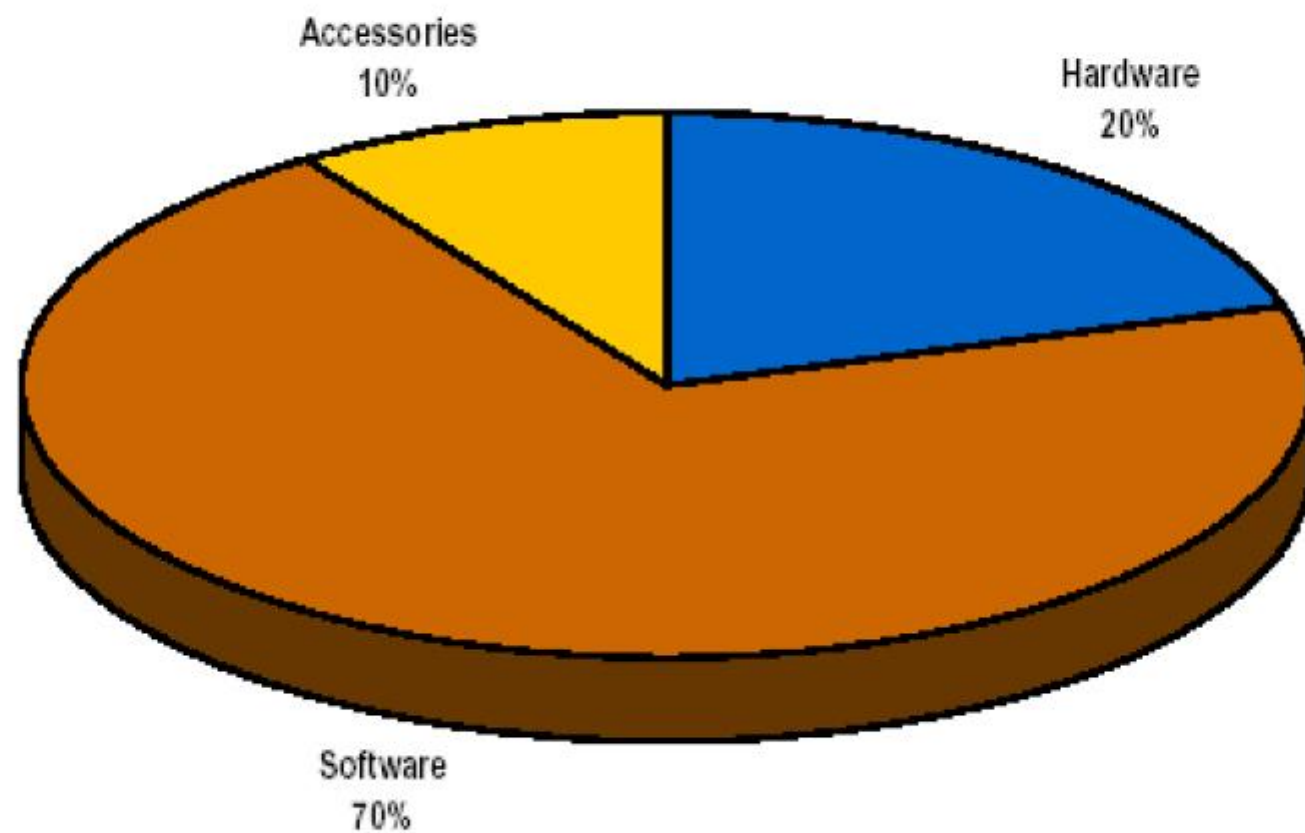
Is it a “**Good Move**”? OR

Is it a ‘**Not-so-good Move**’?

What segments does the home video game industry consist?

Exhibit 1 – Video Game Product Segments

U.S. Video Game Industry Percentage of 2000 Retail Sales



Source: NPD.

How do console makers generate profits?

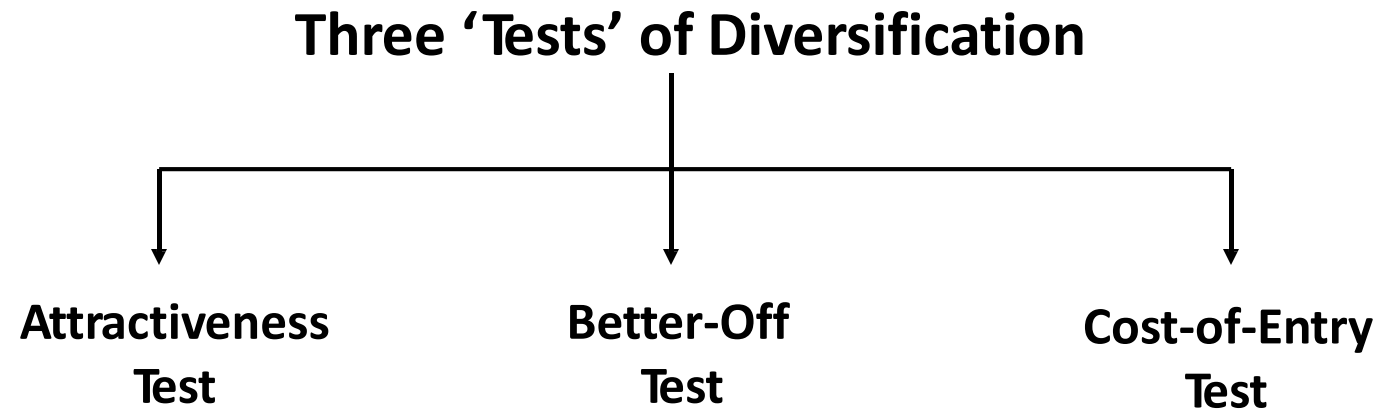
Console makers generate profits by:

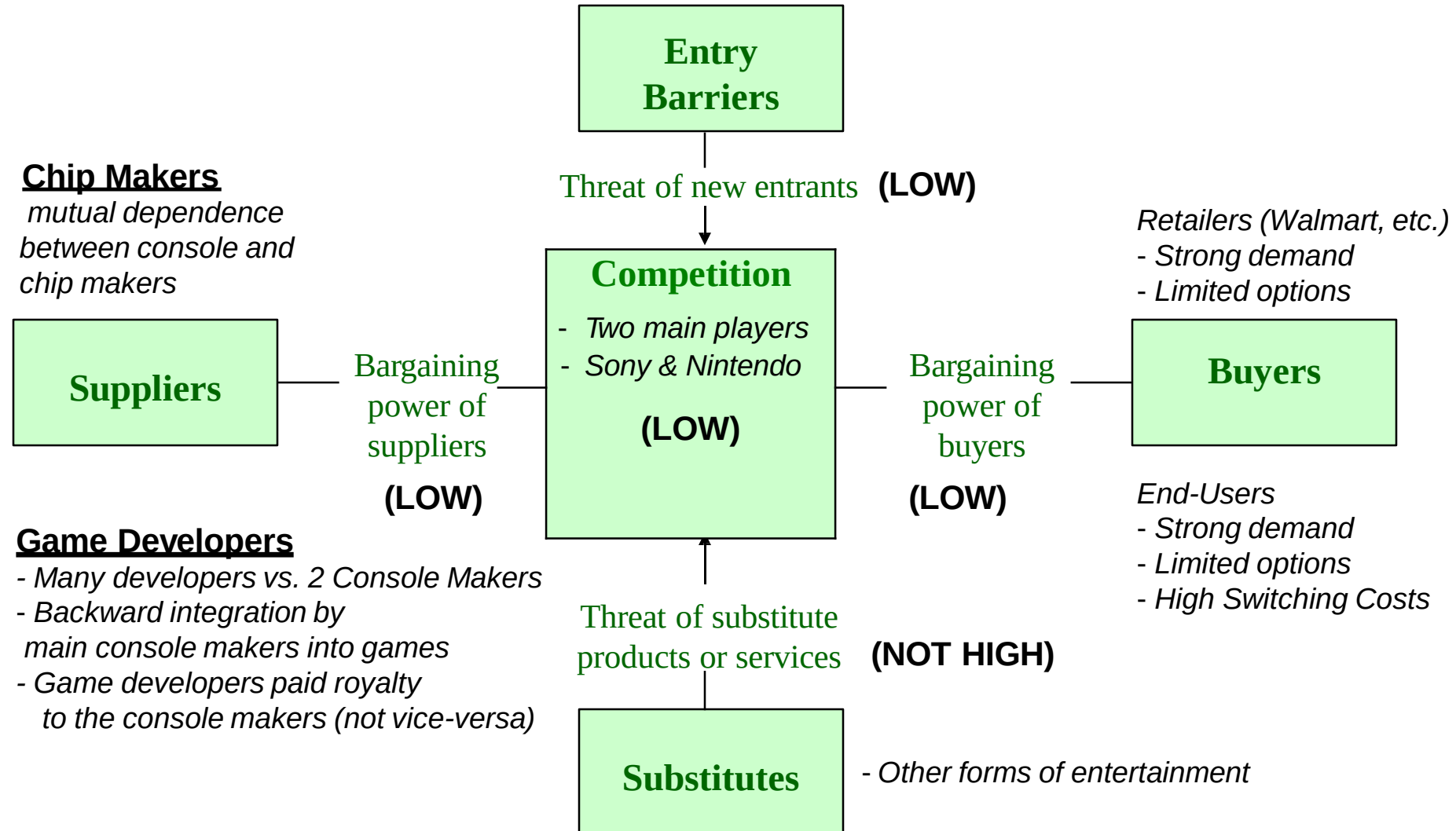
1. Producing game software directly
2. Receiving royalty payments from 3rd party software publishers (75%)
3. Selling accessories and peripherals for their systems (online community)

Fundamental question:

- Is it a good idea for Microsoft to enter the home video game industry?

Diversification Tests





The 'Better-Off' Test (The Synergy Test)

Will some assets/capabilities in the current business give us 'an advantage' over rivals in the new business?



Will presence in the new business now give us an additional advantage in the current business?



*Is there 'synergy' between the new and current business
In terms of 'revenue' and/or 'costs'?*



$1 + 1 > 2$ (Revenues)

$1 + 1 < 2$ (Costs)

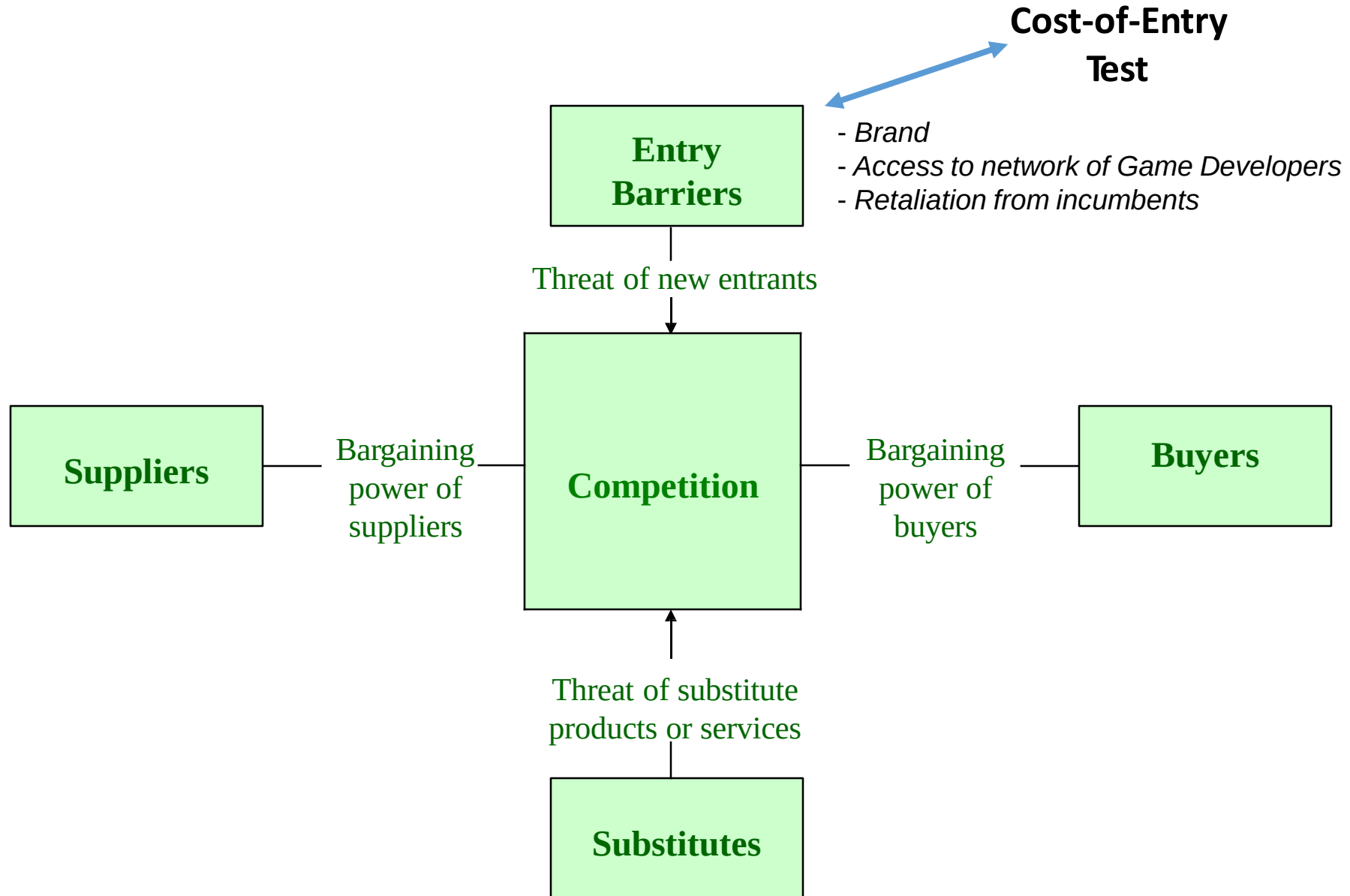
How is MS positioned to Perform?

Microsoft's Strengths

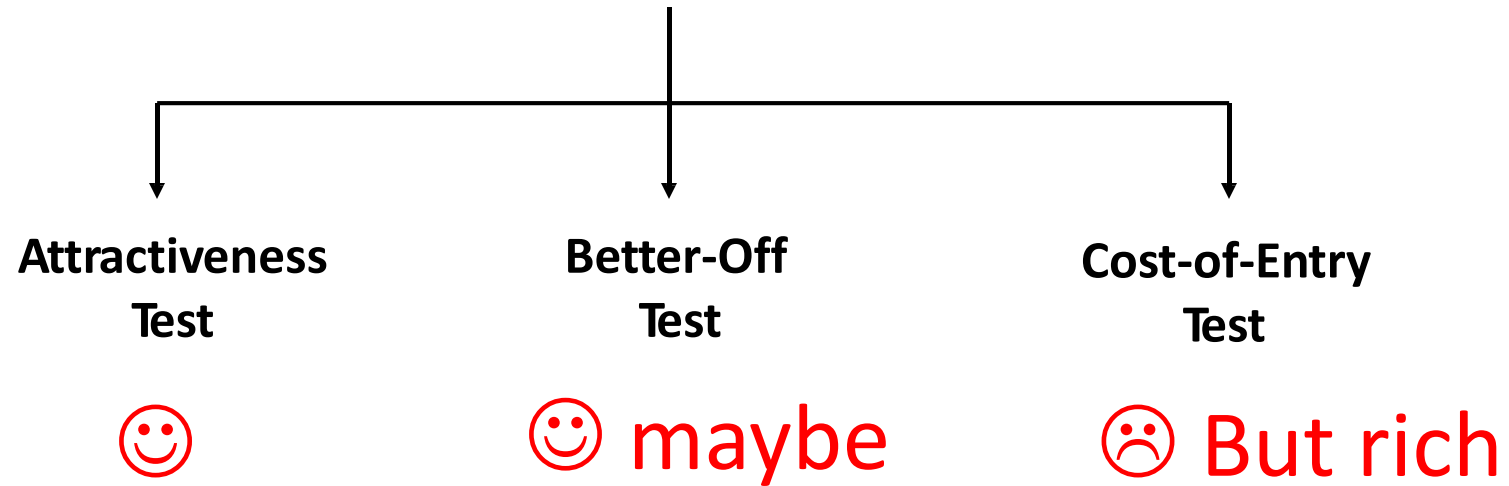
Competitive advantage
in console industry: Yes
or No? Why?

- Software
 - Windows OS → Advantage?
 - Internal S/W Capability → Advantage?
 - Network of Developers → Advantage?
- Brand → Advantage?
- Relationship with Intel → Advantage?
- Distribution Channels → Advantage?
- Ton of Cash (\$36 Billion) → Will Shareholders Support?

- Some of strength can translate into competitive advantage, while some cannot.



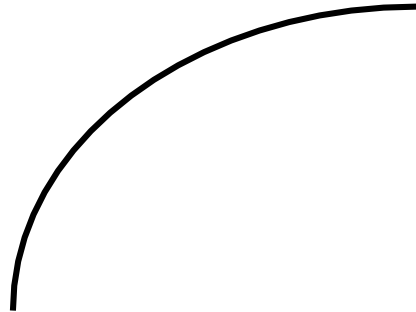
Three 'Tests' of Diversification



Why else did Microsoft get into Consoles?

Decline in PC business

MS would lose Revenues and Profits from Windows!!



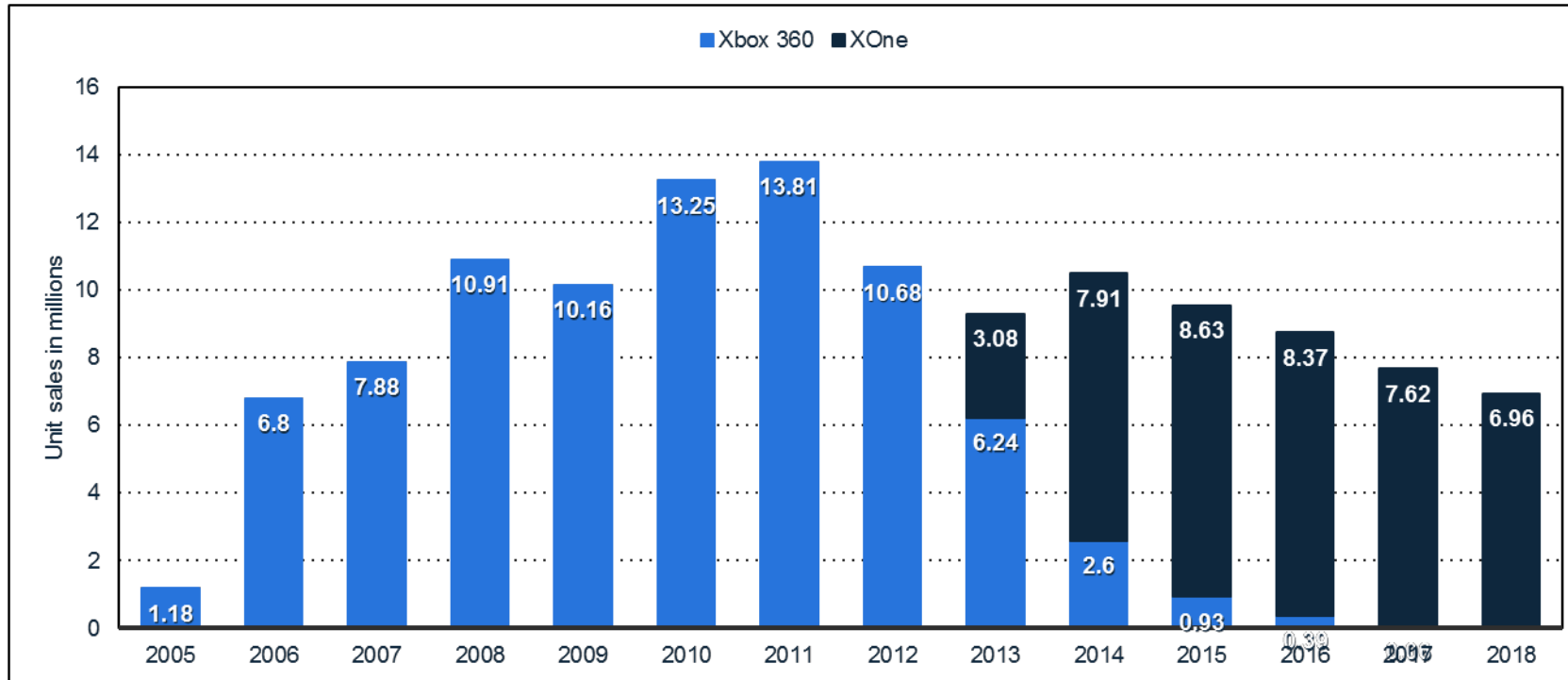
Growth in Alternate Devices

- Console (communication device of choice in future?)
- Could continue to be the PC
- But could it also be,
 - *TVs?*
 - *iPod like device?*
 - *Cell phones*
 - *Refrigerators?*

How did it play out?

- Competition between Sony and MS was fierce after MS' entry
 - *Industry profitability suffered immensely, hurting both MS and Sony*
 - *Buyers and some suppliers were the 'winners'*
- MS shareholders are very unhappy
 - *MS gave a special dividend of \$3/share (\$ 31 billion)*
- MS cumulative loss in video games consoles (device + online)
 - *\$19 billion for the period 2001-2015*

Xbox 360 and Xbox One unit sales worldwide from 2005 to 2018 (in millions)



Note: Worldwide; 2005 to 2018
Further information regarding this statistic can be found on [page 8](#).
Source(s): VGChartz; [ID 680526](#)

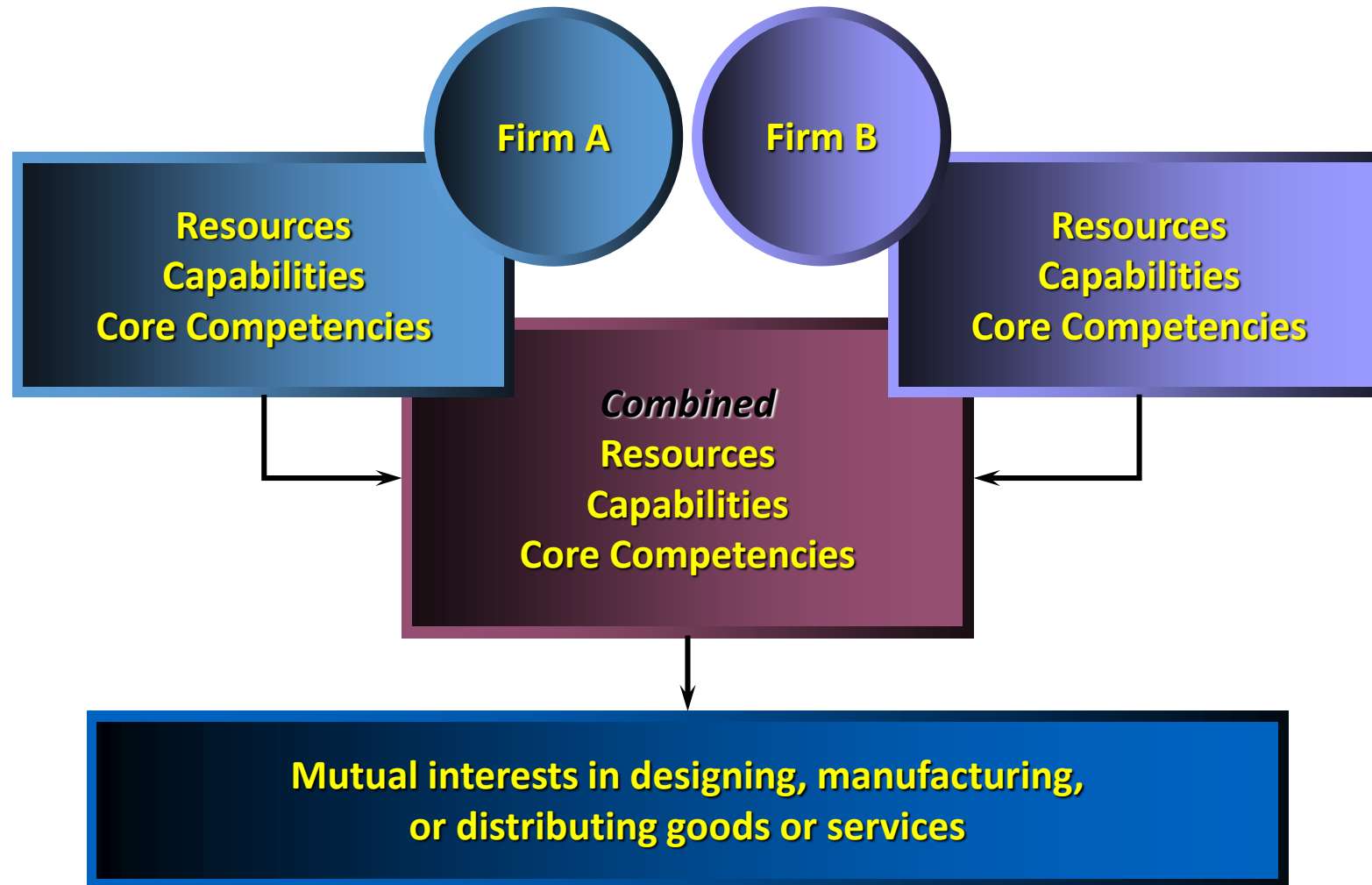
Implementing business strategy

- **Strategic alliances**
- Merger & acquisitions (M&A)

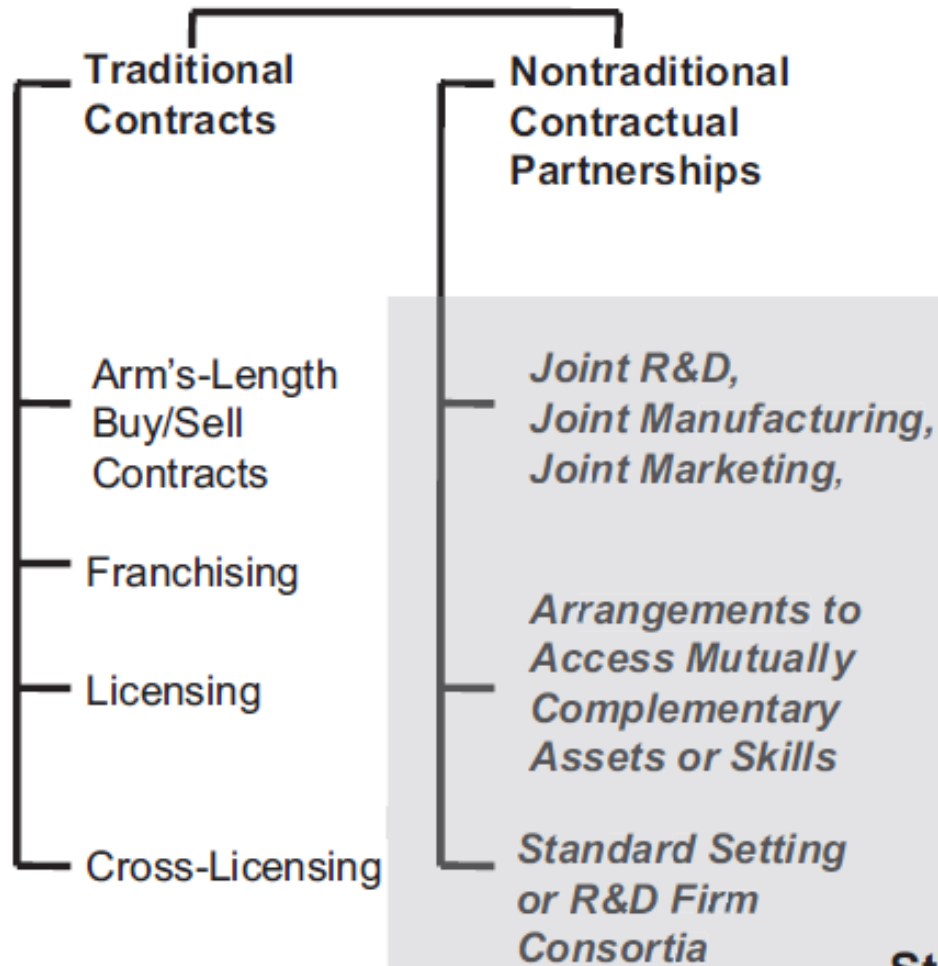
A **strategic alliance** is a formal agreement between two or more companies to work cooperatively toward some common objective.

A **joint venture** is a type of strategic alliance that involves the establishment of an independent corporate entity that is jointly owned and controlled by the two partners.

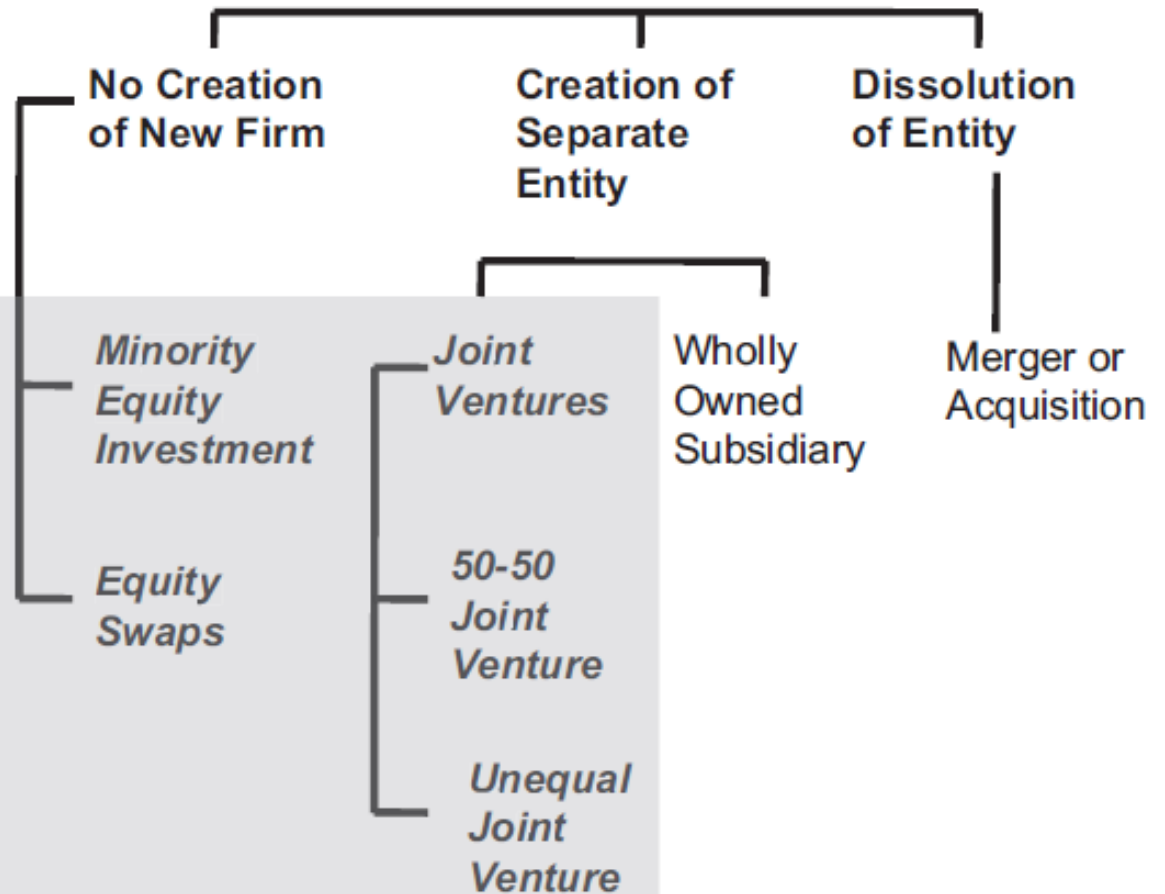
Strategic Alliance



Contractual Arrangements



Equity Arrangements



Strategic Alliances

*Adapted from
Yoshino and Rangan, 1995.*

Phases of alliance

1. Partner selection and formation
2. Alliance governance and design
3. Post-formation alliance management

1. Partner selection and formation

Partner selection

- Complementarity: synergy
- Compatibility: e.g. culture differences
- Commitment

examples

- Markets – Chinese auto market
- Technology – Pharmaceutical with Biotech firm
- Manufacturing and Marketing – Bios with Pharma

2. Alliance governance and design

Alliance Governance and Design

- Equity Sharing or Ownership
- Contractual Provisions
- Relational Governance

3. Post-formation alliance management

Post-formation alliance management

- Use of Coordination Mechanisms
- Development of Trust and Relational Capital
- Conflict Resolution

- failure of 60–70% of alliances each year

Why alliances fail?

- Diverging objectives and priorities
- An inability to work well together
- Changing conditions that make the purpose of the alliance obsolete
- The emergence of more attractive technological paths
- Marketplace rivalry between one or more allies

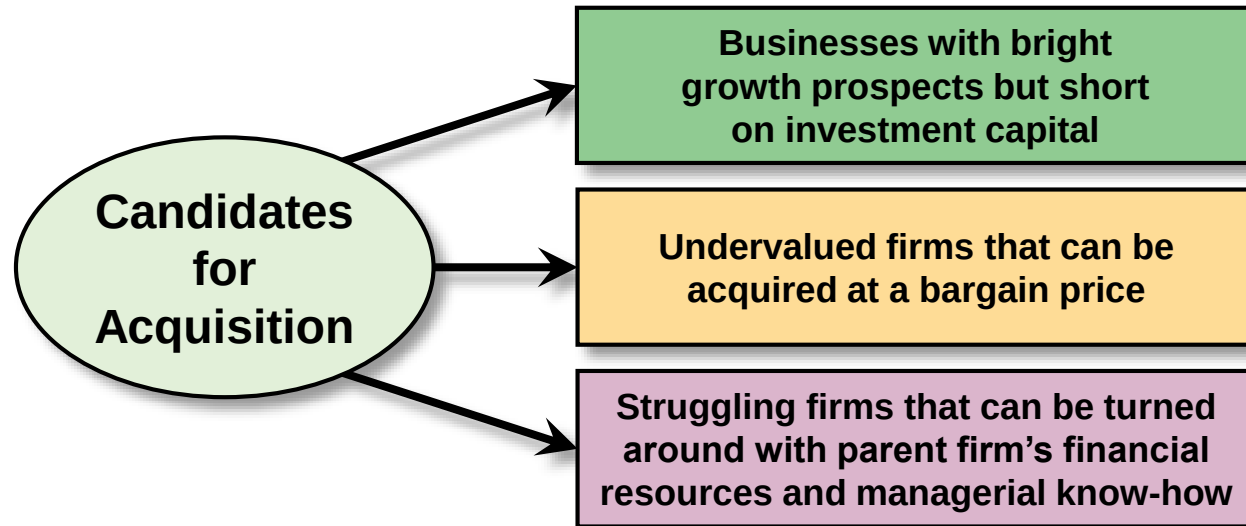
Implementing business strategy

- **Mergers and acquisitions (MA)**

Mergers and Acquisitions

- **Merger:** a strategy through which two firms agree to integrate their operations on a relatively co-equal basis.
 - (a polite way to say acquisition)
- **Acquisition:** a strategy through which one firm buys a controlling interest in another firm with the intent of making the acquired firm a subsidiary business within its own portfolio

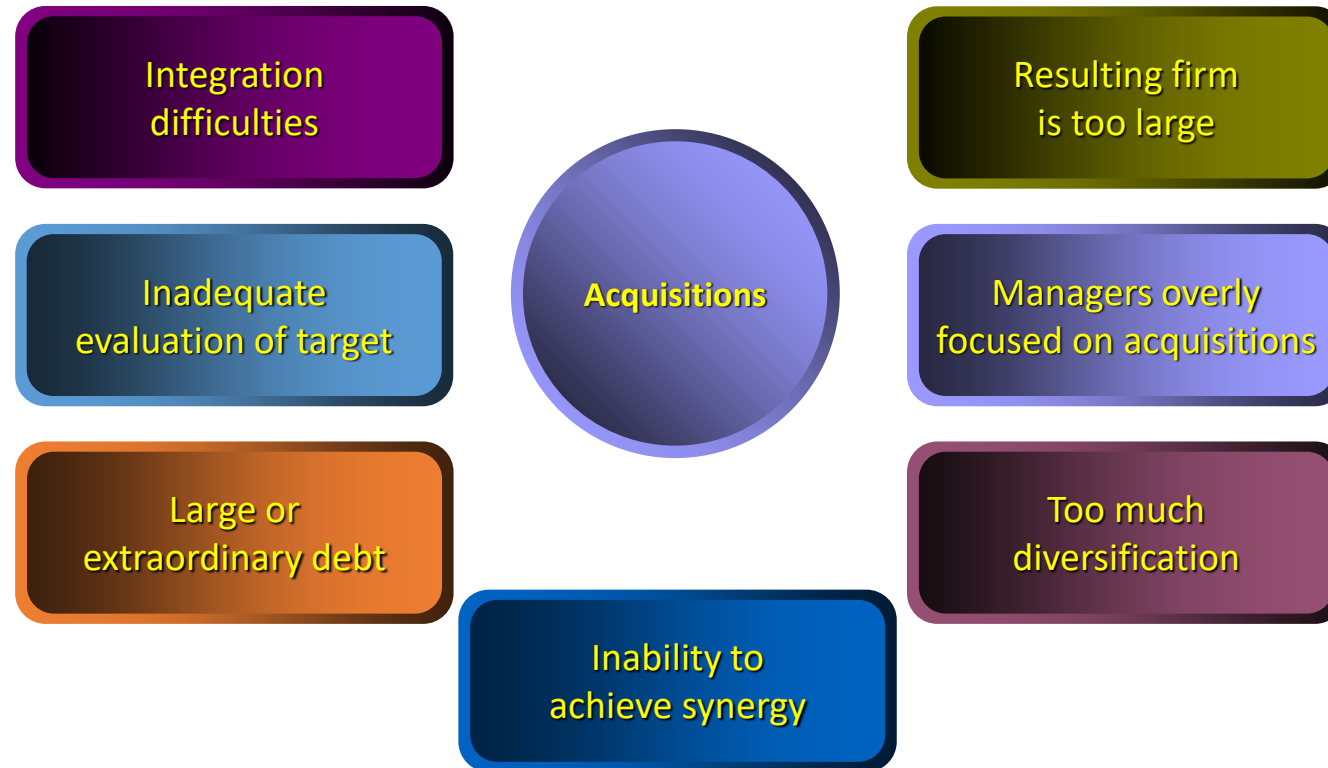
What companies to acquire



Reasons for Making Acquisitions

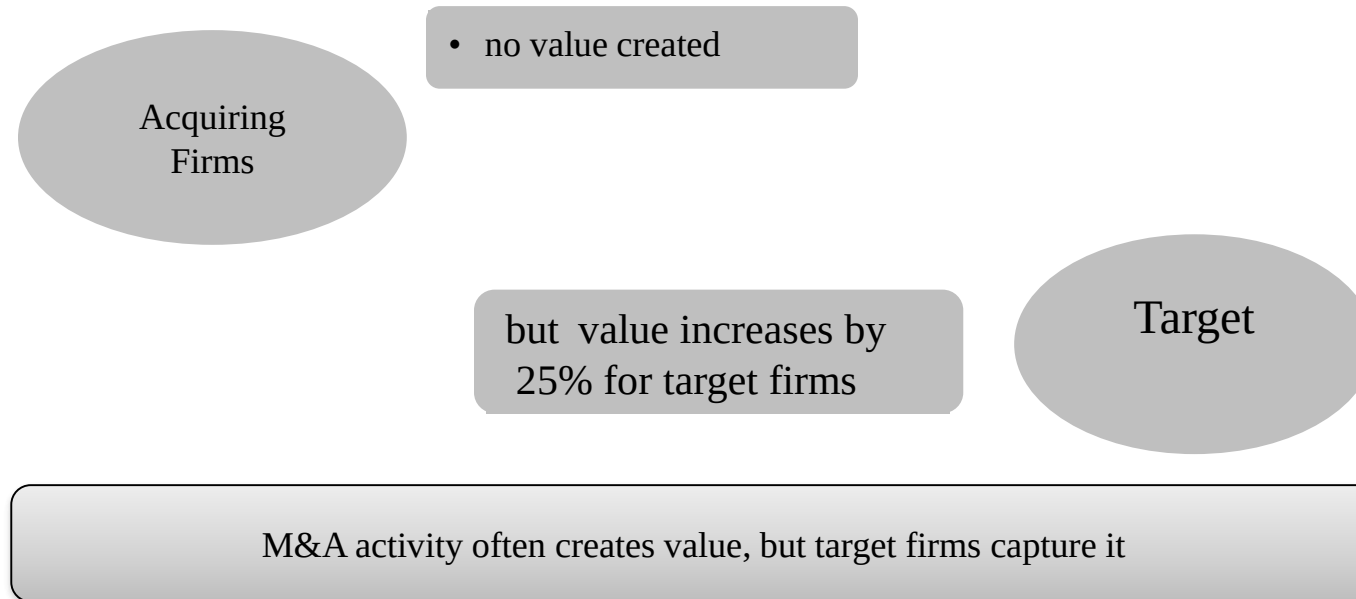


Problems With Acquisitions

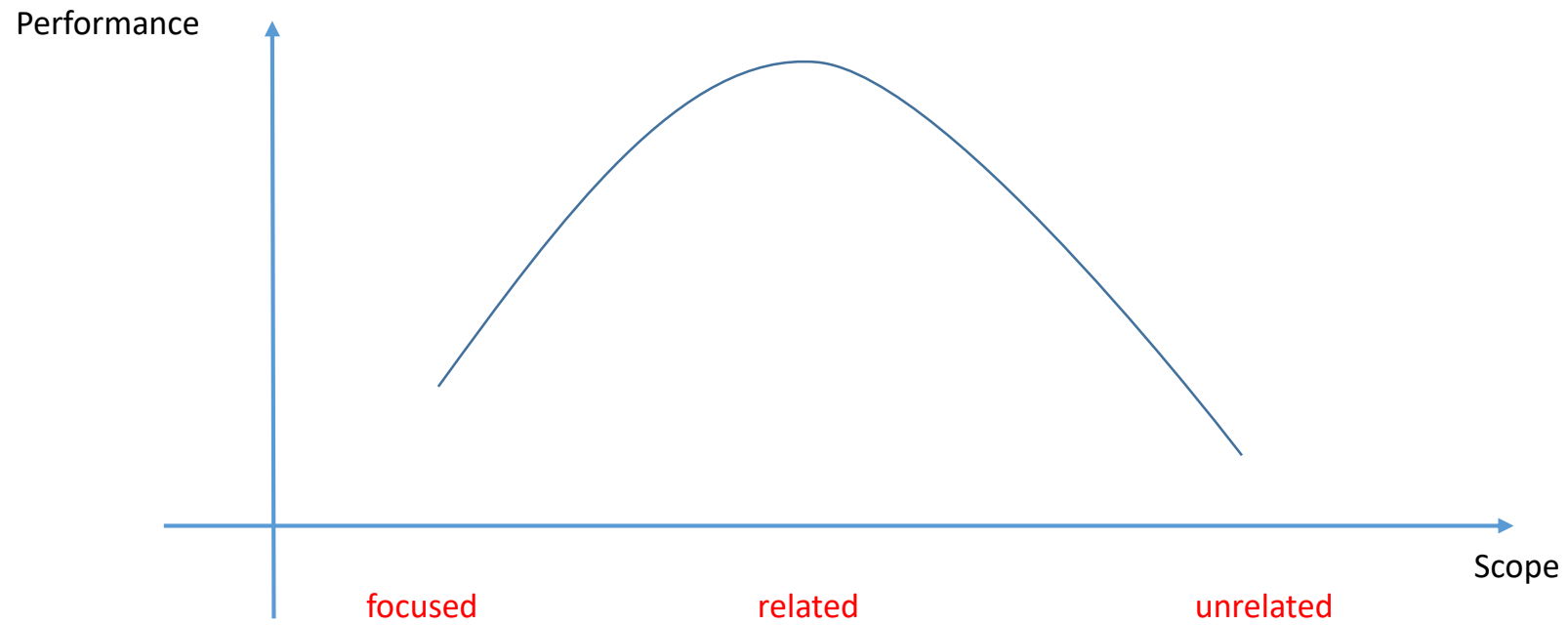


When two public firms are merged:

M&A Activity may create value as follows:



Acquisition performance



Strategic alliance vs. mergers acquisitions

Choose MA if:

- there are no anti-trust issues
- low uncertainty about the investment
- firms can be integrated easily