

12 Diversification Strategy

Telephones, hotels, insurance—it's all the same. If you know the numbers inside out, you know the company inside out.

—HAROLD SYDNEY GENEEN, CHAIRMAN OF ITT, 1959–1978, AND INSTIGATOR OF 275 CORPORATE ACQUISITIONS

Creating three independent, public companies is the next logical step for Tyco ... the new standalone companies will have greater flexibility to pursue their own focused strategies for growth than they would under Tyco's current corporate structure. This will allow all three companies to create significant value for shareholders.

—ED BREEN, CHAIRMAN AND CEO, TYCO INTERNATIONAL LTD, ANNOUNCING THE COMPANY'S BREAKUP, SEPTEMBER 19, 2011

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Introduction and Objectives

Answering *What business are we in?* is the starting point of strategy. Some companies define their businesses broadly: Nestle's objective is "to be the leader in Nutrition, Health and Wellness." Other companies define themselves in terms of a particular sector or product: McDonald's vision is "to be the world's best quick-service restaurant chain."

Firms' choices over their product scope change over time. The dominant trend of the past two decades has been "refocusing on core businesses." In 2000, Philips (based in the Netherlands) was engaged in lighting, domestic appliances, consumer electronics, cell phones, semiconductors, and medical systems. By 2018, Philips was specialized in medical systems. Similar refocusing had taken place at other highly diversified companies such as Siemens, British American Tobacco, and General Mills. Other diversified companies have split into multiple specialist companies. Hanson the UK-US conglomerate split into five separate companies; Tyco International split into three companies; during 2018, General Electric was in the process of spinning off four of its seven divisions.

Yet, diversification continues among leading technology companies, such as Amazon, Alphabet, and Tencent, while the economies of several Asian and Latin America countries are dominated by highly-diversified business groups.

Diversification remains a conundrum. It liberates firms from the constraints of a single industry, yet it has caused more value destruction than almost any other type of strategic initiative.

Our goal in this chapter is to resolve this conundrum. Is it better to be specialized or diversified? Under what conditions does diversification create rather than destroy value? Is there an optimal degree of diversification? What types of diversification are most likely to create value?

We make diversification decisions every day in our personal lives. If my car doesn't start in the morning, should I try to fix it myself or have it towed directly to the garage? There are two considerations. First, is repairing a car an attractive activity to undertake? If the garage charges \$85 an hour but I can earn \$500 an hour consulting, then car repair is not attractive to me. Second, am I any good at car repair? If I am likely to take twice as long as a skilled mechanic then I possess no competitive advantage in car repair.

Diversification decisions by firms involve the same two issues:

- ◆ How attractive is the industry to be entered?
- ◆ Can the firm establish a competitive advantage?

These are the very same factors we identified in Chapter 1 (Figure 1.5) as determining a firm's profit potential. Hence, no new analytic framework is needed for appraising diversification decisions: we can draw upon the industry analysis developed in Chapter 3 and the analysis of competitive advantage developed in Chapters 5 and 7.

Our primary focus will be the latter question: under what conditions does operating multiple businesses assist a firm in gaining a competitive advantage in each? This leads into exploring linkages between different businesses within the diversified firm—a phenomenon often referred to as *synergy*.

By the time you have completed this chapter, you will be able to:

- ◆ Recognize the corporate goals that have motivated diversification and their impact on diversification trends since the late 20th century.
- ◆ Assess the potential for diversification to create value for shareholders from economies of scope, internalizing transactions, and corporate parenting.
- ◆ Comprehend the empirical evidence on the performance outcomes of diversification.
- ◆ Identify the implications of different types of business relatedness for the success of diversification and the management of diversification.

Motives for Diversification

Changing corporate goals has been the primary driver of trends in diversification. Strategy Capsule 12.1 provides a brief summary of the history of diversification. Diversification by large companies during most of the 20th century was driven by two objectives: *growth* and *risk reduction*. The shift from diversification to refocusing during the last two decades of the 20th century was an outcome of the growing commitment of corporate managers to the goal of *creating shareholder value*.

Growth

In the absence of diversification, firms are prisoners of their industry. For firms in stagnant or declining industries this is a daunting prospect. The urge to achieve corporate growth that outstrips that of a firm's primary industry is especially appealing to senior executives. Companies in low-growth, cash flow-rich industries such as tobacco and oil have been especially susceptible to the temptations of diversification. During the 1980s, Exxon diversified into copper and coal mining, electric motors, and computers and office equipment; RJR Nabisco transformed itself from a tobacco company into a diversified consumer products company. In both cases diversification destroyed shareholder value. Exxon returned to its core oil and gas businesses, while the leveraged buyout of RJR Nabisco by Kohlberg Kravis Roberts was followed by its breakup. Reynolds American, Inc. is now a specialist tobacco company.

Diversification is typically very successful in generating revenue growth—especially when it is achieved through acquisition. But what about profitability? If diversification efforts become a cash drain for companies in declining industries—as they did for Eastman Kodak and Blockbuster—then diversification may well hasten rather than stave off bankruptcy.

Risk Reduction

The notion that risk spreading is a legitimate goal for the value-creating firm has become a casualty of modern financial theory. If the cash flows of two different businesses are imperfectly correlated then bringing them together under common ownership certainly reduces the variance of the combined cash flow. But, does a more stable cash flow benefit shareholders? Shareholders can diversify risk by holding diversified portfolios. Hence, what advantage can there be in companies diversifying for them? The only possible advantage could be if firms can diversify at a lower cost than individual investors. In fact, the reverse is true: the transaction costs to shareholders of diversifying their portfolios are far less than the transaction costs to firms diversifying through acquisition. Not only do acquiring firms incur the heavy costs of using investment banks and legal advisers, they must also pay an acquisition premium to gain control of an independent company.

The *capital asset pricing model* (CAPM) formalizes this argument. The theory states that the risk that is relevant to determining the price of a security is not the overall risk (variance) of the security's return but the *systematic risk*—that part of the variance of the return that is correlated with overall stock market returns. This is measured by the security's *beta coefficient*. Corporate diversification does not reduce systematic risk: if two separate companies are brought under common ownership, and their individual cash flow streams are unchanged—the beta coefficient of the combined company is simply the weighted average of the beta coefficients of the constituent companies. Hence, the simple act of bringing different businesses under common ownership does not create shareholder value through risk reduction.¹

STRATEGY CAPSULE 12.1

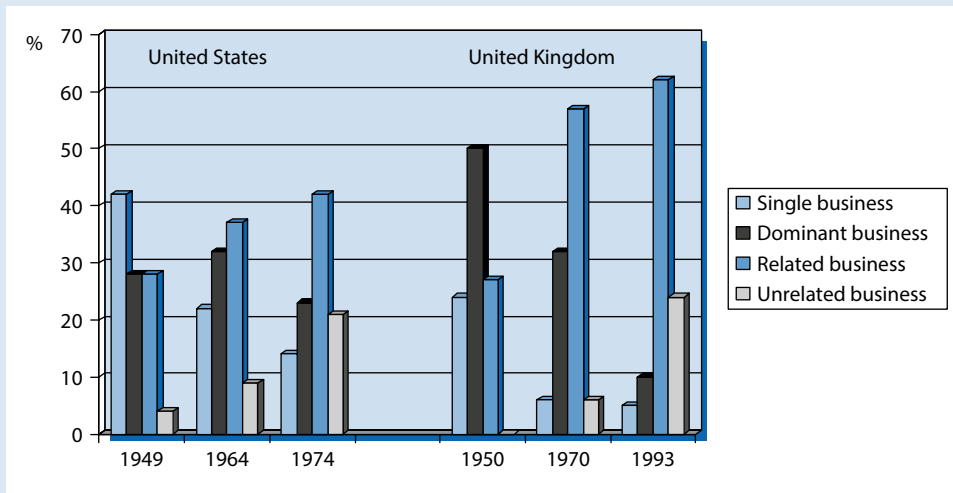
Trends in Corporate Diversification Over Time

Diversification has followed the same trend as that of corporate scope more generally (see Chapter 10, Strategy Capsule 10.1). For most of the 20th century—and especially during the 1960s and 1970s—large companies in all the advanced industrial nations diversified beyond their core business.² The 1960s also saw the emergence of a new type of company—the *conglomerate*: a highly diversified company assembled from multiple, unrelated acquisitions. These included ITT, Textron, and Allied Signal in the United States and Hanson, Slater Walker, and BTR in the United Kingdom. Their existence reflected the belief that top management no longer needed industry-specific experience: the new techniques of financial and strategic management could be applied to any business.³ Figure 12.1 shows the growing number of highly diversified US and UK firms (both “related business” and “unrelated business”) during the latter part of the 20th century.

After 1980, the diversification trend went into reverse as companies divested their “noncore” businesses. Between 1980 and 1990, the average index of diversification for Fortune 500 companies declined from 1.00 to 0.67.⁴

The main driver of this trend was a shift of corporate goals from growth to profitability—typically companies’ diversified businesses were less profitable than their core businesses. Evidence of a “conglomerate discount”—that the stock market was valuing diversified companies at less than the sum of their parts—resulted in diversification in general becoming viewed as the enemy of shareholder interests.⁵ CEOs came under increasing pressure from both institutional shareholders, including pension funds such as California’s Public Employees’ Retirement System, and hostile takeovers launched by private equity groups. Kohlberg Kravis Roberts’ \$31 billion takeover of the tobacco and food giant RJR Nabisco in 1989

FIGURE 12.1 Diversification strategies of large US and UK companies during the late 20th century



Sources: R. P. Rumelt, “Diversification strategy and profitability,” *Strategic Management Journal* 3 (1982): 359–370; R. Whittington, M. Mayer, and F. Certo, “Chandlerism in Post-war Europe: Strategic and Structural Change in France, Germany and the United Kingdom, 1950–1993,” *Industrial and Corporate Change* 8 (1999): 519–550; D. Channon, *The Strategy and Structure of British Enterprise* (Cambridge: Harvard University Press, 1973).

demonstrated that even the largest US companies were vulnerable to attack from corporate raiders.⁶

In Chapter 10, we observed that volatile, uncertain conditions increase the decision-making burden on top management, making large, complex companies less agile than specialized companies. At the same time, the growing availability of private capital encouraged many diversified companies to spin off their growth businesses in order to tap funding from external capital markets.

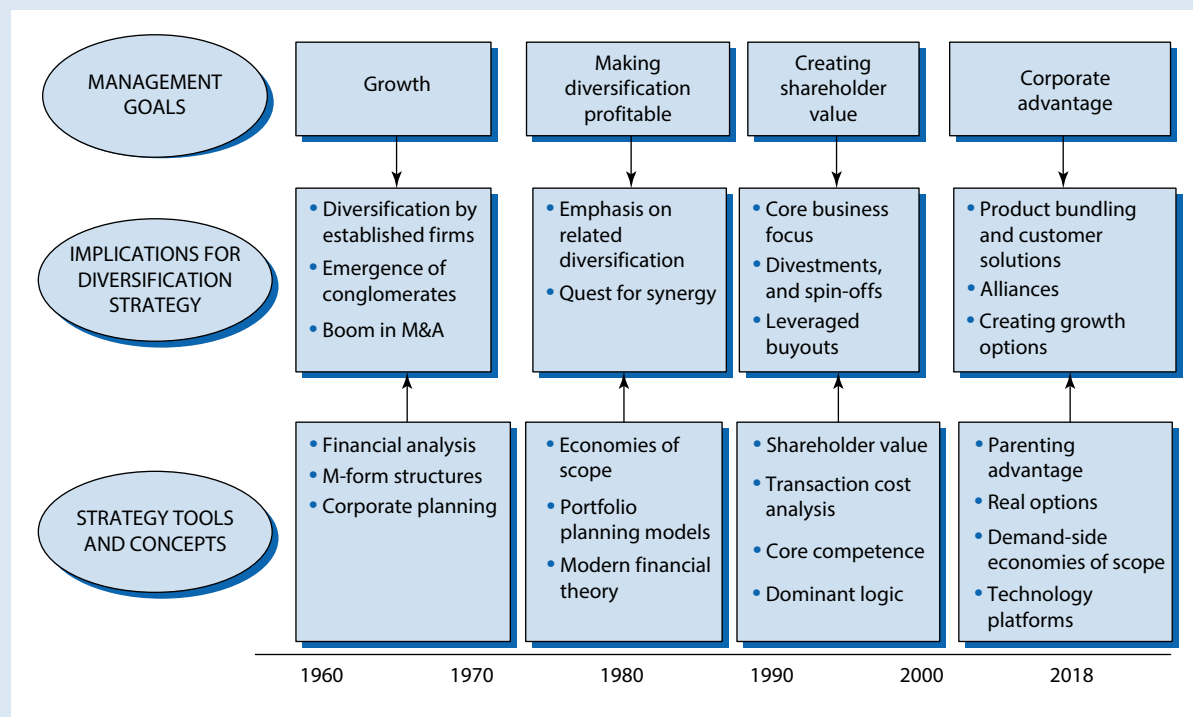
However, many companies still view diversification as an opportunity for value creation. The tendency for digital technologies to erode market boundaries and create hardware/software complementarities has encouraged technology leaders such as Alphabet, Amazon, Alibaba, Baidu, and Rocket Internet to continuously expand their product ranges. In more mature sectors, an emphasis on providing “customer solutions” is similarly

encouraging firms to offer bundles of complementary products and services. In many instances, these diversification initiatives are occurring through collaboration with other companies rather than through conventional diversification.

In the emerging markets of Asia and Latin America, the leading companies tend to be highly diversified—and often family controlled. These include Tata and Reliance in India, Charoen Pokphand (CP) in Thailand, Astra International in Indonesia, Sime Darby in Malaysia, and Grupo Alfa and Grupo Carso in Mexico.⁷ We shall consider the reasons for these differences in diversification patterns between mature and emerging countries later in the chapter.

Figure 12.2 summarizes the trends in diversification strategy since the middle of the last century and points to the influence of corporate goals and developments in strategic management concepts and tools on these trends.

FIGURE 12.2 The evolution of diversification strategies, 1960–2018



Empirical studies are generally supportive of the absence of shareholder benefit from diversification that simply combines independent businesses under a single corporate umbrella.⁸ Diversification may even fail to lower unsystematic risk (risk that is specific to a company and is uncorrelated with overall stock market fluctuations).⁹

Special issues arise once we consider credit risk. Diversification that reduces cyclical fluctuations in cash flows reduces the risk of default on the firm's debt. This may permit the firm to carry a higher level of debt which can create shareholder value because of the tax advantages of debt (i.e., interest is paid before tax; dividends are paid out of post-tax profit).¹⁰

Are there other circumstances in which reductions in unsystematic risk can create shareholder value? If it is cheaper to finance investments internally rather than resort to external capital markets, the stability in the firm's cash flow that results from diversification may reinforce independence from external capital markets. During the financial crisis of 2008–2009, when access to capital markets became highly restricted for many firms, diversified companies benefitted from their ability to rely on funding from their internally generated funds.¹¹

Value Creation: Porter's "Essential Tests"

If corporate strategy is to be directed toward value creation, what are the implications for diversification strategy? At the beginning of the chapter, we revisited our two sources of superior profitability: industry attractiveness and competitive advantage. In establishing the conditions for profitable diversification, Michael Porter refines these into "three essential tests" that determine whether diversification will truly create shareholder value:

- *The attractiveness test:* The industries chosen for diversification must be structurally attractive or capable of being made attractive.
- *The cost-of-entry test:* The cost of entry must not capitalize all the future profits.
- *The better-off test:* Either the new unit must gain competitive advantage from its link with the corporation or vice versa.¹²

The Attractiveness and Cost-of-Entry Tests A critical realization in Porter's "essential tests" is that *industry attractiveness* on its own is insufficient to justify diversification. Diversification may allow a firm access to more attractive investment opportunities than are available in its own industry, yet it faces the challenge of entering a new industry. The second test, *cost of entry*, recognizes that, for outsiders, the cost of entry may counteract the attractiveness of the industry. Pharmaceuticals, corporate legal services, and defense contracting offer above-average profitability precisely because they are protected by barriers to entry. Firms seeking to enter these industries may either acquire an established player—in which case the acquisition cost is likely to fully capitalize the target firm's profit prospects (not to mention the need to pay an acquisition premium)¹³—or establish a new corporate venture—in which case the diversifying firm must directly confront the barriers to entry to that industry.¹⁴

Hewlett-Packard offers a salutary example. It diversified into IT services because of its greater attractiveness than IT hardware. However, its \$13.9 billion acquisition of EDS in 2008 was at a 30% premium over EDS's market value and its \$10.3 billion acquisition of Autonomy in 2011 involved a 60% premium. HP subsequently took write-offs of \$16 billion against the balance sheet values of these two companies.

The Better-Off Test Porter's third criterion for value creation from diversification—the *better-off test*—addresses the issue of competitive advantage. If two different businesses are brought together under the ownership and control of a single enterprise, is there any reason why they should become any more profitable? The issue here is one of *synergy*: what is the potential for interactions between the two businesses that can enhance the competitive advantage of either business?

In most diversification decisions, it is the better-off test that takes center stage. In the first place, industry attractiveness is rarely a source of value from diversification—in most cases, cost-of-entry cancels out the advantages of industry attractiveness. Second, the better-off test can often counteract the disadvantages of an unattractive industry. If a diversifying company can establish a strong competitive advantage in an industry, the low profitability of the industry as a whole may be immaterial. Most of Virgin Group's diversification has been into industries where average profitability has been low (or non-existent): airlines, wireless telecommunications, gym clubs, passenger rail services and retail banking. Yet, Virgin has created competitive advantage through transferring its brand and customer service capabilities. Sony's acquisition of CBS Records, BMG, and EMI Records took it into the spectacularly unattractive recorded music industry—however, for Sony, music forms an integral component of its home entertainment business.

Let us now explore how the better-off test can be applied through analyzing the relationship between diversification and competitive advantage.

Competitive Advantage from Diversification

If the primary source of value creation from diversification is exploiting linkages between different businesses, what are these linkages and how are they exploited? The key linkages are those that permit the sharing of resources and capabilities across different businesses.

Economies of Scope

The most general argument concerning the benefits of diversification focuses on the presence of **economies of scope** in common resources: "Economies of scope exist when using a resource across multiple activities uses less of that resource than when the activities are carried out independently."¹⁵

Economies of scope exist for similar reasons as economies of scale. The key difference is that economies of scale relate to cost economies from increasing output of a *single product*; economies of scope are cost economies from increasing the output of *multiple products*. The nature of economies of scope varies between different types of resources and capabilities.

Tangible Resources Tangible resources—such as distribution networks, information technology systems, sales forces, and research laboratories—confer economies of scope by eliminating duplication—a single facility can be shared among several businesses. The greater the fixed costs of these items, the greater the associated economies of scope are likely to be. Diversification by cable TV companies into telecoms and broadband and by telephone companies into TV, broadband, and music streaming are motivated by the desire to spread the costs of networks and billing systems over as many services as possible. Common resources such as customer databases, customer service centers, and billing systems have encouraged Centrica, Britain's biggest gas utility, to

diversify into supplying electricity, fixed-line and mobile telephony, broadband access, home security, insurance, and home-appliance repair.

Economies of scope also arise from the centralized provision of administrative and support services to the different businesses of the corporation. Accounting, legal services, government relations, and information technology tend to be centralized at the corporate headquarters (or through a *shared service organization*).

Intangible Resources Intangible resources—such as brands, corporate reputation, and technology—offer economies of scope from the ability to extend them to additional businesses at a low marginal cost. Exploiting a strong brand across additional products is called *brand extension*. Starbucks has extended its brand to ice cream, packaged cold drinks, home espresso machines, audio CDs, and books. Similarly with technology: Fujifilm has extended its proprietary coatings technology from photographic film to cosmetics, pharmaceuticals, and industrial coatings.

Organizational Capabilities Organizational capabilities can also be transferred within a diversified company. For example:

- LVMH is the world's biggest and most diversified supplier of branded luxury goods. Its capabilities in design, market analysis, advertising and promotion, retail management, and craftsmanship are deployed across Louis Vuitton (accessories and leather goods); Hennessey (cognac); Moët & Chandon, Dom Pérignon, Veuve Clicquot, and Krug (champagne); Céline, Givenchy, Kenzo, Christian Dior, Guerlain, and Donna Karan (designer clothing); TAG Heuer and Chaumet (watches); Sephora (retailing); Bulgari (jewelry); and some 25 other branded businesses.
- Apple's distinctive capability is in new product development where it combines its expertise in microelectronics, software engineering, and design aesthetics to create products of outstanding functionality, ease of use, and consumer appeal. This capability has taken Apple from laptop computers, to MP3 players, smartphones, tablet computers, TV set-top boxes, and watches and other wearable technology.

Some of the most important capabilities in influencing the performance of diversified corporations are *general management capabilities*. For over a century, General Electric was one of the world's most diversified and successful companies. Its core capabilities were its ability to motivate and develop its managers; its strategic and financial management, which reconciles decentralized decision making with strong centralized control; and its international management.¹⁶ GE's dismal performance since 2001 raised doubts over the effectiveness of these corporate-level capabilities to the extent that, in June 2018, the company announced a far-reaching divestment plan.

The success of Danaher Corporation, the technology-based conglomerate headquartered in Washington, DC, also rests upon its general management capabilities. Its effectiveness in selecting acquisition targets then applying its system of performance management and human resource development have allowed it to triple its market valuation between 2008 and 2018.¹⁷

Demand-side Economies of Scope So far, we have looked only at supply-side economies of scope: cost savings that supplying firms derive from sharing resources and capabilities across different businesses. Economies of scope also arise for customers when they buy multiple products. Walmart's vast array of products offers consumers

the convenience of one-stop shopping. Similarly with online shopping: consumers gravitate toward Amazon because of the ease and time saving of funneling their online purchases through a single website. Suppliers of products and services to business have also diversified in order to provide “integrated solutions.” ISS, based in Denmark, is the world’s biggest supplier of facilities management services with half a million employees in 47 countries. It offers its industrial and commercial clients cleaning, maintenance, security, air conditioning, and catering services.¹⁸

Economies from Internalizing Transactions

Economies of scope provide cost savings from sharing and transferring resources and capabilities among different businesses, but does a firm have to own these businesses to exploit economies of scope? The answer is *no*. Economies of scope in resources and capabilities can be exploited simply by selling or licensing the use of the resource or capability to another company. In Chapter 9, we observed that a firm can exploit proprietary technology by licensing it to other firms. In Chapter 12, we noted how technology and trademarks are licensed across national frontiers as an alternative to direct investment. Similarly across industries: Starbucks’ diversification into the grocery trade was initially through licensing: Unilever and PepsiCo produced Tazo tea beverages, Nestlé produced Starbucks’ ice cream, and Kraft distributed Starbucks’ packaged coffee. Walt Disney exploits its trademarks, copyrights, and characters directly through diversification into theme parks, live theater, cruise ships, and hotels; but it also earned \$2.4 billion in 2013 from licensing its intellectual property to producers of clothing, toys, music, comics, food and drink, and other products.

In industries based upon digital technologies, the owners of digital platforms can reap the benefits of diversification simply by charging third-party suppliers for access to their platforms. Thus, Apple earns substantial revenues from the suppliers of games, rideshare services, air travel, fitness services, and thousands of other goods and services who sell through its app stores.

Even tangible resources can be shared across different businesses through market transactions. Airport and railroad station operators exploit economies of scope in their facilities not by diversifying into catering and retailing but by leasing space to specialist retailers and restaurants.

Is it better to exploit economies of scope in resources and capabilities internally within the firm through diversification or externally through contracts with independent companies? There are two major issues here:

- Can licensing exploit the full value of the resource or capability? This depends, to a great extent, on the transaction costs involved. The transaction costs of licensing include the costs incurred in drafting, negotiating, monitoring, and enforcing a contract. Where property rights are clearly defined—as with trademarks and many types of patents—licensing may be highly effective; for organizational capabilities and know-how more generally, writing and enforcing licensing contracts is problematic. Fujifilm’s diversification into cosmetics, pharmaceuticals, and industrial coatings reflects the fact that, despite owning patents, the commercial exploitation of its coatings technology depends critically upon the capabilities of Fujifilm in applying this technology.¹⁹
- Does the firm have the other resources and capabilities required for successful diversification? For fragrances, Dolce & Gabbana, the Italian fashion house, licenses its brand to Procter & Gamble, which produces and markets Dolce &

Gabbana fragrances (along with other licensed brands such as Gucci, Hugo Boss, Rochas, and Dunhill). Dolce & Gabbana lacks the resources and capabilities needed to design, produce, and globally distribute fragrances. Conversely, Starbucks' decision to terminate its licensing agreement with Kraft reflected Starbucks' belief that it could build the resources and capabilities needed to market and distribute packaged coffee to supermarkets.

Parenting Advantage

So far, our case for diversification has rested upon its potential to create value for the firm.²⁰ Michael Goold, Andrew Campbell, and colleagues argue that this is an insufficient justification for diversification. If a parent company is to own a particular business, not only must it be able to add value to that business but also it should be capable of *adding more value than any other potential parent*. Otherwise, it would be better off selling the business to the company that can add the most value. Consider General Electric's sale of NBC Universal to Comcast in 2011. Irrespective of GE's capacity to add value to NBC Universal, the sale was justified because Comcast (as a result of its other media interests) could add more value to NBC Universal than could GE.

The concept of *parenting value* offers a different perspective on diversification from Porter's better-off test. Parenting value comes from applying the management capabilities of the parent company to a business. While Porter's better-off test focuses on the potential to share resources across businesses, parenting advantage emphasizes on the value-adding role of the corporate center. Successful diversification is more about the relationship between corporate management and the new business rather than about the fit between the different businesses within the diversified firm. We shall return to this concept of the parenting advantage in the next chapter.

The Diversified Firm as an Internal Market

We have seen that economies of scope on their own do not provide an adequate rationale for diversification: there needs to be transaction costs which make diversification preferable to licensing contracts. Indeed, the presence of transaction costs in the markets for resources offers a rationale for diversification even when no economies of scope are present.

Internal Capital Markets Consider the case of financial capital. The diversified firm possesses an internal capital market in which the different businesses compete for investment funds. Which is more efficient, the internal capital market of diversified companies or the external capital market? Diversified companies have two key advantages:

- By maintaining a balanced portfolio of cash-generating and cash-using businesses, diversified firms can avoid the costs of using the external capital market, including the margin between borrowing and lending rates and the heavy costs of issuing new debt and equity.
- Diversified companies have better access to information on the financial prospects of their different businesses than that typically available to external financiers.²¹

Against these advantages is the critical disadvantage that investment allocation within the diversified company is a politicized process in which strategic and financial considerations are subordinated to turf battles and ego building. Evidence suggests that diversified firms' internal capital markets tend to cross-subsidize poorly performing

divisions and are reluctant to transfer cash flows to the divisions with the best prospects.²² According to McKinsey & Company, high-performing conglomerates—including Berkshire Hathaway and Danaher of the United States, Hutchison Whampoa of Hong Kong, Bouygues and Lagardère of France, Wesfarmers of Australia, ITC of India, and Grupo Carso of Mexico—are those with strict financial discipline, a refusal to overpay for acquisitions, rigorous and flexible capital allocation, lean corporate centers, and a willingness to close or sell underperforming businesses.²³

Private equity firms also operate efficient internal capital markets that avoid the transaction costs of external capital markets. Firms such as the Blackstone Group, Carlyle Group, and Kohlberg Kravis Roberts each manage multiple funds. Each fund is created with finance from individual and institutional investors and is then used to acquire equity in companies. Funds typically have lives of 10–15 years. Acquisitions by private equity companies include both private and public companies and typically involve creating value through increasing financial leverage, cost cutting, divesting poorly performing assets, and replacing and incentivizing top management.²⁴

Internal Labor Markets Efficiencies also arise from the ability of diversified companies to transfer employees, especially managers and technical specialists, between their businesses, and to rely less on hiring and firing. The costs associated with hiring include advertising, time spent in interviewing and selection, and the costs of head-hunting agencies. The costs of dismissing employees can be very high where severance payments must be offered. A diversified corporation has a pool of employees and can respond to the specific needs of any one business through transfer from elsewhere within the corporation.

The broader set of career opportunities available in the diversified corporation may also attract a higher caliber of employee. Graduating students compete intensely for entry-level positions in diversified corporations such as Alphabet, Samsung Electronics, Unilever, and Nestlé in the belief that these companies can offer richer career development than more specialized companies.

Most important are informational advantages of diversified firms in relation to internal labor markets. A key problem of hiring from the external labor market is limited information. A résumé, references, and a day of interviews are poor indicators of how a new hire will perform in a particular job. The diversified firm that is engaged in transferring employees between different positions and different internal units can build detailed information on the competencies and characteristics of its employees.

These advantages of internal markets for capital and labor may explain the continued success of highly diversified business groups in emerging economies (Strategy Capsule 12.2).

Diversification and Performance

Where diversification exploits economies of scope in resources and capabilities in the presence of transaction costs, it has the potential to create value for shareholders. Diversification that seeks only growth or risk reduction is likely to destroy value. How do these predictions work in practice?

The Findings of Empirical Research

Empirical research into diversification has concentrated on two major issues: first, how do diversified firms perform relative to specialized firms and, second, does related diversification outperform unrelated diversification?

STRATEGY CAPSULE 12.2

Emerging-market Conglomerates

Highly diversified groups of closely connected companies—*chaebols* in South Korea, *business houses* in India, *holding companies* in Turkey, *grupos económicos* in Latin America, the Hong Kong trading companies that developed from the original British *hongs*—dominate the economies of many Asian and Latin American countries.

The conventional argument for the success of these conglomerates—in contrast to the near disappearance of US and European conglomerates—has been the advantages of this corporate form in countries with poorly developed capital and labor markets. Inefficient capital markets offer a huge advantage to groups, such as Tata of India and Koç of Turkey, in using internally generated cash flows to fund growing businesses and establish new ventures. Similarly with managerial resources, where managerial talent is rare, companies such as Koç or LG of Korea are able to attract exceptionally talented graduates then develop them into highly capable managers.

However, the performance advantages of emerging market conglomerates show no sign of abating,

despite increasingly efficient capital and labor markets in their home countries. South Korean conglomerates have been growing their revenues by 11% a year; Indian business groups by 23% a year.

It seems likely that, especially in growing economies, the management model of the emerging market business groups may offer some advantages over the more integrated multidivisional corporations typical of North America, Europe, and Japan. Business groups such as Tata, Sabancı Holding (Turkey), and SK (Korea) are able to combine high levels of autonomy for their member companies with strong parental leadership that emphasizes identity and values, and also provides strategic guidance.

Sources: “From Dodo to Phoenix,” *The Economist* (January 11, 2014): 58; C. Stadler, “3 Reasons Why Conglomerates Are Back In Fashion,” <https://www.forbes.com/sites/christianstadler/2015/11/05/three-reasons-why-conglomerates-are-back-in-fashion/#4390e0693be6>, Accessed July 28, 2017.

The Performance of Diversified and Specialized Firms Hundreds of empirical studies over the past 50 years have failed to establish a systematic relationship between diversification and either accounting-based or stock market-based measures of performance. Even the widely observed “conglomerate discount”—the stock market’s undervaluation of diversified firms—appears to be the result of measurement and sampling errors.²⁵

Several studies have detected an inverted-U relationship between diversification and profitability: diversification enhances profitability up to a point, after which further diversification reduces profitability due to increasing costs of complexity.²⁶ McKinsey & Company also point to the benefits of moderate diversification—“a strategic sweet spot between focus and broader diversification”—which is beneficial when a company has exhausted growth opportunities in its existing markets and can match its existing capabilities to emerging external opportunities.²⁷

More consistent evidence concerns the performance results of refocusing initiatives by North American and European companies: when companies divest diversified businesses and concentrate more on their core businesses, the result is, typically, increased profitability and higher stock-market valuation.²⁸

Related and Unrelated Diversification Given the importance of economies of scope in shared resources and capabilities, it seems likely that diversification into

related industries should be more profitable than diversification into *unrelated* industries. Empirical research initially supported this prediction. By 1982, Tom Peters and Robert Waterman were able to conclude: “virtually every academic study has concluded that unchanneled diversification is a losing proposition.”²⁹ This observation supported one of their “golden rules of excellence”:

Stick to the Knitting. Our principal finding is clear and simple. Organizations that do branch out but stick very close to their knitting outperform the others. The most successful are those diversified around a single skill, the coating and bonding technology at 3M for example. The second group in descending order, comprise those companies that branch out into related fields, the leap from electric power generation turbines to jet engines from GE for example. Least successful are those companies that diversify into a wide variety of fields. Acquisitions especially among this group tend to wither on the vine.³⁰

Subsequent studies have clouded the picture: once risk and industry influences are taken into account, the superiority of related diversification is less apparent³¹; some studies even point to unrelated diversification outperforming related diversification.³²

This confusing body of evidence points to the complex relationship between diversification and firm performance. Diversification is motivated by different goals; there are different sources of benefit from diversification, each of which depends upon the context in which the diversification takes place; and diversification is managed with different degrees of effectiveness. Also, the performance outcomes of diversification depend not only on the benefits of diversification but also on the management costs that diversification imposes. These costs arise from the greater complexity and coordination needs of diversified companies and are likely to be especially great for related diversification—especially when resources are shared across businesses.³³ Even if a relationship between diversification and performance is observed, there is the problem of distinguishing *association* from *causation*. Not only does diversification impact profitability, but profitability also influences diversification: for example, highly profitable firms may seek to channel their cash flows into diversification.

Given this complexity, Gautam Ahuja and Elena Novelli argue that the relationship between diversification and performance needs to be studied at a much more micro-level. This should focus, first, on the individual sources of synergy and (and “antisynergy”) and, second, upon specific contexts in terms of industries, countries, and time periods. With regard to time they note that, during the 20th century, supply-side economies of scope were principal driver of diversification. During the 21st century, demand-side economies of scope (“consumption synergies”), such as those exploited by Amazon, have become more important.³⁴

The Meaning of Relatedness in Diversification

The most surprising feature of empirical research into the impact of diversification on performance is the failure to find clear support for the superiority of related over unrelated diversification. This points to the difficulty in distinguishing between the two. Related businesses are those with the potential for sharing resources and capabilities—but this depends on the company undertaking the diversification. Empirical studies have defined relatedness in terms of similarities between industries in technologies and markets. These similarities emphasize relatedness at the *operational* level—in

manufacturing, marketing, and distribution—typically activities where economies from resource sharing are small and achieving them is costly in management terms. Conversely, one of the most important sources of value creation within the diversified firm is the ability to apply common general management capabilities, strategic management systems, and resource allocation processes to different businesses. Such economies depend on the existence of *strategic* rather than *operational* similarities among different businesses within the diversified corporation.³⁵

- Berkshire Hathaway is involved in insurance, candy stores, furniture, kitchen knives, jewelry, and footwear. Despite this diversity, all these businesses have been selected on the basis of their ability to benefit from the unique style of corporate management established by its chairman and CEO, Warren Buffett, and vice-chairman, Charles Munger.
- Clothing, leather products, wine, watches, and cosmetics are not obviously related products, but LVMH applies similar design and brand management capabilities to them all.
- Richard Branson's Virgin Group covers a huge array of businesses from airlines to health clubs. Yet, they share certain strategic similarities: almost all are start-up companies that benefit from Branson's entrepreneurial zeal and expertise; almost all sell to final consumers and are in sectors that offer the potential for innovative approaches to differentiation.

The essence of such strategic-level linkages is the ability to apply similar strategies and management systems across the different businesses within the corporate portfolio.³⁶ Table 12.1 lists some of the strategic factors that determine similarities among businesses in relation to corporate management activities.

Unlike operational relatedness, where the opportunities for exploiting economies of scope in joint inputs are comparatively easy to identify—even to quantify—strategic relatedness is more elusive. It necessitates an understanding of the overall strategic approach of the company and recognition of its corporate-level management capabilities.

TABLE 12.1 The determinants of strategic relatedness between businesses

Corporate Management Tasks	Determinants of Strategic Similarity
Resource allocation	Similar sizes of capital investment projects Similar time spans of investment projects Similar sources of risk Similar general management skills required for business unit managers
Strategy formulation	Similar key success factors Similar stages of the industry life cycle Similar competitive positions occupied by each business within its industry
Performance management and control variables	Similar indicators for performance targets Similar time horizons for performance targets

Source: R. M. Grant, "On Dominant Logic, Relatedness, and the Link between Diversity and Performance," *Strategic Management Journal* 9 (1988): 641. Reused by permission of John Wiley & Sons, Ltd.

Ultimately, the linkage between the different businesses within a company may depend upon the strategic rationale of the company—what Prahalad and Bettis refer to as the *dominant logic* of the company.³⁷ Such a common view of a company's identity and *raison d'être* is a critical precondition for effective integration across its different businesses. For example, Richard Branson's Virgin group of companies is based upon a logic that asserts that start-up companies in mature, consumer industries can provide innovative differentiation and a commitment to enthusiasm, fun, and fairness that allows them to establish competitive advantage over bigger, established rivals.³⁸

Summary

Diversification: it's attractions are obvious, yet the experience is often disappointing. For top management, it is a minefield. The diversification experiences of large corporations are littered with expensive mistakes: Exxon's attempt to build Exxon Office Systems as a rival to Xerox and IBM; Vivendi's diversification from water and environmental services into media, entertainment, and telecoms; Royal Bank of Scotland's quest to transform itself from a retail bank into a financial services giant. Despite so many costly failures, the urge to diversify continues to captivate senior managers. Part of the problem is the divergence between managerial and shareholder goals. While diversification has offered meager rewards to shareholders, it is the fastest route to building vast corporate empires. A further problem is hubris. A company's success in one line of business tends to result in the top management team becoming overly confident of its ability to achieve similar success in other businesses.

Nevertheless, for companies to survive and prosper over the long term, they must change; inevitably, this involves redefining the businesses in which they operate. Without diversification, BMW would still be a manufacturer of aircraft engines and Du Pont a bleach producer. For most companies that have survived for more than half a century, diversification has played a key role in their evolution. In most cases, this diversification was not a major discontinuity but an initial incremental step in which existing resources and capabilities were deployed to exploit a perceived opportunity.

If companies are to use diversification as part of their long-term adaptation and avoid the many errors that corporate executives have made in the past then better strategic analysis of diversification decisions is essential. The objectives of diversification need to be clear and explicit. Value creation provides a demanding and illuminating criterion with which to appraise investment in new business opportunities. Rigorous analysis also counters the tendency for diversification to be a diversion—corporate escapism resulting from the unwillingness of top management to come to terms with difficult conditions within the core business.

Our tools for evaluating diversification decisions have developed greatly in recent years. Vague notions of synergy that have been displaced by more precise analysis of the sources of economies of scope both on the supply side and demand side, the role of transaction costs, and the administrative costs that can offset diversification synergies. The inconclusive empirical research into the impact of diversification on performance has illuminated the basic truth about diversification strategy. There are no generally valid rights or wrongs; decisions about diversification need to take careful account of the characteristics of the firm, the specific diversification opportunity being considered, and the overall business context.

Self-Study Questions

1. An ice-cream manufacturer is proposing to acquire a soup manufacturer on the basis that, first, its sales and profits will be more seasonally balanced and, second, from year to year, sales and profits will be less affected by variations in weather. Will this risk spreading create value for shareholders? Under what circumstances could this acquisition create value for shareholders?
2. Tata Group is one of the India's largest companies, employing 424,000 people in many different industries, including steel, motor vehicles, watches and jewelry, telecommunications, financial services, management consulting, food products, tea, chemicals and fertilizers, satellite TV, hotels, motor vehicles, energy, IT, and construction. Such diversity far exceeds that of any North American or Western European company. What are the conditions in India that might make such broad-based diversification both feasible and profitable?
3. Giorgio Armani SpA is an Italian private company owned mainly by the Armani family. Most of its clothing and accessories are produced and marketed by the company (some are manufactured by outside contractors). For other products, notably fragrances, cosmetics, and eyewear, Armani licenses its brand names to other companies. Armani is considering expanding into athletic clothing, hotels, and bridal shops. Advise Armani on whether these new businesses should be developed in-house, by joint ventures, or by licensing the Armani brands to specialist companies already within these fields.
4. General Electric, Berkshire Hathaway, and Richard Branson's Virgin Group each comprise a wide range of different businesses that appear to have few close technical or customer linkages? Are these examples of unrelated diversification? For each of the three companies, can you identify linkages among their businesses such that bringing them under common ownership creates value?
5. Amazon has diversified from online retailing into cloud computing services (Amazon Web Services), tablet computers (Amazon Fire), and the production of movies and TV shows (Amazon Studios). What synergies might justify these diversifications?

Notes

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2. A. D. Chandler Jr., *Strategy and Structure: Chapters in the History of the Industrial Enterprise* (Cambridge, MA: MIT Press, 1962); R. P. Rumelt, *Strategy, Structure and Economic Performance* (Cambridge, MA: Harvard University Press, 1974); H. Itami, T. Kagono, H. Yoshihara, and S. Sakuma, "Diversification Strategies and Economic Performance," *Japanese Economic Studies* 11 (1982): 78–110.
3. M. Goold and K. Luchs, "Why Diversify? Four Decades of Management Thinking," *Academy of Management Executive* 7 (August 1993): 7–25.
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12. M. E. Porter, "From Competitive Advantage to Corporate Strategy," *Harvard Business Review* 65 (May/June 1987): 43–59.
13. M. Hayward and D. C. Hambrick, "Explaining the Premiums Paid for Large Acquisitions," *Administrative Science Quarterly* 42 (1997): 103–127.
14. On average, new, diversifying ventures make losses for their first six years of life; see R. Biggadike, "The Risky Business of Diversification," *Harvard Business Review* (May/June 1979): 103–111.
15. The formal definition of *economies of scope* is in terms of "subadditivity." Economies of scope exist in the production of goods $x_1, x_2, \dots, x_n$, if $C(X) < \sum_i C_i(x_i)$, where $X < \sum_i(x_i)$ $C(X)$ is the cost of producing all n goods within a single firm $\sum_i C_i(x_i)$ is the cost of producing the goods in n specialized firms. See W. J. Baumol, J. C. Panzar, and R. D. Willig, *Contestable Markets and the Theory of Industry Structure* (New York: Harcourt Brace Jovanovich, 1982): 71–72.
16. "Our true core competency today is not manufacturing or services, but the global recruiting and nurturing of the world's best people and the cultivation in them of an insatiable desire to learn, to stretch and to do things better every day." *Letter to Shareholders, General Electric Annual Report*, 2000.
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