

Week 6 Chapter 6 Corporate-Level Strategy

Corporate-level strategy: What businesses should a firm compete in?6:

- There are two key questions to address:
 1. In what product markets and businesses should the firm compete?
 2. How should corporate headquarters manage those businesses?

IMPORTANT DEFINITIONS

- **Corporate-level strategies**
 - **Market development** – moving into different geographic markets
 - **Product development** – developing new products and/or significantly improving on existing products
 - **Horizontal integration** – acquiring competitors; horizontal movement at the same point in the value chain
 - **Vertical integration** – becoming your own supplier or distributor through acquisition; vertical movement up or down the value chain

Corporate-level strategy

Diversification

- Diversification:
 - involves growing into new business areas either related (similar) or unrelated (different) to existing business
 - allows a firm to create value by productively using excess resources.

- Diversified firms:
 - operate in several different and unique product markets and likely in several businesses
 - uses two types of strategies: corporate-level (or company-wide) and business-level (or competitive)
 - must select a business-level strategy for each one of its businesses.

- Product diversification
 - is a primary form of corporate-level strategy
 - concerns the scope of the markets and industries in which a firm competes.
- The ideal portfolio of businesses balances diversification's costs and benefits.
 - Profitability variation is reduced as earnings are generated from different businesses.
 - It offers independence/flexibility to shift investments to those markets with the greatest returns.

Figure 6.1 Levels and types of diversification

Low levels of diversification

Single business: More than 95 per cent of revenue comes from a single business.

Dominant business: Between 70 and 95 per cent of revenue comes from a single business.

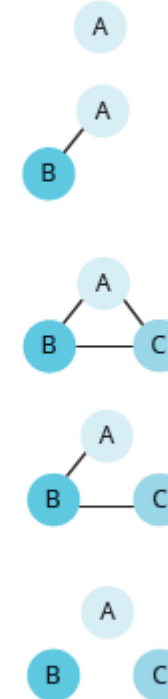
Moderate to high levels of diversification

Related constrained: Less than 70 per cent of revenue comes from the dominant business, and all businesses share product, technological and distribution linkages.

Related linked (mixed related and unrelated): Less than 70 per cent of revenue comes from the dominant business, and there are only limited links between businesses.

Very high levels of diversification

Unrelated: Less than 70 per cent of revenue comes from the dominant business, and there are no common links between businesses.



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

Levels of Diversification

- A firm's diversified businesses are related when they share links among:
 - products (goods or services)
 - technologies
 - distribution channels.
- The more links among businesses, the more 'constrained' is the relatedness of diversification.
- 'Unrelated' refers to **the absence of direct links** between businesses.

Levels of Diversification

- **Single business strategy** – corporate-level strategy in which the firm generates 95 per cent or more of its sales revenue from its core business area
 - Example: Wrigley
 - Wm. Wrigley Jr. Company, the world’s largest producer of chewing and bubble gums, historically used a single-business strategy while operating in few product markets.
 - In 2005, Wrigley employed the dominant-business strategy when it acquired the confectionery assets of Kraft Foods Inc., including Life Savers and Altoids.
 - In 2008, Wrigley was acquired by Mars, a privately held global confection company.

Levels of Diversification

- Dominant business diversification strategy
 - Corporate-level strategy whereby firm generates 70–95 per cent of total sales revenue within a single business area
 - Example: United Parcel Service (UPS)

MODERATE TO HIGH LEVELS OF DIVERSIFICATION

- **Related constrained diversification strategy**
 - Less than 70 per cent of revenue comes from the dominant business.
 - There are direct links (i.e. shared products, technology and distribution linkages) among the firm's businesses.
 - Example: Proctor & Gamble

MODERATE TO HIGH LEVELS OF DIVERSIFICATION

- **Related linked diversification strategy (mixed related and unrelated)**
 - Less than 70 per cent of revenue comes from the dominant business.
 - Mixed: Linked firms sharing fewer resources and assets among their businesses (compared with related constrained) and concentrating on the transfer of knowledge and competencies among the businesses
 - Example: GE

VERY HIGH LEVELS OF DIVERSIFICATION

▪ **Unrelated**

- Less than 70 per cent of revenue comes from dominant business.
- There are no relationships between businesses.
- Examples: Samsung, Wesfarmers

Table 6.1 Reasons for diversification

**Value-creating
diversification**

- Economies of scope (related diversification)
- Sharing activities
- Transferring core competencies
- Market power (related diversification)
- Blocking competitors through multi-point competition
- Vertical integration
- Financial economies (unrelated diversification)
- Efficient internal capital allocation
- Business restructuring

**Value-neutral
diversification**

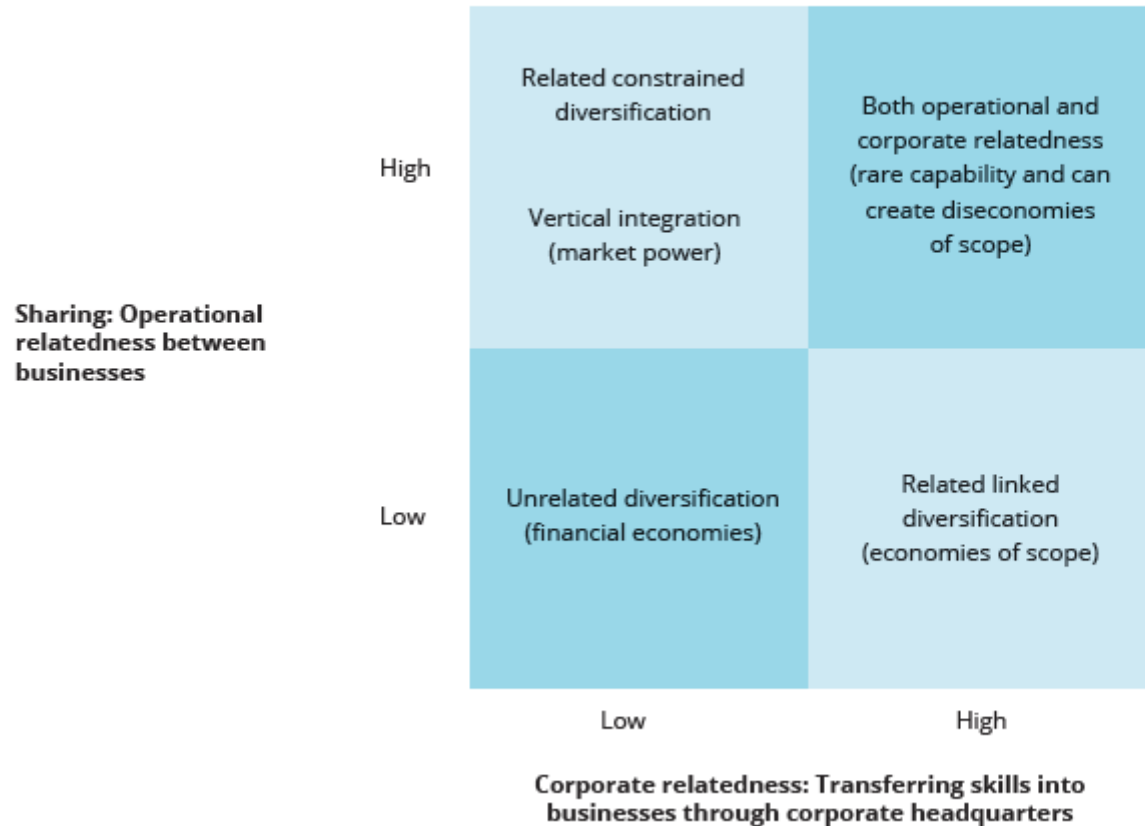
- Antitrust regulation
- Tax laws
- Low performance
- Uncertain future cash flows
- Risk reduction for organisation
- Tangible resources
- Intangible resources

**Value-reducing
diversification**

- Diversifying managerial employment risk
- Increasing managerial compensation

Figure 6.2

Value-creating diversification strategies: operational and corporate relatedness



VALUE-CREATING DIVERSIFICATION: RELATED CONSTRAINED AND RELATED LINKED DIVERSIFICATION

- Operational relatedness in sharing activities
- Corporate relatedness in transferring skills or corporate core competencies among units

The difference between sharing activities and transferring competencies is based on how the resources are jointly used to create economies of scope.

VALUE-CREATING DIVERSIFICATION: RELATED CONSTRAINED AND RELATED LINKED DIVERSIFICATION

- **Corporate relatedness: Transferring of core competencies**
 - Complex sets of resources and capabilities linking different businesses through managerial and technological knowledge, experience and expertise
 - Two sources of **value creation**
 - Expenses incurred in first business and knowledge transfer reduce resource allocation for second business
 - Intangible resources are difficult for competitors to understand and imitate, so there is an immediate competitive advantage over competition.

VALUE-CREATING DIVERSIFICATION: RELATED CONSTRAINED AND RELATED LINKED DIVERSIFICATION

■ **Market power**

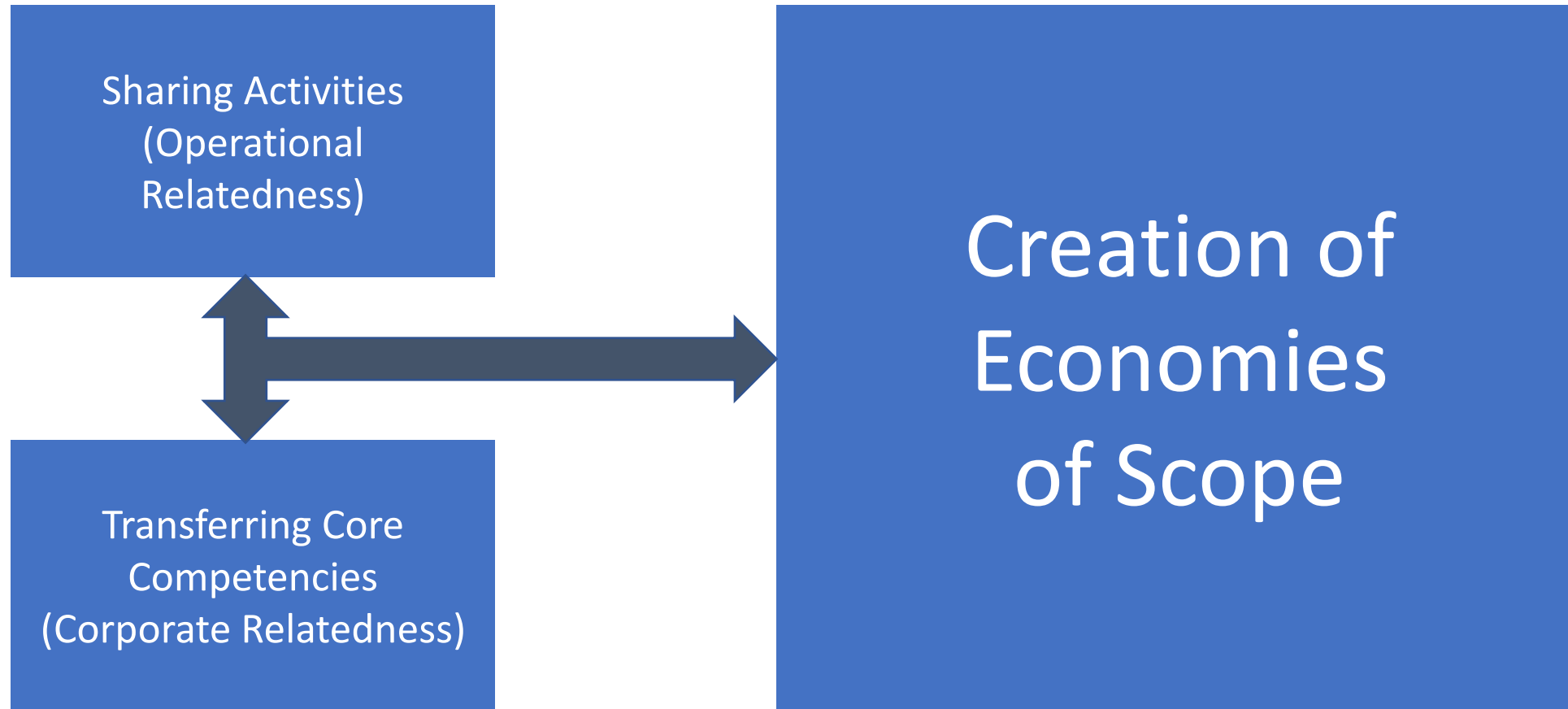
- relevant for related constrained and related linked
- exists when a firm is able to sell its products **above the existing competitive level**, to reduce costs of primary and support activities below the competitive level, or both
- includes related diversification strategies:
 - vertical integration
 - backward integration: produces own inputs
 - forward integration: operates its own distribution system for delivering outputs
 - virtual integration

VALUE-CREATING DIVERSIFICATION: RELATED CONSTRAINED AND RELATED LINKED DIVERSIFICATION

- **Market power:** Many manufacturing firms have been **reducing vertical integration** to gain market power

- **Deintegration** involves **developing independent supplier networks**, which is the focus of many manufacturing firms, such as Intel, Dell, Ford and General Motors

VALUE-CREATING DIVERSIFICATION: RELATED CONSTRAINED AND RELATED LINKED DIVERSIFICATION



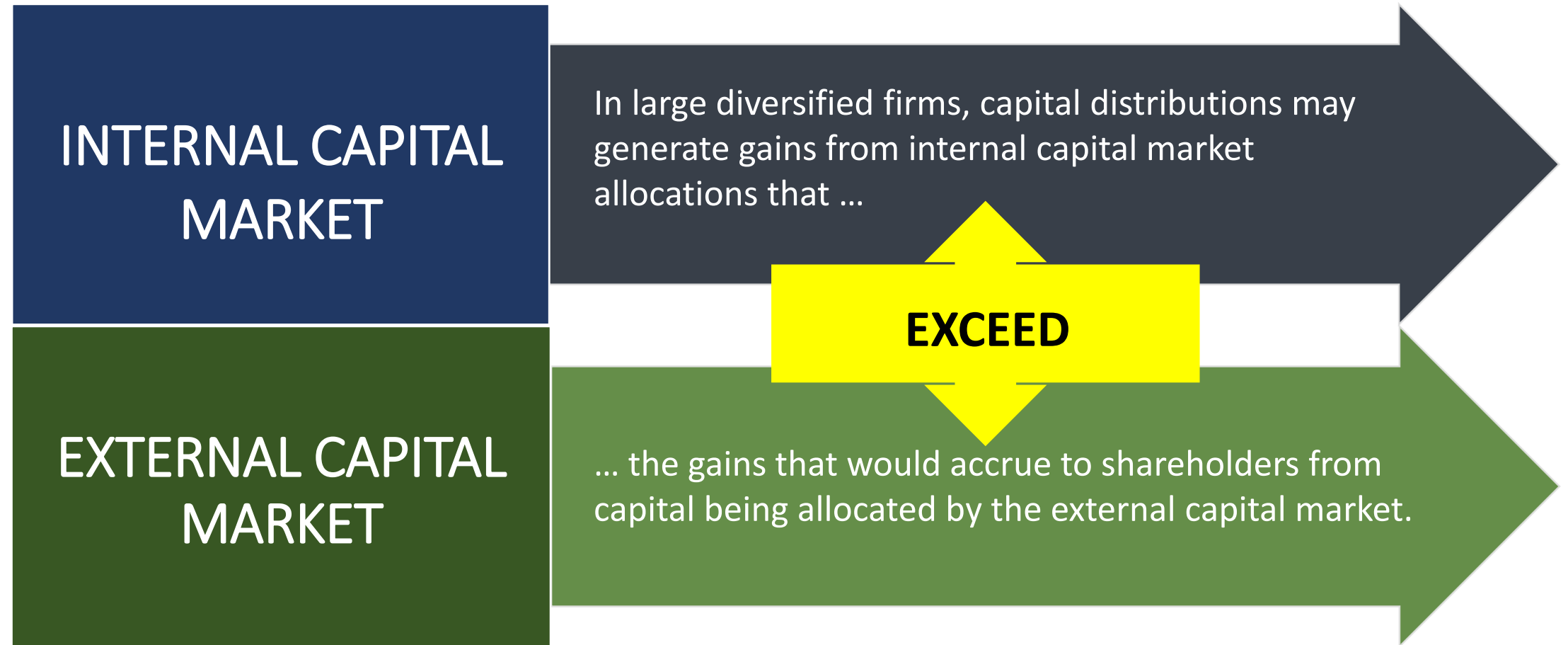
UNRELATED DIVERSIFICATION

- Unrelated diversification creates value through two types of **financial economies**:
 - cost savings realised through **improved allocations of financial resources** based on investments inside or outside firm
 - Efficient internal capital market allocation
 - **restructuring of acquired assets**
 - Firm A buys firm B and restructures assets so it can operate more profitably and then A sells B for a profit in the external market

UNRELATED DIVERSIFICATION: EFFICIENT INTERNAL CAPITAL MARKET ALLOCATION

- In a market economy, capital markets allocate capital efficiently.
- **Equity** – Investors take equity positions (ownership) with high expected future cash-flow values.
- **Debt** – Debt holders try to improve the value of their investments by taking stakes in businesses with high growth and profitability prospects.

UNRELATED DIVERSIFICATION: EFFICIENT INTERNAL CAPITAL MARKET ALLOCATION



UNRELATED DIVERSIFICATION: EFFICIENT INTERNAL CAPITAL MARKET ALLOCATION

■ **Conglomerate discount**

- This discount results from analysts not knowing how to value a vast array of large businesses with complex financial reports.
- Stock markets apply a conglomerate discount of 20 per cent on unrelated diversified firms, which means that investors believe that the value of conglomerates is 20 per cent less than the value of the sum of their parts.
- To overcome this discount, many unrelated diversifiers or conglomerates have sought to establish a brand for the parent company.

UNRELATED DIVERSIFICATION: RESTRUCTURING OF ASSETS

- Restructuring creates financial economies.
 - A firm creates value by buying, restructuring and selling the restructured firm's assets in the external market.
 - An economic downturn can present opportunities but also some risks.
- Resource allocation decisions may become complex, so success often requires:
 - focus on mature, low-technology businesses
 - focus on businesses not reliant on a client orientation.

DIVERSIFICATION ADVANTAGES

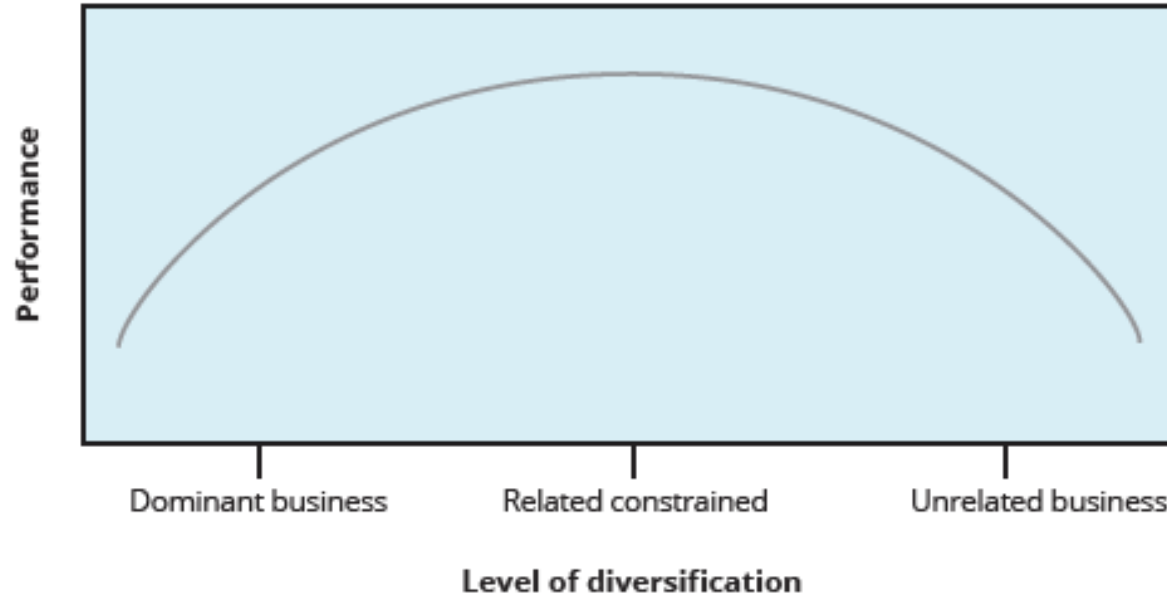


VALUE-NEUTRAL DIVERSIFICATION: INCENTIVES AND RESOURCES

Incentives to diversify

External Incentives	Internal Incentives
Antitrust regulations	Low performance
Tax laws	Uncertain future cash flows
	Synergy and firm risk reduction

Figure 6.3 The curvilinear relationship between diversification and performance



INTERNAL INCENTIVES TO DIVERSIFY

Low performance

Low performance is an incentive for diversification as corporations chase profitable firms (or divest poor performers).

INTERNAL INCENTIVES TO DIVERSIFY

Low performance

Uncertain future
cash flows

Diversification may be a defensive strategy if:

- the product line matures
- the product line is threatened
- the firm is small and is in a mature or maturing industry.

INTERNAL INCENTIVES TO DIVERSIFY

Low performance

Uncertain future
cash flows

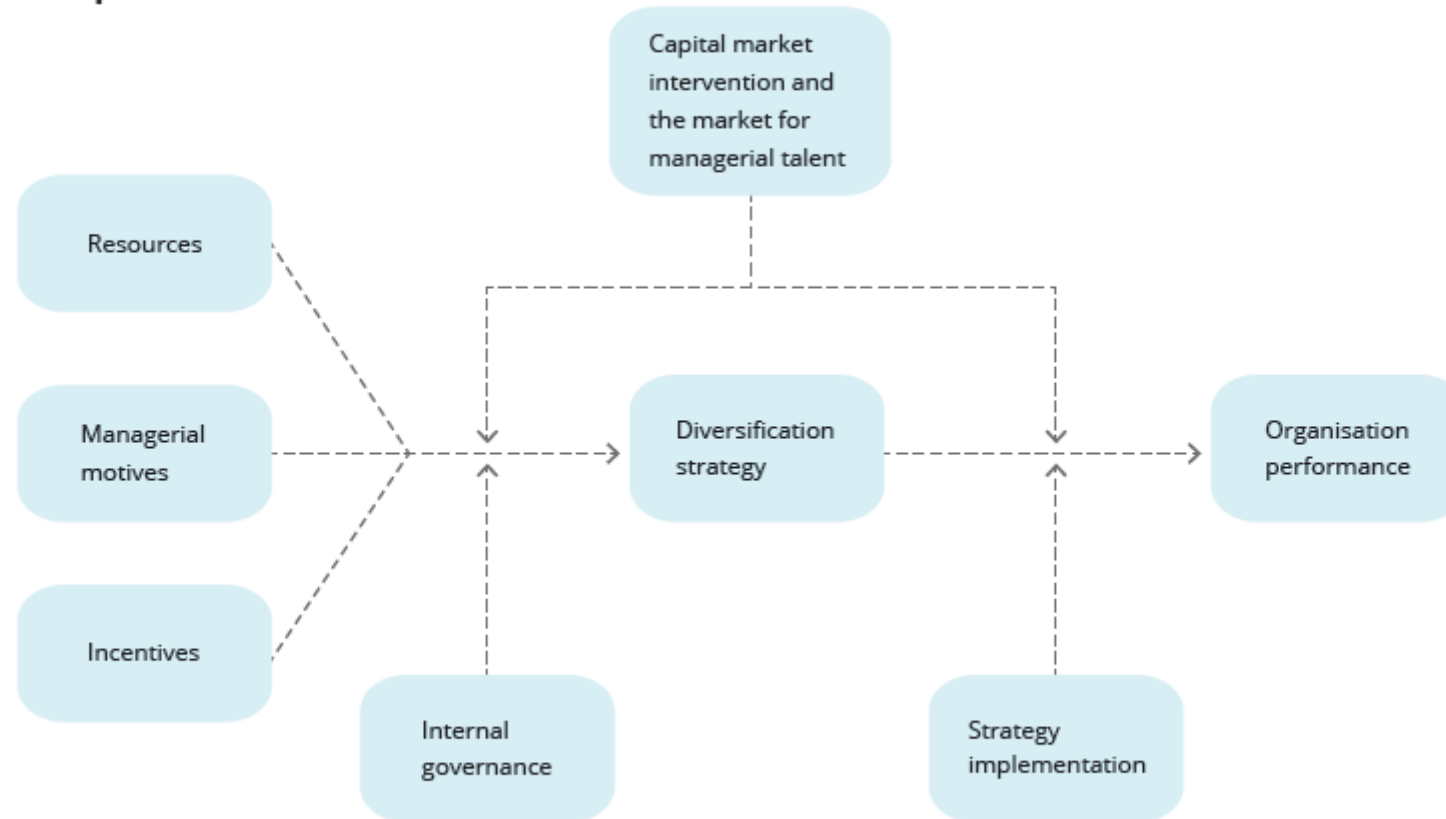
Synergy and risk
reduction

- Synergy exists when the value created by businesses working together exceeds the value created by them working independently.
- However, synergy creates joint interdependence between business units.
- A firm may reduce the level of technological change by operating in more certain environments, resulting in more related types of diversification.
- A firm may become risk averse, constrain its level of activity sharing and forgo potential benefits of synergy, resulting in more unrelated types of diversification.

VALUE-REDUCING DIVERSIFICATION: MANAGERIAL MOTIVES TO DIVERSIFY

- Top-level executives may diversify in order to diversify their own employment risk, as long as profitability does not suffer excessively.
 - Diversification adds benefits for top-level managers but not shareholders.
 - This strategy may be held in check by governance mechanisms or concerns for one's reputation.

Figure 6.4 Summary model of the relationship between diversification and organisation performance



Source: Adapted from R. E. Hoskisson & M. A. Hitt, 1990, Antecedents and performance outcomes of diversification: A review and critique of theoretical perspectives, *Journal of Management*, 16: 498.