



## MODULE NOTE

## Corporate Strategy

As a strategist, you must decide for your firm what products to produce, what customers to serve, what geographies to operate in, and what activities to perform. This module on *Corporate Strategy* provides you with a perspective for thinking about how these questions can be addressed, so that you can determine the scope of your firm, and, given the scope, manage it in the most effective manner.

### The Scope of the Firm

The *Competitive Advantage* note mentioned that to establish a position of advantage, as a strategist you must address two questions:

- **Where to play?** In which product or service lines, customer segments, and geographies should your firm operate? How much of the product value should you develop internally?
- **How to excel?** Pathways to advantage exist in nearly every market. We employ some tools to develop a deeper understanding of those pathways.

The *Competitive Advantage* module focused on the second question: how to excel in a particular market? In this module on *Corporate Strategy*, we discuss how a strategist can address the first question: where to play?

In doing so, it is important to recognize that our unit of analysis is different in this module, compared to most of the other modules of the course. The *Market Attractiveness*, *Competitive Advantage*, and *Strategic Interactions* modules take the business unit as the unit of analysis. The *Corporate Strategy* module considers the entire corporation as the unit of analysis and asks: What should be the **scope** of the firm? And given its scope, how should it be managed for best results?

The scope of your firm can be characterized across three dimensions: horizontal, vertical, and geographic. *Horizontal scope* is the range of product markets in which your firm operates. Each product market comprises a product category that your firm produces and a customer segment to which it sells the product. Some firms operate in a broad product market space; others, in a narrow space. In the cybersecurity market as of 2018, Symantec and McAfee proffered a broad range of offerings that included perimeter security (such as firewalls), which almost all companies used, as well as more sophisticated Identity Management Systems (IMS), which a subset of companies used.

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Another set of cybersecurity firms, such as Okta and Ping Identity, offered a narrower suite that focused on IMS. Yet another set of firms, including CyberArk and BeyondTrust, provided only highly specialized Privileged Account Management (PAM) services, which an even smaller set of companies used.<sup>1</sup>

*Vertical scope*, i.e. how much of the value chain the firm owns, also varies from one firm to another. Some branded apparel retailers, such as Target and Macy's, contract out most of the supply chain (including design, purchase, manufacturing, and supply to retail outlets), retaining only retailing and oversight activities. Others, such as Brooks Brothers, began as vertically integrated establishments but, over time, have narrowed their presence in the supply chain primarily to retail and oversight, choosing to contract with suppliers and designers rather than own or employ them. Yet others, such as Inditex's Zara, are vertically integrated, having their own buyers purchase raw material, cutting and manufacturing in their own factories, and selling their apparel through company-owned stores.

*Geographic scope*, the spread of a firm across geography, also varies considerably across firms. Bulge bracket investment banks have offices that span the globe. As of 2019, Goldman Sachs, for example, operated in 30 countries; Morgan Stanley, in 42. Boutique investment banks typically operate with a much smaller geographic footprint. In 2019, WR Hambrecht + Co. was in five locations, of which one was outside the U.S.; Allen & Company, the "invisible" boutique investment bank, was in one location: New York City.

## Determining the Scope of the Firm

As a strategist, how do you determine whether your firm should have a broad or a narrow scope across these three dimensions: horizontal, vertical, and geographic? Although it might seem that the answer to this question would differ across the three dimensions, in fact, on all three dimensions the answer depends on applying two tests: the *better-off test* and the *ownership test*.<sup>2</sup>

The **better-off test** asks: If two business units in different markets are brought together, does their combined competitive advantage improve upon what they could have achieved on their own?

The **ownership test** asks: Does ownership of both business units produce greater competitive advantage than would an alternative arrangement?

The **better-off test** relies on arguments of cost-side or revenue-side scope economies. Cost-side economies of scope arise when the cost of producing two products together is less than the total cost of producing them separately. Such economies can arise from shared procurement, common production, distribution economies, etc. An example of cost-side economies of scope is petroleum refining, which produces several by-products besides gasoline, including liquefied petroleum gas, wax, lubricants, tar, asphalt, naphtha, kerosene, and fuel oils. Most petroleum refineries, therefore, either contract with, or have, operations, that sell not only gasoline, but also fertilizers, perfumes, asphalt, motor oil, grease, etc.

Revenue-side economies of scope arise when the revenue generated by selling two goods together is greater than the sum of revenues generated if the two goods are sold separately. Such economies can arise from one-stop shopping convenience, cross-selling, etc. An example of an organization relying on revenue-side economies of scope would be the financial services firm Charles Schwab, which offers a range of services including investment advisory, brokerage, investment management, banking, and cash management, with the approach that cross-selling generates revenue synergies.

The **ownership test** relies on arguments of missing markets and relationship-specific investments.<sup>3</sup> Tesla's electric car manufacturing depended crucially on ready availability of battery packs of a particular configuration at a performance-cost point that did not exist in the market. Jointly with battery manufacturer Panasonic, the firm established Gigafactory in 2016 to meet this need. The Chilean pulp and wood producer Arauco builds, owns, and operates sawmills close to its timber forests. Other firms would be reluctant to build sawmills in those locations, even at Arauco's request, because, once the mills are built, they would be entirely at Arauco's mercy.<sup>4</sup>

Provided below are illustrations of how the application of these two tests—the better-off test and the ownership test—helps establish the horizontal, vertical, and geographic scope of firms.

**Horizontal Scope** Business groups of affiliated firms in emerging economies such as India, Indonesia, and Korea are extensively diversified, have cross-equity shareholding among nominally independent businesses, and engage in extensive intragroup business transactions and other forms of resource sharing, such as transferring managerial personnel across business units. Weaker enforcement of property rights and contracts in emerging economies leads to the presence of “institutional voids,” spaces where more mature economies would have functioning market intermediaries. In the absence of well-functioning markets for financial capital, corporate control, and human talent, business groups substitute for those markets. The group structure, by providing its members better access than markets to information, finance, and human capital, helps its member firms perform better together than they would as independent firms. Ownership ensures sharing of resources and information that would not be replicable through contracts, particularly in regimes of weak enforcement.<sup>5</sup>

**Vertical Scope** In a classic study, Paul Joskow studied the relationship between coal mines and electric utilities that consumed coal.<sup>6</sup> In the eastern U.S., coal tends to be homogeneous, there are several mines close by, and mines are small; in the western U.S., coal tends to be heterogeneous across mines, and mines are large and quite some distance apart. Thus, in the western U.S., investments made by electric utilities are specific to the type of coal to which they are close, unlike in the eastern U.S., where investments made by utilities are not specific to particular coalfields. Contracts covering all contingencies for relationship-specific investments would be onerous and difficult to execute. Joskow hypothesized, therefore, that the relationship between mines and utilities would be more akin to ownership in the western U.S. and more akin to spot contracts in the eastern U.S. His empirical tests confirmed the hypothesis that relationship-specificity of investment leads to long-term contracting.

**Geographic Scope** Deloitte Consulting offers to its clients large-scale transformation projects, which often have a significant IT component. The firm may have a large client based in the U.S. Its onsite team will assess the nature of the work needed and divide it into segments. Some of these segments are offshored to Deloitte's Global Delivery Center in India. The Indian operation completes its segment of work with IT professionals who receive lower compensation than IT professionals in the U.S. The work is then sent back to the onsite team, which stitches the various segments together and provides the solution to its client. By taking advantage of labor arbitrage between the U.S. and India, Deloitte offers solutions at a lower cost than a purely American organization could. By having an onshore team, it is able to provide solutions that fit client needs better than what a purely Indian offshoring company could provide. Thus, Deloitte Consulting is better off by having both onshore and offshore teams work on its projects. The two teams have to interact on multiple dimensions of the projects to ensure that their work is seamlessly integrated. Coordination with an outside party on all the dimensions would be extremely tedious, even if possible. Instead, both onshore and offshore operations are better off being part of the same firm.

### *Benefits and Challenges of Narrow Scope*

A firm with a broad scope can apply its assets and conduct its activities across multiple businesses. However, a narrowly focused firm can achieve greater congruence between its assets, its activities, and its strategy.<sup>7</sup>

For several decades since its founding in 1964, Egon Zehnder, one of the “Big Five” executive search firms, focused exclusively on senior level executive searches for its clients, forsaking junior level recruitment. Unlike other executive search firms, it charged a fixed fee rather than a percentage fee linked to the compensation of executives hired. It kept clients and placed candidates off-limits from new recruitment for a longer duration than did its competitors. To encourage its professionals to work collaboratively to find the best candidates, the firm paid its partners compensation that was related to overall firm performance, rather than individual production. The firm was selective and thorough in its recruitment. Most professionals, once recruited, made partner in a few years, and partners rarely left the firm before retirement. The firm operated as an old-fashioned partnership, whose global partners met on multiple-day retreats twice every year. Egon Zehnder’s choices, in terms of organization structure, recruitment, compensation, culture, client service, and pricing, were congruent with its strategy to be the firm of choice for top-level executive searches commissioned by major global companies.

These choices also meant that Egon Zehnder did not (a) expand from senior level executive search to junior level recruitment, (b) invest aggressively in Internet-based hiring, or (c) go public (unlike two of its competitors that were seeking funds to invest in aggressive growth and technology). As a consequence of following a narrow scope, Egon Zehnder did not grow as rapidly as did its major competitors, and the firm served a narrower range of executive searches than most of its competitors, but in its target segment—senior-level executive searches—the firm was generally recognized as excellent.

### **Structure, Governance, and Incentives within the Corporation**

Given its scope of activities, the firm must be managed in a way that allows it to achieve its value creation and value appropriation potential.<sup>8</sup> As a strategist, you must consider how to structure the firm, how to make decisions, and how to reward employees.

An organization’s structure depends on how the activities and resources of the firm are interwoven. For a single-business firm, a *functional organization*, with individuals specialized by activity (such as procurement, production, and sales), handing off from one activity to the next would be optimal. But for a company engaged in multiple businesses that operate very differently, a *multi-divisional organization*, with each business line’s value chain having significant autonomy, is optimal. A multi-national organization with multiple business lines, focused on several large customers, could be organized in at least one of three ways: geographic organization, with considerable autonomy given to each country operation; business line organization, with business units operating in an integrated manner across country boundaries, but remaining somewhat independent of each other; or customer-based organization, with activities serving particular customers grouped together, across business lines and countries. Which organization structure is optimal for the firm depends on how the activities of the firm are interlinked and how its resources are applied.

Given an organization’s structure, decisions can be made in a centralized or decentralized manner. As a strategist, you choose how much to delegate decision-making, taking into account two types of costs:<sup>9</sup>

- The cost of delegating decision rights to subordinates who have better information but whose incentives may not be aligned with those of the firm.
- The cost of not delegating decision rights to subordinates so that an executive with more aligned incentives, but less specific information, makes the decision.

Placing decision rights where these combined costs are minimal should lead to optimal decision-making and therefore better performance. If relevant information (i.e., information needed to make informed business decisions) at the activity level is general (i.e., easy to communicate), decision rights can be centralized. If the relevant information is specific (i.e., tacit and difficult to transmit), decision rights need to be decentralized to those performing the activity.

An additional consideration impacts your choice, as the strategist, on decision-making. Decentralization empowers those at the level of the activity to engage with their work. Even if the cost tradeoffs above suggest centralization, decentralization can be the better choice if it enhances the intrinsic motivation of those performing the activity and thereby boosts their productivity and creativity.<sup>10</sup>

Given the organization's structure and governance, as a strategist, you must design the appropriate incentive system. Incentive systems determine how employees are to be rewarded for their performance. Properly designed incentives motivate firm members to contribute in a way such that the firm creates and appropriates value.<sup>11</sup>

Decisions on structure, governance, and incentives significantly determine the performance of organizations. For instance, in the context of mergers, it is often said that 10% of the value of a merger is unlocked in the decision to merge, whereas 90% is unlocked in the post-merger integration. How the merged organization is structured, how decision rights are allocated, and how incentive systems are established can make or mar the transaction. In 1997, NationsBank acquired Montgomery Securities for \$1.3 billion. Post-merger integration challenges, particularly related to the allocation of decision rights, led in 1999 to a major part of the Montgomery Securities team walking out of NationsBank (which by then had acquired and assumed the name of Bank of America), and causing significant loss in value.<sup>12</sup>

## Common Reasons Why Corporate Strategies Fail<sup>13</sup>

As you consider the right corporate strategy for your firm, it is important to beware of some common pitfalls that cause corporate strategies to go awry.

**Misplaced Motives** Some companies expand scope as a way to “escape” a declining core business. Such diversification does not solve the problems in the core, and the firm may not have the capabilities to succeed in the new areas.

**Zero-sum arguments** Some companies acquire others to “go after where the money is;” some acquire adjacent firms in the supply chain to “reduce costs.” Acquiring profitable companies without creating additional value is a zero-sum game. Gains for the acquirer in terms of future cash flow streams are capitalized in the upfront acquisition price.

**Flawed logic** “Pie in the sky” projections of synergies, or overstatements of intangible core competencies, are employed to rationalize, rather than inform, scope expansion.

**Focus on the deal, not the firm** “Scope creep” is justified by focusing on the incremental gains from individual deals, rather than the overall impact on the scope of the firm.

**Best practices approach** Mimicking another corporation’s choice of scope does not ensure that your corporation is making the right corporate strategy decisions. Organizations have different strategies and different internal organizations. Scope choices that are best for one organization almost certainly are not so for another.

## Other Topics Covered by *Corporate Strategy*

Corporate strategy addresses how a company creates value through the configuration and coordination of its activities, which often transcend multiple markets.<sup>14</sup> Investment bankers that specialize in mergers and acquisitions, strategy consultants that advise senior leaders of large corporations, strategy executives in multi-business companies, and leaders of most large corporations delve in detail into the intricacies of corporate strategy.

What is offered in this note, the module, and the cases in our course should be taken as simply an introduction to corporate strategy. Our course touches only on some of the topics addressed in the field. There are several other topics that we will not address, or address only briefly, in this module. Following are four such topics.

**Does diversification create value?** Influential studies in the 1990s pointed to a *diversification discount* for multi-business firms.<sup>15</sup> Subsequent studies have challenged the existence of such a discount. Some studies argue that causality is reversed: diversification does not lead to poor performance, instead diversification often follows when firms perform poorly in their core businesses.<sup>16</sup>

**How does a multi-business firm create value?** There are four ways for a multi-business corporation to improve its overall performance: (a) improve the performance of its individual business lines; (b) alter its portfolio composition so that it is weighted more in favor of higher performing businesses; (c) exploit synergies between the business lines to improve their performance; and (d) reduce the cost of the corporate center.<sup>17</sup>

**When should a firm enter into an alliance or a joint venture with another firm?** Where spot transactions between parties are at one extreme and shared ownership is at another extreme in terms of length of relationship, alliances and joint ventures occupy a space between the two. Joint ventures and alliances afford firms the opportunity to make specific investments and access complementary assets without worrying about the other party not keeping its side of the bargain, while not having to own the party to ensure compliance.<sup>18</sup>

**What are the advantages and challenges of operating an international organization?** An international footprint allows an organization to achieve scale, customize to multiple local markets, and exploit differences across geography to its advantage. However, managing a multi-national organization also poses the challenge of balancing local flexibility against global coordination.<sup>19</sup>

Those interested in exploring this subject in greater depth should consider further reading and elective curriculum courses on corporate strategy and international business.

## Module Sessions

Our module on corporate strategy comprises three case sessions.

- We begin the module with a classic case, **Disney**. It provides us a close look at how a diversified, multi-business organization creates a corporate advantage. The Walt Disney Company, based originally on an animated mouse, has become one of the best-known media and entertainment companies in the world. Since taking over as CEO in 2005, Bob Iger has led the company to new heights. In recent years, Disney has made some bold moves, including the acquisition of 21st Century Fox for \$71 billion in 2017 and the launch of Disney+ in 2019. The company now faces new challenges and opportunities as it enters direct-to-customer video streaming.
- The second case in this module studies **Wachtell Lipton**, a small, New York City based law firm that is consistently the most profitable and one of the most prestigious among all U.S.-based law firms. Wachtell Lipton focuses on a limited set of specialties, primarily M&A advisory to corporate clients. It operates from one office, has a small number of attorneys, has grown conservatively, and recruits selectively. But as the legal services industry evolves, the firm's tried-and-tested approach faces new challenges.
- Finally, we discuss confectionery and beverage business **Cadbury Schweppes**'s decision of whether to make an acquisition bid for Adams, an underperforming gum company which had been put up for sale by Pfizer. CEO John Sunderland and chief strategy officer Todd Stitzer must evaluate the potential synergies between the two confectionery businesses and determine how likely the deal will be to create value at an estimated price of at least \$4 billion. This case allows us to examine mergers and acquisitions as a means of effecting corporate strategy.

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- Nanda, Ashish and Margaret Cross, "Wachtell Lipton: Focused Excellence," HBS No. 720-396, March 5, 2020.

## Endnotes

<sup>1</sup> For more details on the landscape of the cybersecurity industry, please refer to Sadun, Raffaella, David Yoffie, and Margot Eiran, “CyberArk: Protecting the Keys to the IT Kingdom,” HBS 718-418, September 2017, revised July 31, 2018.

<sup>2</sup> Piskorski, Mikolaj Jan, “Note on Corporate Strategy,” HBS 705-449, January 2005, revised February 7, 2006, p. 2.

<sup>3</sup> Bharat Anand (“Corporate Strategy,” HBS 713-415, July 17, 2012, p. 7) points to two additional rationales for ownership: addressing coordination challenges and resolving double marginalization.

<sup>4</sup> Casadesus-Masanell, Ramon, Jorge Tarzijan, and Jordan Mitchell, “Arauco (A): Forward Integration or Horizontal Expansion?” HBS 705-474, February 15, 2005, revised March 2009.

<sup>5</sup> For a description of institutional voids, refer to Palepu, Krishna G. and Tarun Khanna, “Institutional Voids and Policy Challenges in Emerging Markets,” *Brown Journal of World Affairs*, vol. 5, no. 1 (1998). For empirical work on business groups in emerging markets, please refer to Chang, Sea Jin and Jaebum Hong, “Economic Performance of Group-Affiliated Firms in Korea: Intragroup Resource Sharing and Internal Business Transactions,” *Academy of Management Journal*, vol. 43 (2000): pp. 429-448; Chittoor, Raveendra, Prashant Kale, and Phanish Puranam, “Business Groups in Developing Capital Markets: Towards a Complementarity Perspective,” *Strategic Management Journal*, vol. 36 (2015): pp. 1277-1296; and Ghemawat, Pankaj and Tarun Khanna, “The Nature of Diversified Business Groups: A Research Design and Two Case Studies,” *Journal of Industrial Economics*, vol. 46 (1998): pp. 35-61.

<sup>6</sup> Joskow, Paul, “Contract Duration and Relationship-Specific Investment: Empirical Evidence from Coal Markets,” *American Economic Review*, vol. 77, no. 1 (March 1987): pp. 168-185.

<sup>7</sup> Van den Steen, Eric, “Creating and Sustaining Competitive Advantage,” HBS 717-479, December 15, 2017, p. 6. This note is not currently available for purchase.

<sup>8</sup> Bharat Anand (“Corporate Strategy,” HBS 713-415, July 17, 2012, pp. 7-8) and Ramon Casadesus-Masanell (“Corporate Strategy,” HBP 8118, April 13, 2017, pp. 25-28) describe this as the third test of corporate strategy (beyond the better-off test and the ownership test): the organizational test.

<sup>9</sup> Jensen, Michael C., and William H. Meckling, “Specific and General Knowledge, and Organizational Structure,” *Journal of Applied Corporate Finance*, 8(2), Summer 1995, pp. 4-19.

<sup>10</sup> See, for example, Amabile, Teresa A., “Motivation for Creativity in Organizations,” HBS 396-240, January 22, 1996.

<sup>11</sup> For a detailed review of incentive systems, see Hall, Brian J., “Incentive Strategy within Organizations,” HBS 902-131, March 13, 2002.

<sup>12</sup> For details, refer DeLong, Thomas J., Ashish Nanda, Boris Groysberg, Matthew C. Lieb, and Scott D. Landry, “Thomas Weisel Partners (A),” HBS 800-331, February 2, 2005.

<sup>13</sup> This section draws upon Anand, Bharat, “Corporate Strategy,” HBS 713-415, July 17, 2012, pp. 9-11.

<sup>14</sup> For descriptions of the field of corporate strategy and the topics it covers, please refer to Anand, Bharat, “Corporate Strategy,” HBS 713-415, July 17, 2012; Casadesus-Masanell, Ramon, “Corporate Strategy,” HBP 8118, April 13, 2017; Collis, David and Cynthia Montgomery, “Corporate Strategy: A Conceptual Framework,” HBS 391-284, April 17, 1995; Piskorski, Mikolaj Jan, “Note on Corporate Strategy,” HBS 705-449, February 7, 2006; and Sadun, Raffaella, “Corporate Strategy: Course Introduction 2018,” HBS 718-459, March 2, 2018.

<sup>15</sup> Berger, Philip G. and Eli Ofek, “Diversification’s effect on Firm Value,” *Journal of Financial Economics*, 37 (1995), pp. 39-65.

<sup>16</sup> Campa, Jose Manuel, and Simi Kedia, “Explaining the Diversification Discount,” *Journal of Finance*, 57 (2002), pp. 1731-1762; Villalonga, Belen, “Diversification Discount or Premium? New evidence from the Business Information Tracking Series,” *The Journal of Finance*, vol. 59 (2), April 2004.

<sup>17</sup> Anand, Bharat, “Corporate Strategy,” HBS 713-415, July 17, 2012, pp. 3-4. Anand also points out that in addition to these “efficiency reasons,” there may be “market power” reasons for increase in corporate performance.

<sup>18</sup> See, for example, Chan, Su H., John W. Kensinger, Arthur J. Keown, and John D. Martin, “Do Strategic Alliances Create Value?” *Journal of Financial Economics*, vol. 46 (2), November 1997, pp. 199-221.

<sup>19</sup> See, for instance, Ghemawat, Pankaj, “Managing Differences: The Central Challenge of Global Strategy,” *Harvard Business Review*, R0703C, March 2007.