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MODULE NOTE

Corporate Strategy

This module of the required strategy course turns attention from companies with a single primary line of business to exploring strategies of multi-business organizations—also termed "corporate strategy" (in contrast to "business level strategy"). This note describes the basic strategic choices facing multi-business organizations, and a framework by which to approach such decisions. Although the level of analysis is different for corporate level versus business unit strategy, the central principles of strategy continue to apply here. Specifically, and first, "creating advantage" at the corporate level invariably requires *differentiating* from competitors rather than mimicking them. Second, a hallmark of effective corporate decision making is that such decisions are treated in an *integrated* manner rather than piecemeal. Third, organizational choices create important *corporate-level tradeoffs*—that, in turn, imply that different multi-business firms can add value to their underlying businesses in different ways. As a result, "best practice" approaches to corporate strategy formulation and analysis are best avoided.

The remainder of this note elaborates on these issues, exploring four questions in turn: (a) How is corporate advantage defined, and who are a multi-business firm's competitors? (b) What are relevant corporate level choices? (c) What are different ways by which corporations add value to underlying businesses? (d) What are some pitfalls to avoid when analyzing, formulating, or executing corporate level strategy?

Corporate advantage

Corporate advantage refers to the ability of a firm to add value to its underlying businesses. In other words, corporate advantage is a derived concept—it is defined in terms of the competitive advantage of a corporation's business units. In order to assess whether a multi-business company has a "corporate advantage" one first needs to establish a benchmark against which to compare its performance (just like we do at the business unit level). A natural benchmark in assessing value creation is the ability of other corporate parents to add value to similar underlying businesses. In practice, however, it is often hard to come by examples of other companies with identical portfolios to the firm in question. Therefore, in practice, one often adopts a simpler litmus test—a comparison with the performance of similar businesses that are run as stand-alone operations.[1] Obtaining

[1] Thus, to assess GE's corporate advantage, one would use data on comparables for each of its individual businesses to impute the stand-alone performance of each business. This set of imputed values can then be aggregated to provide an estimate of the break-up value of GE.

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estimates of this counterfactual (also referred to as the "break-up value" of a firm) is often easier since one can rely on publicly available data.

This definition also highlights the various sources of *competition* that are relevant for multi-business firms. At the level of the firm's individual business units are the familiar "five forces" of competition—buyers and suppliers, potential entrants, immediate rivals, and substitute products or services. When a company spans multiple businesses that are very similar or "related" these sources of competition will also naturally be relevant for corporate-level analyses. For example, consider Newell, a Fortune 500 firm that manufactures and markets a broad range of household products including picture frames, children's strollers, paintbrushes, and cookware. The power of Wal-Mart as a retail buyer, or the threat of entry by a low-cost manufacturer from China, affects *all* of Newell's businesses. Similarly, a media company that competes in print publishing, music, and film will face similar (substitution) threats from digital media to *all* its individual businesses). In other cases, however, where a firm may be spread across a range of rather different businesses—as, for example, the case of GE—the relevant competitors will be different for each individual business as well.

Empirical findings on the value from diversification

Whether or not firms add value through diversification remains one of the most spirited debates in management and strategy. Certain influential studies during the 1990s pointed to a "diversification discount" for multi-business firms. Specifically, diversified firms were shown, on average, to trade at a discount when compared to the imputed "break-up value" of their individual businesses (which is measured using data on the market values of comparable stand-alone businesses). Together, these findings raised considerable skepticism about the ability of multi-business firms to add value through diversification. On top of this, particularly in developed countries, "markets" were thought to perform quite well in allocating resources like capital and labor to individual businesses anyway, and in providing investors with options to diversify their portfolios. Last, the publicized failures of various high-profile mergers—from AOL-Time Warner to Daimler-Chrysler and financial services mega-mergers—increased skepticism about the value from diversification.

Recently, however, both the accuracy prescriptive implications of these findings have been challenged for various reasons. First, certain recent studies—using both richer datasets, and more sophisticated econometric treatments—directly call into question the existence of the "diversification discount." For example, one important critique[2] is that many prior studies documenting the discount rely on Compustat data that contain measurement errors in self-reporting of business segments. When the same analyses are performed using more accurate data at the establishment level (specifically, the Business Information Tracking Series or BITS), such a discount no longer exists. Second, the standard approach to measuring corporate advantage using "break-up values" suffers from selection bias. That is, certain studies find, firms often diversify only after they have become relatively unproductive in their core business and go onto show that the market affords these firms a discount as a result of the decline in their core business. In other words, these firms already suffer from a discount before they even begin to diversify, not because of it. Third, the debate on the discount focuses on differences in the average performance of diversified and undiversified firms as a group. Average effects ignore the large differences *within* each group and, as a result, the ability of a significant fraction of multi-business firms to add value. Recent studies show that, even for periods

[2] Villalonga, Belen (2004b) ["Diversification Discount or Premium? New Evidence from the Business Information Tracking Series." *The Journal of Finance,* April, Vol. 59 (2)].

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where multi-business firms suffer a market discount on average, between 30-40% of all diversified firms systematically outperform the average focused firm. [3]

This raises the important strategy question of why some diversified firms appear to perform very well even while others do not. The corporate strategy module allowed us to probe further into reasons for why and when diversified firms create value, common reasons for why they fail, and certain tests to evaluate the effectiveness of a multi-business firm's strategy.

Different sources of value creation

Consider a hypothetical multi-business firm that operates in four businesses, labeled A through D, whose individual performance is as follows:

Business	Weight on business in portfolio	Performance
A	17%	13%
B	50%	16%
C	20%	24%
D	13%	7.5%

The performance of the multi-business firm can be computed as the weighted average of the performance of the individual businesses (where the weights reflect the asset allocation across these businesses) minus the cost of the corporate center (which, say, is 2%). In this example, the overall firm performance can be computed to be 16%.

Using this simple example, one can see there are four different ways for the firm to increase overall performance:

1. It can alter its portfolio composition (or, the weights on each business in column 2): specifically, corporate performance can be improved by increasing the weight on high-performing businesses and reducing the weight on lower-performing ones. (Note, however, an important caveat: in order to do so the firm must have some informational advantage over the market or external investors. Absent this, the adjustment in portfolio weights has no overall performance effect since the benefits from gaining access to higher cash flow streams are already capitalized in the purchase price for the new shares).
2. It can try to improve the performance of the individual businesses (in column 3) independent of each other—that is, without necessarily exploiting any linkages between them. (Note here, again, that in order to do so the multi-business firm must have some ability to add value in a way that the underlying individual businesses could not do on their own).

[3] See, for example, Anand, Bharat N. and Dmitri Byzalov, (2011), "Systematic Heterogeneity versus Average Effects in the Returns to Diversification."

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3. It can improve the performance of the portfolio by exploiting linkages across individual businesses (or, *synergies*). Synergies can arise from various sources. Broadly, we can classify these as either sharing of resources—for example, brands, intellectual property, or managerial expertise—across businesses, or sharing activities between them—such as a common manufacturing facility, retail stores, or sales persons.[4]

4. It can reduce the cost of the corporate center.

The first three approaches are, respectively, referred to as strategies of *portfolio management*, *restructuring*, or *exploiting synergies (*which in turn includes either *resource transfers or activity sharing)*. As we see later, it is often hard for firms to be best-in-class at exploiting all these different types of value creation possibilities. The reason (as we see later) is that the organizational structures, systems, and processes that are necessary to exploit any of these different sources can be rather different from those required to optimize on others. For example, private equity firms try to improve the efficiency of individual businesses in isolation by providing high-powered incentives for managers running each business, by providing separate monitoring (and boards) for each portfolio business, and by reducing linkages across businesses that can result in reduced transparency (for example, from cross-subsidization) and slack. However, this very approach can often make it more difficult for them to exploit synergies across businesses in a way that operating companies can.

Each of the above approaches constitutes *efficiency* reasons for performance improvement. There are also *market-power* related reasons by which a firm can increase its performance. For example, combining two businesses can increase a firm's bargaining power vis-à-vis buyers or suppliers and allow it to extract more value. However, the result in this case is a transfer of value from one party to another rather than value creation in the aggregate. For this reason, we don't explicitly consider such market power reasons in what follows.[5]

Corporate level choices—and three tests

What choices are central in allowing multi-business firms to create corporate advantage (of the types described above)? To see this, first recall the choices available to business units in creating competitive advantage.

A business unit's assets and activities comprise the basic building blocks of its competitive strategy. Effective business unit strategy (i.e., strategy that yields a competitive advantage) typically involves tight integration between the business' activities; and, staff functions at the business unit level support these different activities. For a multi-business firm, additional considerations arise since the center of focus is no longer a single business unit but rather the portfolio of businesses within the firm. Supporting activities are provided not by staff functions at the BU level but via *corporate functions* at the level of the overall parent. And, the choice of whether or not to outsource particular activities in the BU is now generalized to whether or not to *own* each business at the corporate level.

As a result, there are three central choices of interest for multi-business firms: where to compete (or, the choice of businesses); what to own (or, the choice of firm boundaries); and, how to organize (or, the choice of structures, processes, and incentives). At any point in time, these choices will interact with the existing set of assets (both tangible and intangible) and attributes of the firm.

[4] These different sources of synergies are described in more detail later in the note.

[5] Furthermore, one ought to be cognizant of antitrust considerations that apply in those cases. Refer to "A Note on Antitrust and Competitive Tactics" for a description of certain important considerations in antitrust law.

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Below, we examine these choices in greater detail in the context of a particular decision to expand into a new business (i.e., horizontal diversification) or up or down the value chain (i.e., vertical integration).

The better-off test: The first question to ask is whether there is value created by putting two businesses together, or by upstream or downstream expansion. For example, should Wal-Mart get into the retail banking business, Pepsi into the restaurant business, or Comcast into content production? Might expansion into the new business either leverage particular strengths from existing ones, or benefit them in turn? Typically, one can separate cost-side from revenue synergies. *Cost-side scope economies* arise when the cost of producing product A and product B together is lower than the cost of producing A alone plus the cost of producing B alone. Cost-side synergies can arise from centralizing procurement, combining staff functions, economies in distribution and logistics, or common production platforms. *Revenue-side scope economies* arise when the willingness to pay for (or volume from selling) product A and product B together is greater than the willingness to pay for (or volume from selling) product A alone plus the willingness to pay for (or volume from selling) product B alone. They may arise from the convenience of one-stop shopping, bundling, or cross-selling.

While cost synergies are often a common driving force in mergers, the search for revenue synergies has become more common as well. For example, as we saw in this module, one objective behind Disney's long-term contractual relationship with Pixar during the 1990s was to facilitate investment in theme park rides based on Pixar movie characters (from Toy Story and Cars)…that might further contribute to interest in Pixar sequels…which in turn would drive more viewers to the theme parks…and so on. Similarly, several mergers between high-end and low-end machine tool manufacturers during the last decade were driven by the desire to combine product offerings towards "one-stop shopping" for industrial customers. Health care delivery has seen the emergence of multi-business firms like Covenant Health Systems, whose outpatient ambulatory care centers led to more referrals for more profitable inpatient care. And, cross selling motivated financial services firms like Charles Schwab to expand their product offerings to include money market funds and investment advisory services.

Each of these synergies described above stems from the *sharing of activities* by different businesses. Activity analysis is a useful, and concrete, way to evaluate value creation potential. However, tangible activity coordination is not the only source of synergies. Often, synergies arise from the *sharing of resources* or intangible skills. These might include a common brand, reputation, specific knowledge or expertise, managerial talent, or a common culture. Resource sharing suggests a different way to evaluate the "relatedness" of two businesses. Specifically, rather than simply ask whether the products being sold by the businesses are related, it asks whether there are common resources or competencies that one might share across them. For example, Honda expanded into cars, motorcycles, lawn mowers, and generators, leveraging its competence in engines and power trains. Canon expanded into copiers, laser printers, and cameras, exploiting its expertise in optics, imaging, and processor controls. And, Minebea expanded from ball bearings into semiconductors, leveraging its competence in miniaturized manufacturing.[6]

Identifying common resources or core competencies has the virtue of broadening how companies think about relatedness between their businesses—in particular, shifting focus from a product-market lens to a factor market or resource-based lens. However, one of the problems with the traditional

[6]These examples are drawn from C.K. Prahalad and Gary Hamel (1990), "The Core Competence of the Corporation," *Harvard Business Review*, 2-15.

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"core-competence" logic for expansion is that, in practice, virtually no company fails the test of identifying *some* core competence. Each of these examples above suggests an important principle to keep in mind when evaluating resource sharing benefits—namely, such benefits are most compelling not only when the competencies or resources are important drivers of performance in the business, but also when they are *distinctive* or unique to the firm in question.[7] Asking the question "what is the Mickey Mouse" that binds your different businesses is a provocative and useful question for many businesses to consider in this regard.

The ownership test: Does a firm need to own all its businesses in order to capture the value created from linkages across them; and, where should a firm's boundaries be drawn? For example, does Gucci need to own retail stores in order to realize the value from its brand? Is it necessary for Disney to own its hotels, cruise lines, and retail stores in order to capture the value from its brand, or might licensing, franchising, and other forms of contracting work equally well in those cases? Often, extracting the value from expansion into a new arena does *not* require that the firm fully own the new business as well. Firms contract with others all the time, and markets work reasonably well in most developed economies. As a result, the choice of whether or not to own two businesses should ultimately rest on some reason *why markets, or contracts, fail.*

The choice of ownership is relevant for most horizontal expansion decisions, but is particularly central to firms' decisions on whether or not to expand into adjacent parts of the value chain – the vertical integration question. Therefore, while the key questions behind the ownership test generally apply to either setting, we discuss them here largely in the context of the choice to vertically integrate.

Broadly speaking, expansion via ownership is justified either when it allows a company to create a larger pie, or to capture a larger share of an existing pie. The most common cases under which each of these are justified include the following:

An absence of markets: In early stages of industry development, firms may often find it necessary to expand into parts of the value chain that are adjacent to their core business in order to provide services that otherwise do not exist. Vertical integration by industry pioneers is often necessary to solve the "chicken-and-egg" problem that requires the simultaneous development of different parts of the value chain. Then, as the industry matures and develops, this is often accompanied by vertical de-integration by firms. The reason is that when the size of the market becomes large enough, independent players find it attractive to enter each part of the value chain.

Relationship specific investments: Consider a seller that invests $100 to produce a good that is customized to the needs of a buyer, and for whom it is worth $150. Customization is an example of a relationship-specific investment—where the investment or good has little value outside this relationship. In this setting, ex-post bargaining can result in the buyer "holding up" the seller: any negotiated price less than $100 does not allow the seller to recoup its investment. Examples of relationship-specific investments are common. A railroad has to build a branch line to an automaker's factory. An aluminum maker has to adjust its smelting process to match the chemical composition of the bauxite from a particular mine. A software developer has to write programs for an operating system that is not compatible with other systems. Transactions that involve such investments typically require lengthy, detailed, expensive contracts. If the contract is especially costly to write, the railroad and the automaker may fail to come to terms, even though both could benefit from the branch line. In that case, a single vertically integrated entity can minimize these holdup cost since it only cares about the overall pie, not its pattern of redistribution.

[7] See David Collis and Cynthia Montgomery (1997), *Corporate Strategy: A Resource-Based Approach* (McGraw-Hill).

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Coordination: Sometimes, coordination requirements between different stages of the value chain can be high. For example, businesses where the flow of orders is highly variable and orders embody non-standard specifications may require significant flexibility and coordination between the different stages of production. Similarly, when customer trends or tastes change quickly, rapid information feedback from downstream to upstream units can be valuable. In these cases, firms may find it easier to coordinate internally rather than through the market mechanism. Doing so can allow firms to respond quicker to environmental changes or customer needs.

Resolving double marginalization: The "double marginalization" (or "double mark-up) problem refers to a situation where both an upstream and downstream business enjoy monopoly power. In that case, since each business attempts to extract monopoly profits from its customers, the resulting "double markup" in prices can be so high as to restrict demand for the products. A vertically integrated company can mitigate this problem by setting the transfer price for the upstream product equal to the marginal cost of producing that good, and then setting "one markup" for the downstream product. Since prices are lower, demand is, as a result, higher—and often can be high enough to offset the price reduction itself.[8] Interestingly, even though vertical integration appears to create one large monopoly in such a setting, consumers are also better off as a result of integration since prices are lower than in the de-integrated case.[9] Evidence on the "double markup" problem has been documented in fast food restaurants (where franchised operations have systematically higher prices than owned restaurants since franchisees pay royalty rates on revenues), liquor, and automobiles.[10]

The organizational test: Can the firm organize the two businesses in a way that allows it to realize the value creation potential from their common ownership? For example, can the firm create appropriate incentives so that the combined businesses work together rather than pursue separate agendas? Or, might culture clashes from combining two different businesses even result in value destruction? Different settings (considered in this module of the required strategy course) illustrate each of these tensions: for example, is the right structure for Cadbury-Schweppes one of organizing by geography (to take advantage of within-country synergies) or by global product category (to exploit cross-market scale economies)? What is the right balance of autonomy and integration that Disney should grant Pixar so that it allows its creative culture to flourish, while at the same time leveraging its expertise into Disney's animation business? The question of post-merger organizational choice is often considered important to strategy "implementation". But, failing to consider ex-ante the organizational choices and changes that ought to accompany any scope expansion is one of the most common reasons why mergers fail.

Realizing the value creation potential from a merger will typically require organizing in a certain way—for example, leveraging revenue synergies from cross-selling typically is typically easier when there is a common sales force for both products than with different ones for each. Reducing SG&A costs may require centralizing certain functions. Or, leveraging company-wide competencies is often easier with a functional organizational than with a divisional structure. However, often the required

[8] This depends on the price elasticity of demand. See Pindyck and Rubinfeld, *Microeconomics,* Prentice-Hall (1995), for a more detailed description.

[9] Vertical integration need not always be an effective solution to the double marginalization since the inter-firm conflict over the appropriate transfer price might simply be replaced by an inter-divisional conflict after integration.

[10] See, respectively, Lafontaine, Francine (1995), "Pricing Decisions in Franchised Chains: A Look at the Restaurant and Fast-Food Industry." *NBER Working Paper No. 5247;* Bresnahan, Timothy F. and Peter C. Reiss, (1985), "Dealer and Manufacturer Margins." *Rand Journal of Economics,* 16(2): pp. 253-268; and, West, Douglas (2000), "Double Marginalization and Privatization in Liquor Retailing." *Review of Industrial Organization*, 16(4): pp. 388-415.

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changes can come into conflict with existing approaches to running the businesses—thereby creating important tradeoffs.

Consider, for example, the expansion of Saatchi and Saatchi (one of the leading advertising agencies during the 1980s) into the consulting arena. On the one hand, integrating different advertising agencies required leveraging scale economies on the "back-end" and leaving the front-end autonomous. On the other hand, integrating the new consulting acquisitions with its existing advertising businesses required leaving the back-end separate because, for example, there were basic differences in the budgeting systems in these two types of businesses. The resulting organizational conflict doomed the expansions to fail.

Organizational tradeoffs imply that it may sometimes be neither feasible nor optimal for a firm to put in place all the organizational changes required to realize the potential value from a deal. For example, firms may choose *not* to centralize operations or combine two sales forces even though doing so can result in cost reductions. The reason is that the resulting loss in autonomy and entrepreneurial freedom may be too great a cost to bear for these benefits. Indeed, as a result, firms often appear to "leave money on the table" after an acquisition, choosing not to integrate activities or operations that yield certain synergies. Doing so, however, may in fact be a rational response to such organizational conflicts.

A Few Themes

This definition, and the preceding discussion, yields a few central themes (that recur throughout the module and should be familiar from an understanding of business unit strategy):

Alignment: Depending on how a multi-business firm adds value to its portfolio will impact its logic of ownership & organization as well. For example, for Disney (whose value creation rests on exploiting key shared resources—its animation characters—across different properties), its corporate center must naturally exert a substantial degree of brand control and coordination (of marketing and cross-selling activities) across the businesses. In contrast, for Danaher, value creation requires a fair degree of systemization of (its DBS) processes across the various platforms, but virtually no activity sharing across them, since the platforms comprise very different businesses. As a result, its corporate center acts very differently from Disney's, exerting little brand control or explicit coordination of activities. Similarly, for a private equity firm whose value creation rests on providing sharp incentives, governance, and monitoring, virtually no integration across the PE firm's portfolio is required (indeed the firms are legally separate). In each case, the nature of value addition, and, as a result, the structure of ownership (whether private versus public, short term or long term) and organizational choices (whether decentralized or centralized) is different.

These arguments point to the importance of evaluating the three corporate tests together, rather than independent of each other. They also lead to the following important implication: a merger, or a corporate strategy, that is right for one particular firm may *not* be for another, even if the two compete in similar businesses. Indeed, the idea that there is a single "right choice" of corporate strategy is as incorrect as the idea that there is a single right choice of business unit strategy. Rather, successful corporate strategies embody a close fit between the firm's three central choices. This "alignment test" is useful to apply when evaluating the effectiveness of any corporate strategy. (Indeed, it should be reminiscent of the earlier test of *consistency* across functional choices in business unit strategy). How these choices add up to create value and, in turn, differentiation from competitors is therefore central.

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To see this, it is instructive to contrast the following pairs of multi-business firms that compete in related arenas, but employing sharply contrasting corporate strategies: in consumer products, Procter & Gamble versus Unilever; in financial services, Citigroup versus HSBC; or, in media and entertainment, Disney versus Time-Warner.

Heterogeneity and corporate level tradeoffs: Alignment across corporate level choices in turn implies that different configurations—and therefore different corporate strategies—can work. In this module of the course, we have seen a range of strategies employed by successful multi-business companies, from closely related activity and resource sharing in Disney to "unrelated diversification" in Danaher. Indeed, firms employing different sets of choices on these dimensions can be successful even while competing within the same industry. For example, some players in the hotel industry choose to franchise operations, others expand via wholly-owned entities. Similarly, while Cisco competed in the network equipment market as a horizontal collection of alliances, Lucent adopted a vertically integrated approach.

This discussion illustrates that each corporate strategy will embody different *corporate* level tradeoffs. For example, companies that choose to organize as divisional silos are then unlikely to extract substantial gains from cross-selling of products from multiple divisions. Similarly, companies that choose to develop expertise in particular "verticals" are typically better positioned to offer consistent and reliable service to their customers by virtue of controlling the entire value chain, but in the process often forego the ability to easily "mix and match" new product offerings to their customers. Recognizing, and managing, such tradeoffs are often a hallmark of successful corporate strategies. Indeed, the existence of such tradeoffs implies that straddling different corporate strategies can be hard, and sometimes impossible.

Sustainability: Factors that undermine the sustainability of corporate advantage will typically stem from the sources of competition described earlier, and from the three building blocks identified above: viz., limits to continual scope expansion, from internal organizational factors, and from ownership structures. Different corporate strategies however face different risks, stemming from their underlying choices about business mix, organizational design, and ownership. Thus, the factors that threaten the "conglomerate model" and its ability to sustain value over the long run are often quite different than those that undermine the advantage of companies engaged in related diversification. In turn, this will imply that the prescriptions for corporate change will differ according to the particular corporate strategy.

Each of these themes—alignment, differentiation, and tradeoffs—is reminiscent of similar themes from business unit strategy analysis. This should be reassuring: whereas the level of analysis and the particular building blocks are different when considering business unit strategy versus corporate-level strategy, the central principles of strategy are not.

Errors, traps, and pitfalls—or, common reasons why corporate strategies fail

Following are common reasons why diversification efforts fail or corporate strategies go awry. Some of these result from an incomplete assessment of opportunities and threats, others from cognitive biases or incentive distortions, and still others from poor logic.

Misplaced motives: Sometimes, companies often look to diversify as a way to "escape" a declining core business. Other times, firms diversify in order to find growth in more attractive businesses (either driven by managerial preferences or by "capital market pressures"), to diversify their risk from being present in only one business line, or to smooth their earnings streams. Such

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reasons for diversification are misplaced, and rarely result in successful outcomes. For under-performing firms, diversification per se neither solves the problems in their core, nor do these firms necessarily have the capabilities or strengths to succeed in new arenas. Furthermore, diversification without value creation merely results in profitless growth. Last, risk diversification by firms is hard to justify particularly in advanced economies where investors face plentiful opportunities to effectively diversify risk on their own.

Zero-sum arguments: Sometimes, firms often look to expand into adjacent businesses or other parts of the value chain in order to "go after where the money is," or try to acquire other firms in order to reduce their input costs. As examples, numerous biotechnology firms during the 1990s declared their intention of acquiring downstream marketing and distribution capabilities in order to emulate the more profitable "big pharma" companies. Similarly, media distribution firms often look to acquire upstream production companies in order to reduce their programming costs. These reasons for scope expansion often represent "zero-sum" arguments that, in the absence of any other associated value creation potential, are misguided. For example, acquiring a production studio in order to reduce programming cost can benefit downstream distributors, but it comes at the expense of the upstream production studio's profit stream. In addition, acquiring profitable companies without additional value creation rarely results in gains for the acquirer since the cash flow streams are simply capitalized in the upfront acquisition price—thereby, again, resulting in a zero-sum transfer of value between acquiring and target firm.

Flawed synergy logic: Earlier, we noted various sources of value creation in mergers—activity sharing versus resource transfers, demand-side synergies versus cost-side ones. Certain types of synergies, however, are harder to realize or harder to identify than others. First, revenue synergies can often be more difficult to quantify or realize in practice than cost savings, leaving considerable room for undesirable managerial creativity and "pie in the sky" projections. Second, and related, justifying scope expansions on the basis of sharing intangible "core competencies" can often be problematic for two reasons: (i) Firms often overestimate or overstate their core competencies—equating competencies with anything they do well, rather than identifying *distinctive* competencies. (ii) Because they are more intangible, valuing "resources" often presents a harder challenge than identifying concrete benefits from activity sharing. As a result, in practice, the core competence logic can be tempting for companies to employ as a means to *rationalize*, rather than *inform*, scope expansions.

Incorrect unit of analysis: Realizing the potential value creation in a deal invariably requires accompanying organizational changes (in structure or incentives), as we have seen in various cases in this module. The challenge arises when such changes conflict with the existing structure or culture of the firm (as in the Saatchi and Saatchi example above). The implication is that the right unit of analysis for any corporate strategy decision should be the level of the *firm*, rather than the individual deal. A common consequence from doing otherwise is "scope creep"—resulting from a series of diversification decisions where each individual expansion can appear logical but, put together, the resulting portfolio appears more like a hodge-podge collection of unrelated businesses. As an illustrative, though fictional (and intentionally contrived), example, consider a car dealership looking to first expand into service centers, from there into gas stations, then mini-markets, then bigger grocery stores, then supermarkets, then department stores, and so on. Each stage of expansion can be individually justified. Put together, the portfolio appears arbitrary and illogical.

"Best practice" approach to corporate strategy: Probably the most common starting point in corporate strategy evaluations by multi-business firms is the question: "what should our portfolio be?" To answer this question, firms then tend to identify "portfolio gaps" by comparisons with peers.

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This approach, however, can tend to bias firms toward a best practice approach to corporate strategy. The reason is that portfolio choices by themselves reveal little about sources of value creation or the organizational mechanisms that are required to realize such value, and offer at best partial clues about a company's corporate strategy. As we have seen, firms that choose to be in similar businesses often exhibit large differences in performance. As a result, portfolio choices that are right for one organization may be inappropriate for others.

Beyond this, the portfolio approach tends to bias firms towards identifying relatedness across a firm's portfolio based on product-market linkages rather than other forms of synergy (for example, shared resources). In part for this reason, "conglomerates" are often *a priori* thought to create no value since the product market linkages between their portfolio businesses are relatively weak. As seen in the module, however, a number of such firms (including conglomerates like General Electric and Danaher, or certain private equity firms) can often add value through distinctive and common resources—well-honed organizational processes, sharp incentives, or superior governance.

Similar "best practice" thinking is often seen in evaluating organizational or ownership choices. For example, debates regarding whether private or public ownership is superior for delivering high performance, or whether centralized or decentralized approaches are better, exemplify this way of thinking. Not only is the empirical evidence on these questions mixed,[11] but focusing on any particular decision independent of the other corporate level choices represents a flawed approach. Indeed, this "best practice trap" is reminiscent of similar traps in analyzing or crafting business unit strategy (where, for example, considerations of the "optimal price" set by a sales representative cannot be made independent of its impact on after-sales service requirements, or of R&D investment levels).

[11] Belen Villalonga and Raphael Amit (2006), "How do family ownership, control, and management affect firm value?" *Journal of Financial Economics* (80): 385-417.

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