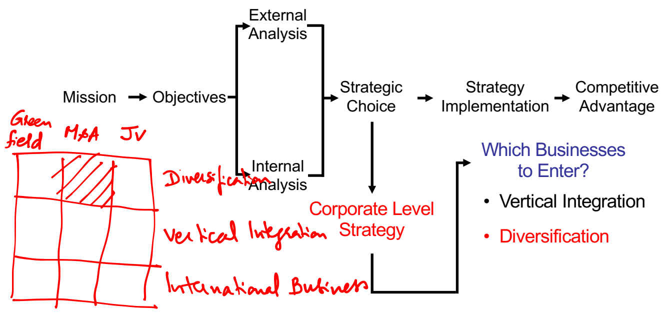
The Strategic Management Process



1

Logic of Corporate Level Strategy

Corporate level strategy should create value:

$A + B < AB$

1) such that businesses forming the corporate whole are worth more than they would be under independent ownership
2) that equity holders cannot create through portfolio investing

Finance is Strategy.
PE

Therefore,

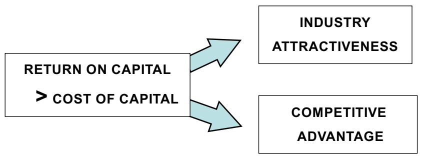
- a corporate level strategy must create synergies
  - economies of scope—diversification

2

INTRODUCTION: THE BASIC ISSUES

Core Issues in Diversification Decisions

Superior profit derives from two sources:



CapEx
↳ LTD
↳ Equity.

Diversification decisions involve these same two issues:

- **How attractive is the industry to be entered?**
- **Can the firm achieve a competitive advantage?**

3

MANAGING PORTFOLIO

4

Trends in Diversification

- Urge to Diversify: 1950 – 1980
  – Diversification major source of corporate growth
  – 1970s saw the emergence of conglomerate – from multiple, unrelated acquisitions
- Refocusing: 1980 – 2009
  – Noncore businesses divested, only related diversification
  – Emphasis on shareholder value

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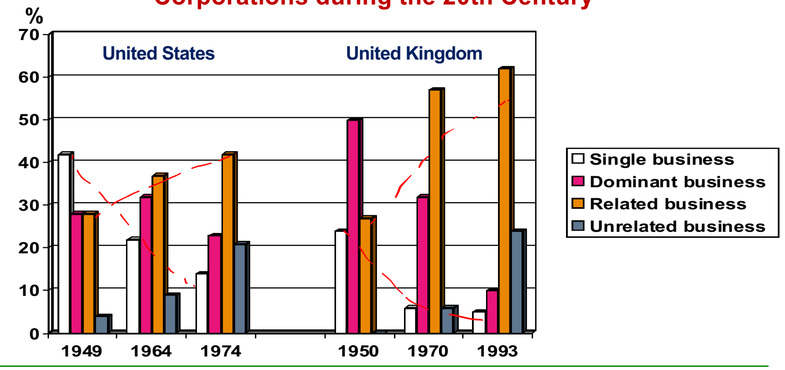
INTRODUCTION: THE BASIC ISSUES

Diversification Strategies of US and UK Corporations during the 20th Century



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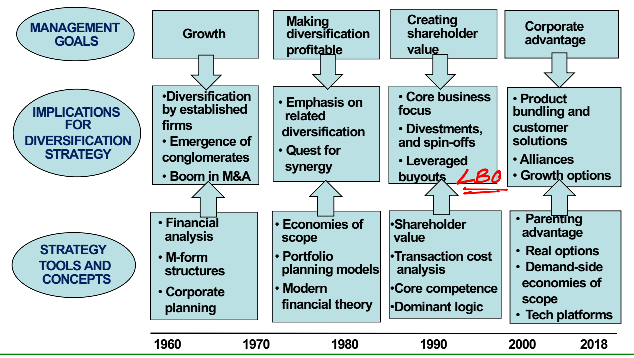
INTRODUCTION: THE BASIC ISSUES

The Evolution of Diversification Strategies, 1960-2018



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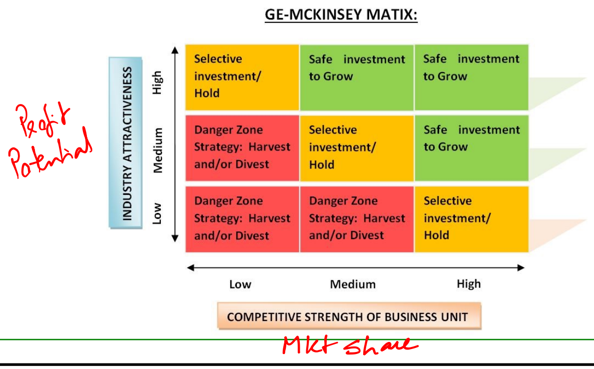
Directional Policy Matrix



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42% / 42% = 1   Mkt share = Your Sales / Total Industry Sales.

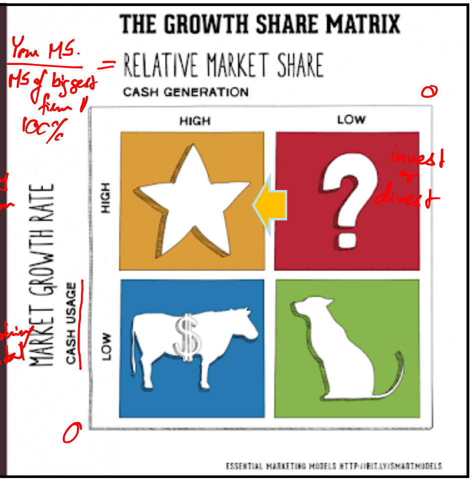
BCG Matrix

Question marks. Question marks have potential to gain market share and become a star, which would later become cash cow.

Strategic choices: Market penetration, market development, product development, divestiture

$120 a $150 a
$30 a

Capacity ↗ Addition
CapEx + OpEx ↳ Working Capital



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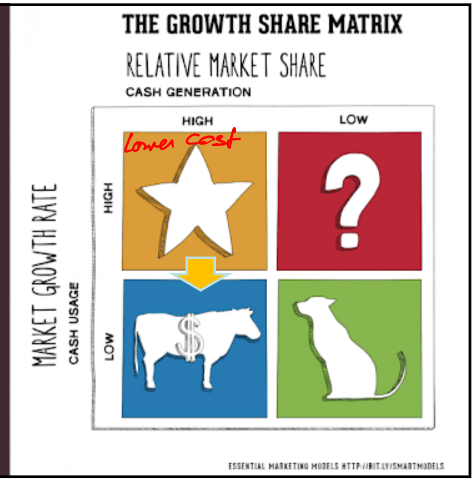
BCG Matrix

Stars. Stars are the primary units in which the company should invest its money, because stars are expected to become cash cows and generate positive cash flows.

Strategic choices: Vertical integration, horizontal integration, market penetration, market development, product development



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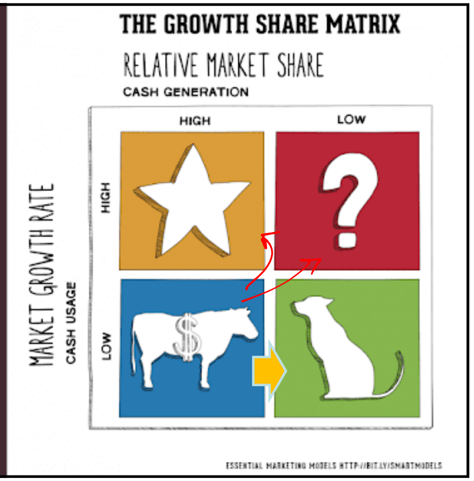
BCG Matrix

Cash cows. Cash cows are the most profitable brands and should be “milked” to provide as much cash as possible. The cash gained from “cows” should be invested into stars to support their further growth.

Strategic choices: Product development, diversification, divestiture, retrenchment

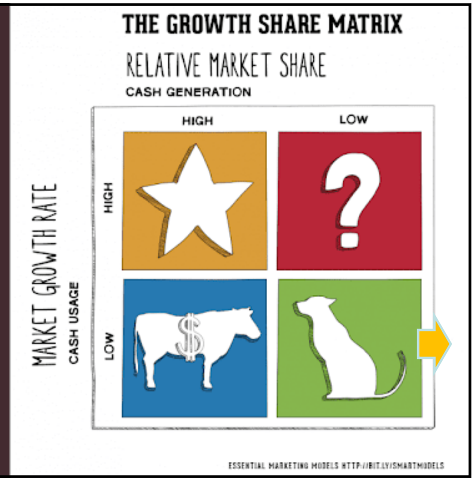


11

BCG Matrix

Dogs. Not worth investing in unless, they provide synergies for other brands or SBUs or simple act as a defense to counter competitors moves.

Strategic choices: Retrenchment, divestiture, liquidation



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Strategies of Danaher Corporation

DANAHER

- **Business Level Strategies:**
- Cost leadership: lowest cost manufacturer, scale economies (12 of 14 subsidiaries mkt leaders)
- Product Differentiation: innovation, new product development

- **Corporate strategies:**
- Diversification: related and unrelated, debt driven growth, manufacturing sector
- Merger & Acquisitions: 50 M&A in 5 years
- Global Strategies: New market entry

Medical Infra.

- **M&A strategies:**
- Attractive industry: growth (5-7%), size ($1 bn), cyclicity, fragmentation, competition Retail.
- Attractive firm: market leader, weak leadership, missing infra, inefficiency
- New platforms, Bolt-ons, Adjacencies

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Types of

DIVERSIFICATION

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Diversification

Diversification

Other Businesses — Current Businesses — Other Businesses

No Links — Unrelated — Related — Many Links

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RELATEDNESS IN DIVERSIFICATION

The Sources 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	• Targets defined in terms of similar performance variables • Similar time horizons for performance targets

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Types of Corporate Diversification

At a general level…

Product Diversification:

- operating in multiple industries

Geographic Market Diversification:

- operating in multiple geographic markets

Product-Market Diversification

- operating in multiple industries in multiple geographic markets

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Product and Geographic Diversification

Possibilities:

- single-business in one geographic area undiversified
- single-business in multiple geographic areas international business
- related-constrained in one or multiple geographic areas related. diversifica
- related-linked in one or multiple geographic areas
- unrelated in one or multiple geographic areas unrelated.

B2B heavy compressors
martar shells. B2C

Note:

- Relatedness usually refers to products.
- Seemingly unrelated products may be related on other dimensions. Supplier, machinery.

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Types of Corporate Diversification

At a more specific level…

Limited Diversification

- single business: > 95% of sales in single business
- dominant business: 70% to 95% in single business

Related Diversification (<70% of sales from single business)

- related-constrained: all businesses related on most dimensions
- related-linked: some businesses related on some dimensions

Unrelated Diversification

- businesses are not related

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Types of Corporate Diversification

Market \ Geography	Single	Multiple
Multiple	Product Diversified	Product-Market Diversified
Single	Single Business	Market Diversified

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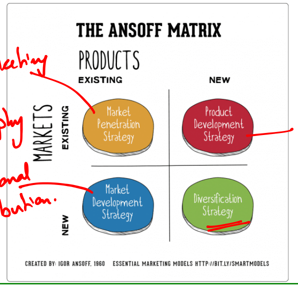
Diversification

- Diversification through the development of new products delivered in new markets (Ansoff, 1957)



marketing
Geography
International Distribution.
R&D / Innovation.

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Conglomerates

Emerging Countries.
↳ Institutional Voids.
↳ Legal.
↳ Labor.
↳ Capital.

- A unique category of firms that are affiliated with a group of firms tied together by a common ownership network
- Known by different names in different countries
  - Chaebol in South Korea
  - Grupos in Latin America
  - Business Groups in India
- The control and coordination in affiliated firms is through a complex web of multiple and reciprocated equity, debt and commercial ties in its network.

Birla
Tata
Reliance.
ownership Network
Pyramid Structure
TAS.
Tata Sons
TCS 5% + 5% + 5%
Tata Steel 5% + 5%
Tata Motors 5% + 5%

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Why

DIVERSIFY?

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MOTIVES FOR DIVERSIFICATION

Motives for Diversification

GROWTH	• The desire to escape stagnant or declining industries a powerful motives for diversification (e.g. tobacco, oil, newspapers). • *But*, growth in the interests of *managers* not *shareholders* • Growth-seeking diversification (esp. by acquisition) tends to destroy shareholder value
RISK SPREADING	• Diversification reduces the variance of profit flows • *But*, doesn't create value for shareholders—they can hold diversified portfolios of securities. [Capital Asset Pricing Model shows that diversification only lowers *unsystematic risk* not *systematic risk]*
VALUE CREATION	• For diversification to create shareholder value, then bringing putting different businesses under common ownership must increase their total profitability

Synergy.

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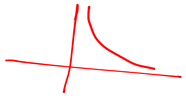
Why firms diversify?

Diversification allows the firm to grow rapidly by expanding operations into new business fields



Why is (rapid) growth beneficial?
- Economies of scale
- Learning and experience curve effects
- Lower average unit costs (running at full capacity)
- More bargaining power with suppliers and customers
- Exploiting differences between diverse geographical areas

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Why firms diversify?

Related Prefer

Transfer of skills
- Knowledge, and other competences across businesses

Economies of scope
- Advantages arising from 'umbrella branding'
- Developing innovative products and/or processes

Unrelated

In search of new investments

Attractive profitability/risk and growth prospects

Attractive speculative prospects

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Value of Diversification

Two Criteria → Synergy → Economies of Scope.

1) There must be some economy of scope.

2) The focal firm must have a cost advantage over outside equity holders in exploiting any economies of scope.

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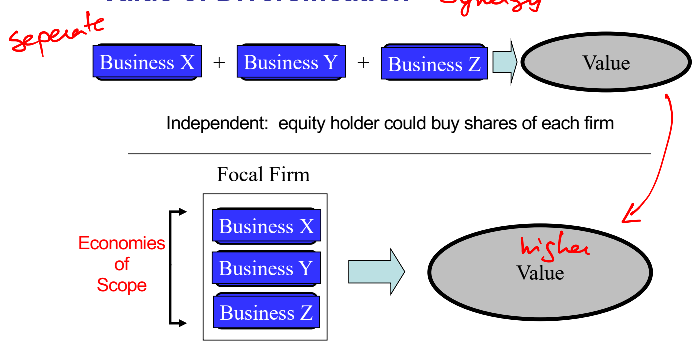
Value of Diversification Synergy



Combined: equity holder buys shares in one firm

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MOTIVES FOR DIVERSIFICATION

Diversification and Shareholder Value: Porter's Three Essential Tests

$10/share

$11/share

$1/share

Premium.

For diversification to create shareholder value, it must meet three tests:

1. ***The Attractiveness Test***: diversification must be directed towards attractive industries (or those with e the potential to become attractive).
2. ***The Cost of Entry Test*** : the cost of entry must not capitalize all future profits.
3. ***The Better-Off Test***: either the new unit must gain competitive advantage from its link with the company, or vice-versa. (i.e. some form of "*synergy*" must be present)

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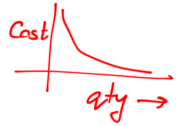
Economies of Scope



Four Types

Operational

Financial

Anticompetitive

Managerialism

Economies of scale relate to cost economies from increasing output of a ***single product***.

Mkt shr.

Economies of scope relate to cost economies from increasing the output of ***multiple products***.

steel.

Tata.

Cars

IT

↳ reliability

↳ quality

↳ trust.

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Economies of Scope

Operational Economies of Scope

Legal, CC, HR

Sharing Activities

- exploiting efficiencies of sharing business activities & avoiding duplication

Spreading Core Competencies

- exploiting core competencies in other businesses
  - competency must be strategically relevant

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Economies of Scope

Operational Economies of Scope

- Sharing tangible resources (e.g. research labs, distribution systems) across multiple businesses
- Sharing intangible resources (e.g. brands, technology) across multiple businesses
- Transferring functional capabilities (e.g. marketing, product development) across businesses
- Applying common general management capabilities to different businesses

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Economies of Scope

Operational Economies of Scope

Economies of scope in diversification derive from two types of relatedness:

- ***Operational Relatedness***—synergies from sharing resources across businesses (common distribution facilities, brands, joint R&D)
- ***Strategic Relatedness***—synergies at the corporate level deriving from the ability to apply common management capabilities to different businesses.

Problem of operational relatedness:

The benefits from economies of scope may be dwarfed by the administrative costs involved in their exploitation.

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Economies of Scope

Agency Problem.

60% 40%

Frs Firm A $150a

5%

Firm B

Tunneling.

Financial Economies of Scope

Escalation of Commitment.

↳ $150a.

↳ $50a.

↳ $25a.

↳ $10a.

Internal Capital Market

- Premise: insiders can allocate capital across divisions more efficiently than the external capital market.
  - works only if managers have better information
  - may protect proprietary information
  - may suffer from escalating commitment

- Auditors.

- Rating Agencies.

- Media.

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Economies of Scope

Financial Economies of Scope

Internal Capital Market

- Economies of scope not a sufficient basis for diversification—must be supported by transaction costs in markets for resources
- Diversified firm can avoid external transactions by operating internal capital and labor markets
- Diversified firm has better information on resource characteristics than external markets

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Economies of Scope

Financial Economies of Scope

Risk Reduction

- counter cyclical businesses may provide decreased overall risk

however,

- individual investors can usually do this more efficiently than a firm

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Economies of Scope

$5cr.
$50cr.
Profit vs Maya.

Financial Economies of Scope

Tax Advantages

- transfer pricing policy allows profits in one division to be offset by losses in another division
  - this is especially true internationally
- can be used to "smooth" income

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Economies of Scope

Anticompetitive Economies of Scope

P&G. HUL.
Cosmetics Detergent

Multipoint Competition

- mutual forbearance MAD.
  - a firm chooses not to compete aggressively in one market to avoid competition in another market

Market Power

- using profits from one business to compete in another business
- using buying power in one business to obtain advantage in another business

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Economies of Scope

Managerialism

- An economy of scope that accrues to managers at the expense of equity holders.

Revenue.

- Managers of larger firms receive more compensation (larger scope = more compensation).
  - Therefore, managers have an incentive to acquire other firms and become ever larger.
- Even though the incentive is there, it is difficult to know if managerialism is the reason for an acquisition.

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Equity Holders and Economies of Scope

Most economies of scope cannot be captured by equity holders.

- Risk reduction can be captured by equity holders.

Managers should consider whether corporate diversification will generate economies of scope that equity holders can capture.

- If a corporate diversification move is unlikely to generate valuable economies of scope, managers should avoid it.

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Measuring

DIVERSIFICATION

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Measure of Diversification

Measure	Mathematical Form	Empirical Base	Relatedness Component	Primary usage	Source
1. Herfindahl Index	$D = 1 - \sum_{i=1}^{n} s_i^{\,2}$ where n = number of activities in portfolio and s = each activities' share	Patterns of firm revenues within portfolio	None in standard measure. Gollop and Monihan (1991) insert Euclidean distances among product class input shares	Diversification research; e.g. Berry, 1971, 1975;	Berry, 1971

Firm A.

	s_i
1.	25%
2.	25%
3.	25%
4.	25%

$D = 1 - (0.25^2 + 0.25^2 + 0.25^2 + 0.25^2)$
$= 0.75$

Firm B.

1. 70%
2. 10%
3. 10%
4. 10%

$D = 0.5$

Firm C

1. 100%
2. 0%
3. 0%
4. 0%

$D = 0$

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Measure of Diversification

Measure	Mathematical Form	Empirical Base	Relatedness Component	Primary usage	Source
1. Herfindahl Index	$D = 1 - \sum_{i=1}^{n} s_i^{\,2}$ where n = number of activities in portfolio and s = each activities' share	Patterns of firm revenues within portfolio	None in standard measure. Gollop and Monihan (1991) insert Euclidean distances among product class input shares	Diversification research; e.g. Berry, 1971, 1975;	Berry, 1971
2. Entropy	$D = \sum_{i=1}^{n} s_i \ln(1/s_i)$, where s_i is the share of sales in segment i.	Patterns of firm revenues within portfolio; SIC hierarchical structure	Entropy calculated separately for 2- and 4-digit industries; difference in these scores is relatedness. SIC	Diversification research; e.g. Palepu, 1985	Jacquemin and Berry, 1979

Firm A

1. 25%
2. 25%
3. 25%
4. 25%

$D = 0.25 \ln 4 + 0.25 \ln 4 + 0.25 \ln 4 + 0.25 \ln 4 = 1.38.$

NIC

Firm B.

1. 70%
2. 10%
3. 10%
4. 10%

$D = 0.7 \ln\left(\frac{1}{0.7}\right) + (0.1 \ln 10) \times 3 = 0.4.$

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Measure of Diversification

Measure	Mathematical Form	Empirical Base	Relatedness Component	Primary usage	Source
1. Herfindahl Index	$D = 1 - \sum_{i=1}^{n} s_i^{\,2}$ where n = number of activities in portfolio and s = each activities' share	Patterns of firm revenues within portfolio	None in standard measure. Gollop and Monihan (1991) insert Euclidean distances among product class input shares	Diversification research; e.g. Berry, 1971, 1975;	Berry, 1971
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3. Wrigley-Rumelt categorizations	Categorization into one of nine categories based on three ratios: specialization, vertical, and related	Patterns of firm revenues within portfolio	Business is related if revenue from largest group of related activities (defined by researcher) is greater than 70 percent (related ratio) while no single industry's revenue is greater than 70 percent (specialization ratio)	Diversification research	Wrigley, 1970; Rumelt, 1974

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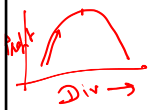
DIVERSIFICATION AND PERFORMANCE

The Findings of Empirical Research



Do diversified firms outperform specialized firms?	• No consistent relationship • Evidence of a ∩-shaped relationship: dn. first increases profitability, then further dn. reduces profitability (increased complexity?) • McKinsey & Co. identify benefits from moderate dn.—especially for firms that have run out of growth opportunities • Question of direction of causation: does dn. drive profitability, or vice-versa?
What type of diversification is most profitable? - --Related dn. vs. unrelated dn.	• Most studies show related dn. outperforms unrelated dn. • Related dn. offers greater synergies—but also imposes higher management costs • But what is "related dn."? Businesses can be related in many different ways (e.g. LMVH, GE, Virgin group)

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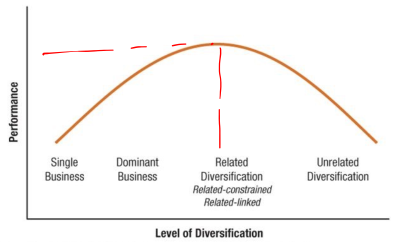
Trends in Diversification



Adapted from L. E. Palich, L. B. Cardinal, and C. C. Miller (2000), "Curvilinearity in the diversification-performance linkage: An examination of over three decades of research," *Strategic Management Journal* 21: 155–174.

Diversification into related industries may be more profitable than into unrelated industries (Rumelt, 1974)

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Summary

Corporate Strategy: In what businesses should the firm operate?

- An understanding of diversification helps managers answer that question.

Two Criteria:

1) economies of scope must exist

2) must create value that outside equity holders cannot create on their own

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Summary

Economies of Scope

- Operational; Functional; Anticompetitive; Managerial;

Porters Three Criteria:

1) Attractiveness Test

2) Cost of Entry Test

2) Better-off Test

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