Chapter 6

Diversification

Strategies for Managing a Group of Businesses

Learning Objectives

- When to Diversify
- Choosing the Diversification Path: Related versus Unrelated Businesses
- Combination Related-Unrelated Diversification Strategies
- Evaluating the Strategy of a Diversified Company
- After a Company Diversifies: The Four Main Strategy Alternatives

Objective 1

When to Diversify

When Should a Firm Diversify?

- It is faced with ***diminishing growth prospects*** in ***present business***
- It has opportunities to ***expand*** into industries whose ***technologies and products complement*** its present business
- It can ***leverage existing competencies and capabilities*** by expanding into businesses where these resource strengths are key success factors
- It can ***reduce costs*** by diversifying into closely related businesses
- It has a ***powerful brand name*** it can transfer to products of other businesses to increase sales and profits of these businesses

Strategies for Entering New Businesses

Acquire existing company

Internal start-up

Joint ventures/strategic partnerships

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Objective 2

Choosing the Diversification Path: Related versus Unrelated Businesses

Related vs. Unrelated Diversification

Related Diversification	***Unrelated Diversification***
Involves diversifying into businesses whose value chains possess competitively valuable "strategic fits" with value chain(s) of firm's present business(es)	Involves diversifying into businesses with no competitively valuable value chain match-ups or strategic fits with firm's present business(es)

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What Is Related Diversification?

- Involves diversifying into businesses whose ***value chains*** possess competitively valuable ***"strategic fits"*** with the value chain(s) of the present business(es)
- Capturing the ***"strategic fits"*** makes related diversification a ***1 + 1 = 3 phenomenon***

Core Concept: Strategic Fit

- Exists ***whenever one or more activities*** in the ***value chains*** of ***different businesses*** are sufficiently similar to ***present opportunities*** for
  - ***Transferring*** competitively valuable expertise or technological know-how from one business to another
  - ***Combining*** performance of common value chain activities to achieve lower costs
  - ***Exploiting*** use of a well-known brand name
  - Cross-business ***collaboration*** to create competitively valuable resource strengths and capabilities

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Strategic Appeal of Related Diversification

- Reap ***competitive advantage*** benefits of
  - Skills transfer
  - Lower costs
  - Common brand name usage
  - Stronger competitive capabilities
- ***Spread*** investor ***risks*** over a broader base
- Preserves ***strategic unity*** in its business activities
- Achieve ***consolidated performance*** greater than the sum of what individual businesses can earn operating independently

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Types of Strategic Fits

- Cross-business ***strategic fits*** can exist anywhere along the value chain
  - R&D and technology activities
  - Supply chain activities
  - Manufacturing activities
  - Distribution activities
  - Sales and marketing activities
  - Managerial and administrative support activities

Core Concept: Economies of Scope

- Stem from ***cross-business*** opportunities to reduce costs
  - Arise when costs can be cut by operating two or more businesses under same corporate umbrella
  - ***Cost saving opportunities*** can stem from interrelationships anywhere along the ***value chains*** of different businesses

Related Diversification and Competitive Advantage

- ***Competitive advantage*** can result from related diversification ***when a company captures cross-business opportunities to***
  - ***Transfer*** expertise/capabilities/technology from one business to another
  - ***Reduce costs by combining*** related activities of different businesses into a single operation
  - ***Transfer*** use of firm's ***brand name reputation*** from one business to another
  - ***Create valuable competitive capabilities*** via cross-business collaboration in performing related value chain activities

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Potential Pitfalls of Related Diversification

- Failing the ***cost-of-entry test*** may occur if a company overpaid for acquired companies
- Problems associated with passing the ***better-off test***
  - Cost savings of combining related value chain activities and capturing economies of scope may be overestimated
  - Transferring resources from one business to another may be fraught with unforeseen obstacles that diminish strategic-fit benefits actually captured

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Acquisition Criteria For Unrelated Diversification Strategies

- Can business meet corporate targets for profitability and ROI?
- Will business require substantial infusions of capital?
- Is business in an industry with growth potential?
- Is business big enough to contribute to parent firm's bottom line?
- Is there potential for union difficulties or adverse government regulations?
- Is industry vulnerable to recession, inflation, high interest rates, or shifts in government policy?

Attractive Acquisition Targets

- Companies with ***undervalued assets***
  - Capital gains may be realized
- Companies in ***financial distress***
  - May be purchased at bargain prices and turned around
- Companies with ***bright growth prospects*** but ***short on investment capital***
  - Cash-poor, opportunity-rich companies are coveted acquisition candidates

Appeal of Unrelated Diversification

- Business risk scattered over different industries
- Financial resources can be directed to those industries offering best profit prospects
- If bargain-priced firms with big profit potential are bought, shareholder wealth can be enhanced
- Stability of profits – Hard times in one industry may be offset by good times in another industry

Objective 3

Combination Related-Unrelated Diversification Strategies

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Combination Related-Unrelated Diversification Strategies

- ***Dominant-business firms***
  - One major core business accounting for 50 - 80 percent of revenues, with several small related or unrelated businesses accounting for remainder
- ***Narrowly diversified firms***
  - Diversification includes a few (2 - 5) related or unrelated businesses
- ***Broadly diversified firms***
  - Diversification includes a wide collection of either related or unrelated businesses or a mixture
- ***Multibusiness firms***
  - Diversification portfolio includes several unrelated groups of related businesses

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Objective 4

Evaluating the Strategy of a Diversified Company

How to Evaluate a Diversified Company′s Strategy

Step 1: Assess long-term attractiveness of each industry firm is in

Step 2: Assess competitive strength of firm’s business units

Step 3: Check competitive advantage potential of cross-business strategic fits among business units

Step 4: Check whether firm’s resources fit requirements of present businesses

Step 5: Rank performance prospects of businesses and determine priority for resource allocation

Step 6: Craft new strategic moves to improve overall company performance

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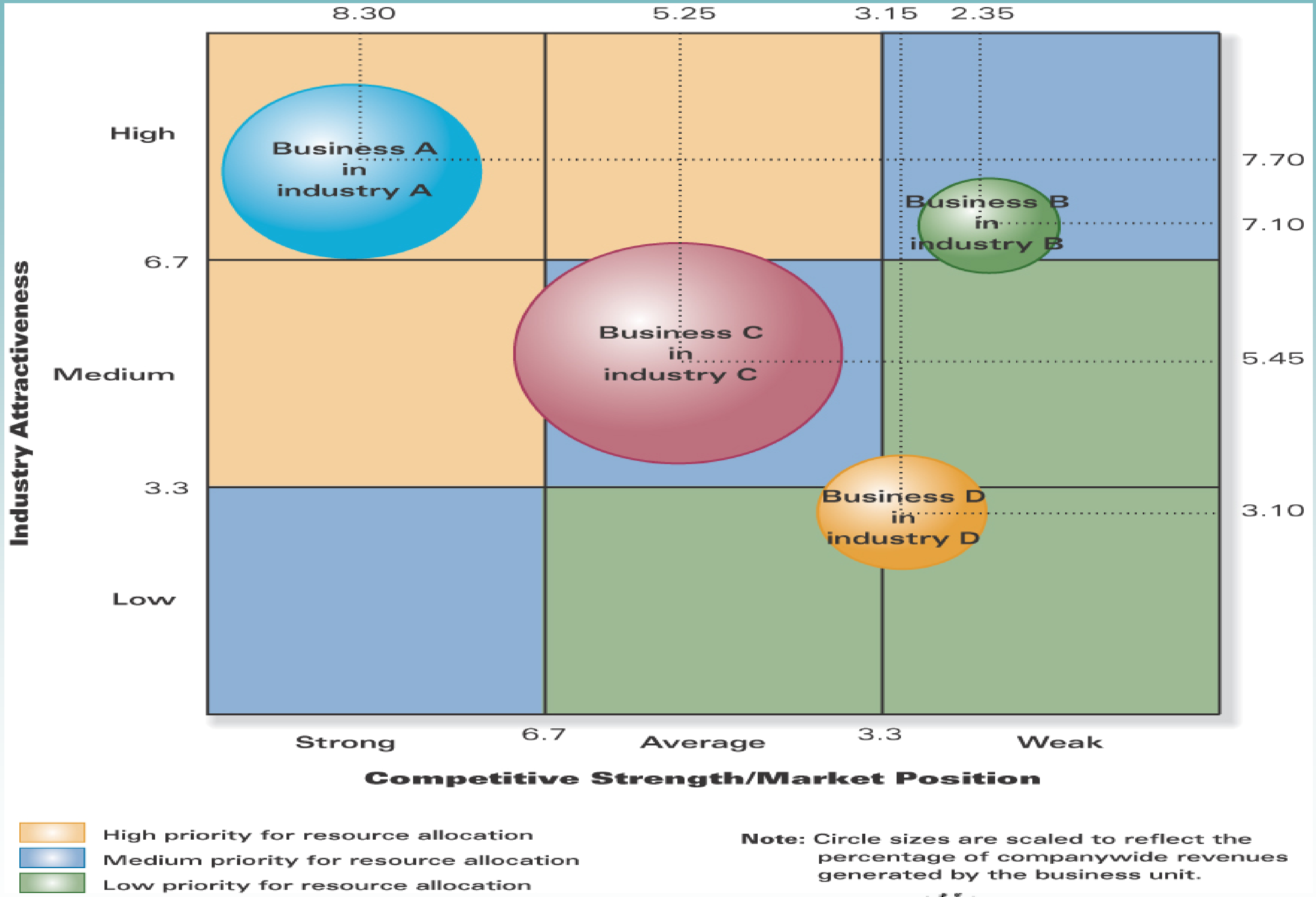
Fig. 6.5: Industry Attractiveness-Competitive Strength Matrix



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Objective 5

After a Company Diversifies: The Four Main Strategy Alternatives

Fig. 9.8: Strategy Options for a Company Already Diversified

Strategy Options for a Company That Is Already Diversified

Broaden the Diversification Base

- Acquire more businesses and build positions in new related or unrelated industries.
- Add businesses that will complement and strengthen the market position and competitive capabilities of business in industries where the company already has a stake.

Divest Some Businesses and Retrench to a Narrower Diversification Base

- Get out of businesses that are competitively weak, that are in unattractive industries, or that lack adequate strategic and resource fits.
- Focus corporate resources on businesses in a few, carefully selected industry arenas.

Restructure the Company's Business Lineup

- Sell off competitively weak businesses, businesses in unattractive industries, businesses with little strategic or resource fit, and noncore businesses.
- Use cash from divestitures plus unused debt capacity to make acquisitions in other, more promising industries.

Pursue Multinational Diversification

- Offers two major avenues for sustained growth—entering more businesses or entering more country markets.
- Contains more competitive advantage potential than any other diversification strategy.

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Summary

Most companies have their business roots in a single industry. Even though they may have since diversified into other industries, a substantial part of their revenues and profits still usually comes from the original or core business. Diversification becomes an attractive strategy when a company runs out of profitable growth opportunities in its original business.