Chapter 8 Learning Objectives

1. Understand what diversification is and when and how it can enhance shareholder value.
2. Learn the strategic difference between related and unrelated diversification strategies.
3. Gain an understanding of the pros and cons of related and unrelated diversification strategies.
4. Gain command of the analytical approaches to evaluating a company’s diversification strategy.
5. Become familiar with a diversified company’s principal strategic options after it has diversified.

What Is Meant by “Diversification”?

- A firm is diversified when it is in two or more lines of business that are in distinctly different industries.
  - A firm is not diversified if it produces two brands of soft drinks (both products are in the same industry) or operates two kinds of fast food chains (all fast food chains are part of the fast food industry—having different menu selections does not equate to being in a different line of business).
- Since a diversified firm is a collection of individual businesses, the strategy-making task is more complicated because it requires:
  - Assessing multiple industry environments
  - Developing a set of business strategies, one for each industry arena (or line of business) in which the diversified firm operates.

What Does Crafting a Diversification Strategy Entail?

- Strategy-making in a diversified company has four facets:
  1. Picking new industries to enter and deciding whether to enter the industry by starting a new business from the ground up, acquiring a firm already in the target industry, or forming a joint venture or strategic alliance with another firm.
  2. Initiating actions to boost the combined performance of the businesses the firm has entered.
  3. Pursuing opportunities to leverage cross-business value chain relationships and strategic fits into competitive advantage.
  4. Evaluating the growth and profitability prospects for each business and then investing aggressively in businesses with the best prospects, investing cautiously in businesses with just average prospects, and divesting businesses with unacceptable prospects.
Diversification does not produce added long-term value for shareholders unless it produces a 1 + 1 = 2 result where sister businesses perform better together as part of the same firm than as independent enterprises.

---

**When Does It Make Sense for a Firm to Diversify?**

- A firm's move to diversify into a new business is not successful unless it results in added long-term economic value for shareholders.
- For there to be reasonable expectations of producing added long-term shareholder value, a move to diversify into a new business must pass three tests:
  1. **Industry Attractiveness Test**—Industry conditions must be conducive to good profitability.
  2. **Cost-of-Entry Test**—Cost of entering cannot be so high as to spoil the profit opportunities.
  3. **Better-Off Test**—Diversifying must offer potential for the firm's existing businesses and the new business to perform better together under a single corporate umbrella than they would perform operating as independent stand-alone businesses.

---

**Moves to Diversify into a New Business Should Pass Three Tests**

- A firm's move to diversify into a new business is not successful unless it results in added long-term economic value for shareholders.
- For there to be reasonable expectations of producing added long-term shareholder value, a move to diversify into a new business must pass three tests:
  1. **Industry Attractiveness Test**—Industry conditions must be conducive to good profitability.
  2. **Cost-of-Entry Test**—Cost of entering cannot be so high as to spoil the profit opportunities.
  3. **Better-Off Test**—Diversifying must offer potential for the firm's existing businesses and the new business to perform better together under a single corporate umbrella than they would perform operating as independent stand-alone businesses.

---

**Core Concept**

Creating added long-term value for shareholders via diversification requires building a multi-business firm where the whole is greater than the sum of its parts.

---

**Diversification Possibilities**

- There are many ways for a company to pursue diversification:
  - Diversify into closely related businesses or into totally unrelated businesses.
  - Diversify the present revenue and earning base to a small extent or to a major extent.
  - Move into one or two large new businesses or a greater number of small ones.
  - Achieve multibusiness/multi-industry status by acquiring an existing firm already in a business/industry it wants to enter.
  - Form a new business subsidiary to enter a promising industry.
  - Form a joint venture with one or more other firms to enter new businesses.

---

**Will Diversification Produce Added Long-Term Value for Shareholders?**

- **The Industry Attractiveness Test**
- **The Cost-of-Entry Test**
- **The Better-Off Test**

---

**Why The “Better-Off” Test Is So Important**

- Creating added long-term value for shareholders via diversification requires building a multi-business firm where the whole is greater than the sum of its parts.
- Suppose Firm A diversifies by purchasing Firm B in another industry.
  - If A and B's consolidated future profits are no greater than what each could have earned on its own, then A's diversification produces a 1 + 1 = 2 result which does not provide its shareholders with added value because A's shareholders could have achieved the same 1 + 1 = 2 result by merely purchasing stock in B.

---

**Rule**

Diversification does not produce added long-term value for shareholders unless it produces a 1 + 1 = 2 effect where sister businesses perform better together as part of the same firm than as independent enterprises.
Choosing the Diversification Path: Related versus Unrelated Businesses

**Related Diversification**
- Involves diversifying into businesses whose value chains possess competitively valuable “strategic fits” with value chain(s) of the firm’s present business(es)

**Unrelated Diversification**
- Involves diversifying into businesses with no competitively valuable value chain match-ups or strategic fits with value chain(s) of the firm’s present business(es)

Core Concept

**Related businesses** possess competitively valuable cross-business value chain matchups.

**Unrelated businesses** have such dissimilar value chains that no competitively useful cross-business relationships exist.

---

**Core Concept**

The value chains of different businesses possess **strategic fit** when they contain opportunities for:
- Cross-business transfer of competitively valuable resources,
- Lowering costs by combining the performance of related value chain activities,
- Cross-business use of a potent brand name, and/or
- Cross-business collaboration to build new or stronger competitive capabilities.

---

**Figure 8.2 Fundamental Alternatives for Pursuing a Diversification Strategy**

- Diversify into Related Businesses
- Diversify into Unrelated Businesses
- Diversify into Both Related and Unrelated Businesses

---

**Concept**

- Related diversification involves building the firm around businesses with value chains that have **competitively valuable strategic fits**
- **Strategic fits** among the value chains of different businesses present opportunities for:
  - Transferring competitively valuable expertise, technological know-how, or other valuable resources from one business to another
  - Combining related value chain activities of separate businesses into a single operation to achieve lower costs through economies of scale and scope
  - Exploiting the use of a well-known and potent brand name
  - Cross-business collaboration to create competitively valuable resource strengths and capabilities

- Related diversification represents an attractive opportunity to convert cross-business strategic fits into a **competitive advantage** over rivals whose operations do not offer comparable strategic fit benefits.

---

**Figure 8.3 Related Businesses Possess Related Value Chain Activities and Competitively Valuable Cross-Business Strategic Fits**

- **Business A**
  - Technology: Competitively valuable opportunities for technology or skills transfer, collaboration, customer development, and cross-business coordination exist at one or more points along the value chain.
  - Support Activities: Competitively valuable opportunities for technology or skills transfer, collaboration, customer development, and cross-business coordination exist at one or more points along the value chain.

- **Business B**
  - Technology: Competitively valuable opportunities for technology or skills transfer, collaboration, customer development, and cross-business coordination exist at one or more points along the value chain.
  - Support Activities: Competitively valuable opportunities for technology or skills transfer, collaboration, customer development, and cross-business coordination exist at one or more points along the value chain.
**Economies of Scope** are cost reductions that flow from operating in multiple businesses. They are achieved by capturing cost-saving strategic fits along the value chains of related businesses that allow multiple businesses to operate more cost efficiently by:
- Sharing use of the same manufacturing facilities and/or
- Sharing use of the same distribution centers and/or
- Sharing use of a common sales force and/or
- Sharing use of the same administrative infrastructure

**Economies of Scale** are cost savings that occur because a large-scale operation is more cost-efficient than a small one.

---

**Why Achieving Economies of Scope in Related Businesses Is Competitively Valuable**

- The greater the cost-savings associated with strategic fits among the value chains of sister businesses, the greater the potential for a related diversification strategy to **yield a low-cost competitive advantage over**:
  - Undiversified competitors
  - Competitors whose own diversification efforts do not offer equivalent cost-saving benefits

---

**Strategic Fit and Competitive Advantage: Keys to Added Profitability and Greater Shareholder Value**

- The greater the relatedness among a diversified firm’s sister businesses, the bigger a firm’s window for converting strategic fits into competitive advantage via:
  - Cross-business transfer of competitively valuable skills and technology
  - The capture of cost-saving efficiencies along the value chains of related businesses
  - Cross-business use of a well-respected brand name, and/or
  - Cross-business collaboration to create new resource strengths and capabilities.

- The competitive advantage potential that flows from the capture of strategic-fit benefits is what enables a firm pursuing related diversification to achieve $1 + 1 = 3$ financial performance and the expected gains in shareholder value.

---

**Core Concept**

Diversifying into related businesses where competitively valuable strategic fit benefits can be captured puts sister businesses in position to perform better financially as part of the same firm than they could have performed as independent enterprises, thus providing a clear avenue for **boosting long-term shareholder value**.

---

**Strategies for Diversifying into Unrelated Businesses**

- Unrelated diversification strategies involve entering any **industry** and operating any **business** where senior managers see opportunity to realize consistently good financial results:
  - There is no deliberate effort to diversify only into businesses with strategic fits
  - New businesses are usually entered by acquiring an established firm rather than forming a new start-up subsidiary to enter a new business or collaborating in a joint venture with other companies to get into a new business
  - An acquisition is deemed attractive if it passes the industry attractiveness and cost-of-entry tests and if it has good prospects for attractive financial performance
Core Concept

The basic premise of unrelated diversification is that any firm or business that can be acquired on good financial terms and that has satisfactory growth and earnings potential represents a good acquisition and a good business opportunity.

What Is Appealing about Unrelated Diversification?

- Business risk is scattered over a set of truly diverse industries
- The firm’s financial resources can be employed to maximum advantage by:
  - Investing in whatever industries offer the best profit prospects
  - Diverting cash flows from the firm’s businesses with lower growth and profit prospects to acquiring and expanding businesses with higher growth and profit potentials
- If corporate managers spot bargain-priced firms with big upside profit potential, shareholder wealth can be enhanced by:
  - Buying distressed businesses at a low price
  - Turning their operations around fairly quickly with infusions of cash and managerial know-how supplied by the parent company
  - Enjoying the resulting profit increases
- The firm’s profitability may prove somewhat more stable over the course of economic upswings and downswings because market conditions in all industries do not move upward or downward simultaneously

Building Shareholder Value via Unrelated Diversification

- To succeed in using a strategy of unrelated diversification to produce companywide financial results above and beyond what the businesses could generate operating as stand-alone entities, corporate executives must:
  - Do a superior job of diversifying into new businesses that can produce good earnings and returns on investment (to satisfy the attractiveness test)
  - Negotiate favorable acquisition prices (to satisfy the cost-of-entry test)
  - Do such a good job overseeing the businesses and contributing to how they are managed that the businesses perform at a higher level (a possible way to satisfy the better-off test)
  - Be shrewd in identifying when to shift resources out of businesses with dim prospects and into businesses with good prospects
  - Be good at discerning when a business needs to be sold (because it is on the verge of probable declines in long-term profitability) and then finding buyers who will pay a price higher than the firm’s net investment in the business (so that the sale of diversified businesses will result in capital gains for shareholders rather than capital losses)

The Drawbacks of Unrelated Diversification

- The greater the number and diversity of businesses, the harder it is for top executives to:
  - Discern good acquisitions from bad ones
  - Have in-depth knowledge about each of the businesses
  - Hard to judge soundness of strategic proposals of business-unit managers
  - Select capable managers to manage the diverse requirements of each business
  - Know what to do if a business stumbles
- Avoid big mistakes
  - Misjudging the importance of certain competitive forces or the impact of driving forces or key success factors
  - Discovering that the problems of a newly acquired business will require more time and money to correct than expected
- Being too optimistic about a newly acquired firm’s future prospects

- Best to avoid casting a wide net—a few unrelated businesses is often better than many unrelated businesses

The Demanding Managerial Requirements Are a Serious Issue
Limited Competitive Advantage: Potential Is a Major Shortcoming

- Unrelated diversification’s lack of cross-business strategic fits reduces its competitive advantage potential to what each separate business can generate on its own.
- Without cross-business strategic fits, it is hard for the consolidated performance of an unrelated group of businesses to be any better than the sum of what the individual business units could achieve independently.
- \(1 + 1 > 2\) implies something new and better.

Unrelated Diversification Strategies: Do Not Have Much Appeal

Without the added competitive advantage potential that cross-business strategic fit provides, it is hard for the consolidated performance of an unrelated group of businesses to be any better than the sum of what the individual business units could achieve if they were independent.

Strategy Lesson

It is very hard to build long-term shareholder value by pursuing a strategy of unrelated diversification.

Related versus Unrelated Diversification Strategies

**CONCLUSION:**
Relying solely on the expertise of corporate executives to wisely manage a set of unrelated businesses is a much weaker foundation for enhancing shareholder value than is a strategy of related diversification (where the presence of strategic fits presents many opportunities to build long-term economic value for shareholders).

Combination Related-Unrelated Diversification Strategies

Real-world companies have diversified in a variety of ways:

- **Dominant-business firms**
  - Have one major core business accounting for 50-80 percent of total revenues, with several small related or unrelated businesses accounting for the remainder of total revenues
- **Narrowly diversified firms**
  - Have a few (2-5) related or unrelated businesses
- **Broadly diversified firms**
  - Have a wide collection of either related or unrelated businesses or a mixture
- **Firms that have diversified into unrelated areas but have a collection of related businesses within each area**
  - Have several unrelated groups of related businesses

Evaluating a Diversified Firm’s Strategy

**Step 1:** Assess long-term attractiveness of each industry in which the firm has a business
**Step 2:** Assess competitive strength of each of the firm’s business units
**Step 3:** Check competitive advantage potential of cross-business strategic fits among the various business units
**Step 4:** Check whether firm’s resources fit requirements of its 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

Step 1: Evaluating Industry Attractiveness

- A principal consideration in evaluating a diversified firm’s business make-up and the caliber of its strategy is the attractiveness of the industries in which it has business operations.
- Answers to three questions are required:
  1. Does each industry the firm has diversified into represent a good industry to be in?
  2. Which industries are most attractive and which are least attractive?
  3. How appealing is the whole group of industries in which the firm has businesses?

The more attractive the industries a diversified firm is in, the better its prospects for good long-term performance.
Factors to Consider in Calculating Industry Attractiveness Scores

- Market size and projected growth
- Intensity of industry competition
- Emerging opportunities and threats
- Presence of cross-industry strategic fits
- Resource requirements
- Seasonal and cyclical factors
- Social, political, regulatory, and environmental factors
- Industry profitability
- Industry uncertainty and business risk

Calculating Attractiveness Scores for Each Industry

- Once the measures of industry attractiveness are selected, quantitative industry attractiveness scores are calculated according to the following procedure:
  - Assign importance weights to each industry attractiveness measure (the measures are unlikely to be equally important)
  - Sum of weights must equal 1.0
  - Rate each industry on each attractiveness measure, using a scale of 1 to 10 (where 1 = very unattractive to the company, 5 = average attractiveness, and 10 = very attractive to the company)
  - Multiply the importance weight by the assigned attractiveness rating to obtain a weighted attractiveness score
  - Sum the weighted ratings for each industry to obtain an overall industry attractiveness score

Table 8.1 Calculating Weighted Industry Attractiveness Scores

<table>
<thead>
<tr>
<th>Industry Attractiveness Assessments</th>
<th>Industry A</th>
<th>Industry B</th>
<th>Industry C</th>
</tr>
</thead>
<tbody>
<tr>
<td>Industry Attractiveness Measures</td>
<td>Importance Weights</td>
<td>Weighted Score</td>
<td>Importance Weights</td>
</tr>
<tr>
<td>Industry size and growth potential</td>
<td>0.15</td>
<td>0.80</td>
<td>0.30</td>
</tr>
<tr>
<td>Intensity of competition</td>
<td>0.25</td>
<td>2.80</td>
<td>0.90</td>
</tr>
<tr>
<td>Presence of cross-industry strategic fits</td>
<td>0.18</td>
<td>0.80</td>
<td>0.50</td>
</tr>
<tr>
<td>Resource requirements</td>
<td>0.18</td>
<td>0.80</td>
<td>0.50</td>
</tr>
<tr>
<td>Degree of rivalry and complexity</td>
<td>0.05</td>
<td>0.45</td>
<td>0.25</td>
</tr>
<tr>
<td>Intensity of regulation and environmental factors</td>
<td>0.05</td>
<td>0.40</td>
<td>0.15</td>
</tr>
<tr>
<td>Industry profitability</td>
<td>0.18</td>
<td>0.50</td>
<td>0.25</td>
</tr>
<tr>
<td>Industry uncertainty and business risk</td>
<td>0.05</td>
<td>0.25</td>
<td>0.05</td>
</tr>
<tr>
<td>Sum of importance weights</td>
<td>1.00</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Weighted overall attractiveness score</td>
<td>1.20</td>
<td>2.05</td>
<td>5.00</td>
</tr>
</tbody>
</table>

Interpreting the Industry Attractiveness Scores

- Industries with a score below 5.0 do not pass the attractiveness test
  - The group of industries a firm is in takes on a decidedly lower degree of attractiveness as the number of industries with scores below 5.0 increases (especially if industries with low scores account for a sizable fraction of the firm’s revenues)
  - If a firm’s industry attractiveness scores are all above 5.0, the group of industries the firm operates in is attractive as a whole
  - To be a strong performer, a diversified firm’s principal businesses should be in attractive industries—those with
    - A good outlook for growth
    - Above-average profitability

Step 2: Evaluating Each Business Unit’s Competitive Strength

- Doing an appraisal of each business unit’s strength and competitive position in its industry
  - Reveals each business’s chances for industry success
  - Provides a basis for ranking the units from competitively strongest to competitively weakest and sizing up the competitive strength of all the business units as a group.
  - The procedure involves selecting a set of measures of competitive strength and calculating quantitative competitive strength scores using a similar methodology as for the industry attractiveness scores

Potential Measures of Business-Unit Competitive Strength

- Relative market share
- Costs relative to competitors
- Ability to match or beat rivals on key product attributes
- Ability to benefit from strategic fits with sister businesses
- Ability to exercise bargaining leverage with key suppliers or customers
- Brand image and reputation
- Competitively valuable capabilities
- Profitability relative to competitors
What Is “Relative Market Share” and How Is It Calculated?

- A business unit’s relative market share is defined as the ratio of its market share to the market share held by the largest rival firm in the industry, with market share measured in unit volume, not dollars.
  - If business A has a 15 percent market share and A’s largest rival has 30 percent, A’s relative market share is 0.5.
  - If a firm is the market leader, then its relative market share equals its market share divided by the market share of the next largest rival.
  - If business B has a market-leading share of 40 percent and its largest rival has 30 percent, B’s relative market share is 1.33.
  - Only market share leaders in their respective industries can have relative market shares greater than 1.0.

Relative Market Share Is an Important Measure of Competitive Strength

- The further below 1.0 a business unit’s relative market share, the weaker its competitive strength and market position vis-à-vis rivals.
  - A business unit with a 10% market share is not in a strength and market position vis-à-vis rivals.
  - If business B has a market-leading share of 40 percent and its relative market share is 0.20
  - But a business unit with a 10% market share is in a competitively strong market position when the market leader’s share is only 12% (and the business unit’s relative market share is 0.83)

Relative Market Share Is an Important Measure of Competitive Strength (cont’d)

- A business unit with an industry-leading market share is in a much stronger competitive position vis-à-vis rivals the greater its relative market share is above 1.0.
  - A business unit with a 30 market share has considerably more competitive strength when its next largest rival only has a market share of 10% (which means the leader’s relative market share is 3.0) as compared to when its next largest rival has a market share of 25% (which means the leader’s relative market share is 1.2).

Calculating Competitive Strength Scores for Each Business Unit

- Once the measures of competitive strength are selected, quantitative competitive strength scores are calculated according to the following procedure:
  - Assign importance weights to each competitive strength measure (the measures are unlikely to be equally important)
    - Sum of weights must equal 1.0
  - Rate each business unit on each strength measure relative to rival firms, using a scale of 1 to 10 (where 1 = very weak, 5 = average or on a par, and 10 = very strong)
  - Multiply the importance weight by the assigned strength rating to obtain a weighted score
  - Sum the weighted scores for each business unit to obtain a weighted overall competitive strength score

Table 8.2 Calculating Weighted Competitive Strength Scores for a Diversified Company’s Business Units
Interpreting the Competitive Strength Scores

- Business units with ratings **above 6.7** are strong market contenders
  - The more such business units with high scores, the better a diversified firm's prospects for good financial performance (unless these businesses are in unattractive industries).
- Businesses with ratings in the **3.3 to 6.7** range have moderate competitive strength vis-à-vis rivals
- Business units with ratings **below 3.3** are in competitively weak market positions
  - As the number of business units with scores below 5.0 increases, there is reason to question whether a diversified firm can be a strong performer especially if such businesses account for a large share of the firm's revenues

Using a Nine-Cell Matrix to Simultaneously Portray Industry Attractiveness and Competitive Strength

- The industry attractiveness scores (Table 8.1) and competitive strength scores (Table 8.2) can be used to portray the strategic positions of each business in a diversified firm.
  - Industry attractiveness scores are plotted on the vertical axis
  - Competitive strength scores are plotted on the horizontal axis.
  - A nine-cell grid emerges from dividing the vertical axis into three regions (high, medium, and low attractiveness) and the horizontal axis into three regions (strong, average, and weak competitive strength).
  - Each business unit's industry attractiveness and competitive strength scores determine its location on the matrix, shown as a circle or "bubble"
  - Size of each business unit bubble is scaled to represent the individual percentage of total corporate revenues that each business generates

Interpreting the Attractiveness-Strength Matrix

- The locations of the business units on the attractiveness-strength matrix provide guidance in deploying corporate resources
  - A diversified firm's prospects for good overall performance are enhanced by concentrating corporate resources and strategic attention on its business units having the greatest competitive strength and positioned in highly attractive industries
    - Businesses in the three upper left (orange) cells merit top priority
    - Businesses in the three diagonal (gray) cells merit medium priority
    - Businesses in the three lower right (green) cells merit the lowest priority and are candidates to be divested (sold to other firms) or else managed in a manner calculated to produce the maximum cash flows from operations

Core Concepts

The appeal of a firm's related diversification strategy derives from
- The presence of competitively valuable strategic fits among its businesses
- Aggressive management efforts to actually capture the potential benefits and opportunities afforded by the various cross-business strategic fits

**The greater the value of cross-business strategic fits in enhancing a firm’s performance in the marketplace or on the bottom line, the more competitively powerful is its strategy of related diversification.**
Step 4: Checking for Resource Fit

- A diversified company’s collection of businesses exhibit resource fit when
  - The various sister businesses add to a diversified firm’s overall resource strengths
  - A diversified firm has adequate resources to support its entire group of businesses without spreading itself too thin.

Core Concept

Sister businesses possess resource fit when they add to a diversified company’s overall resource strengths and when a company has adequate resources to support their requirements.

There are two types of resource fit:
- Financial resource fit
- Nonfinancial resource fit

Core Concept

A cash hog business generates cash flows that are too small to fully fund its operations and growth; a cash hog business requires cash infusions to provide additional working capital and finance new capital investment.

A cash cow business generates cash flows over and above its internal requirements, thus providing a corporate parent with funds for investing in cash hog businesses, financing new acquisitions, or paying dividends.

Financial Resource Fits: Cash Cows versus Cash Hogs

- An important dimension of financial resource fit concerns whether a diversified firm can generate internal cash flows sufficient to fund the capital requirements of its businesses, pay dividends, meet its debt obligations, and otherwise remain financially healthy.
- A cash hog business generates cash flows that are too small to fully fund its operations and growth; a cash hog business requires cash infusions to provide additional working capital and finance new capital investment.
- A cash cow business generates cash flows over and above its internal requirements, thus providing a corporate parent with funds for investing in cash hog businesses, financing new acquisitions, or paying dividends.

A diversified firm’s businesses exhibit good financial resource fit when the excess cash generated by its cash cow businesses is sufficient to fund the investment requirements of promising cash hog businesses.

What To Do with Cash Hog Businesses

- Does it make good financial and strategic sense to keep pouring new money into a business that continually needs cash infusions?

  Strategic Options:
  - Invest in promising cash hogs to grow them into star businesses (strong, profitable market contenders)
  - Divest cash hogs with questionable promise (either because of low industry attractiveness or a weak competitive position)
  - Redeploy resources to better advantage elsewhere

Why Cash Cow Businesses Are Valuable

- The surplus cash flows they generate can be used to:
  - Pay corporate dividends
  - Finance acquisitions
  - Provide funds for investing in the firm’s promising cash hogs

- It makes good financial and strategic sense for diversified companies to keep cash cows in healthy condition so that they are able to:
  - Fortify and defend their market position
  - Preserve their cash-generating capabilities over the long term to provide an ongoing source of financial resources to deploy elsewhere.
Other Financial Resource Fit Considerations

- Two other financial considerations are pertinent in determining financial resource fit:
  1. Does the firm have adequate financial strength to fund its different businesses and maintain a healthy credit rating?
  2. Do any of the firm’s individual businesses not contribute adequately to achieving firm-wide performance targets?

Nonfinancial Resource Fits

- A diversified firm needs a big enough and deep enough pool of managerial, administrative, and competitive capabilities to support all of its different businesses.
- Two questions help reveal whether a diversified firm has adequate nonfinancial resources:
  1. Does the firm have or can it develop the specific resource strengths and competitive capabilities needed to be successful in each of its businesses?
  2. Are the firm’s nonfinancial resources being stretched too thinly by the managerial, administrative, or competitive capability requirements of one or more of its businesses?

Step 5: Ranking the Performance Prospects of Business Units and Assigning a Priority for Resource Allocation

- This step entails using the prior analysis to rank the performance prospects of the businesses from best to worst.
- As a rule, business units with the brightest profit and growth prospects, attractive positions in the nine-cell matrix, and solid strategic and resource fits should receive top priority for allocation of corporate resources.
- But it is also wise to consider each business’s past performance:
  - Sales and profit growth
  - Contribution to company earnings
  - Return on capital invested in business
  - Cash flows from operations
- Medium priority should go to business units with satisfactory prospects for growth and profitability (usually those in the three diagonal cells of the attractiveness-strength matrix and cash cow businesses in the lower-right cells of the attractiveness-strength matrix).

The Importance of Resource Allocation

For a firm to make the best use of its limited pool of resources, both financial and nonfinancial, top executives must be diligent in:

- Steering resources to those businesses with the best opportunities and performance prospects
- Allocating few, if any, resources to businesses with weak prospects.

Focusing corporate resources on a few core and mostly related businesses avoids the mistake of diversifying so broadly that resources and management attention are stretched too thin.

Step 6: Crafting New Strategic Moves to Improve Overall Corporate Performance

- Strategic options to improve a diversified firm’s overall performance fall into five broad categories of actions:
  1. Sticking closely with the existing business lineup and pursuing the opportunities these businesses present
  2. Broadening the firm’s business scope by making new acquisitions in new industries
  3. Divesting certain businesses and retrenching to a narrower base of business operations
  4. Restructuring the firm’s business lineup and putting a whole new face on the firm’s business makeup
  5. Pursuing multinational diversification and striving to globalize the operations of several of the firm’s business units.
Core Concepts and Analytical Approaches

**Strategic Choices**

- **Sticking with the Existing Business Lineup**
  - This option makes sense when the firm’s present businesses:
    - Offer attractive growth opportunities
    - Can be counted on to generate good earnings and cash flows.
  - If existing businesses have good strategic and/or resource fits (along with good future prospects), then rocking the boat with major changes in the business lineup is usually unnecessary.
  - Corporate executives can concentrate their attention on:
    - Getting the best performance from each of its businesses
    - Steering corporate resources into those areas of greatest potential and profitability

- **Broadening the Firm’s Business Scope**
  - Factors motivating firms to building positions in new related or unrelated industries:
    - Sluggish growth prospects in existing businesses
    - The potential for transferring resources and capabilities to other related or complementary businesses
    - Rapidly changing conditions (either favorable or unfavorable) in one or more of a firm’s core businesses that make it desirable to expand into other industries
    - The addition of certain new businesses will complement and strengthen the market position and competitive capabilities of one or more present businesses

- **Retrenching to a Narrower Diversification Base**
  - Retrenching to a narrower diversification base is considered when:
    - Diversification has ranged too far afield, resources are stretched too thin, performance can only be improved by building stronger positions in fewer core businesses and industries.
    - Market conditions in a once-attractive industry have badly deteriorated
    - A business lacks a cultural, strategic or resource fit or is a cash hog with poor long-term potential or is weakly positioned in its industry with little prospect that the corporate parent will realize a decent return on its investment in the business
    - An acquired business has not worked out as profitable—some mistakes will be made because it is hard to foresee how a new line of business will actually evolve
    - Subpar performance in some business units raises questions of whether to divest them or keep them and attempt a turnaround
    - Certain businesses, despite adequate financial performance, do not mesh well with the rest of the firm’s businesses
    - A useful guide to determine whether or not to divest a business subsidiary is to ask, “If we were not in this business today, would we want to get into it now?”
    - When the answer is no or probably not, divestiture should be considered.

- **Restructuring a Firm’s Business Lineup**
  - Restructuring involves divesting some businesses and acquiring others so as to put a whole new face on the firm’s business lineup
  - Performing radical surgery on a firm’s business lineup is appealing when a firm’s financial performance is being weakened by:
    - Too many businesses in slow-growth, declining, low-margin, or otherwise unattractive industries
    - Too many competitively weak businesses
    - The emergence of new technologies that threaten the survival of one or more important businesses
    - Ongoing declines in the market shares of one or more major business units that are failing prey to more market-savvy competitors
    - An excessive debt burden with interest costs that eat deeply into profitability
    - Il-chosen acquisitions that have not lived up to expectations

- **Pursuing Multinational Diversification**
  - Offers two major avenues for growing revenues and profits:
    - Growth by entering additional businesses
    - Growth by extending the operations of existing businesses into additional country markets
  - Pursuing both growth avenues at the same time can provide a diversified firm with exceptional competitive advantage potential

- **Building Competitive Advantage through Multinational Diversification**
  - Multinational diversification offers five paths to competitive advantage (if a company is pursuing related diversification):
    - Full capture of economies of scale and learning/experience curve effects.
    - The ability to drive down unit costs by expanding sales to additional country markets is one reason why a diversified company may seek to acquire a business and then rapidly expand its operations into more and more countries.
    - Opportunities to capture economies of scope arising from cost-saving strategic fits among related businesses
    - Opportunities to transfer competitively valuable resources both from one business to another and from one country to another.
    - Opportunities to leverage a well-known and powerful brand name.
    - Opportunities to develop and leverage competitively valuable resources and capabilities via cross-business collaboration
    - All five paths to competitive advantage can be pursued simultaneously
No other diversification strategy offers more built-in potential for competitive advantage than does a strategy of multinational diversification.

Any and all of five approaches to competitive advantage can be pursued simultaneously when a company's strategy is one of related diversification:

- Increased capture of economies of scale
- Increased capture of economies of scope
- Cross-business and cross-country resource transfer
- exploitation of a competitively powerful brand name
- Cross-business collaboration to develop/leverage valuable resource capabilities