STRATEGY
Core Concepts and Analytical Approaches

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CHAPTER 8 — Diversification Strategies

Presentation Design by Charlie Cook

"I think our biggest achievement to date has been bringing back to life an inherent Disney synergy that enables each part of our business to draw from, build upon, and bolster the others."

— **Michael Eisner,** *former CEO, Walt Disney Company*

 8–2

"Fit between a parent and its businesses is a two-edged sword: A good fit can create value; a bad one can destroy it."

— **Andrew Campbell, Michael Gould, and Marcus Alexander**

 8–3

"Make winners out of every business in your company. Don't carry losers."

— **Jack Welch,** *former CEO, General Electric*

 8–4

Learning Objectives

1. Understand when to diversify and how to test whether a move to diversify into a new business is sound.
2. Learn the strategic difference between related and unrelated diversification strategies.
3. Gain an understanding of the pros and cons of related diversification strategies.
4. Gain an understanding of the pros and cons of unrelated diversification strategies.
5. Gain command of the analytical approaches to evaluating a company's diversification strategy.
6. Become familiar with a diversified company's principal strategic options after it has diversified.

 8–5

Chapter 8 Roadmap

- What Does Crafting a Diversification Strategy Entail?
- When and Why Diversification Makes Good Strategic Sense
- Choosing the Diversification Path: Related versus Unrelated Businesses
- The Case for Diversifying into Related Businesses
- The Case for Diversifying into Unrelated Businesses
- Evaluating a Diversified Company's Strategy—The Six Analytical Steps

 8–6

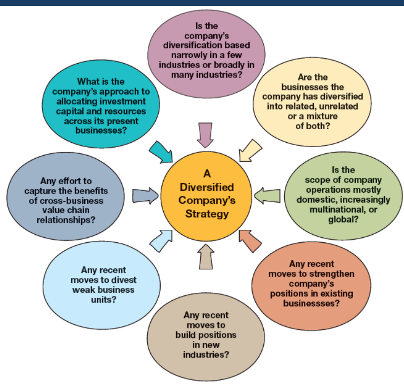
What Is Meant by "Diversification"?

- A firm is diversified when it operates in two or more lines of business that are in distinctly different industries
- Diversification complicates the strategy-making task because it requires:
  - Assessing the multiple industry environments of a collection of individual businesses
  - Developing a separate business strategy for each industry arena (or line of business) in which the diversified firm operates
  - Devising a companywide (or corporate) strategy for improving the attractiveness and performance of the company's overall business lineup and for making a rational whole out of its diversified collection of individual businesses and individual business strategies

What Does Crafting a Diversification Strategy Entail?

- Strategy-making in a diversified firm requires:
  1. Picking new industries to enter and deciding whether to enter the industry by start-up, acquisition, or a joint venture or strategic alliance with another firm
  2. Initiating actions to boost the combined performance of the firm's collection of businesses
  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 the best prospects, investing cautiously in businesses with average prospects, and divesting businesses with unacceptable prospects

FIGURE 8.1 Identifying a Diversified Company's Strategy



When to Diversify

- There's no urgency for a single-business firm to diversify into other businesses so long as it has ample opportunities for growth and profitability in its present industry
  - But it is risky for a single-business company to continue to keep all of its eggs in one industry basket when, for whatever reason, its prospects for continued good performance start to dim
- A single-business company becomes a prime candidate for diversifying when:
  - Conditions in its present industry turn sour and are expected to be long-lasting
  - There are opportunities to expand into industries whose technologies and products complement its present business
  - Its present competencies and capabilities are key success factors and valuable competitive assets for competing in another business
  - Diversifying into closely related businesses will reduce its costs
  - It has a powerful and well-known brand name that can be transferred to the products of other businesses and help drive the sales and profits of such businesses to higher levels

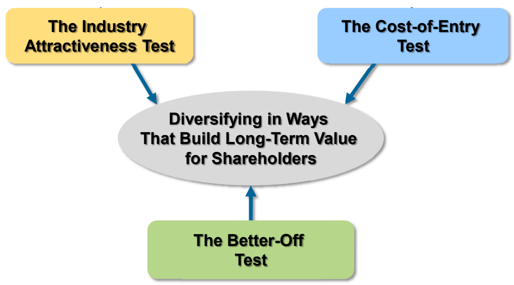
Diversification Possibilities

- A firm can pursue diversification by:
  - Diversifying into closely-related or totally-unrelated businesses
  - Diversifying the present revenue and earning base to a small extent or to a major extent
  - Moving into a single large new business or several small ones
  - Acquiring an existing firm in a business/industry it wants to enter
  - Forming a new business subsidiary to enter a promising industry
  - Forming joint ventures with other firms to enter new businesses

Core Concept

Creating added long-term value for shareholders via diversification requires building a multibusiness firm where the whole is greater than the sum of its parts—such 1 + 1 = 3 effects are called ***synergy***.

Will Diversification Produce Added Long-Term Value for Shareholders?



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Moves to Diversify into a New Business Must Pass Three Tests

- To produce added long-term economic value for shareholders, a diversifying move must pass three tests:
  1. Industry Attractiveness Test
     - Industry conditions must be conducive to good profitability
  2. Cost-of-Entry Test
     - High cost of entering cannot spoil the profit opportunities
  3. Better-Off Test
     - Diversifying must offer potential for the firm's businesses to perform better together under a single corporate umbrella than they would perform as independent stand-alone businesses

 8–14

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 that does not create 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 = 3 effect*** where the firm's different businesses ***perform better together*** than they would as independent enterprises.

 8–15

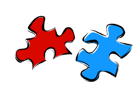
Choosing the Diversification Path: Related versus Unrelated Businesses

Related Diversification

Involves diversifying into businesses whose value chains possess competitively valuable "strategic fits" with the value chain(s) of the firm's present business(es)

Unrelated Diversification

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



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Core Concept

The value chains of different businesses are said to possess ***strategic fit*** when they present opportunities for

- Transferring competitively valuable resources from one sister business to another
- Reducing costs by sharing resources or combining the performance of related value chain activities
- Cross-business use of a potent brand name
- Cross-business collaboration to build new or stronger competitive capabilities

Capturing such opportunities puts sister businesses in position to perform better financially as part of the same company than they could have performed as independent enterprises, thus producing the 1 + 1 = 3 benefits that boost shareholder value.

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Core Concept

Related businesses possess competitively valuable cross-business value chain matchups or strategic fits.

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

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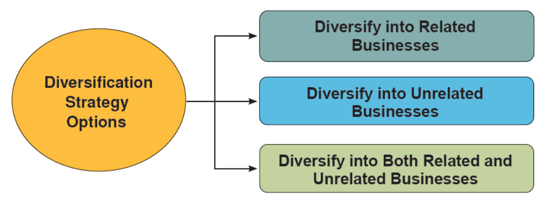
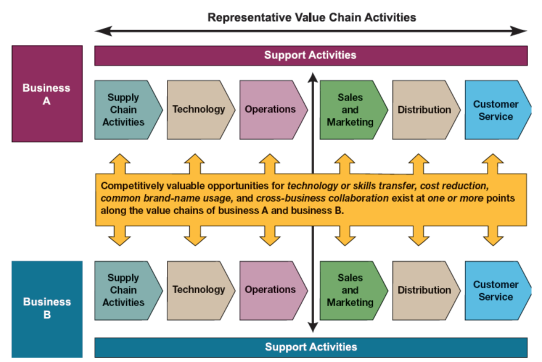
FIGURE 8.2 The Three Fundamental Strategy Alternatives for Pursuing Diversification



The Case for Diversifying into Related Businesses

- What makes related diversification an attractive strategy is the opportunity to convert cross-business strategic fits into a competitive advantage over business rivals *whose operations do not offer comparable strategic fit benefits*
- The greater the relatedness among a diversified company's sister businesses, the bigger a company's window for converting strategic fits into competitive advantage via:
  - Transfer of valuable expertise, technological know-how, or other resources from one business to another
  - The capture of cost-saving efficiencies along the value chains of related businesses
  - Cross-business use of a well-respected brand name
  - Cross-business collaboration to create competitively valuable resource strengths and capabilities

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



Core Concept

Economies of scope stem from successful managerial efforts to capture cost-saving strategic fits along the value chains of ***related*** businesses.

- Economies of scope can be achieved only if a diversified firm operates in two or more ***related businesses with cost-related strategic fits*** in one or more value chain activities.
- Often these cost-saving efficiencies are captured by combining the cost-related value chain activities of related businesses into a single, more cost-efficient operation.
- When economies of scope exist, sister businesses can be operated more cost-efficiently as part of the same firm than they could operate as stand-alone businesses.

Economies of Scope Are Different from Economies of Scale

- **Economies of scope** are achieved by capturing cost-saving strategic fits along the value chains of ***related*** businesses; examples of such cost-saving efficiencies include:
  - Production-related strategic fits that enable two or more related businesses to use the same manufacturing facility to perform their production activities (using a single plant is likely to be more cost-effective than having multiple plants) and/or
  - Distribution-related strategic fits that enable two or more related businesses to share use of the same distribution centers (utilizing a single distribution center is cheaper than having multiple distribution centers) and/or
  - Sales- and customer-related strategic fits that enable two or more related businesses to use a common sales force to sell their products to customers (a single sales force is more cost-efficient than having separate sales forces) and/or
  - The ability of two or more related businesses to share use of the same administrative infrastructure and thus spread admin costs over a bigger sales volume
- **Economies of scale** are cost savings that occur because a large-scale operation is more cost-efficient than a small-scale operation

Why Achieving Economies of Scope in Related Businesses Is Competitively Valuable

- The greater the cost-savings associated with cost-related 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: The Keys to Added Profitability and Gains in Shareholder Value

- Diversified firms having sister businesses with multiple strategic fits among their value chain activities have a larger opportunity window for cross-business resource transfer, cost reduction, cross-business use of a respected and potent brand name, and/or cross-business collaboration to:
  - Enhance *the overall competitive strength* of the various sister businesses
  - Boost the *profitability and performance* of the firm's collection of related businesses
  - Achieve a *competitive advantage over rivals* whose own operations do not offer equivalent strategic fit benefits

Such strategic-fit benefits can be substantial and capturing them are what enables a firm pursuing related diversification to achieve 1 + 1 = 3 or better financial performance and to enhance shareholder value.

 8–25

The Case for Diversifying into Unrelated Businesses

- Unrelated diversification strategies involve
  - Entering any industry and operating any business where there is opportunity to realize consistently good financial results
  - No deliberate effort to diversify into businesses with strategic fits
  - Acquiring a firm rather than forming a start-up subsidiary or collaborating in a joint venture to get into a new business
  - An acquisition passing both the industry attractiveness and cost-of-entry tests and having good prospects for financial performance

 8–26

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.

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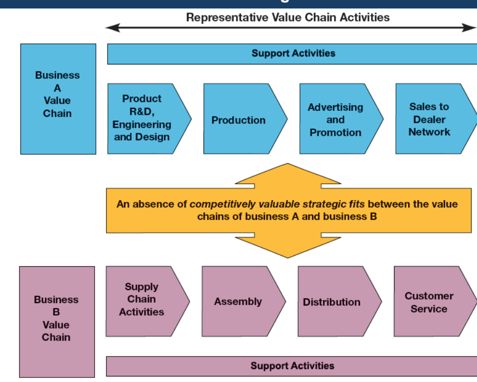
FIGURE 8.4 Unrelated Businesses Have Unrelated Value Chains and No Cross-Business Strategic Fits



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What Is Appealing about Unrelated Diversification?

- The firm's profitability may be more stable in those situations where business risk is spread across industries whose market conditions do NOT grow stronger or weaker simultaneously. In a broadly diversified company, there's a chance that market downtrends in some of the company's businesses will be partially offset by cyclical upswings in its other businesses, thus producing somewhat less earnings volatility.
- Financial resources can be employed to maximum advantage by:
  - Investing in whatever industries offer the best profit prospects
  - Diverting cash flows from firms with low growth and profit prospects to acquiring and expanding firms with high growth and profit potentials
- For bargain-priced firms with upside profit potential, shareholder wealth can be enhanced by
  - Buying distressed firms at a low price and turning their operations around quickly with infusions of cash and parent firm managerial know-how, then selling them at a profit

 8–29

Building Shareholder Value via Unrelated Diversification—The Benefits of Astute Corporate Parenting

- Managing a successful unrelated diversification strategy requires:
  - Doing a superior job of diversifying into new businesses that can produce good earnings and returns on investment (to satisfy the attractiveness test)
  - Negotiating favorable acquisition prices (to satisfy the cost-of-entry test)
  - Do such a good job of overseeing, guiding, and otherwise parenting the firm's business subsidiaries that the subsidiaries perform at a higher level than they would otherwise be able to do through their own efforts alone (a possible way to satisfy the better-off test)
  - Identifying when to shift resources out of businesses with dim prospects and into businesses with good prospects
  - Discerning when a business needs to be sold, and then selling it for a price higher than the firm's net investment in the divested business, resulting in a capital gain for shareholders rather than a capital loss

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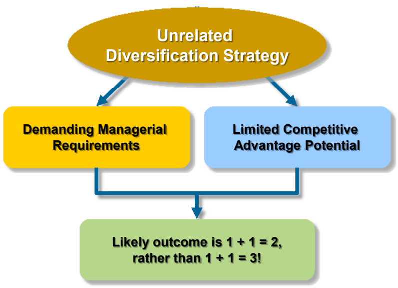
The Drawbacks of Unrelated Diversification



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The Demanding Managerial Requirements Are a Serious Issue

- Great diversity in business makes it harder 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 competitive forces, impact of driving forces or key success factors
    - Discovering that problems of an acquired business will require more time and resources to correct than expected
    - Being too optimistic about a newly acquired firm's future prospects
- *It is wise to avoid casting a wide net*—experience shows that diversifying into a few unrelated businesses often results in better overall company performance than diversifying into many unrelated businesses

 8–32

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
- With no ability to capture cross-business strategic fits, *it takes **very astute management** for the consolidated performance of an unrelated group of businesses to reach 1 + 1 = 3 levels*
- Given the demanding requirements it takes to successfully manage a collection of unrelated businesses, pursuing a strategy of unrelated diversification is ***chancy and unreliable—it is far tougher than it might seem to achieve 1 + 1 = 3 results***.

 8–33

Unrelated Diversification Strategies Often Result in "Ho-Hum" Performance

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	**There are significant challenges in building long-term shareholder value via a strategy of unrelated diversification—1 + 1 = 2 outcomes (or worse) are far more likely than 1 + 1 = 3 outcomes.**

 8–34

Related versus Unrelated Diversification Strategies

CONCLUSION: Relying solely on the expertise of corporate executives to astutely manage a set of unrelated businesses is ***a much weaker foundation for enhancing shareholder value*** than is a strategy of related diversification (where successful capture of strategic fits enhances competitive strength, boosts profitability, and offers potential competitive advantage—outcomes that raise the chances of 1 + 1 = 3 results for shareholders).

A strategy of unrelated diversification is a riskier and more problematic approach to diversifying than is a strategy of related diversification.

 8–35

Combination Related-Unrelated Diversification Strategies

- The business make-up of diversified companies varies considerably:
  - **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-ranging collection of either related or unrelated businesses or a mixture of both
  - **Diversified firms that have diversified into unrelated areas but have a collection of related businesses within each area**—thus giving them a portfolio of *several unrelated groups of related businesses*

 8–36

Evaluating and Improving a Diversified Firm's Strategy: The Six Steps

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: Evaluate 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: Assessing Industry Attractiveness

- How attractive are the various industries into which the firm has diversified?
  1. Does each industry 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 (both individually and as a group) 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 industry attractiveness measures are selected, quantitative attractiveness scores are calculated by:
  - Assigning importance weights to each industry attractiveness measure (the measures are unlikely to be equally important)
    - Sum of weights must equal 1.0
  - Rating each industry on each attractiveness measure, using a scale of 1 to 10 (where 1 = very unattractive, 5 = average attractiveness, and 10 = very attractive)
  - Multiplying the importance weight by the assigned attractiveness rating to obtain a weighted attractiveness score
  - Summing the weighted ratings for each industry to obtain an overall industry attractiveness score

TABLE 8.1 Calculating Weighted Industry Attractiveness Scores

[Rating scale: 1 = Very unattractive to company; 10 = Very attractive to company]

		Industry Attractiveness Assessments					
		Industry A		Industry B		Industry C	
Industry Attractiveness Measures	Importance Weight	Attractive-ness Rating	Weighted Score	Attractive-ness Rating	Weighted Score	Attractive-ness Rating	Weighted Score
Market size and projected growth rate	0.10	8	0.80	3	0.30	5	0.50
Intensity of competition	0.25	8	2.00	2	0.50	5	1.25
Emerging opportunities and threats	0.10	6	0.60	5	0.50	4	0.40
Cross-industry strategic fits	0.20	8	1.60	2	0.40	3	0.60
Resource requirements	0.10	6	0.60	5	0.50	4	0.40
Seasonal and cyclical influences	0.05	9	0.45	5	0.25	10	0.50
Social, political, regulatory, and environmental factors	0.05	8	0.40	3	0.15	7	0.35
Industry profitability	0.10	5	0.50	3	0.30	6	0.60
Industry uncertainty and business risk	0.05	5	0.25	1	0.05	10	0.50
Sum of importance weights	**1.00**						
Weighted overall industry attractiveness scores			**7.20**		**2.95**		**5.10**

Interpreting the Industry Attractiveness Scores

- Industries with a score below 5.0 do not pass the attractiveness test
  - The group of industries into which the firm has diversified grows decidedly less attractive as the number of industries with scores below 5.0 increases (especially if those industries with low scores account for a sizable fraction of the diversified firm's revenues)
- If a firm's industry attractiveness scores are all above 5.0, the industry group in which the firm operates 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 and above-average profitability

Step 2: Assessing Business Unit Competitive Strength

- Doing an appraisal of each business unit's strength and competitive position in its industry
  - Reveals each unit'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

 8–43

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

 8–44

What Is "Relative Market Share" and How Is It Calculated?

- A firm's ***relative market share*** is the ratio of its market share to its largest rival's market share, with market share measured in unit volume, not dollars
  - If firm A has a 15% market share and its largest rival has a 30% share, firm A's relative market share is 0.50
- For a market-leader firm, relative market share equals its market share divided by the next largest rival's market share
  - If firm B has a market-leading share of 40% and its largest rival has 30%, firm 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

 8–45

Relative Market Share Signals Competitive Strength or Weakness

- The further a firm's *relative market share* falls below 1.0, the weaker its competitive strength and market position vis-à-vis the industry leader.
  - **For example:** A firm with a 10% market share is in a weaker competitive market position

    When the leader's market share is 50% (in which case the firm's relative market share is only 0.20)

    as compared to when

    The firm has a 10% market share and the market leader's share is 12% (in which case the firm's relative share is 0.83)

A firm with a relative market share of 0.83 is in a much stronger competitive position vis-à-vis the market leader than is a firm with a relative market share of 0.20.

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Relative Market Share Signals Competitive Strength or Weakness (cont'd)

- Firms with a large industry-leading market share (greater than 1.0) are in a much stronger overall competitive position vis-à-vis their rivals.
  - A firm 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).

 8–47

Conclusions: Relative Market Share Versus Percentage Market Share

- Using relative market share as a measure of a firm's competitive strength vis-à-vis rivals is analytically superior to using straight-percentage market share.
- Relative market share is a very telling measure of a firm's competitive strength vis-à-vis rival firms (and should be assigned a high importance weight in determining its competitive strength)

 8–48

Calculating Competitive Strength Scores

- Competitive strength scores are calculated by:
  - Assigning importance weights to each competitive strength measure (measures are unlikely to be equally important)
    - Sum of weights must equal 1.0
  - Rating each business unit on each strength measure relative to its rivals, using a scale of 1 to 10 (where 1 = very weak, 5 = average or on a par, and 10 = very strong)
  - Multiplying the importance weight by the assigned strength rating to obtain a weighted score
  - Summing the weighted scores for each business unit to obtain a weighted overall competitive strength score

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TABLE 8.2 Calculating Weighted Competitive Strength Scores for a Diversified Company's Business Units

[Rating scale: 1 = Very unattractive to company; 10 = Very attractive to company]

		Competitive Strength Assessments					
		Business A in Industry A		Business B in Industry B		Business C in Industry C	
Competitive Strength Measures	**Importance Weight**	**Strength Rating**	**Weighted Score**	**Strength Rating**	**Weighted Score**	**Strength Rating**	**Weighted Score**
Relative market share	0.15	10	1.50	2	0.30	6	0.90
Costs relative to competitors' costs	0.20	7	1.40	4	0.80	5	1.00
Ability to match or beat rivals on key product attributes	0.05	9	0.45	5	0.25	8	0.40
Ability to benefit from strategic fits with sister businesses	0.20	8	1.60	4	0.80	8	0.80
Bargaining leverage with suppliers/customers	0.05	9	0.45	2	0.10	6	0.30
Brand image and reputation	0.10	9	0.90	4	0.40	7	0.70
Competitively valuable capabilities	0.15	7	1.05	2	0.30	5	0.75
Profitability relative to competitors	0.10	5	0.50	2	0.20	4	0.40
Sum of importance weights	**1.00**						
Weighted overall competitive strength scores			**7.85**		**3.15**		**5.25**

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Interpreting Competitive Strength Scores

- Firms with ratings ***above 6.7*** are strong market contenders
  - Higher scores are indicative of a diversified firm's prospects for good financial performance (unless the units are in unattractive industries)
- Firms with ratings in the ***3.3 to 6.7*** range have moderate competitive strength vis-à-vis rivals
- Firms with ratings ***below 3.3*** are in competitively weak market positions
  - As the number of business units in relatively weak competitive positions with scores below 5.0 increases, a diversified firm will not be a strong performer if these units account for a large share of the firm's revenues

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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 unit 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 is created by 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 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's bubble is scaled to represent the percentage of total corporate revenues that the business unit generates

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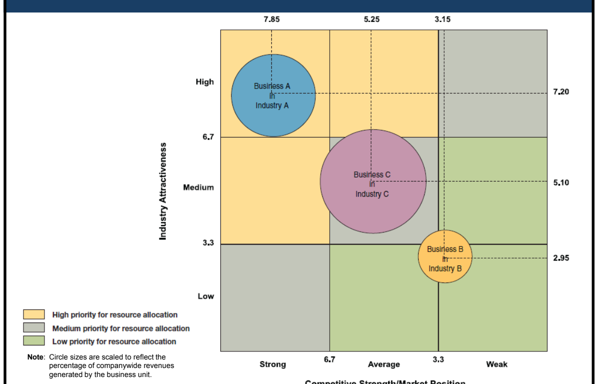
FIGURE 8.5 A Nine-Cell Industry Attractiveness–Competitive Strength Matrix



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Interpreting the Attractiveness-Strength Matrix

- Locations of the business units on the attractiveness–strength matrix provide guidance in concentrating corporate resources and focusing strategic attention on units having the greatest competitive strength and positioned in highly attractive industries
  - Businesses in the three upper left (gold) 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 or else managed to produce maximum cash flows from operations

 8–54

Step 3: Evaluating the Competitive Advantage Potential of Cross-Business Strategic Fits

- The greater the competitive value of cross-business strategic fits, the more competitively powerful is a firm's related diversification strategy
- Requires an evaluation of how much benefit a diversified firm can gain from value chain matchups that can:
  - Reduce costs and capture economies of scope by combining the performance of certain activities
  - Transfer skills, technology, or intellectual capital from one business to boost the performance of another business
  - Share the use of a highly regarded brand name
  - Create new competitive capabilities via cross-business collaboration among sister businesses

Core Concepts

A company's related diversification strategy derives its power and business appeal in large part from the presence of competitively valuable strategic fits along the value chains of its businesses.

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 firm's collection of businesses exhibit ***resource fit*** when
  - Its various sister businesses ***add*** to its overall resource strengths
  - It 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 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 Concepts

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

- To remain financially healthy, a diversified firm must generate ***internal cash flows*** sufficient to fund its capital requirements, pay dividends, and meet its debt and financial obligations.
- A ***cash hog business*** generates insufficient cash flows to fully fund its current needs for working capital and new capital investment.
- A ***cash cow business*** generates surplus cash flows for use in 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 from divested cash hogs*** to ***better advantage*** elsewhere

 8–61

Why Cash Cow Businesses Are Valuable

- The surplus cash flows cash cow businesses 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 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

 8–62

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 businesses and maintain a healthy credit rating?
  2. Are any of the firm's individual businesses not contributing adequately to achieving firm-wide performance targets?
     - Subpar profitability?
     - Slow or declining revenue growth?
     - A poor image with customers?

 8–63

Nonfinancial Resource Fits

- A diversified firm must have a sufficiently large and talented pool of managerial, administrative, and resource capabilities to support all of its 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 capabilities to be successful in each of its businesses?
  2. Are the firm's nonfinancial resources being stretched too thinly by the managerial, administrative, or resource requirements of one or more of its businesses?

 8–64

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

- 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.***
  - There may also be merit in considering each business's past performance in arriving at resource allocation decisions
    - Sales and profit growth
    - Contribution to company earnings
    - Return on capital invested in business
    - Cash flows from operations
- Medium priority should go to units with satisfactory prospects for growth and profitability (business units in the diagonal cells and cash cow businesses in the lower-right cells of the attractiveness-strength matrix)

 8–65

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, additional 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.

 8–66

FIGURE 8.6 The Chief Strategic and Financial Options for Allocating a Diversified Company's Financial Resources

Strategic Options for Allocating Company Financial Resources	Financial Options for Allocating Company Financial Resources
Invest in ways to strengthen or grow existing businesses	Pay off existing long-term or short-term debt
Make acquisitions to establish positions in new industries or to complement existing businesses	Increase dividend payments to shareholders
Fund long-range R&D ventures aimed at opening market opportunities in new or existing businesses	Repurchase shares of the company's common stock
	Build cash reserves; invest in short-term securities

 8–67

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 acquisitions in new industries
  3. Divesting underperforming 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 the firm's business units

 8–68

Sticking with the Existing Business Lineup

- This option is sensible when present businesses:
  - Offer attractive growth opportunities
  - Can be counted on to generate good earnings and cash flows
- If existing businesses have good fits, then major changes in the business lineup is usually unnecessary
- 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
  - Seeking good acquisition prospects

 8–69

Broadening the Firm's Business Scope

- Factors motivating firms to build positions in new related or unrelated industries:
  - Sluggish growth prospects for current business lineup
  - 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

 8–70

Retrenching to a Narrower Diversification Base

- Retrenching to a narrower diversification base is considered when:
  - Resources are stretched too thin and overall performance can only be improved by building stronger positions in fewer core businesses and industries
  - Market conditions in a particular business unit's industry have badly deteriorated
  - A weakly-positioned business lacks cultural, strategic or resource fit, is a cash hog with poor long-term potential, and has little prospect of a decent return on investment
  - An acquired business is simply not profitable—mistakes were made in foreseeing how a new line of business would 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, have a culture that does not mesh well with the rest of the firm's businesses

A useful guide to divesting 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.

 8–71

Restructuring a Firm's Business Lineup

- Restructuring
  - Involves divesting businesses and acquiring others 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 falling prey to more market-savvy competitors
    - An excessive debt burden with interest costs that eat deeply into profitability
    - Ill-chosen acquisitions that have not lived up to expectations

 8–72

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

 8–73

Building Competitive Advantage through Multinational Diversification

- Multinational diversification offers five opportunities for competitive advantage (if a firm is pursuing related diversification):
  - Economies of scale and learning/experience curve effects gained as expanding overseas sales from an acquired firm drive down unit costs
  - Capture of economies of scope arising from cost-saving strategic fits among related business units
  - Transfer of competitively valuable resources both from one business unit to another and from one country to another
  - Leveraging of a well-known and powerful brand name
  - Development and leveraging competitively valuable resources and capabilities via cross-business unit collaboration
- All paths to competitive advantage can be pursued simultaneously

 8–74

Core Concept

A strategy of ***multinational diversification*** has ***more built-in potential for competitive advantage than any other diversification strategy***.

Any and all of five approaches to competitive advantage can be pursued simultaneously when a firm's multinational diversification strategy is keyed to 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

 8–75

