

Corporate Diversification Strategies

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Abstract

Attention shifts from formulating strategy for a single-business enterprise to formulating strategy for a diversified enterprise. Because a diversified firm is a collection of individual businesses but corporate strategy - making is a bigger picture exercise than crafting strategy for a single-business company. A single-business enterprise, management only has to contend with one industrial environment and how to compete successfully in it. But in diversified company, corporate managers have to craft a multi-business, multi-industry strategic action plan for a number of different business divisions competing in diverse industry environments. A corporate strategy in a diversified company concentrates on: -

- Making moves to position the company in the industries chosen for diversification; taking actions to improve the long-term performance of the corporations portfolio of businesses once diversification has been achieved;*
- Trying to capture whatever strategic benefits that exist within the portfolio of businesses and turn them into competitive advantage; and*

- *Evaluate the profit prospects of each business unit and steer corporate resources into the most attractive strategic opportunities.*

Keywords: diversification, single business strategy, attractiveness, joint venture, divestiture, liquidation.

Introduction

Bright (1965) says that companies that concentrate on a single-business can achieve enviable success over many decades without relying on diversification to sustain their growth. Concentrating on a single-line business (totally or with a small amount of diversification) has some useful organizational and managerial advantages shown below:

- Single-business concentration entails less ambiguity about “what we are and what we do.”
- Energies of the total organization are directed down one business path;
- Senior management’s time or organizational resources are not stretched thinly over too many activities;
- Entrepreneurial efforts are focused exclusively on keeping the firm’s strategy and competitive approach responsive to industry change fine-tuned to customer needs;
- Management has hands-on contact with the core business and in-depth knowledge of operations;
- Managers come up with ways to strengthen the firm’s long-term competitive position in the industry rather than pursuing the fleeting benefits of higher short-term profit;

- Company uses all its organisational resources to become better at what it does and competitive skills are likely to emerge;
- As management is exclusively focused on just one business, the probability is higher that ideas will emerge on how to improve production technology that better meets customer needs with innovative new product features.

The more successful a single-business enterprise is, the more able it is to exhibit its accumulated experience and distinctive expertise into a sustainable competitive advantage and a prominent leadership position in its industry.

The risk of a Single-Business Strategy

Arthur, Thompson and Strickland (1992) say that the big risk of single-business concentration is putting all firms' eggs in one industry basket. If the industry stagnates, declines or otherwise it becomes unattractive, a company's future outlook dims, its growth rate becomes tougher to sustain and superior profit performance is much harder to achieve.

Because of the above, most single-business companies turn their strategic attention to diversification when their business starts to show signs of peaking. Diversification is resorted to as a means of spreading business risk and transferring the skills the company has built up into closely related businesses.

What companies in weak competitive position should do

Companies with weak competitive position in a relatively slow growth, market should look at:

- Reformulating their present competitive strategy to turn their situation around and create a more attractive competitive position;
- Integrating forward or backward provided good profit improvement and competitive positioning opportunities exist;
- Diversifying into related or unrelated areas;
- Merge with another firm;
- Employing a harvest, then divest strategy; and
- Liquidating their position in the business by either selling out to another firm or closing down operations.

Companies that are strongly positioned in a slow-growth industry should consider using their excess cash to begin diversifying. Diversification into business where a firm can leverage its core is usually the best strategy. But diversification into totally unrelated businesses has to be considered if more of the related business opportunities offer attractive profit prospects.

Joint ventures with other organizations into new fields are another logical possibility. Vertical integration should be a last resort (since it provides no escape from the industry's slow growth condition) and makes strategic sense only if a firm can expect sizable profit gains. A strong company in a slow-growth industry usually needs to curtail new investment in its present facilities to free cash for new endeavours.

Tests for judging diversification move

Bettis, Richard and Hall (1981) say that strategists have to base diversification decisions on future expectations. Corporate strategists can make before-the-fact assessments of whether a particular diversification move is capable of increasing shareholder value by using the following tests: -

Attractiveness test

The industry chosen for diversification must be attractive enough to produce consistently good returns on investment. True industry attractiveness is defined by the presence of favourable competitive conditions and a market environment conducive to long-term profitability.

Cost of entry test

The cost to enter the target industry must not be so high as to erode the potential for good profitability. The more attractive the industry, the more expensive it is to get into. Entry barriers for new start-up companies are nearly always high where barriers are low, a rush of new entrants would soon erode the potential for high profitability. And a buying company already in the business typically entails a high acquisition cost because of the industry's strong appeal. Costly entry undermines the potential for enhancing shareholder value.

Better-off test

The diversifying company must bring some potential for competitive advantage to the company's other businesses. The opportunity to create sustainable competitive advantage where none existed before, means there is also opportunity for added profitability.

Diversification moves that satisfy all three tests have the greatest potential to build shareholder value over the long-term. Diversification moves that can pass only one or two tests, are highly suspect.

Diversification Strategies

There are a number of diversification strategies and some of them are hereunder: -

- Strategies for entering new industries;
- Related diversification strategies;
- Unrelated diversification strategies;
- Divestiture and liquidation strategies;
- Corporate turnaround, retrenchment and restructuring strategies;
- Multinational diversification.

The first three (3) involve strategies to strengthen the positions and performance of companies that have already diversified.

Strategies for entering new businesses

Entry into new businesses can take any of the following: -

- **Acquisition of an existing business** is probably the most popular means of diversifying into another industry and has the advantage of much quicker entry into the target market. It also helps the diversifier overcome such entry barriers as technological inexperience, establishing suppliers relationship, being big enough to match rivals' efficiency unit costs, having to spend large sums on introductory advertising and promotion to gain market visibility and brand recognition. The cost-of-entry test requires that the expected profit stream of the acquired business provide an attractive return on the total acquisition cost and on any new capital investment needed to sustain or expand its operation.

- **Internal start-up**

Diversification through internal start-up involves creating a new company under the corporate umbrella to compete in the desired industry. A newly formed organization not only has to overcome entry barriers, but also has to invest in new production capacity, develop sources of supply, grow customer base etc.

Forming a start-up company to enter new industry is more attractive when: -

- there is ample time to launch the business from the ground up;
- existing firms are likely to be slow or ineffective in responding to a new entrant's efforts to crack market;
- internal entry has Lower costs than entry via acquisition;
- the company already has most or all of the skills it needs to compete effectively;

- adding new production capacity will not adversely impact the supply-demand balance in the industry;
- the targeted industry is populated with many relatively small firms so the new start-up does not have to compete head-to-head against large and more powerful rivals.

- **Joint ventures**

These are a useful way to gain access to a new business in a number of situations. First, joint venture is a good device for doing something that is uneconomical or risky or an organization to do it alone. Second, joint ventures make sense when pooling the resources and competences of two or more independent organizations with more of the skills needed to be a strong competitor. Third, joint ventures with foreign partners are sometimes the only or best way to surmount the import quotas, tariffs and cultural roadblocks. Political realities of nationalism often require a foreign company to team up with a domestic partner in order to gain access to the national market in which the domestic partner is located. Domestic partners offer foreign companies benefits of local knowledge and access to distribution channels.

However, such joint ventures often pose complicated questions about how to divide efforts among the partners and who has effective control.

Related diversification strategies

A related diversification strategy involves diversifying into businesses that possess some kind of strategic fit. Strategic fit exists when different businesses have sufficiently related activity-cost chains that there are important opportunities for activity sharing in one business or another. A diversified firm that exploits these activity-cost chain interrelationships and captures the benefits of strategic fit achieves a consolidated performance greater than the sum of what the businesses can earn pursuing independent strategies. The bigger the strategic fit benefits, the bigger the competitive advantage of related diversification and the more that related diversification satisfies the better-off-test for building the shareholder value.

Strategic fit relationships can arise out of technology sharing, common labour skills and requirements etc. Strategic fit relationships are important because they represent opportunities for cost-saving efficiencies, skills transfer or other benefits of activity-sharing, all of which are avenues for gaining competitive advantages, over rivals that have not diversified.

Unrelated Diversification Strategies

A Strategy of unrelated diversification involves diversifying into whatever industries and businesses that hold the promise for attractive financial gain, pursuing strategic fit relationships that assume a back-seat role.

In unrelated diversification, the corporate strategy is to diversify into any industry where top management spots a good profit opportunity. The basic premise of unrelated

diversification is that any company that can be acquired on good financial terms represents a good business to diversify into. Much time and effort goes into finding and screening acquisition candidates.

Criteria used to identify suitable companies to acquire

Unrelated diversification is usually accomplished through acquisition. Corporate strategists use a variety of criteria to identify suitable companies to acquire and these are hereunder: -

1. Companies whose assets are undervalued

Opportunities may exist to acquire such companies for less than full market value and make substantial capital gains by reselling their assets and businesses for more than their acquired costs.

2. Companies that are financially distressed

Such type of business can often be purchased at a bargain price. Their operations are turned around with the aid of the parent companies' financial resources and managerial know-how and then either held as a long-term investment (because of their strong earnings potential) or sold at a profit, which ever is more attractive.

3. Companies with bright growth prospects but are short on investment.

Companies that are poor in capital but opportunity rich, are usually coveted diversification candidates for a financially strong firm. Firms that pursue unrelated

diversification nearly always enter new businesses by acquiring an established company rather than by forming a start-up subsidiary within its own corporate structure. Their premise is that growth by acquisition translates into enhanced shareholder value.

Appeals/Attractiveness of unrelated diversification

Unrelated diversification has the following appeal from several financial angles: -

- business risk is scattered over a variety of industries, making the company less dependent on any one business. While the same can be said for related diversification, unrelated diversification places no restraint on how risk is spread.
- capital resources can be invested in whatever industries offer the best profit prospects. Cash from businesses with lower profit prospects can be diverted to acquiring and expanding business with higher growth and profit potentials. Corporate financial resources are thus employed to maximum advantage.
- company profitability is somewhat more stable because hard times in one industry may be partially offset by good times in another. Ideally, cyclical downswings in some of the company's businesses are counter balanced by cyclical upswings in other businesses the company has diversified into.
- to the extent that corporate managers are astute at spotting bargain-priced companies with big upside profit potential, shareholders wealth can be enhanced.

While entry into an unrelated business can often pass the attractiveness and cost-of-entry test, unrelated diversification has drawbacks:

- It places on corporate-level management to make sound decisions about fundamentally different businesses operating in fundamentally different industry and competitive environments.
- The greater the number of businesses a company is in and more diverse they are, the harder it is for corporate managers to oversee each subsidiary and spot problems early.

Hoffman and Richards (1989) say that, despite there are draw-backs, unrelated diversification can be desirable corporate strategy. It certainly makes sense when a firm needs to diversify away from an unattractive industry and has no distinctive industry and has no distinctive skills it can transfer to related businesses. Also some owners prefer to invest in several unrelated businesses instead of family of related ones.

Divestiture and Liquidation Strategies

Misfits or partial fits cannot be completely avoided because it is impossible to predict precisely how getting into a new line of business will actually work out. In addition, long-term industry attractiveness changes with the times. What was one a good diversification come into a attractive industry may later turn sour. Sub-par performance by some business units is bound to occur thereby raising questions of whether to keep them or divest them. Other business units, despite adequate financial performance, may not mesh as well with the rest of the firm as originally thought. Sometimes, a business that seems sensible from a strategic fit standpoint turns out to lack the compatibility of values essential to a cultural fit.

When a particular line of businesses loses its appeal, the most attractive solution usually is to sell it. Such businesses should be divested as fast as is practical, unless time is needed to get them in better shape to sell. The more business units in a diversified firm's portfolio, the more likely it will have to divest poor performance and misfits. Divestiture can take the following forms:

- Parent company can spin off a business as a financially and managerially independent company in which the parent may or may not retain partial ownership.
- Or the parent company may sell the unit out-rightly, in which case a buyer needs to be found.

Liquidation Strategies

Of all strategic alternatives, liquidation is the most unpleasant and painful, especially for a single business enterprise where it means the organization ceases to exist. For a multi-business firm to liquidate one of its lines of business, is less traumatic. The hardships of lay-off, plant closing e.t.c. still leave an ongoing organization that may be healthier after its pruning. In hopeless situations, an early liquidation usually serves owner-stockholder interests better than bankruptcy.

Multinational diversification strategies

The distinguishing characteristic of a multinational diversification strategy is diversity of business and diversity of national markets. Here corporate strategies must conceive and

execute a substantial number of strategies at least one for each industry, with as many multinational variations as is appropriate for the situation. At the same time, managers of diversified multinational corporations need to be alert for beneficial ways to coordinate the firm's strategic actions across industries and countries. The goal of strategic coordination at the headquarters' level is to bring the full force of corporate advantage in each business and national market.

Emergence of multinational diversification

Until the 1960s, multinational companies operated fairly autonomous subsidiaries in each host country, each catering to the special requirement of its own national market. Management tasks at company headquarters primarily involved finance functions, technology transfer and export coordination. Frequently, a multinational corporation's presence and market position in country was negotiated with the host government rather than driven by international competition.

Why Diversified Multinational Corporational (DMNC) strategies emerged

During the 1970s, multi-country strategies based on national responsiveness began to lose their effectiveness because of the following: -

- Competition broke out on a global scale in more and more industries as Japanese, European and US companies expanded internationally in the wake of trade liberalization and the opening of market opportunities in both industrialized and less developed countries.

- The relevant market arena in many industries shifted from national to global principally because of the strategies of global competitors involving gaining a foothold in host-country markets by matching or beating the product quality of local companies and under-cutting their prices.
- Global strategy enable MNC to exploit differences in tax rates, setting transfer prices in its integrated operations to produce higher profits in low-tax countries and lower profits in high-tax countries.

Conclusion

Diversification becomes an attractive strategy when a company runs out of profitable growth opportunities in its present business. There are two fundamental approaches to diversification - into related businesses and into unrelated businesses. The rationale for related diversification is strategic - diversify into businesses with strategic fit to gain competitive advantage, then use competitive advantage to achieve the desired shareholder value. The reasons for diversifying into unrelated businesses, hinge almost exclusively on opportunities for attractive financial gain.

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