

travel—it has the advantage of global reach, an unparalleled traffic base and access to enormous amounts of data.”

Could Google and ITA have developed these services through a market relationship like a license or strategic alliance? Not likely. The asymmetry in size, power, and what each partner contributed would have put ITA at risk: In a partnership, Google might have been able to assimilate ITA's proprietary technology and over time developed its own competing alternative. ITA, on the other hand, could not credibly threaten to counter Google's advantage in capturing buyers. The benefits of collaborating were potentially large, but the risk of doing so via an arms-length contract were even larger. Thus, ITA agreed to be acquired by Google so that their interests would be irrevocably aligned.

Sources: Google press announcement, July 10, 2010; A. Efrati and G. Chon, “Google's Empire Expands to Travel,” *The Wall Street Journal*, July 2, 2010; H. Grigoris, “Google Pulls Flight API Search, Putting Its Competition in a Tight Spot,” *Digital Trends*, November 1, 2017; D. Schaal, “Google Flights Is Making Gains with Consumers,” *Skift*, January 31, 2017; K. May, “Google Breathes Down the Neck of Kayak in Clicks Sent to Airlines,” *Phocuswire*, September 5, 2017; D. Seviitt, “Google Flights Continued: Closing the Delta,” *Market Intelligence Insights*, August 28, 2018; S. O'Neill, “Google is one step closer to its user-centric vision of travel booking,” February 6, 2018; M. A. Schilling, “Potential Sources of Value in Mergers and Their Indicators,” *Antitrust Bulletin* (2018) 26: pp. 183–197.

10-1 OVERVIEW

Diversification can create, and destroy, value. As shown in the Opening Case, diversification enabled Google to leverage its strength in general online search to provide exceptional online travel booking, and the Closing Case illustrates how Louis Vuitton uses diversification to leverage its expertise, distribution reach, influence, and capital resources to help new brands grow more profitably than they would grow on their own. However, diversification can also lead a firm away from its key strengths, reduce the firm's transparency in reporting its results, and make it more difficult for managers to provide adequate oversight within the organization. Diversification can be very alluring to managers, and it is easy to overestimate potential synergies. It is much harder to realize them.¹

In this chapter, we continue to discuss both the challenges and opportunities created by corporate-level strategies of related and unrelated diversification. A diversification strategy is based upon a company's decision to enter one or more new industries to take advantage of its existing distinctive competencies and business model. We examine the different kinds of multibusiness models upon which related and unrelated diversification are based. Then, we discuss three different ways companies can implement a diversification strategy: internal new ventures, acquisitions, and joint ventures. By the end of this chapter, you will understand the advantages and disadvantages associated with strategic managers' decisions to diversify and enter new markets and industries.

10-2 INCREASING PROFITABILITY THROUGH DIVERSIFICATION

diversification

The process of entering new industries, distinct from a company's core or original industry, to make new kinds of products for customers in new markets.

diversified company

A company that makes and sells products in two or more different or distinct industries.

Diversification is the process of entering new industries, distinct from a company's core or original industry, to make new kinds of products that can be sold profitably to customers in these new industries. A multibusiness model based on diversification aims to find ways to use a company's existing strategies and distinctive competencies to make products that are highly valued by customers in the new industries it enters. A **diversified company** is one that makes and sells products in two or more different or distinct industries (industries *not* in adjacent stages of an industry value chain, as in vertical integration). As in the case of the corporate strategies discussed in Chapter 9, a diversification strategy should enable a company or its individual business units to perform one or more value-chain functions: (1) at a lower cost, (2) in a way that allows for greater differentiation and gives the company better pricing options, or (3) in a way that helps the company manage industry rivalry better—in order to increase profitability.

Most companies consider diversification when they are generating *free cash flow*; that is, cash in excess of that required to fund new investments in the company's current business and meet existing debt commitments.² In other words, free cash flow is cash beyond that needed to make profitable new investments in the existing business. When a company's successful business model is generating free cash flow and profits, managers must decide whether to return that cash to shareholders in the form of higher dividend payouts or to invest it in diversification.

The free cash flow of a firm technically belongs to the company's owners—its shareholders. So, for diversification to create value, a company's return on investing free cash flow to pursue diversification opportunities—that is, its future ROIC—*must exceed* the value shareholders would reap by returning the cash to them. When a firm does not pay out its free cash flow to its shareholders, the shareholders bear an opportunity cost equal to their next best use of those funds (i.e., another investment that pays a similar return at a similar risk, an investment that pays a higher return at a higher risk, or an investment that pays a lower return but at a lower risk). Thus, a diversification strategy must pass the “better off” test: The firm must be more valuable than it was before the diversification, and that value must not be fully capitalized by the cost of the diversification move (i.e., the cost of entry into the new industry must be taken into account when assessing the value created by the diversification). Thus, managers might defer paying dividends now to invest in diversification, but they should do so only when this is expected to create even greater cash flow (and thus higher dividends) in the future.

There are four primary ways in which pursuing a multibusiness model based on diversification can increase company profitability. Diversification can increase profitability when strategic managers (1) transfer competencies between business units in different industries, (2) leverage competencies to create business units in new industries, (3) share resources between business units to realize synergies or economies of scope, or (4) utilize *general* organizational competencies that increase the performance of *all* a company's business units.

10-2a Transferring Competencies Across Businesses

Transferring competencies involves taking a distinctive competency developed by a business unit in one industry and implanting it in a business unit operating in another industry. The second business unit is often one a company has acquired. Companies that base their diversification strategy on transferring competencies aim to use one or more of their existing distinctive competencies in a value-chain activity—for example, in manufacturing, marketing, materials management, or research and development (R&D)—to significantly strengthen the business model of the acquired business unit or company. For example, over time, Philip Morris developed distinctive competencies in product development, consumer marketing, and brand positioning that had made it a leader in the tobacco industry. Sensing a profitable opportunity, it acquired Miller Brewing, which at the time was a relatively small player in the brewing industry. Then, to create valuable new products in the brewing industry, Philip Morris transferred some of its best marketing experts to Miller, where they applied the skills acquired at Philip Morris to turn around Miller's lackluster brewing business (see Figure 10.1). The result was the creation of Miller Light, the first "light" beer, and a marketing campaign that helped to push Miller from number 6 to number 2 in market share in the brewing industry.

Companies that base their diversification strategy on transferring competencies tend to acquire new businesses *related* to their existing business activities because of commonalities between one or more of their value-chain functions. A **commonality** is a skill or attribute that, when shared or used by two or more business units, allows both businesses to operate more effectively and efficiently and create more value for customers.

For example, Miller Brewing was related to Philip Morris's tobacco business because it was possible to create important marketing commonalities; both beer and tobacco are mass-market consumer goods in which brand positioning, advertising, and

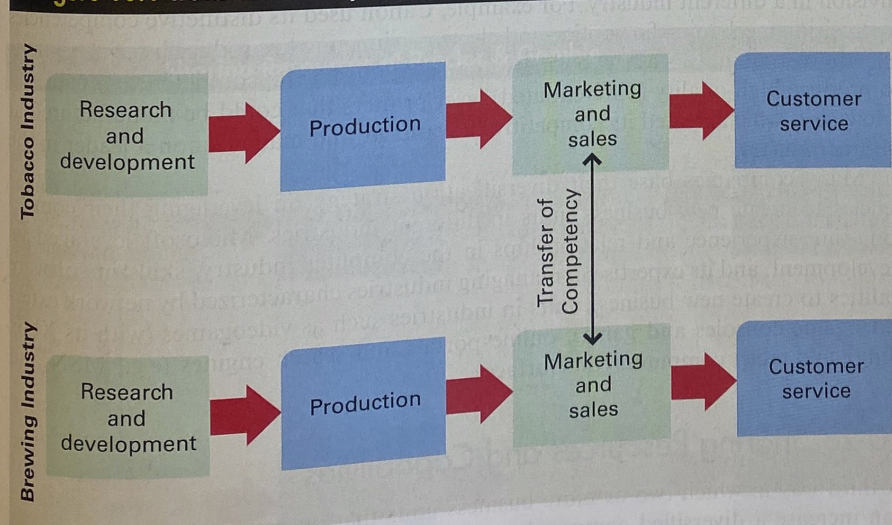
transferring competencies

The process of taking a distinctive competency developed by a business unit in one industry and implanting it in a business unit operating in another industry.

commonality

A skill or competency that, when shared by two or more business units, allows them to operate more effectively and create more value for customers.

Figure 10.1 Transfer of Competencies at Philip Morris



product development skills are crucial to create successful new products. In general, such competency transfers increase profitability when they either (1) lower the cost structure of one or more of a diversified company's business units or (2) enable one or more of its business units to better differentiate their products, both of which give business-unit pricing options to lower a product's price to increase market share, or to charge a premium price.

To increase profitability, transferred competencies must involve value-chain activities that become an important source of a specific business unit's competitive advantage in the future. In other words, the distinctive competency being transferred must have real strategic value. However, all too often, companies assume that *any* commonality between their value chains is sufficient for creating value. When they attempt to transfer competencies, they find the anticipated benefits are not forthcoming because the different business units did not share some important attribute in common. For example, Coca-Cola acquired Minute Maid, the fruit juice maker, to take advantage of commonalities in global distribution and marketing, and this acquisition has proved to be highly successful. On the other hand, Coca-Cola once acquired the movie studio Columbia Pictures because it believed it could use its marketing prowess to produce blockbuster movies. This acquisition was a disaster that cost Coca-Cola billions in losses, and Columbia was eventually sold to Sony, which was then able to base many of its successful PlayStation games on the hit movies the studio produced.

10-2b Leveraging Competencies to Create a New Business

leveraging competencies

The process of taking a distinctive competency developed by a business unit in one industry and using it to create a new business unit in a different industry.

By **leveraging competencies**, a company can develop a new business in a different industry. For example, Apple leveraged its competencies in personal computer (PC) hardware and software to enter the smartphone industry. Once again, the multibusiness model is based on the premise that the set of distinctive competencies that are the source of a company's competitive advantage in one industry might be applied to create a differentiation or cost-based competitive advantage for a new business unit or division in a different industry. For example, Canon used its distinctive competencies in precision mechanics, fine optics, and electronic imaging to produce laserjet printers, which, for Canon, was a new business in a new industry. Its competencies enabled it to produce high-quality (differentiated) laser printers that could be manufactured at a low cost, which created its competitive advantage, and made Canon a leader in the printer industry.

Many companies base their diversification strategy on leveraging their competencies to create new business units in different industries. Microsoft leveraged its long-time experience and relationships in the computer industry, skills in software development, and its expertise in managing industries characterized by network externalities to create new business units in industries such as videogames (with its Xbox videogame consoles and game), online portals and search engines (e.g., MSN and Bing), and tablet computers (the Surface).

economies of scope

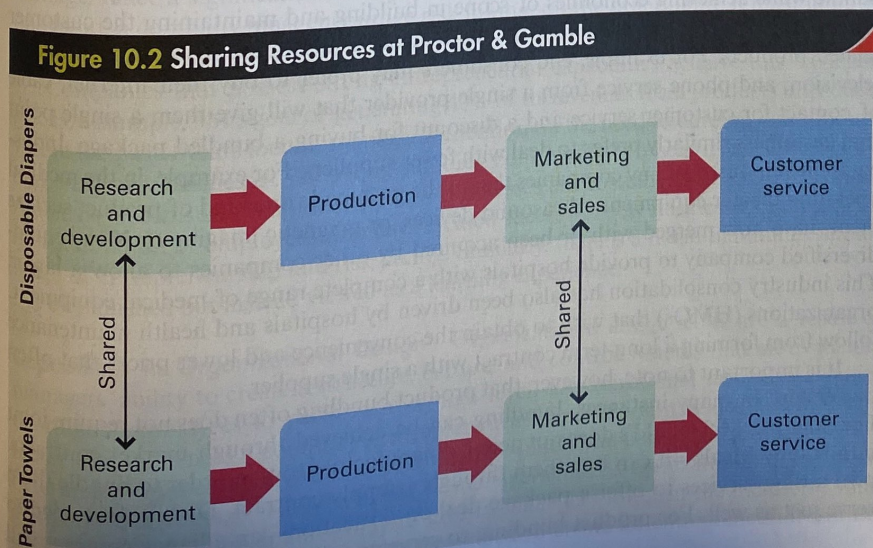
The synergies that arise when one or more of a diversified company's business units are able to lower costs or increase differentiation because they can more effectively pool, share, and utilize expensive resources or capabilities.

10-2c Sharing Resources and Capabilities

A third way in which two or more business units that operate in different industries can increase a diversified company's profitability is when the shared resources and capabilities result in economies of scope, or synergies.³ **Economies of scope** arise when

one or more of a diversified company's business units are able to realize cost-saving or differentiation synergies because they can more effectively pool, share, and utilize expensive resources or capabilities such as skilled people, equipment, manufacturing facilities, distribution channels, advertising campaigns, and R&D laboratories. If business units in different industries can share a common resource or function, they can collectively lower their cost structure; the idea behind synergies is that $2 + 2 = 5$, not 4, in terms of value created.⁴ As shown in the Closing Case, LVMH can utilize its distribution channels and its influence with fashion editors to help newer brands reach a global market more quickly and cost effectively. Similarly, GE can leverage its consumer-products advertising, sales, and service activities across a wide range of products such as light bulbs, appliances, air conditioners, and furnaces, thereby reducing the average cost of these activities for each product line. There are two major resources of cost reductions.

There are two major sources of cost reductions. First, when companies can share resources or capabilities across business units, it lowers their cost structure compared to a company that operates in only one industry and bears the full costs of developing resources and capabilities. For example, P&G makes disposable diapers, toilet paper, and paper towels, which are all paper-based products that customers value for their ability to absorb fluids without disintegrating. Because these products need the same attribute—absorbency—P&G can share the R&D costs associated with developing and making even more advanced absorbent, paper-based products across the three distinct businesses (only two are shown in Figure 10.2). Similarly, because all of these products are sold to retailers, P&G can use the same sales force to sell its whole array of products (see Figure 10.2). In contrast, P&G competitors that make only one or two of these products cannot share these costs across industries, so their cost structures are higher. As a result, P&G has lower costs; it can use its marketing function to better differentiate its products, and it achieves a higher ROIC than companies that operate only in one or a few industries—which are unable to obtain economies of scope from the ability to share resources and obtain synergies across business units.



Similarly, Nike, which began strictly as a maker of running shoes, realized that its brand image, and its relationships with athletes and sports events, could be profitably leveraged into other types of athletic footwear, athletic apparel, and accessories such as sunglasses and headphones. Those products were more **differentiated** because of the Nike brand name and had better exposure because Nike was able to place them in suitable endorsement spots via its relationships with athletes and events, and Nike is able to amortize the cost of its brand-building activities across a wider range of products, thus achieving economies of scope.

To reiterate, diversification to obtain economies of scope is possible only when there are *significant* commonalities between one or more value-chain functions in a company's different business units or divisions that result in synergies which increase profitability. In addition, managers must be aware that the costs of coordination necessary to achieve synergies or economies of scope within a company may sometimes be *higher* than the value that can be created by such a strategy.⁵ For example, from 1990 to 2010, Citibank transitioned from being wholly focused on retail consumer banking to a "financial supermarket" by diversifying into insurance, mortgage banking, stock brokering, and more, believing that it would achieve major cost savings from consolidating operations across its acquisitions, and revenue-increasing opportunities from cross-selling. In reality, the coordination costs that Citi bore (in the form of massive losses due to inadequate oversight over its investment activities) vastly exceeded the synergies it gained, and proved devastating for the firm. Citibank subsequently dismantled its financial supermarket, selling off Smith Barney, Phibro, Diner's Club, Primerica, and more. The Citi example illustrates that diversification based on obtaining economies of scope should be pursued only when the sharing of competencies will result in *significant* synergies that will achieve a competitive advantage for one or more of a company's new or existing business units, and when those advantages will exceed the costs and risks created.

The Citi case also illustrates that one of the sources of economies of scope that firms seek through diversification is through product bundling. Product bundling allows a company to satisfy customers' needs for a complete package of related products, potentially leveraging the advantage the firm has in one part of the bundle to other parts of the bundle while achieving economies of scope in building and maintaining the customer relationship. Customers often want the convenience and reduced price of a bundle of related products. For example, end consumers may prefer to buy their internet, cable television, and phone service from a single provider that will give them a single point of contact for customer service and a discount for buying a bundled package. Industrial customers similarly prefer to deal with fewer suppliers. For example, in the medical equipment industry, many companies that in the past made one kind of product such as operating theater equipment, ultrasound devices, or magnetic imaging or X-ray equipment, have now merged with or been acquired by other companies to allow a larger, diversified company to provide hospitals with a complete range of medical equipment. This industry consolidation has also been driven by hospitals and health maintenance organizations (HMOs) that wish to obtain the convenience and lower prices that often follow from forming a long-term contract with a single supplier.

It is important to note, however, that product bundling often does not require joint ownership. In many instances, bundling can be achieved through market contracts. For example, McDonald's does not need to manufacture toys in order to bundle them into Happy Meals—it can buy them through a supply contract. Disney does need to own airline services to offer a package deal on a vacation—an alliance contract will serve just as well. For product bundling to serve as a justification for diversification,

there must be products that

10-2d Util

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there must be a strong need for coordination between the producers of the different products that cannot be overcome through market contracts.

10-2d Utilizing General Organizational Competencies

General organizational competencies transcend individual functions or business units and are found at the top or corporate level of a multibusiness company. Typically, **general organizational competencies** are the result of the skills of a company's top managers and functional experts. When these general competencies are present—and at a higher level than it could if it operated as a separate or independent company. This increases the profitability of the entire corporation.⁶ Three general organizational competencies help a company increase its performance and profitability: (1) entrepreneurial capabilities, (2) organizational design capabilities, and (3) strategic capabilities.

general organizational competencies

Competencies that result from the skills of a company's top managers and that help every business unit within a company perform at a higher level than it could if it operated as a separate or independent company.

Entrepreneurial Capabilities A company that generates significant excess cash flow can take advantage of it only if its managers are able to identify new opportunities and act on them to create a stream of new and improved products, in its current industry and in new industries. Companies such as Apple, 3M, Google, and Samsung are able to promote entrepreneurship because they have an organizational culture that stimulates managers to act entrepreneurially.⁷ As a result, they create new, profitable business units more quickly than do other companies, and this allows them to take advantage of profitable opportunities for diversification. We discuss one of the strategies required to generate new, profitable businesses later in this chapter: internal new venturing. For now, it is important to note that, to promote entrepreneurship, a company must (1) encourage managers to take risks, (2) give managers the time and resources to pursue novel ideas, (3) not punish managers when a new idea fails, and (4) make sure that the company's free cash flow is not wasted in pursuing too many risky ventures that have a low probability of generating a profitable return on investment. Strategic managers face a significant challenge in achieving all four of these objectives. On the one hand, a company must encourage risk taking; on the other hand, it must limit the number of risky ventures in which it engages.

Companies that possess strong entrepreneurial capabilities achieve this balancing act. For example, 3M's goal of generating 40% of its revenues from products introduced within the past 4 years focuses managers' attention on the need to develop new products and enter new businesses. 3M's long-standing commitment to help its customers solve problems also ensures that ideas for new businesses are customer focused. The company's celebration of employees who have created successful new businesses reinforces the norm of entrepreneurship and risk taking. Similarly, there is a norm that failure should not be punished but instead viewed as a learning experience.

Capabilities in Organizational Design **Organizational design skills** are a result of managers' ability to create a structure, culture, and control systems that motivate and coordinate employees to perform at a high level. Organizational design is a major factor that influences a company's entrepreneurial capabilities; it is also an important determinant of a company's ability to create the functional competencies that give it a competitive advantage. The way strategic managers make organizational design decisions, such as how much autonomy to give to managers lower in the hierarchy, what kinds of norms and values should be developed to create an entrepreneurial culture,

organizational design skills

The ability of a company's managers to create a structure, culture, and control systems that motivate and coordinate employees to perform at a high level.

and even how to design its headquarters to encourage the free flow of ideas, is an important determinant of a diversified company's ability to profit from its multibusiness model. Effective organizational structure and controls create incentives that encourage business-unit (divisional) managers to maximize the efficiency and effectiveness of their units. Moreover, good organizational design helps prevent strategic managers from missing out on profitable new opportunities, as happens when employees become so concerned with protecting their company's competitive position in existing industries that they lose sight of new or improved ways to do business and gain profitable opportunities to enter new industries.

Chapters 11 and 12 of this book look at organizational design in depth. To profit from pursuing the corporate-level strategy of diversification, a company must be able to continuously manage and change its structure and culture to motivate and coordinate its employees to work at a high level and develop the resources and capabilities upon which its competitive advantage depends. The need to align a company's structure with its strategy is a complex, never-ending task, and only top managers with superior organizational design skills can do it.

Superior Strategic Management Capabilities For diversification to increase profitability, a company's top managers must have superior capabilities in strategic management. They must possess the intangible, hard-to-define governance skills that are required to manage different business units in a way that enables these units to perform better than they would if they were independent companies.⁸ These governance skills are a rare and valuable capability. However, certain CEOs and top managers seem to have them; they have developed the aptitude of managing multiple businesses simultaneously and encouraging the top managers of those business units to devise strategies that achieve superior performance. Examples of CEOs famous for their superior strategic management capabilities include Jeffrey Immelt at GE, Steve Jobs at Apple, and Larry Ellison at Oracle.

An especially important governance skill in a diversified company is the ability to diagnose the underlying source of the problems of a poorly performing business unit, and then to understand how to proceed to solve those problems. This might involve recommending new strategies to the existing top managers of the unit, or knowing when to replace them with a new management team that is better able to fix the problems. Top managers who have such governance skills tend to be very good at probing business-unit managers for information and helping them think through strategic problems, as the example of United Technologies Corporation (UTC) discussed in Strategy in Action 10.1 suggests.

Related to strategic management skills is the ability of the top managers of a diversified company to identify inefficient, poorly managed companies in other industries and then acquire and restructure them to improve their performance—and thus the profitability of the total corporation. This is known as a **turnaround strategy**.⁹ There are several ways to improve the performance of an acquired company. First, the top managers of the acquired company are replaced with a more aggressive top-management team. Second, the new top-management team sells off expensive assets such as underperforming divisions, executive jets, and elaborate corporate headquarters; it also terminates staff to reduce the cost structure. Third, the new management team devises new strategies to improve the performance of the operations of the acquired business and improve its efficiency, quality, innovativeness, and customer responsiveness.

turnaround strategy

When managers of a diversified company identify inefficient, poorly managed companies in other industries and then acquire and restructure them to improve their performance—and thus the profitability of the total corporation.

goal is to find ways to improve *quality and reliability*, to *lower the costs* of making a product, and, especially, to find ways to make the next generation of a particular product perform better—in other words, to encourage *technological innovation*. David makes every employee in every function at every level personally responsible for achieving the incremental, step-by-step gains that result in state-of-the-art, innovative, efficient products that allow a company to dominate its industry.

David calls these techniques “process disciplines,” and he has used them to increase the performance of all UTC companies. Through these techniques, he has created the extra value for UTC that justifies it owning and operating such a diverse set of businesses. David’s success can be seen in the performance that his company has achieved in the decade since he took control: he has quadrupled UTC’s earnings per share, and its sales and profits have soared. UTC has been in the top three performers of the companies that make up the Dow Jones industrial average for most of the 2000s, and the company has consistently outperformed GE, another huge conglomerate, in its return to investors.

Source: <http://utc.com>.

David and his managers believe that the gains that can be achieved from UTC’s process disciplines are never-ending because its own R&D—in which it invests more than \$2.5 billion a year—is constantly producing product innovations that can help all its businesses. Recognizing that its skills in creating process improvements are specific to manufacturing companies, UTC’s strategy is to only acquire companies that *make* products that can benefit from the use of its ACE program—hence its Chubb acquisition. At the same time, David invests only in companies that have the potential to remain leading companies in their industries and can therefore charge above-average prices. His acquisitions strengthen the competencies of UTC’s existing businesses. For example, he acquired Sundstrand, a leading aerospace and industrial systems company, and combined it with UTC’s Hamilton Aerospace Division to create Hamilton Sundstrand, which is now a major supplier to Boeing and makes products that command premium prices. In October 2011, UTC acquired Goodrich, a major supplier of airline components, for over \$22 billion in order to strengthen its aircraft division.

Fourth, to motivate the new top-management team and the other employees of the acquired company to work toward such goals, a companywide, pay-for-performance bonus system linked to profitability is introduced to reward employees at all levels for their hard work. Fifth, the acquiring company often establishes “stretch” goals for employees at all levels; these are challenging, hard-to-obtain goals that force employees at all levels to work to increase the company’s efficiency and effectiveness. The members of the new top-management team clearly understand that if they fail to increase their division’s performance and meet these stretch goals within some agreed-upon amount of time, they will be replaced. In sum, corporate managers of the acquiring company establish a system of rewards and sanctions that incentivize new top managers of the acquired unit to develop strategies to improve their unit’s operating performance.

10-3 TWO TYPES OF DIVERSIFICATION

The last section discussed five principal ways in which companies use diversification to transfer and implant their business models and strategies into other industries and so increase their long-term profitability. The two corporate strategies of *related diversification* and *unrelated diversification* can be distinguished by how they attempt to realize the five profit-enhancing benefits of diversification.¹⁰

10-3a Related Diversification

Related diversification is a corporate-level strategy based on the goal of establishing a business unit (division) in a new industry that is *related* to a company's existing business units by some form of commonality or linkage between the value-chain functions of the existing and new business units. As you might expect, the goal of this strategy is to obtain benefits from transferring competencies, leveraging competencies, sharing resources, and bundling products, as just discussed.

The multibusiness model of related diversification is based on taking advantage of strong technological, manufacturing, marketing, and sales commonalities between new and existing business units that can be successfully "tweaked" or modified to increase the competitive advantage of one or more business units. Figure 10.3 illustrates the commonalities or linkages possible among the different functions of three different business units or divisions. The greater the number of linkages that can be formed among business units, the greater the potential to realize the profit-enhancing benefits of the five reasons to diversify discussed previously.

Another advantage of related diversification is that it can allow a company to use any general organizational competency it possesses to increase the overall performance of *all* its different industry divisions. For example, strategic managers may strive to create a structure and culture that encourages entrepreneurship across divisions, as Google, Apple, and 3M have done; beyond these general competences, these companies all have a set of distinctive competences that can be shared among their different business units and that they continuously strive to improve.

related diversification

A corporate-level strategy based on the goal of establishing a business unit in a new industry that is related to a company's existing business units by some form of commonality or linkage between their value-chain functions.

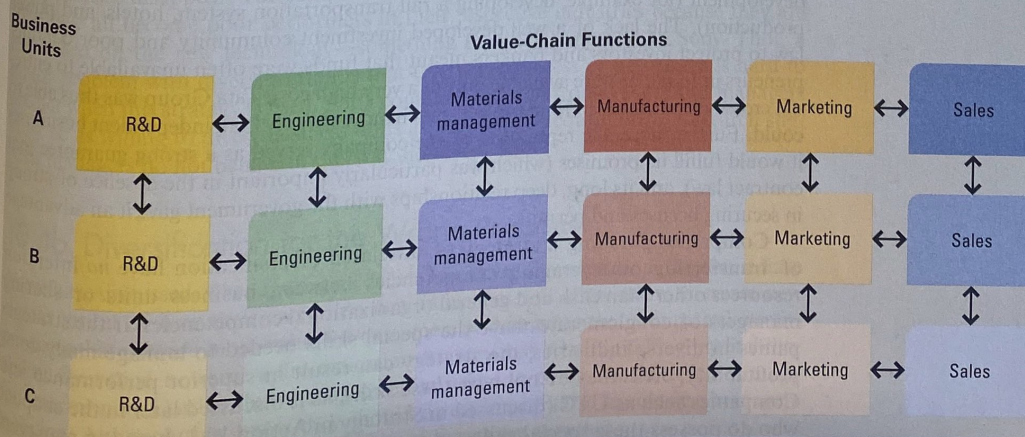
10-3b Unrelated Diversification

Unrelated diversification is a corporate-level strategy whereby firms own unrelated businesses and attempt to increase their value through an internal capital market, the

unrelated diversification

A corporate-level strategy based on a multibusiness model that uses general organizational competencies to increase the performance of all the company's business units.

Figure 10.3 Commonalities Between the Value Chains of Three Business Units



internal capital market

A corporate-level strategy whereby the firm's headquarters assesses the performance of business units and allocates money across them. Cash generated by units that are profitable but have poor investment opportunities within their business is used to cross-subsidize businesses that need cash and have strong promise for long-run profitability.

use of general organizational competencies, or both. Business organizations that operate in many diverse industries are often called *conglomerates*. An **internal capital market** refers to a situation whereby corporate headquarters assesses the performance of business units and allocates money across them. Cash generated by units that are profitable but have poor investment opportunities within their business is used to cross-subsidize businesses that need cash and have strong promise for long-run profitability. A large, diverse firm may have free cash generated from its internal businesses, or readier access to cheap cash on the external capital market, than an individual business unit might have. For example, GE's large capital reserves and excellent credit rating enable it to provide funding to advanced-technology businesses within its corporate umbrella (e.g., solar power stations, subsea oil-production equipment, avionics, photonics) that would otherwise pay a high price (either in interest payments or equity shares) for funding due to their inherent uncertainty.

The benefits of an internal capital market are limited, however, by the efficiency of the external capital market (banks, stockholders, venture capitalists, angel investors, and so on). If the external capital market were perfectly efficient, managers could not create additional value by cross-subsidizing businesses with internal cash. An internal capital market is, in essence, an arbitrage strategy whereby managers make money by making better investment decisions within the firm than the external capital market would, often because they possess superior information. The amount of value that can be created through an internal capital market is thus directly proportional to the inefficiency of the external capital market. In the United States, where capital markets have become fairly efficient due to (1) reporting requirements mandated by the Securities and Exchange Commission (SEC), (2) large numbers of research analysts, (3) an extremely large and active investment community, (4) strong communication systems, and (5) strong contract law, it is not common to see firms create significant value through an internal capital market. As a result, few large conglomerates have survived, and many of those that do survive trade at a discount (that is, their stock is worth less than the stock of more specialized firms operating in the same industries). On the other hand, in a market with a less efficient capital market, conglomerates may create significant value. Tata Group, for example, is an extremely large, diverse, business-holding group in India. Founded during the 1800s, it took on many projects that its founders felt were crucial to India's development (for example, developing a rail transportation system, hotels, and power production). The lack of a well-developed investment community and poor contract law to protect investors and bankers meant that funds were often unavailable to entrepreneurs in India, or were available only at a very high cost. Tata Group was thus able to use cross-subsidization to fund projects much more cheaply than independent businesses could. Furthermore, the reputation of the company served as a strong guarantee that it would fulfill its promises (which was particularly important in the absence of strong contract law), and its long, deep relationships with the government gave it an advantage in securing licenses and permits.

Companies pursuing a strategy of unrelated diversification have *no* intention of transferring or leveraging competencies between business units or sharing resources other than cash and general organizational competencies. If the strategic managers of conglomerates have the special skills needed to manage many companies in diverse industries, the strategy can result in superior performance and profitability; often they do not have these skills, as is discussed later in the chapter. Companies such as UTC (discussed in Strategy in Action 10.1) have top managers who do possess these special skills.

10-4

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10-4 THE LIMITS AND DISADVANTAGES OF DIVERSIFICATION

Many companies, such as 3M, Samsung, UTC, and Cisco, have achieved the benefits of pursuing either or both of the two diversification strategies just discussed, and they have sustained their profitability over time. On the other hand, GM, Tyco, Textron, and Philips failed miserably and became unprofitable when they pursued diversification. There are three principal reasons why a business model based on diversification may lead to a loss of competitive advantage: (1) changes in the industry or inside a company that occur over time, (2) diversification pursued for the wrong reasons, and (3) excessive diversification that results in increasing bureaucratic costs.

10-4a Changes in the Industry or Company

Diversification is a complex strategy. To pursue it, top managers must have the ability to recognize profitable opportunities to enter new industries and implement the strategies necessary to make diversification profitable. Over time, a company's top-management team often changes; sometimes its most able executives join other companies and become CEOs, and sometimes successful CEOs retire or step down. When the managers who possess the hard-to-define skills leave, they often take their vision with them. A company's new leaders may lack the competency or commitment necessary to pursue diversification successfully over time; thus, the cost structure of the diversified company increases and eliminates any gains the strategy may have produced.

In addition, the environment often changes rapidly and unpredictably over time. When new technology blurs industry boundaries, it can destroy the source of a company's competitive advantage. For example, by 2011, it was clear that Apple's iPhone and iPad had become a direct competitor with Nintendo's and Sony's mobile gaming consoles. When such a major technological change occurs in a company's core business, the benefits it has previously achieved from transferring or leveraging distinctive competencies disappear. The company is then saddled with a collection of businesses that have all become poor performers in their respective industries because they are not based on the new technology—something that has happened to Sony. Thus, a major problem with diversification is that the future success of a business is hard to predict when this strategy is used. For a company to profit from it over time, managers must be as willing to divest business units as they are to acquire them. Research suggests managers do not behave in this way, however.

10-4b Diversification for the Wrong Reasons

As we have discussed, when managers decide to pursue diversification, they must have a clear vision of how their entry into new industries will allow them to create new products that provide more value for customers and increase their company's profitability. Over time, however, a diversification strategy may result in falling profitability for reasons noted earlier, but managers often refuse to recognize that their strategy is failing. Although they know they should divest unprofitable businesses, managers "make up" reasons to keep their collection of businesses together.

In the past, for example, one widely used (and false) justification for diversification was that the strategy would allow a company to obtain the benefits of risk pooling. The idea behind risk pooling is that a company can reduce the risk of its revenues and profits rising and falling sharply (something that sharply lowers its stock price) if it acquires and operates companies in several industries that have different business cycles. The business cycle is the tendency for the revenues and profits of companies in an industry to rise and fall over time because of “predictable” changes in customer demand. For example, even in a recession, people still need to eat—the profits earned by supermarket chains will be relatively stable; sales at Safeway, Kroger, and also at “dollar stores,” rise as shoppers attempt to get more value for their dollars. At the same time, a recession can cause demand for cars and luxury goods to plunge. Many CEOs argue that diversifying into industries that have different business cycles would allow the sales and revenues of some of their divisions to rise, while sales and revenues in other divisions would fall. A more stable stream of revenue and profits is the net result over time. An example of risk pooling occurred when U.S. Steel diversified into the oil and gas industry in an attempt to offset the adverse effects of cyclical downturns in the steel industry.

This argument ignores two important facts. First, stockholders can eliminate the risk inherent in holding an individual stock by diversifying their own portfolios, and they can do so at a much lower cost than a company can. Thus, for a publicly-held firm, attempts to pool risks through diversification represent an unproductive use of resources; instead, profits should be returned to shareholders in the form of increased dividends. Second, research suggests that corporate diversification is not an effective way to pool risks because the business cycles of different industries are *inherently difficult to predict*, so it is likely that a diversified company will find that an economic downturn affects *all* its industries simultaneously. If this happens, the company’s profitability plunges.¹¹

When a company’s core business is in trouble, another mistaken justification for diversification is that entry into new industries will rescue the core business and lead to long-term growth and profitability. Kodak made this mistake. In the 1980s, increased competition from low-cost, Japanese competitors such as Fuji, combined with the beginnings of the digital revolution, soon led Kodak’s revenues and profits to plateau and then fall. Its managers should have done all they could to reduce its cost structure; instead, they took its huge free cash flow and spent tens of billions of dollars to enter new industries such as health care, biotechnology, and computer hardware in a desperate and mistaken attempt to find ways to increase profitability.

This was a disaster because every industry Kodak entered was populated by strong companies such as 3M, Canon, and Xerox. Also, Kodak’s corporate managers lacked any general competencies to give their new business units a competitive advantage. Moreover, the more industries Kodak entered, the greater the range of threats the company encountered, and the more time managers had to spend dealing with these threats. As a result, they could spend much less time improving the performance of their core film business, which continued to decline.

In reality, Kodak’s diversification was solely for growth, but *growth does not create value for stockholders*; growth is the by-product, not the objective, of a diversification strategy. However, in desperation, companies diversify for reasons of growth alone rather than to gain any well-thought-out, strategic advantage.¹² In fact, many studies suggest that too much diversification may reduce rather than improve company profitability.¹³ That is, the diversification strategies many companies pursue may *reduce* value instead of creating it.¹⁴

10-4c The Bureaucratic Costs of Diversification

A major reason why diversification often fails to boost profitability is that, very often, the *bureaucratic costs* of diversification exceed the benefits created by the strategy (that is, the increased profit that results when a company makes and sells a wider range of differentiated products and/or lowers its cost structure). As we mentioned in the previous chapter, *bureaucratic costs* are the costs associated with solving the transaction difficulties that arise between a company's business units and between business units and corporate headquarters, as the company attempts to obtain the benefits from transferring, sharing, and leveraging competencies. They also include the costs associated with using general organizational competencies to solve managerial and functional inefficiencies. The level of bureaucratic costs in a diversified organization is a function of two factors: the number of business units in a company's portfolio, and the degree to which coordination is required between these different business units to realize the advantages of diversification.

Number of Businesses The greater the number of business units in a company's portfolio, the more difficult it is for corporate managers to remain informed about the complexities of each business. Managers simply do not have the time to assess the business model of each unit. This problem occurred at GE in the 1970s, when its growth-hungry CEO, Reg Jones, acquired many new businesses. As he commented:

I tried to review each plan [of each business unit] in great detail. This effort took untold hours and placed a tremendous burden on the corporate executive office. After a while I began to realize that no matter how hard we would work, we could not achieve the necessary in-depth understanding of the 40-odd business unit plans.¹⁵

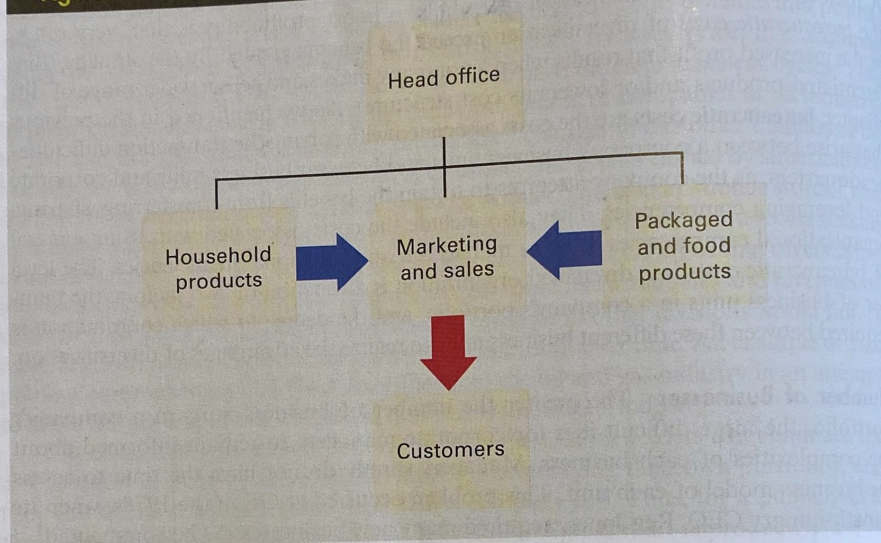
The inability of top managers in extensively diversified companies to maintain control over their multibusiness models over time often leads them to base important resource-allocation decisions on a superficial analysis of each business unit's competitive position. For example, a promising business unit may be starved of investment funds, while other business units receive far more cash than they can profitably reinvest in their operations. Furthermore, because they are distant from the day-to-day operations of the business units, corporate managers may find that business-unit managers try to hide information on poor performance to save their own jobs. For example, business-unit managers might blame poor performance on difficult competitive conditions, even when it is the result of their inability to craft a successful business model. As such organizational problems increase, top managers must spend an enormous amount of time and effort to solve them. This increases bureaucratic costs and cancels out the profit-enhancing advantages of pursuing diversification, such as those obtained from sharing or leveraging competencies.

Coordination Among Businesses The amount of coordination required to realize value from a diversification strategy based on transferring, sharing, or leveraging competencies is a major source of bureaucratic costs. The bureaucratic mechanisms needed to oversee and manage the coordination and handoffs between units, such as cross-business-unit teams and management committees, are a major source of these costs. A second source of bureaucratic costs arises because of the enormous amount of managerial time and effort required to accurately measure the performance and unique profit contribution of a business unit that is transferring or sharing resources with another. Consider a company that has two business units, one making

bureaucratic costs

The costs associated with solving the transaction difficulties between business units and corporate headquarters as a company obtains the benefits from transferring, sharing, and leveraging competencies.

Figure 10.4 Coordination Among Related Business Units



household products (such as liquid soap and laundry detergent) and another making packaged food products. The products of both units are sold through supermarkets. To lower the cost structure, the parent company pools the marketing and sales functions of each business unit, using an organizational structure similar to that illustrated in Figure 10.4. The company is organized into three divisions: a household products division, a food products division, and a marketing division.

Although such an arrangement may significantly lower operating costs, it can also give rise to substantial control problems, and hence bureaucratic costs. For example, if the performance of the household products business begins to slip, identifying who is to be held accountable—managers in the household products division or managers in the marketing division—may prove difficult. Indeed, each may blame the other for poor performance. Although such problems can be resolved if corporate management performs an in-depth audit of both divisions, the bureaucratic costs (managers' time and effort) involved in doing so may once again cancel out any value achieved from diversification. The need to reduce bureaucratic costs is evident from the experience of Pfizer, as discussed in Strategy in Action 10.2.

In sum, although diversification can be a highly profitable strategy to pursue, it is also the most complex and difficult strategy to manage because it is based on a complex, multibusiness model. Even when a company has pursued this strategy successfully in the past, changing conditions both in the industry environment and within a company can quickly reduce its profit-creating advantages. For example, such changes may result in one or more business units losing their competitive advantage. Or, changes may cause the bureaucratic costs associated with pursuing diversification to rise sharply and cancel out its advantages. Thus, the existence of bureaucratic costs places a limit on the amount of diversification that a company can profitably pursue. It makes sense for a company to diversify only when the profit-enhancing advantages of this strategy exceed the bureaucratic costs of managing the increasing number of business units required when a company expands and enters new industries.

10.2

How Bureaucratic

Pfizer is one of the most successful companies in the world in 2017. Its research and development is the most successful as the first cholesterol-lowering drug, however, Pfizer attempted to innovate a new blockbuster drug for protection. Where profits per year, in 2012, Lipitor was desperately needed for development pipeline. Mackay, believed

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Source: www.pfizer.com

10-5 CHOOSING A STRATEGY

10-5a Related Versus Unrelated Diversification

Because related diversification involves more sharing of competencies, one might think it can boost profitability in more ways than unrelated diversification, and is therefore the better diversification strategy. However, some companies can create as much or more value from pursuing unrelated diversification, so this strategy must also have some substantial benefits. An unrelated company does *not* need to achieve coordination between business units; it must cope only with the bureaucratic costs that arise from the number of businesses in its portfolio. In contrast, a related company must achieve coordination *among* business units if it is to realize the gains that come from utilizing its distinctive competencies. Consequently, it has to cope with the bureaucratic costs that arise *both* from the number of business units in its portfolio *and* from coordination among business units. Although it is true that related diversified companies can create value and profit in more ways than unrelated companies, they also have to bear higher bureaucratic costs to do so. These higher costs may cancel out the greater benefits, making the strategy no more profitable than one of unrelated diversification.

How, then, does a company choose between these strategies? The choice depends upon a comparison of the benefits of each strategy against the bureaucratic costs of pursuing it. It pays for a company to pursue related diversification when (1) the company's competencies can be applied across a greater number of industries and (2) the company has superior strategic capabilities that allow it to keep bureaucratic costs under close control—perhaps by encouraging entrepreneurship, or by developing a value creating organizational culture.

Using the same logic, it pays for a company to pursue unrelated diversification when (1) each business unit's functional competencies have few useful applications across industries, but the company's top managers are skilled at raising the profitability of poorly run businesses and (2) the company's managers use their superior strategic management competencies to improve the competitive advantage of their business units and keep bureaucratic costs under control. Well-managed companies such as UTC (as discussed in Strategy in Action 10.1) have managers who can successfully pursue unrelated diversification and reap its rewards.

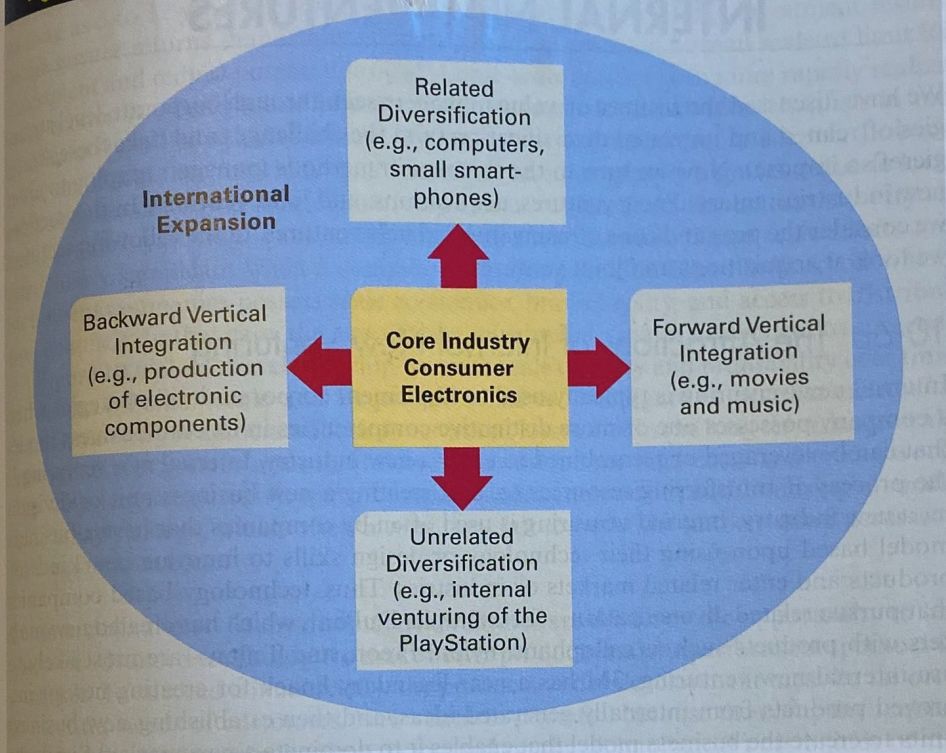
10-5b The Web of Corporate-Level Strategy

Finally, it is important to note that although some companies may choose to pursue a strategy of related or unrelated diversification, there is nothing that stops them from pursuing both strategies at the same time. The purpose of corporate-level strategy is to increase long-term profitability. A company can pursue multiple strategies as long as strategic managers have weighed the advantages and disadvantages of those strategies and arrived at a multibusiness model that justifies them. Figure 10.5 illustrates how Sony developed a web of corporate strategies to compete in many industries—a program that proved a mistake, reduced its differentiation advantage, and increased its cost structure in the 2000s.

Figure 10.5

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Figure 10.5 Sony's Web of Corporate-Level Strategy



Sony's core business is electronic products, and in the past it was well known for innovative products that made it a leading, global brand. To protect the quality of its electronic products, Sony decided to manufacture a high percentage of the component parts for its televisions, DVD players, and other units, and it pursued a strategy of backward vertical integration. Sony also engaged in forward vertical integration by opening a chain of Sony stores in shopping malls (to compete with Apple), and it diversified into complements by acquiring Columbia Pictures and MGM. Sony also shared and leveraged its distinctive competencies by developing its own business units to operate in the computer and smartphone industries, a strategy of related diversification. Finally, it decided to enter the home videogame industry, and developed PlayStation to compete with Nintendo.

Sony's profitability fell dramatically because its multibusiness model led it to diversify into too many industries, in each of which the focus was upon innovating high-quality products. As a result, its cost structure increased so much it swallowed up all the profits its businesses were generating. Sony's strategy of individual-business-unit autonomy also resulted in each unit pursuing its own goals at the expense of the company's multibusiness model—which escalated bureaucratic costs and drained its profitability. Divisions did not share their knowledge and expertise, and this incongruence allowed competitors such as Samsung to supersede Sony, especially with smartphones and flatscreen, LCD TV products.

10-6 ENTERING NEW INDUSTRIES: INTERNAL NEW VENTURES

We have discussed the sources of value managers seek through corporate-level strategies of related and unrelated diversification (and the challenges and risks these strategies also impose). Now we turn to the three main methods managers employ to enter new industries: internal new ventures, acquisitions, and joint ventures. In this section, we consider the pros and cons of using internal new ventures. In the following sections, we look at acquisitions and joint ventures.

10-6a The Attractions of Internal New Venturing

internal new venturing

The process of transferring resources to, and creating a new business unit or division in, a new industry to innovate new kinds of products.

Internal new venturing is typically used to implement corporate-level strategies when a company possesses one or more distinctive competencies in its core business model that can be leveraged or recombined to enter a new industry. **Internal new venturing** is the process of transferring resources to, and creating a new business unit or division in, a new industry. Internal venturing is used often by companies that have a business model based upon using their technology or design skills to innovate new kinds of products and enter related markets or industries. Thus, technology-based companies that pursue related diversification—for example, DuPont, which has created new markets with products such as cellophane, nylon, Freon, and Teflon—are most likely to use internal new venturing. 3M has a near-legendary knack for creating new or improved products from internally generated ideas, and then establishing new business units to create the business model that enables it to dominate a new market. Similarly, HP entered into the computer and printer industries by using internal new venturing.

A company may also use internal venturing to enter a newly emerging or embryonic industry—one in which no company has yet developed the competencies or business model to give it a dominant position in that industry. This was Monsanto's situation in 1979, when it contemplated entering the biotechnology field to produce herbicides and pest-resistant crop seeds. The biotechnology field was young at that time, and there were no incumbent companies focused on applying biotechnology to agricultural products. Accordingly, Monsanto internally ventured a new division to develop the required competencies necessary to enter and establish a strong competitive position in this newly emerging industry.

10-6b Pitfalls of New Ventures

Despite the popularity of internal new venturing, there is a high risk of failure. Research suggests that somewhere between 33 and 60% of all new products that reach the marketplace do not generate an adequate economic return,¹⁶ and that most of these products were the result of internal new ventures. Three reasons are often put forward to explain the relatively high failure rate of internal new ventures: (1) market entry on too small a scale, (2) poor commercialization of the new-venture product, and (3) poor corporate management of the new-venture division.¹⁷

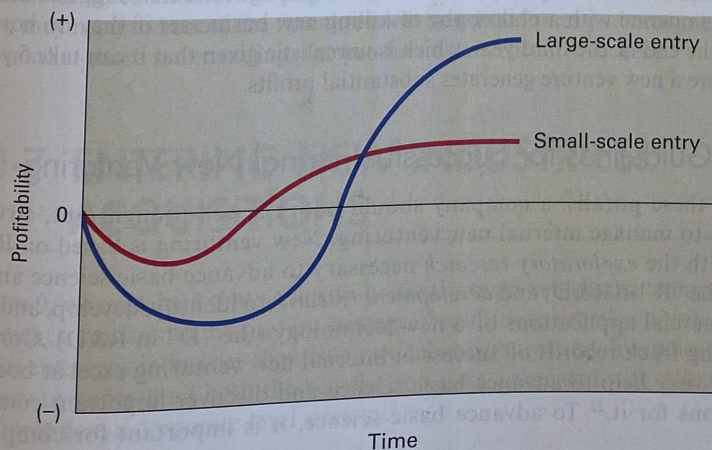
Scale of Entry Research suggests that large-scale entry into a new industry is often a critical precondition for the success of a new venture. In the short run, this means that

a substantial capital investment must be made to support large-scale entry; thus, there is a risk of major losses if the new venture fails. But, in the long run—which can be as long as 5 to 12 years (depending on the industry)—such a large investment results in far greater returns than if a company chooses to enter on a small scale to limit its investment and reduce potential losses.¹⁸ Large-scale entrants can more rapidly realize scale economies, build brand loyalty, and gain access to distribution channels in the new industry, all of which increase the probability of new-venture success. In contrast, small-scale entrants may find themselves handicapped by high costs due to lack of scale economies and lack of market presence, which limits the entrant's ability to build brand loyalty and gain access to distribution channels. These scale effects are particularly significant when a company is entering an established industry in which incumbent companies possess scale economies, brand loyalty, and access to distribution channels. In that case, the new entrant must make a major investment to succeed.

Figure 10.6 plots the relationship between scale of entry and profitability over time for successful small-scale and large-scale ventures. The figure shows that successful small-scale entry is associated with lower initial losses, but in the long term, large-scale entry generates greater returns. However, because of the high costs and risks associated with large-scale entry, many companies make the mistake of choosing a small-scale entry strategy, which often means they fail to build the market share necessary for long-term success.

Commercialization Many internal new ventures are driven by the opportunity to use a new or advanced technology to make better products and outperform competitors in a market. To succeed commercially, the products under development must be tailored to meet the needs of customers. New ventures often fail because the company ignores these needs; its managers become so focused on the technological possibilities of the new product that customer requirements are forgotten.¹⁹ Thus, a new venture may fail because it is marketing a product based on a technology for which there is no demand, or the company fails to correctly position or differentiate the product in the market to attract customers.

Figure 10.6 Scale of Entry and Profitability



For example, consider the desktop PC marketed by NeXT, a company started by Apple founder Steve Jobs. The NeXT system failed to gain market share because the PC incorporated an array of expensive technologies that consumers simply did not want, such as optical disk drives and hi-fidelity sound. The optical disk drives, in particular, turned off customers because it was difficult to move work from PCs with floppy drives to NeXT machines with optical drives. In other words, NeXT failed because its founder was so dazzled by leading-edge technology that he ignored customer needs. However, Jobs redeemed himself and was named “CEO of the Decade” by *Fortune* magazine in 2010, after he successfully commercialized Apple’s iPod, which dominates the MP3 player market. Also, the iPhone set the standard in the smartphone market, and the iPad quickly dominated the tablet computer market following its introduction in 2010.

Poor Implementation Managing the new-venture process, and controlling the new-venture division, creates many difficult managerial and organizational problems.²⁰ For example, one common mistake companies make to try to increase their chances of introducing successful products is to establish too many internal new-venture divisions at the same time. Managers attempt to spread the risks of failure by having many divisions, but this places enormous demands upon a company’s cash flow. Sometimes, companies are forced to reduce the funding each division receives to keep the entire company profitable, and this can result in the most promising ventures being starved of the cash they need in order to succeed.²¹ Another common mistake is when corporate managers fail to do the extensive advanced planning necessary to ensure that the new venture’s business model is sound and contains all the elements that will be needed later if it is to succeed. Sometimes corporate managers leave this process to the scientists and engineers championing the new technology. Focused on the new technology, managers may innovate new products that have little strategic or commercial value. Corporate managers and scientists must work together to clarify how and why a new venture will lead to a product that has a competitive advantage, and jointly establish strategic objectives and a timetable to manage the venture until the product reaches the market.

The failure to anticipate the time and costs involved in the new-venture process constitutes a further mistake. Many companies have unrealistic expectations regarding the time frame and expect profits to flow in quickly. Research suggests that some companies operate with a philosophy of killing new businesses if they do not turn a profit by the end of the third year, which is unrealistic given that it can take 5 years or more before a new venture generates substantial profits.

10-6c Guidelines for Successful Internal New Venturing

To avoid these pitfalls, a company should adopt a well-thought-out, structured approach to manage internal new venturing. New venturing is based on R&D. It begins with the *exploratory research* necessary to advance basic science and technology (the “R” in R&D) and *development research* to identify, develop, and perfect the commercial applications of a new technology (the “D” in R&D). Companies with strong track records of success at internal new venturing excel at both kinds of R&D; they help to advance basic science and discover important commercial applications for it.²² To advance basic science, it is important for companies to

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have strong links with universities, where much of the scientific knowledge that underlies new technologies is discovered. It is also important to make sure that research funds are being controlled by scientists who understand the importance of both “R” and “D” research. If the “D” is lacking, a company will probably generate few successful commercial ventures no matter how well it does basic research. Companies can take several steps to ensure that good science ends up with good, commercially viable products.

First, many companies must place the funding for research into the hands of business-unit managers who have the skill or knowhow to narrow down and then select the optimal set of research projects—those that have the best chance of a significant commercial payoff. Second, to make effective use of its R&D competency, top managers must work with R&D scientists to continually develop and improve the business model and strategies that guide their efforts, and make sure that all its scientists and engineers understand what they have to do to make it succeed.²³

Third, a company must foster close links between R&D and marketing to increase the probability that a new product will be a commercial success in the future. When marketing works to identify the most important customer requirements for a new product and then communicates these requirements to scientists, it ensures that research projects meet the needs of their intended customers. Fourth, a company should also foster close links between R&D and manufacturing to ensure that it has the ability to make a proposed new product in a cost-effective way. Many companies successfully integrate the activities of the different functions by creating cross-functional project teams to oversee the development of new products from their inception to market introduction. This approach can significantly reduce the time it takes to bring a new product to market. For example, while R&D is working on design, manufacturing is setting up facilities, and marketing is developing a campaign to show customers how much the new product will benefit them.

Finally, because large-scale entry often leads to greater long-term profits, a company can promote the success of internal new venturing by “thinking big.” A company should construct efficient-scale manufacturing facilities and allocate marketing a large budget to develop a future product campaign that will build market presence and brand loyalty quickly and well in advance of that product’s introduction. Also, corporate managers should not panic when customers are slow to adopt the new product; they need to accept the fact there will be initial losses and recognize that as long as market share is expanding, the product will eventually succeed.

10-7 ENTERING NEW INDUSTRIES: ACQUISITIONS

In Chapter 9, we explained that acquisitions are the main vehicle that companies use to implement a horizontal integration strategy. Acquisitions are also a principal way companies enter new industries to pursue vertical integration and diversification, so it is necessary to understand both the benefits and risks associated with using acquisitions to implement a corporate-level strategy.

10-7a The Attraction of Acquisitions

In general, acquisitions are used to pursue vertical integration or diversification when a company lacks the distinctive competencies necessary to compete in a new industry, and so uses its financial resources to purchase an established company that has those competencies. A company is particularly likely to use acquisitions when it needs to move rapidly to establish a presence in an industry, commonly an embryonic or growth industry. Entering a new industry through internal venturing is a relatively slow process; acquisition is a much quicker way for a company to establish a significant market presence. A company can purchase a leading company with a strong competitive position in months, rather than waiting years to build a market leadership position by engaging in internal venturing. Thus, when speed is particularly important, acquisition is the favored entry mode. Intel, for example, used acquisitions to build its communications chip business because it sensed that the market was developing very quickly, and that it would take too long to develop the required competencies.

In addition, acquisitions are often perceived as being less risky than internal new ventures because they involve less commercial uncertainty. Because of the risks of failure associated with internal new venturing, it is difficult to predict its future success and profitability. By contrast, when a company makes an acquisition, it gains a company with an already established reputation, and it knows the magnitude of the company's market share and profitability.

Finally, acquisitions are an attractive way to enter an industry that is protected by high barriers to entry. Recall from Chapter 2 that barriers to entry arise from factors such as product differentiation, which leads to brand loyalty, and high market share, which leads to economies of scale. When entry barriers are high, it may be very difficult for a company to enter an industry through internal new venturing because it will have to construct large-scale manufacturing facilities and invest in a massive advertising campaign to establish brand loyalty—difficult goals that require huge capital expenditures. In contrast, if a company acquires another company already established in the industry, possibly the market leader, it can circumvent most entry barriers because that company has already achieved economies of scale and obtained brand loyalty. In general, the higher the barriers to entry, the more likely it is that acquisitions will be the method used to enter the industry.

10-7b Acquisition Pitfalls

For these reasons, acquisitions have long been the most common method that companies use to pursue diversification. Numerous research studies have been conducted to assess whether, on average, acquisitions create or destroy shareholder value. These studies have used a wide range of methodological approaches (e.g., event studies, large panel analyses, case studies), samples (e.g., acquisitions in particular industries, acquisitions where both the acquirer and target are publicly-held U.S. firms, acquisitions that vary in the share that is taken by the acquirer), and performance measures (e.g., stock price reactions, long-run cumulative abnormal returns, accounting performance, productivity, patenting outcomes). The research falls well short of a consensus on the effect of acquisitions, however a very large number of studies conclude that many acquisitions fail to increase the profitability of the acquiring company and may result in losses. For example, one study of 700 large acquisitions found that although 30% of these resulted

in higher profits, 31% led to losses, and the remainder had little impact.^{24,25} Another study of the postacquisition performance of acquired companies found that their profitability and market share often decline, suggesting that many acquisitions destroy rather than create value.²⁶

Acquisitions may fail to raise the performance of the acquiring companies for four reasons²⁷: (1) companies frequently experience management problems when they attempt to integrate a different company's organizational structure and culture into their own; (2) companies often overestimate the potential economic benefits from an acquisition; (3) acquisitions tend to be so expensive that they do not increase future profitability; (4) companies are often negligent in screening their acquisition targets and fail to recognize important problems with their business models; and (5) managers may have incentives to make acquisitions even when they do not increase shareholder value (i.e., "agency problems").

Integrating the Acquired Company Once an acquisition has been made, the acquiring company must integrate the acquired company and combine it with its own organizational structure and culture. Integration involves the adoption of common management and financial control systems, the joining together of operations from the acquired and the acquiring company, the establishment of bureaucratic mechanisms to share information and personnel, and the need to create a common culture.²⁸ Experience has shown that many problems can occur as companies attempt to integrate their activities. When the processes and cultures of two companies are very different, integration can be extremely challenging. For example, when Daimler Benz acquired Chrysler, the two companies discovered that the more formal and hierarchical culture at Daimler chafed Chrysler employees, who were used to a looser, more entrepreneurial culture. Furthermore, though Daimler had hoped to benefit from Chrysler's more rapid new-product development processes, they soon realized that to do so they would have to adopt a more modular approach to developing cars, for instance by re-using platforms across different car models. This contrasted sharply with Daimler's historic emphasis on holistic "ground up" development of car designs. In the end, few of the anticipated advantages of the acquisition materialized. After paying roughly \$36 billion for Chrysler (through a stock swap), Daimler ended up having to *pay out* another \$650 million to Cerberus Capital Management to shed the Chrysler group.²⁹

Many acquired companies experience high management turnover because their employees do not like the acquiring company's way of operating—its structure and culture.³⁰ Research suggests that the loss of management talent and expertise, and the damage from constant tension between the businesses, can materially harm the performance of the acquired unit.³¹ Moreover, companies often must take on an enormous amount of debt to fund an acquisition, and they are frequently unable to pay it once the management problems (and sometimes the weaknesses) of the acquired company's business model surface.

Overestimating Economic Benefits Even when companies find it easy to integrate their activities, they often overestimate the combined businesses' future profitability. Managers often overestimate the competitive advantages that will derive from the acquisition and so pay more for the acquired company than it is worth. One reason is that top managers typically overestimate their own general competencies

to create valuable new products from an acquisition (this is known as the “hubris hypothesis”).³² The very fact that they have risen to the top of a company gives some managers an exaggerated sense of their own capabilities and a self-importance that distorts their strategic decision making. Coca-Cola’s acquisition of several midsized winemakers illustrates this. Reasoning that a beverage is a beverage, Coca-Cola’s then-CEO decided he would be able to mobilize his company’s talented marketing managers to develop the strategies needed to dominate the U.S. wine industry. After purchasing three wine companies and enduring 7 years of marginal profits because of failed marketing campaigns, he subsequently decided that wine and soft drinks are very different products; in particular, they have different kinds of appeal, pricing systems, and distribution networks. Coca-Cola eventually sold the wine operations to Joseph E. Seagram and took a substantial loss.³³

The Expense of Acquisitions Perhaps the most important reason for the failure of acquisitions is that acquiring a company with stock that is publicly traded tends to be very expensive—and the expense of the acquisition can more than wipe out the value of the stream of future profits that are expected from the acquisition. One reason is that the top managers of a company that is “targeted” for acquisition are likely to resist any takeover attempt unless the acquiring company agrees to pay a substantial premium above its current market value. These premiums are often 30 to 50% above the usual value of a company’s stock. Similarly, the stockholders of the target company are unlikely to sell their stock unless they are paid major premiums over market value prior to a takeover bid. Collectively, this means that it is far easier to overpay for an acquisition target than to “get a bargain,” and research shows that managers do regularly overpay for acquisitions.³⁴

To pay such high premiums, the acquiring company must be certain it can use its acquisition to generate the stream of future profits that justifies the high price of the target company. This is frequently difficult to do given how fast the industry environment can change and other problems discussed earlier such as integrating the acquired company. This is a major reason why acquisitions are frequently unprofitable for the acquiring company.

The reason why the acquiring company must pay such a high premium is that the stock price of the acquisition target increases enormously during the acquisition process as investors speculate on the final price the acquiring company will pay to capture it. In the case of a contested bidding contest, where two or more companies simultaneously bid to acquire the target company, its stock price may surge. Also, when many acquisitions are occurring in one industry, investors speculate that the value of the remaining industry companies that have *not* been acquired has increased, and that a bid for these companies will be made at some future point. This also drives up their stock price and increases the cost of making acquisitions. This happened in the telecommunications sector when, to make sure they could meet the needs of customers who were demanding leading-edge equipment, many large companies went on acquisition “binges.” Nortel and Alcatel-Lucent engaged in a race to purchase smaller, innovative companies that were developing new telecommunications equipment. The result was that the stock prices for these companies were bid up by investors, and they were purchased at a hugely inflated price. When the telecommunications boom turned to bust, the acquiring companies found that they had vastly overpaid for their acquisitions and had to take enormous accounting

write-downs. Nortel was forced to declare bankruptcy and sold off all its assets, and the value of Alcatel-Lucent's stock plunged almost 90%.

Inadequate Pre-acquisition Screening As the problems of these companies suggest, top managers often do a poor job of pre-acquisition screening—that is, evaluating how much a potential acquisition may increase future profitability. Researchers have discovered that one important reason for the failure of an acquisition is that managers make the decision to acquire other companies without thoroughly analyzing potential benefits and costs.³⁵ In many cases, after an acquisition has been completed, many acquiring companies discover that instead of buying a well-managed business with a strong business model, they have purchased a troubled organization. Obviously, the managers of the target company may manipulate company information or the balance sheet to make their financial condition look much better than it is. The acquiring company must be wary and complete extensive research. In 2009, IBM was in negotiations to purchase chip-maker Sun Microsystems. After spending 1 week examining its books, IBM reduced its offer price by 10% when its negotiators found its customer base was not as solid as they had expected. Sun Microsystems was eventually sold to Oracle in 2010 for \$7.4 billion. For the next 5 years, Sun Microsystems was a drain on Oracle's profit, but Ellison persevered in investing in Sun's technologies, and by 2015 it appeared his investment finally might be paying off.³⁶

Agency Problems It is important to note that managers may make acquisitions for reasons that have nothing to do with shareholder value. This is called an “agency problem,” and will be discussed further in Chapter 11. It is well established, for example, that the pay, perquisites, and other benefits managers receive are strongly related to firm size.³⁷ Furthermore, managers often have a very large portion of their personal wealth tied to the firm they manage. This means they may be extremely underdiversified. Their solution might be to diversify the firm, even if that is not in the interests of other shareholders (who may more easily and inexpensively diversify by holding shares in other firms).

10-7c Guidelines for Successful Acquisition

To avoid these pitfalls and make successful acquisitions, companies need to follow an approach to targeting and evaluating potential acquisitions that is based on four main steps: (1) target identification and pre-acquisition screening, (2) bidding strategy, (3) integration, and (4) learning from experience.³⁸

Identification and Screening Thorough pre-acquisition screening increases a company's knowledge about a potential takeover target and lessens the risk of purchasing a problem company—one with a weak business model. It also leads to a more realistic assessment of the problems involved in executing an acquisition so that a company can plan how to integrate the new business and blend organizational structures and cultures. The screening process should begin with a detailed assessment of the strategic rationale for making the acquisition, an identification of the kind of company that would make an ideal acquisition candidate, and an extensive analysis of the strengths and weaknesses of the prospective company's business model compared to other possible acquisition targets.

Indeed, an acquiring company should select a set of top potential acquisition targets and evaluate each company using a set of criteria that focus on revealing (1) its financial position, (2) its distinctive competencies and competitive advantage, (3) changing industry boundaries, (4) its management capabilities, and (5) its corporate culture. Such an evaluation helps the acquiring company perform a detailed strength, weakness, opportunities, and threats (SWOT) analysis that identifies the best target, for example, by measuring the potential economies of scale and scope that can be achieved between the acquiring company and each target company. This analysis also helps reveal potential problems that might arise when it is necessary to integrate the corporate cultures of the acquiring and acquired companies. For example, managers at Microsoft and SAP, the world's leading provider of enterprise resource planning (ERP) software, met to discuss a possible acquisition by Microsoft. Both companies decided that despite the strong, strategic rationale for a merger—together they could dominate the software computing market, satisfying the need of large global companies—they would have challenges to overcome. The difficulties of creating an organizational structure that could successfully integrate their hundreds of thousands of employees throughout the world, and blend two very different cultures, were insurmountable.

Once a company has reduced the list of potential acquisition candidates to the most favored one or two, it needs to consult expert third parties such as investment bankers like Goldman Sachs and Merrill Lynch. These companies provide valuable insights about the attractiveness of a potential acquisition, assess current industry competitive conditions, and handle the many other issues surrounding an acquisition such as how to select the optimal bidding strategy for acquiring the target company's stock and keep the purchase price as low as possible.

Bidding Strategy The objective of the bidding strategy is to reduce the price that a company must pay for the target company. The most effective way a company can acquire another is to make a friendly takeover bid, which means the two companies decide upon an amicable way to merge the two companies, satisfying the needs of each company's stockholders and top managers. A friendly takeover prevents speculators from bidding up stock prices. By contrast, in a hostile bidding environment, such as existed between Oracle and PeopleSoft, and between Microsoft and Yahoo!, the price of the target company often gets bid up by speculators who expect that the offer price will be raised by the acquirer, or by another company with a higher counteroffer.

Another essential element of a good bidding strategy is timing. For example, Hanson PLC, one of the most successful companies to pursue unrelated diversification, searched for sound companies suffering from short-term problems because of the business cycle or because performance was being seriously impacted by one underperforming division. Such companies are often undervalued by the stock market and can be acquired without paying a high stock premium. With good timing, a company can make a bargain purchase.

Integration Despite good screening and bidding, an acquisition will fail unless the acquiring company possesses the essential organizational-design skills needed to integrate the acquired company into its operations and quickly develop a viable multibusiness model. Integration should center upon the source of the

potential strategic share market. Integration should be divested.

Learning from companies over value from them to develop and effectively acquisitions; companies to increase cost savings lead the new in the acquisition diversified, less as much value spun off. In 2 own stock: T business security and controls)

10-8

Joint ventures, new business, pose a competitive industry. must make the required to maintain position can be a company in a purchase.

In this situation method to enter costs associated company. This or distinctive culture's success. Dow Chemicals UTC was already and Dow Chemicals composites. T

potential strategic advantages of the acquisition; for instance, opportunities to share marketing, manufacturing, R&D, financial, or management resources. Integration should also involve steps to eliminate any duplication of facilities or functions. In addition, any unwanted business units of the acquired company should be divested.

Learning from Experience Research suggests that organizations that acquire many companies over time become expert in this process and can generate significant value from their experience of the acquisition process.³⁹ Their experience enables them to develop a “playbook” they can follow to execute an acquisition efficiently and effectively. One successful company, Tyco International, never made hostile acquisitions; it audited the accounts of the target companies in detail, acquired companies to help it achieve a critical mass in an industry, moved quickly to realize cost savings after an acquisition, promoted managers one or two layers down to lead the newly acquired entity, and introduced profit-based, incentive-pay systems in the acquired unit.⁴⁰ Over time, however, Tyco tended to become too large and diversified, leading both investors and management to suspect it was not generating as much value as it could. In 2007, Tyco’s health-care and electronics divisions were spun off. In 2012, Tyco was split again into three parts that would each have their own stock: Tyco Fire and Security, ADT (which provided residential and small-business security installation), and Flow Control (which sold water and fluid valves and controls).⁴¹

10-8 ENTERING NEW INDUSTRIES: JOINT VENTURES

Joint ventures, where two or more companies agree to pool their resources to create new business, are most commonly used to enter an embryonic or growth industry. Suppose a company is contemplating the creation of a new-venture division in an embryonic industry. Such a move involves substantial risks and costs because the company must make the huge investment necessary to develop the set of value-chain activities required to make and sell products in the new industry. On the other hand, an acquisition can be a dangerous proposition because there is rarely an established leading company in an emerging industry; even if there is, it will be extremely expensive to purchase.

In this situation, a joint venture frequently becomes the most appropriate method to enter a new industry because it allows a company to share the risks and costs associated with establishing a business unit in the new industry with another company. This is especially true when the companies share *complementary* skills or distinctive competencies, because this increases the probability of a joint venture’s success. Consider the 50/50 equity joint venture formed between UTC and Dow Chemical to build plastic-based composite parts for the aerospace industry. UTC was already involved in the aerospace industry (it builds Sikorsky helicopters), and Dow Chemical had skills in the development and manufacture of plastic-based composites. The alliance called for UTC to contribute its advanced aerospace skills,

and for Dow to contribute its skills in developing and manufacturing plastic-based composites. Through the joint venture, both companies became involved in new product markets. They were able to realize the benefits associated with related diversification without having to merge their activities into one company or bear the costs and risks of developing new products on their own. Thus, both companies enjoyed the profit-enhancing advantages of entering new markets without having to bear the increased bureaucratic costs.

Although joint ventures usually benefit both partner companies, under some conditions they may result in problems. First, although a joint venture allows companies to share the risks and costs of developing a new business, it also requires that they share in the profits if it succeeds. So, if one partner's skills are more important than the other partner's skills, the partner with more valuable skills will have to "give away" profits to the other party because of the 50/50 agreement. This can create conflict and sour the working relationship as time passes. Second, the joint-venture partners may have different business models or time horizons, and problems can arise if they start to come into conflict about how to run the joint venture; these kinds of problems can disintegrate a business and result in failure.

Third, while one advantage of joint ventures is that they allow frequent and close contact between companies, which facilitates learning and transfer of knowledge, this also creates a risk that a joint venture can lead to the unintentional leak of proprietary information across companies.⁴² Even when collaboration agreements have extensive contractual clauses designed to protect the proprietary knowledge possessed by each partner or developed through the collaboration, it is still very difficult to prevent that knowledge from being expropriated. Secrecy clauses are very difficult to enforce when knowledge is dispersed over a large number of employees.⁴³ A company that enters into a joint venture thus runs the risk of giving away important, company-specific knowledge to its partner, which might then use it to compete with its other partner in the future. For example, having gained access to Dow's expertise in plastic-based composites, UTC might have dissolved the alliance and produced these materials on its own. As the previous chapter discussed, this risk could be minimized if Dow got a *credible commitment* from UTC, which is what it did. UTC had to make an expensive, asset-specific investment to make the products the joint venture was formed to create.

10-8a Restructuring

Many companies expand into new industries to increase profitability. Sometimes, however, companies needing to exit industries to increase their profitability split their existing businesses into separate, independent companies. **Restructuring** is the process of reorganizing and divesting business units and exiting industries to refocus upon a company's core business and rebuild its distinctive competencies.⁴⁴ Why are so many companies restructuring, and how do they do it?

10-8b Why Restructure?

One main reason that diversified companies have restructured in recent years is that the stock market has valued their stock at a *diversification discount*, meaning that the

restructuring

The process of reorganizing and divesting business units and exiting industries to refocus upon a company's core business and rebuild its distinctive competencies.

stock of highly diversified companies is valued lower, relative to their earnings, than the stock of less-diversified companies.⁴⁵ Investors see highly diversified companies as less attractive investments for four reasons. First, as we discussed earlier, investors often feel these companies no longer have multibusiness models that justify their participation in many different industries. Second, the complexity of the financial statements of highly diversified enterprises disguises the performance of individual business units; thus, investors cannot determine if their multibusiness models are succeeding. The result is that investors perceive the company as being riskier than companies that operate in one industry, whose competitive advantage and financial statements are more easily understood. Given this situation, restructuring can be seen as an attempt to boost returns to shareholders by splitting up a multibusiness company into separate, independent parts.

The third reason for the diversification discount is that many investors have learned from experience that managers often have a tendency to pursue too much diversification or diversify for the wrong reasons: Their attempts to diversify *reduce* profitability.⁴⁶ For example, some CEOs pursue growth for its own sake; they are empire builders who expand the scope of their companies to the point where fast-increasing bureaucratic costs become greater than the additional value that their diversification strategy creates. Restructuring thus becomes a response to declining financial performance brought about by overdiversification.

A final factor leading to restructuring is that innovations in strategic management have diminished the advantages of vertical integration or diversification. For example, a few decades ago, there was little understanding of how long-term cooperative relationships or strategic alliances between a company and its suppliers could be a viable alternative to vertical integration. Most companies considered only two alternatives for managing the supply chain: vertical integration or competitive bidding. As we discussed in Chapter 9, in many situations long-term cooperative relationships can create the most value, especially because they avoid the need to incur bureaucratic costs or dispense with market discipline. As this strategic innovation has spread throughout global business, the relative advantages of vertical integration have declined.

KEY TERMS

diversification	314	economies of scope	316	related diversification	323	bureaucratic costs	327
diversified company	314	general organizational competencies	319	unrelated diversification	323	internal new venturing	332
transferring competencies	315	organizational design skills	319	internal capital market	324	restructuring	342
commonality	315	turnaround strategy	320				
leveraging competencies	316						