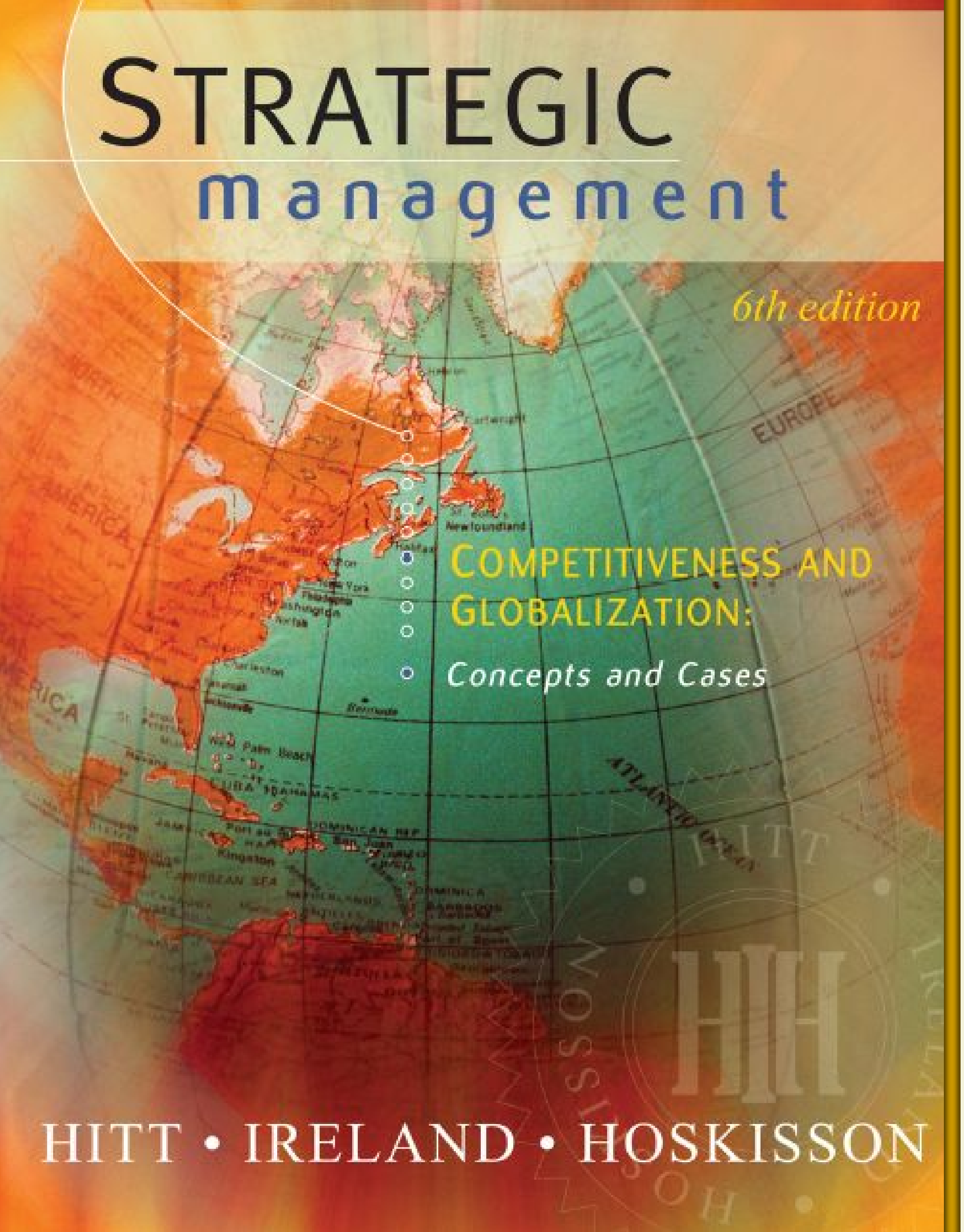

Chapter 6

Corporate-Level Strategy

PowerPoint slides by:
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Colorado State University

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Knowledge Objectives

- ***Studying this chapter should provide you with the strategic management knowledge needed to:***
  - ***Define corporate-level strategy and discuss its importance to the diversified firm.***
  - ***Describe the advantages and disadvantages of single- and dominant- business strategies.***
  - ***Explain three primary reasons why firms move from single- and dominant-business strategies to more diversified strategies.***
  - ***Describe how related diversified firms create value by sharing or transferring core competencies.***

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Knowledge Objectives (cont'd)

- ***Studying this chapter should provide you with the strategic management knowledge needed to:***
  - *Explain the two ways value can be created with an unrelated diversification strategy.*
  - *Discuss the incentives and resources that encourage diversification.*
  - *Describe motives that can encourage managers to overdiversify a firm.*

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The Strategic Management Process

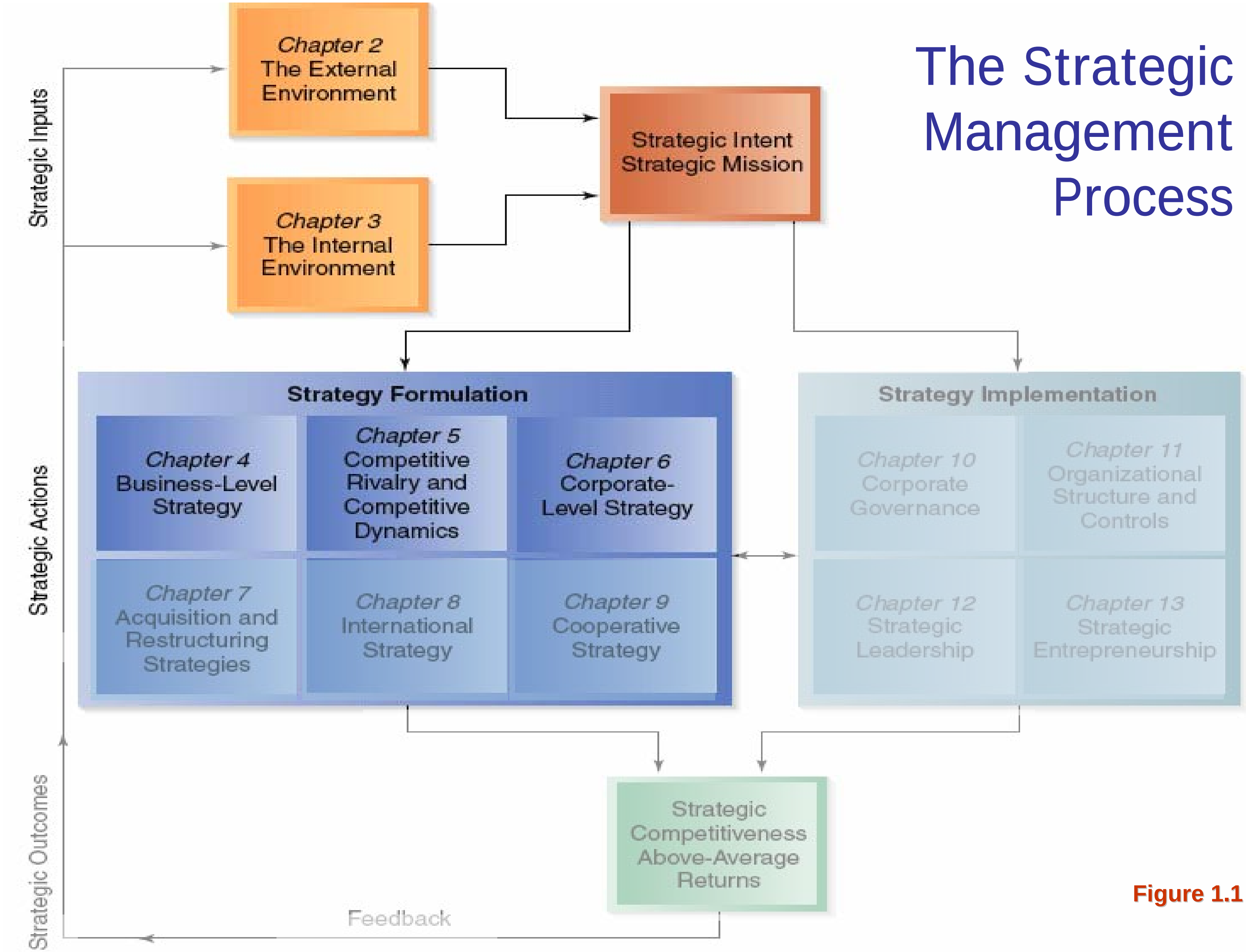

Figure 1.1

The Role of Diversification

- **Diversification strategies play a major role in the behavior of large firms**
- **Product diversification concerns:**
  - **The scope of the industries and markets in which the firm competes**
  - **How managers buy, create and sell different businesses to match skills and strengths with opportunities presented to the firm**

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Two Strategy Levels

- **Business-level Strategy (Competitive)**
  - **Each business unit in a diversified firm chooses a business-level strategy as its means of competing in individual product markets**
- **Corporate-level Strategy (Companywide)**
  - **Specifies actions taken by the firm to gain a competitive advantage by selecting and managing a group of different businesses competing in several industries and product markets**

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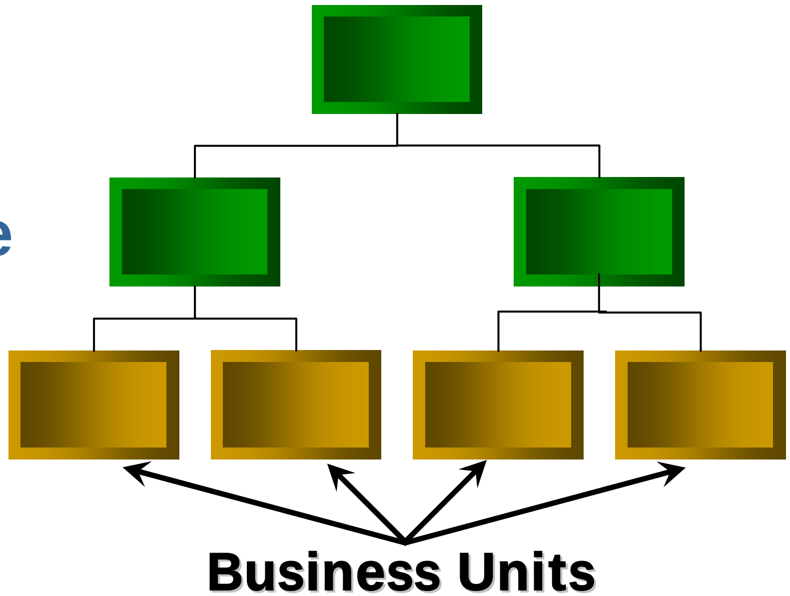
Corporate-Level Strategy: Key Questions

- **Corporate-level Strategy's Value**
  - **The degree to which the businesses in the portfolio are worth more under the management of the company than they would be under other ownership**
  - **What businesses should the firm be in?**
  - **How should the corporate office manage the group of businesses?**



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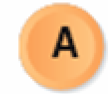
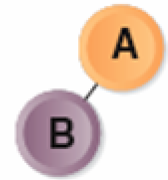
Levels and Types of Diversification

Low Levels of Diversification

Single business: More than 95% of revenue comes from a single business.

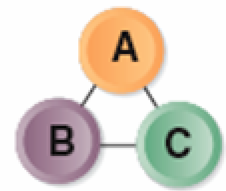


Dominant business: Between 70% and 95% of revenue comes from a single business.

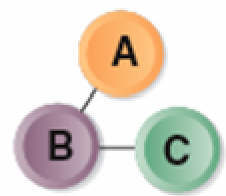


Moderate to High Levels of Diversification

Related constrained: Less than 70% of revenue comes from the dominant business, and all businesses share product, technological, and distribution linkages.



Related linked (mixed related and unrelated): Less than 70% of revenue comes from the dominant business, and there are only limited links between businesses.



Very High Levels of Diversification

Unrelated: Less than 70% of revenue comes from the dominant business, and there are no common links between businesses.

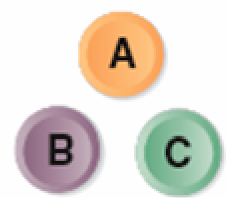


Figure 6.1

SOURCE: Adapted from R. P. Rumelt, 1974, *Strategy, Structure and Economic Performance,* Boston: Harvard Business School.

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Diversifying to Enhance Competitiveness

- **Related Diversification**
  - **Economies of scope**
  - **Sharing activities**
  - **Transferring core competencies**
  - **Market power**
  - **Vertical integration**
- **Unrelated Diversification**
  - **Financial economies**
    - **Efficient internal capital allocation**
    - **Business restructuring**

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Reasons for Diversification

- **Incentives and Resources with Neutral Effects on Strategic Competitiveness:**
  - Antitrust regulation
  - Tax laws
  - Low performance
  - Uncertain future cash flows
  - Risk reduction for firm
  - Tangible resources
  - Intangible resources

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Reasons for Diversification (cont'd)

- **Managerial Motives (Value Reduction)**
  - **Diversifying managerial employment risk**
  - **Increasing managerial compensation**

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Strategic Motives for Diversification

To Enhance Strategic Competitiveness:

- **Economies of scope (related diversification)**
  - Sharing activities
  - Transferring core competencies
- **Market power (related diversification)**
  - Blocking competitors through multipoint competition
  - Vertical integration
- **Financial economies (unrelated diversification)**
  - Efficient internal capital allocation
  - Business restructuring

Table 6.1a

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Incentives and Resources for Diversification

Incentives and Resources with Neutral Effects on Strategic Competitiveness

- Antitrust regulation
- Tax laws
- Low performance
- Uncertain future cash flows
- Risk reduction for firm
- Tangible resources
- Intangible resources

Table 6.1b

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Managerial Motives for Diversification

Managerial Motives (Value Reduction)

- Diversifying managerial employment risk
- Increasing managerial compensation

Table 6.1c

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Value-creating Strategies of Diversification: Operational and Corporate Relatedness

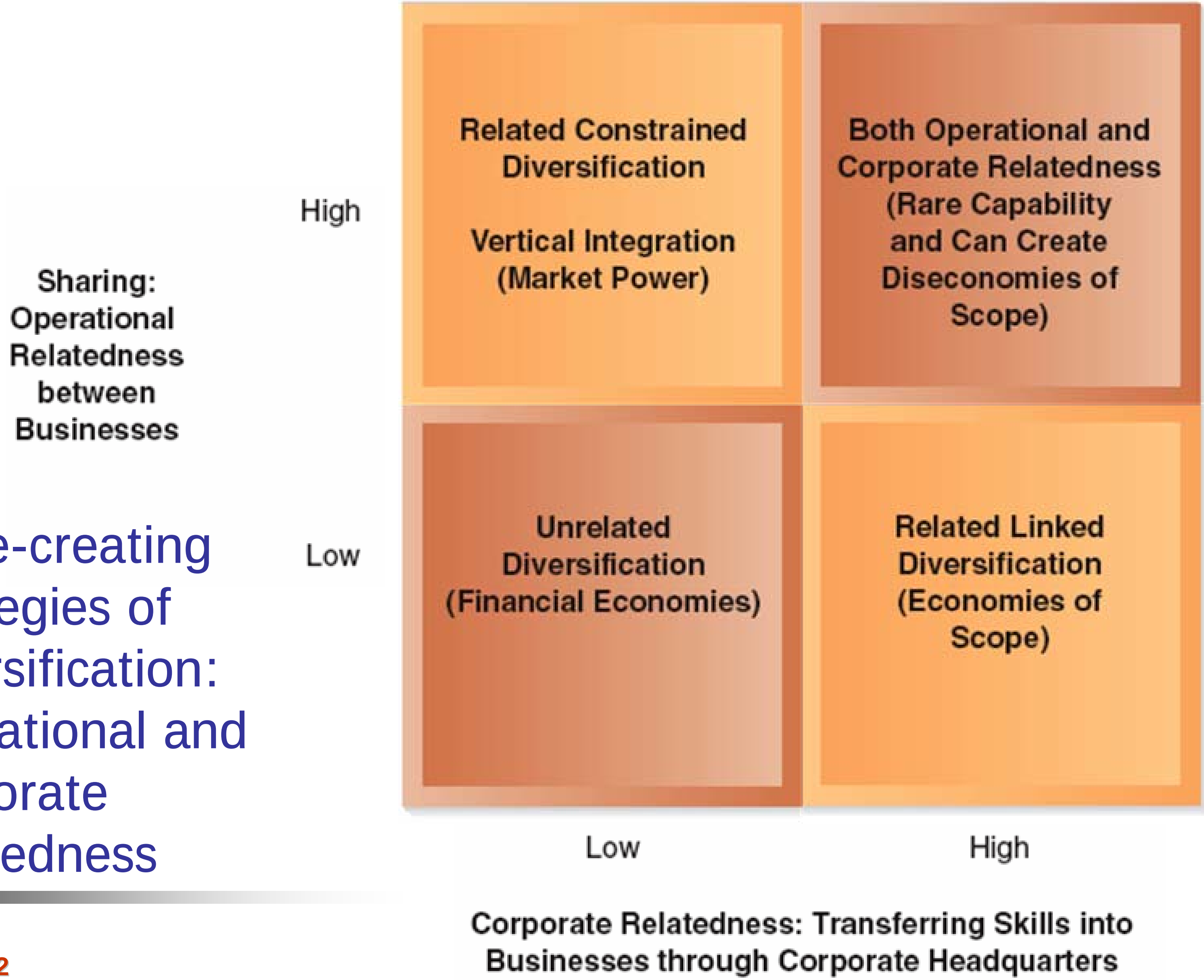

Figure 6.2

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Related Diversification

- **Firm creates value by building upon or extending its:**
  - **Resources**
  - **Capabilities**
  - **Core competencies**
- **Economies of scope**
  - **Cost savings that occur when a firm transfers capabilities and competencies developed in one of its businesses to another of its businesses**

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Related Diversification: Economies of Scope

- **Value is created from economies of scope through:**
  - ***Operational relatedness*** **in sharing activities**
  - ***Corporate relatedness*** **in transferring skills or corporate core competencies among units**
- **The difference between sharing activities and transferring competencies is based on how the resources are jointly used to create economies of scope**

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Sharing Activities

- **Operational Relatedness**
  - **Created by sharing either a primary activity such as inventory delivery systems, or a support activity such as purchasing**
  - **Activity sharing requires sharing strategic control over business units**
  - **Activity sharing may create risk because business-unit ties create links between outcomes**

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Transferring Corporate Competencies

- **Corporate Relatedness**
  - **Using complex sets of resources and capabilities to link different businesses through managerial and technological knowledge, experience, and expertise**

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Corporate Relatedness

- **Creates value in two ways:**
  - **Eliminates resource duplication in the need to allocate resources for a second unit to develop a competence that already exists in another unit**
  - **Provides intangible resources (resource intangibility) that are difficult for competitors to understand and imitate**
    - **A transferred intangible resource gives the unit receiving it an immediate competitive advantage over its rivals**

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Related Diversification: Market Power

- **Market power exists when a firm can:**
  - **Sell its products above the existing competitive level and/or**
  - **Reduce the costs of its primary and support activities below the competitive level**

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Related Diversification: Market Power

- **Multipoint Competition**
  - Two or more diversified firms simultaneously compete in the same product areas or geographic markets
- **Vertical Integration**
  - Backward integration—a firm produces its own inputs
  - Forward integration—a firm operates its own distribution system for delivering its outputs

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Related Diversification: Complexity

- **Simultaneous Operational Relatedness and Corporate Relatedness**
  - **Involves managing two sources of knowledge simultaneously:**
    - **Operational forms of economies of scope**
    - **Corporate forms of economies of scope**
  - **Many such efforts often fail because of implementation difficulties**

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Unrelated Diversification

- **Financial Economies**
  - Are cost savings realized through improved allocations of financial resources
    - **Based on investments inside or outside the firm**
  - Create value through two types of financial economies:
    - **Efficient internal capital allocations**
    - **Purchasing other corporations and restructuring their assets**

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Unrelated Diversification (cont'd)

- **Efficient Internal Capital Market Allocation**
  - **Corporate office distributes capital to business divisions to create value for overall company**
    - **Corporate office gains access to information about those businesses' actual and prospective performance**
  - **Conglomerates have a fairly short life cycle because financial economies are more easily duplicated by competitors than are gains from operational and corporate relatedness**

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Unrelated Diversification: Restructuring

- **Restructuring creates financial economies**
  - **A firm creates value by buying and selling other firms' assets in the external market**
- **Resource allocation decisions may become complex, so success often requires:**
  - **Focus on mature, low-technology businesses**
  - **Focus on businesses not reliant on a client orientation**

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External Incentives to Diversify

Anti-trust Legislation

- **Antitrust laws in 1960s and 1970s discouraged mergers that created increased market power (vertical or horizontal integration**
- **Mergers in the 1960s and 1970s thus tended to be unrelated**
- **Relaxation of antitrust enforcement results in more and larger horizontal mergers**
- **Early 2000 antitrust concerns seem to be emerging and mergers now more closely scrutinized**

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External Incentives to Diversify (cont'd)

Anti-trust Legislation

Tax Laws

- **High tax rates on dividends cause a corporate shift from dividends to buying and building companies in high-performance industries**
- **1986 Tax Reform Act**
  - **Reduced individual ordinary income tax rate from 50 to 28 percent**
  - **Treated capital gains as ordinary income**
  - **Thus created incentive for shareholders to prefer dividends to acquisition investments**

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Internal Incentives to Diversify

Low Performance

- **High performance eliminates the need for greater diversification**
- **Low performance acts as incentive for diversification**
- **Firms plagued by poor performance often take higher risks (diversification is risky)**

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The Curvilinear Relationship between Diversification and Performance

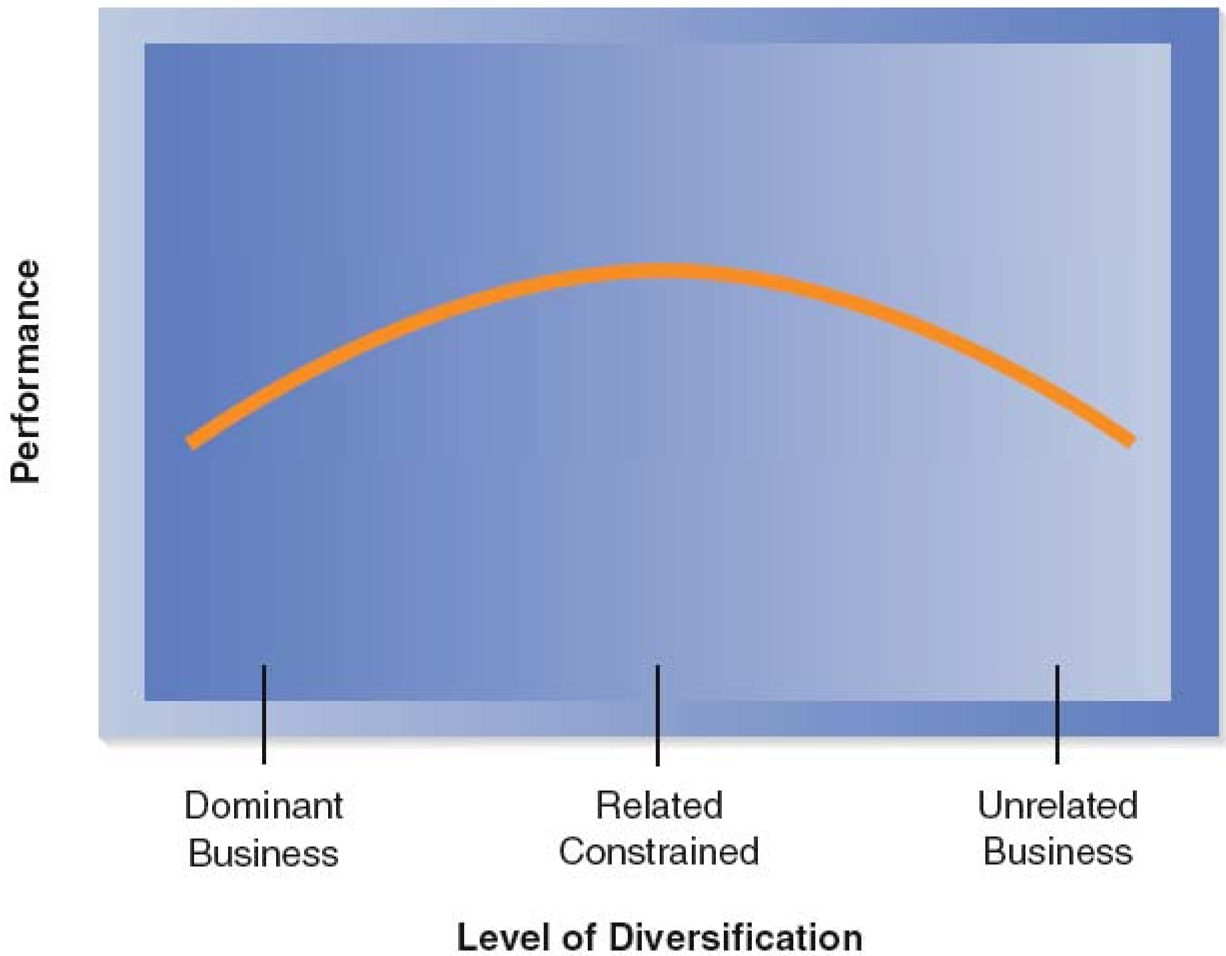

Figure 6.3

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Internal Incentives to Diversify (cont'd)

- Low Performance
- Uncertain Future Cash Flows

- **Diversification may be defensive strategy if:**
  - **Product line matures**
  - **Product line is threatened.**
  - **Firm is small and is in mature or maturing industry**

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Internal Incentives to Diversify

- Low Performance
- Uncertain Future Cash Flows
- **Synergy and Risk Reduction**

- **Synergy exists when the value created by businesses working together exceeds the value created by them working independently**
- **… but synergy creates joint interdependence between business units**
- **A firm may become risk averse and constrain its level of activity sharing**
- **A firm may reduce level of technological change by operating in more certain environments**

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Resources and Diversification

- **A firm must have both:**
  - **Incentives to diversify**
  - **Resources required to create value through diversification**
    - **Cash**
    - **Tangible resources (e.g., plant and equipment)**
- **Value creation is determined more by appropriate use of resources than by incentives to diversify**

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Managerial Motives to Diversify

- **Managerial risk reduction**
- **Desire for increased compensation**

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Summary Model of the Relationship between Firm Performance and Diversification

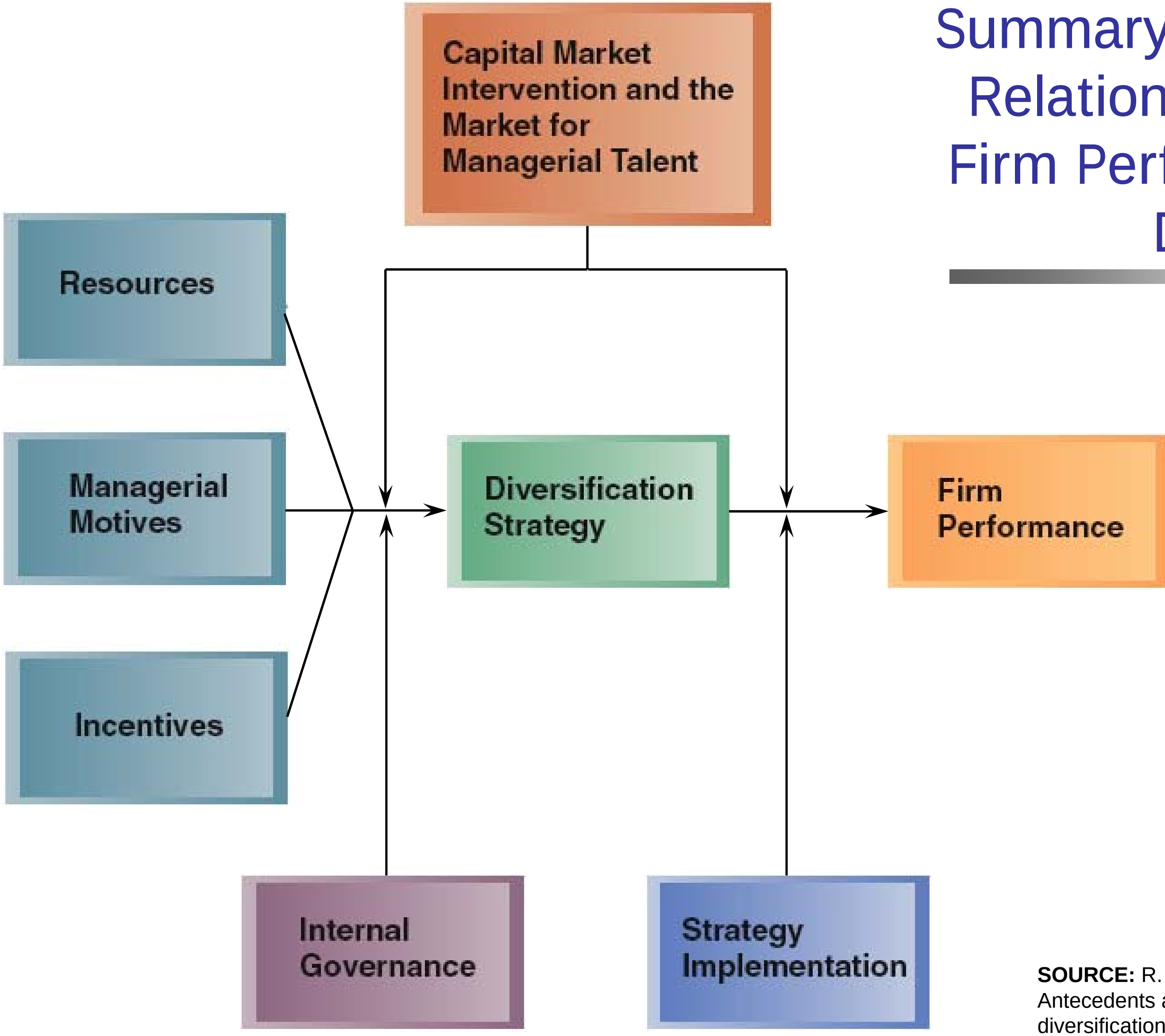

Figure 6.4

SOURCE: R. E. Hoskisson & M. A. Hitt, 1990, Antecedents and performance outcomes of diversification: A review and critique of theoretical perspectives, *Journal of Management,* 16: 498.

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