

STRATEGIC management

6th edition

COMPETITIVENESS AND
GLOBALIZATION:
Concepts and Cases

Chapter 6 Corporate-Level Strategy

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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.***

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.***

The Strategic Management Process

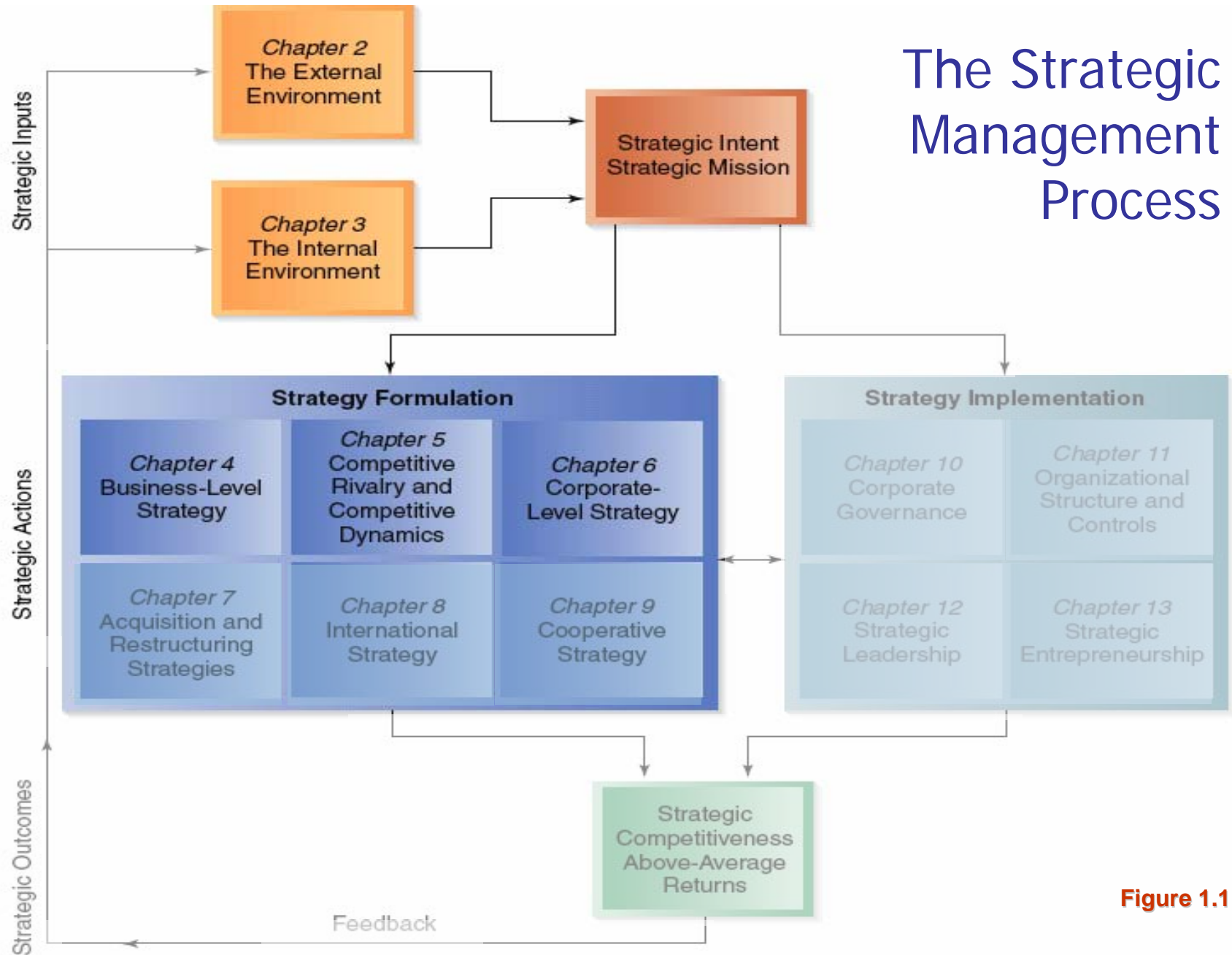


Figure 1.1

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**

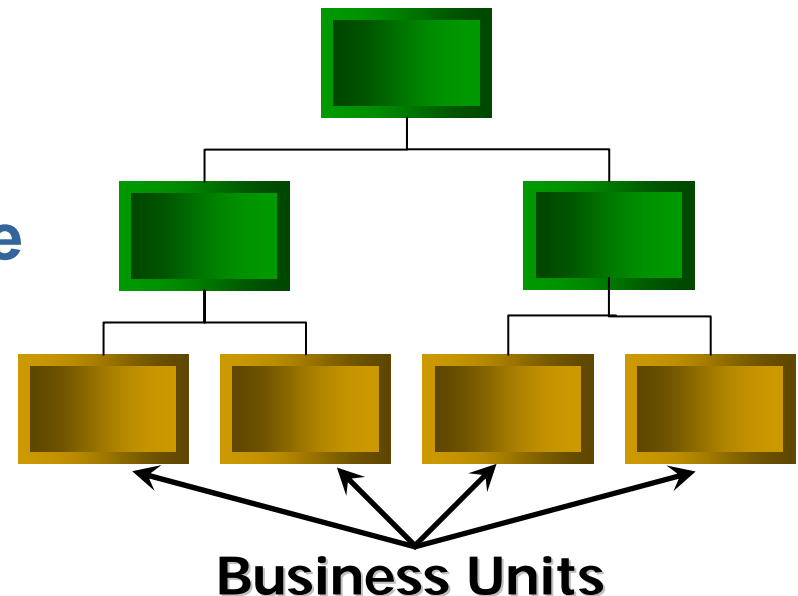
Two Strategy Levels

- **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

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?



Levels and Types of Diversification

Low Levels of Diversification

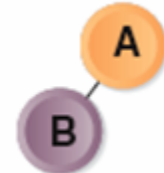
Single business:

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



Dominant business:

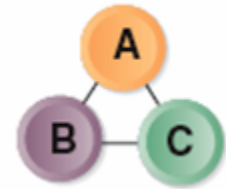
Between 70% and 95% of revenue comes from a single business.



Moderate to High Levels of Diversification

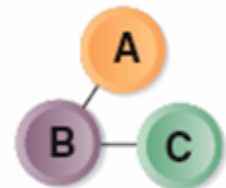
Related constrained:

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. Copyright © 2004 South-Western. All rights reserved.

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**

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**

Reasons for Diversification (cont'd)

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

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

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

Managerial Motives for Diversification

Managerial Motives (Value Reduction)

- Diversifying managerial employment risk
- Increasing managerial compensation

Table 6.1c

Value-creating Strategies of Diversification: Operational and Corporate Relatedness

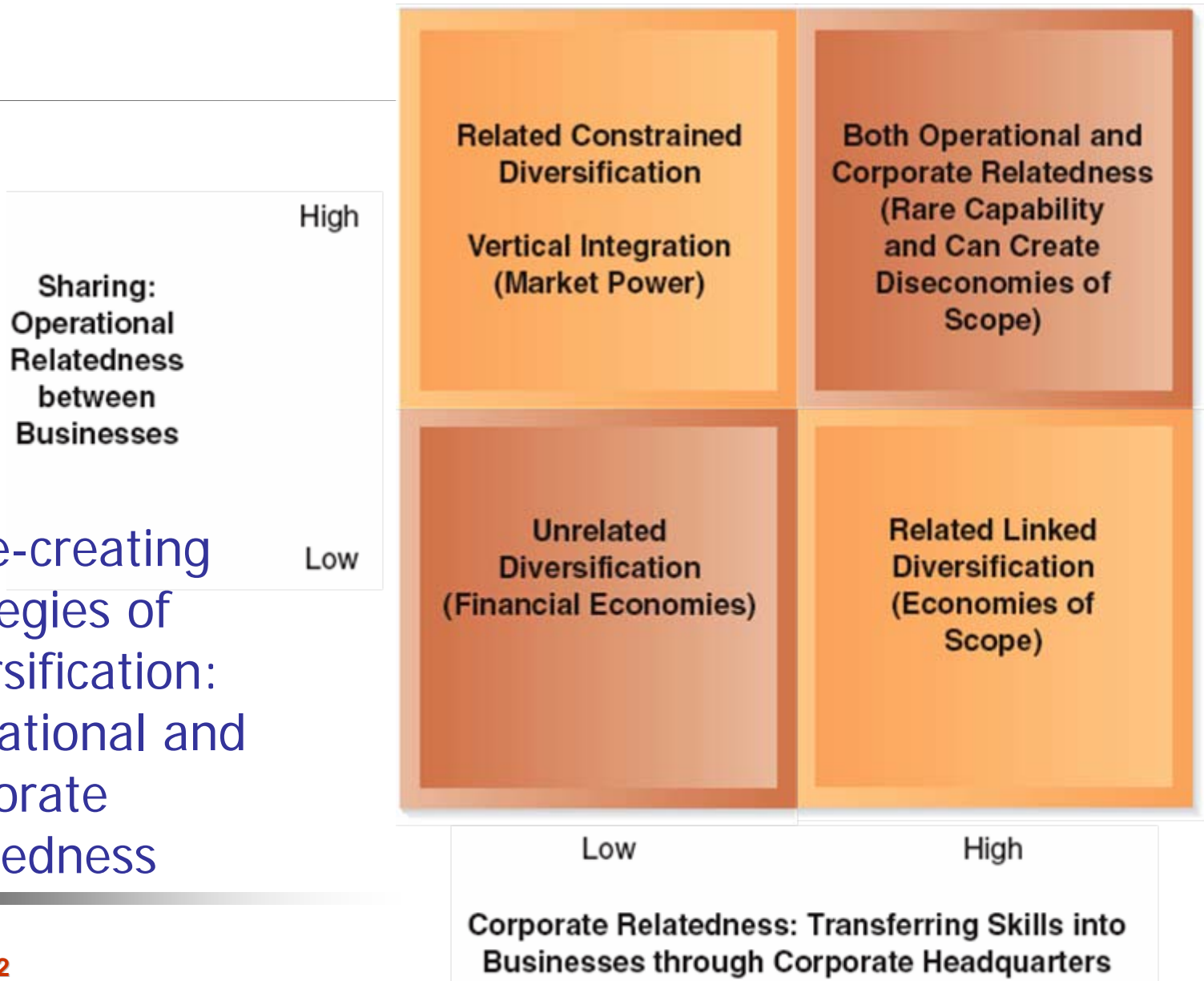


Figure 6.2

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**

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**

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**

Transferring Corporate Competencies

- **Corporate Relatedness**

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

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**

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**

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

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**

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**

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**

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**

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**

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**

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)**

The Curvilinear Relationship between Diversification and Performance

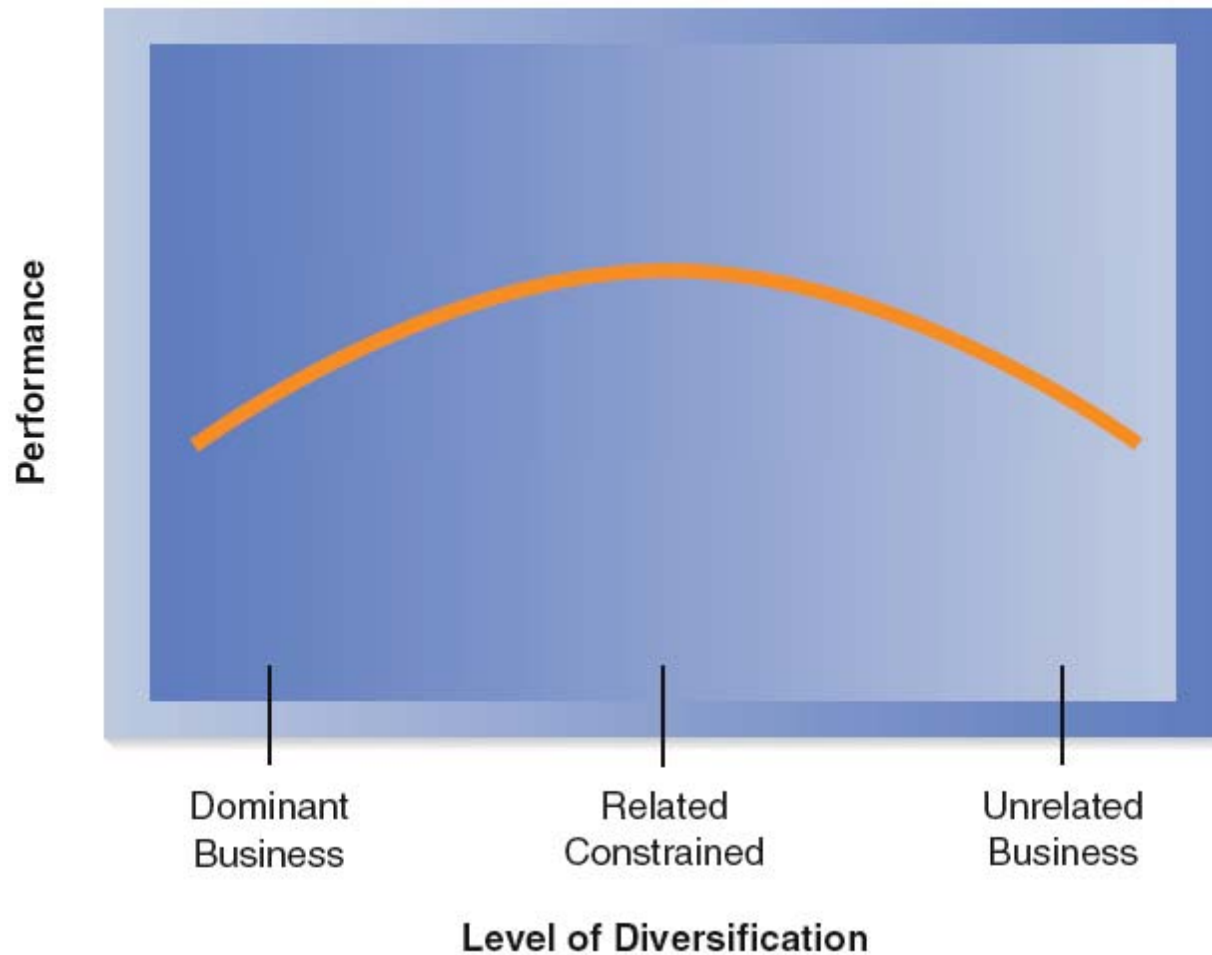


Figure 6.3

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**

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**

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**

Managerial Motives to Diversify

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

Summary Model of the Relationship between Firm Performance and Diversification

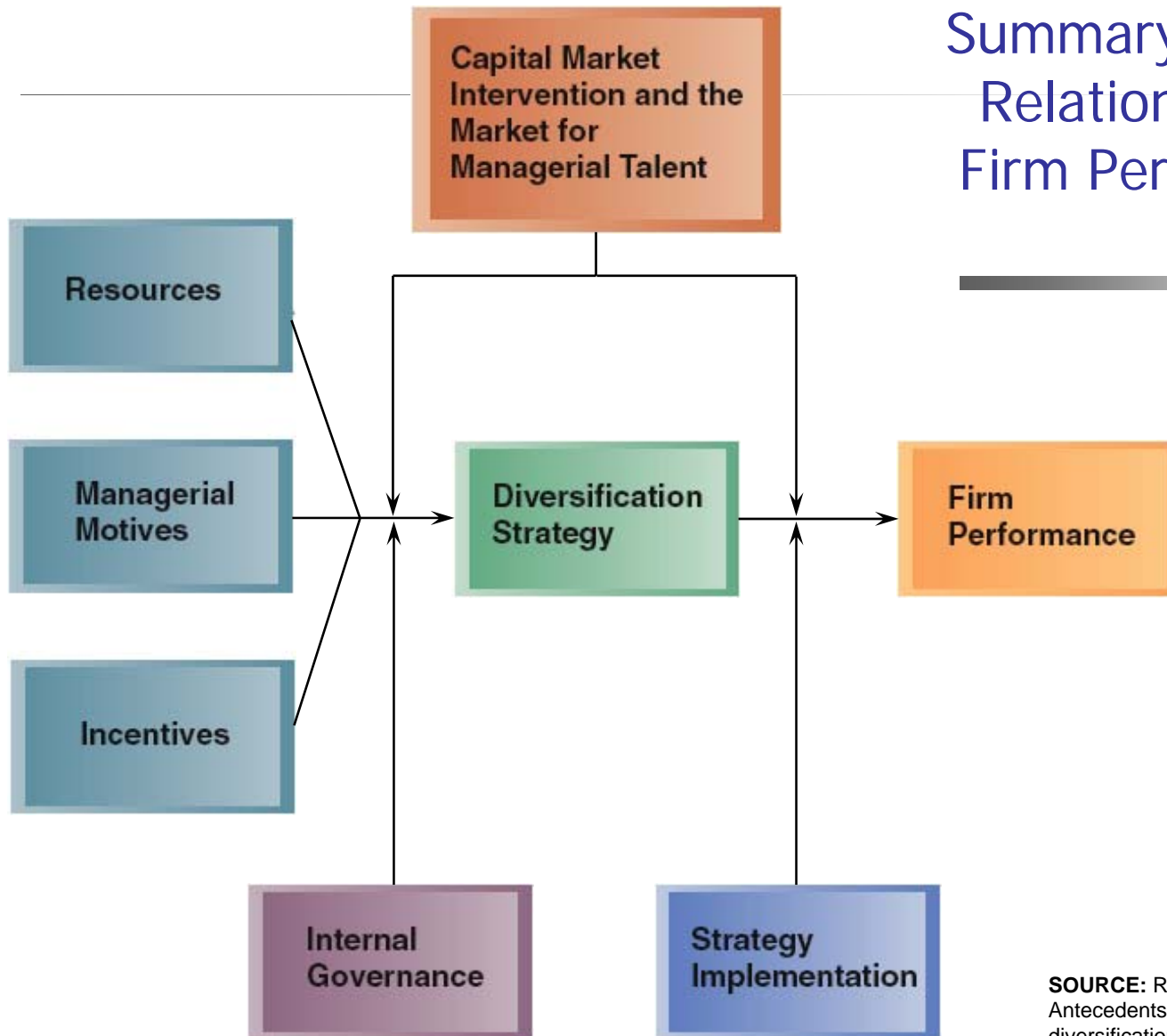


Figure 6.4

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.