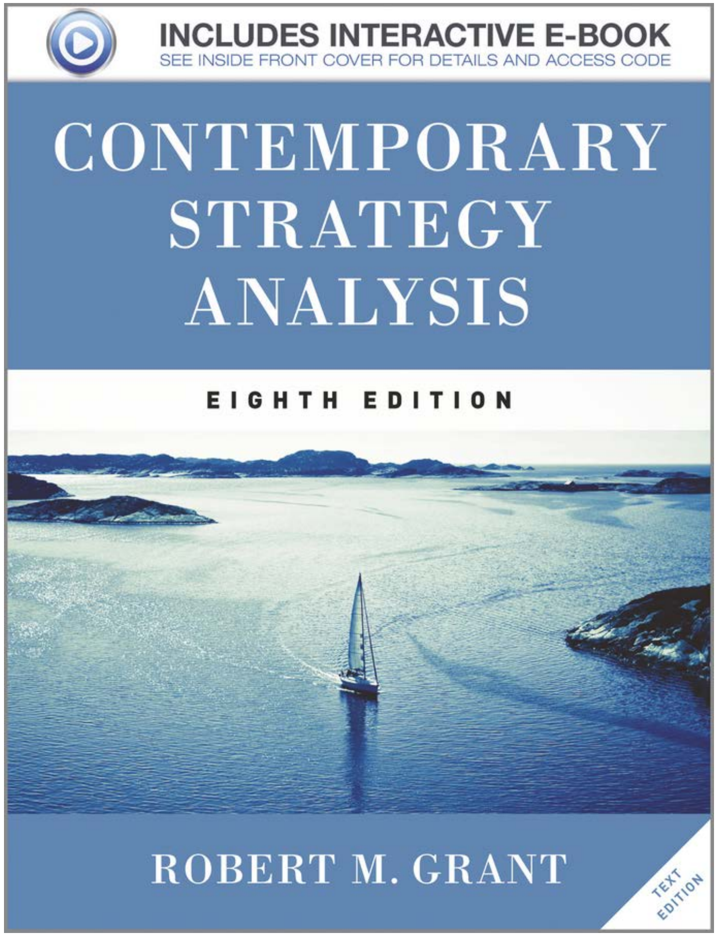
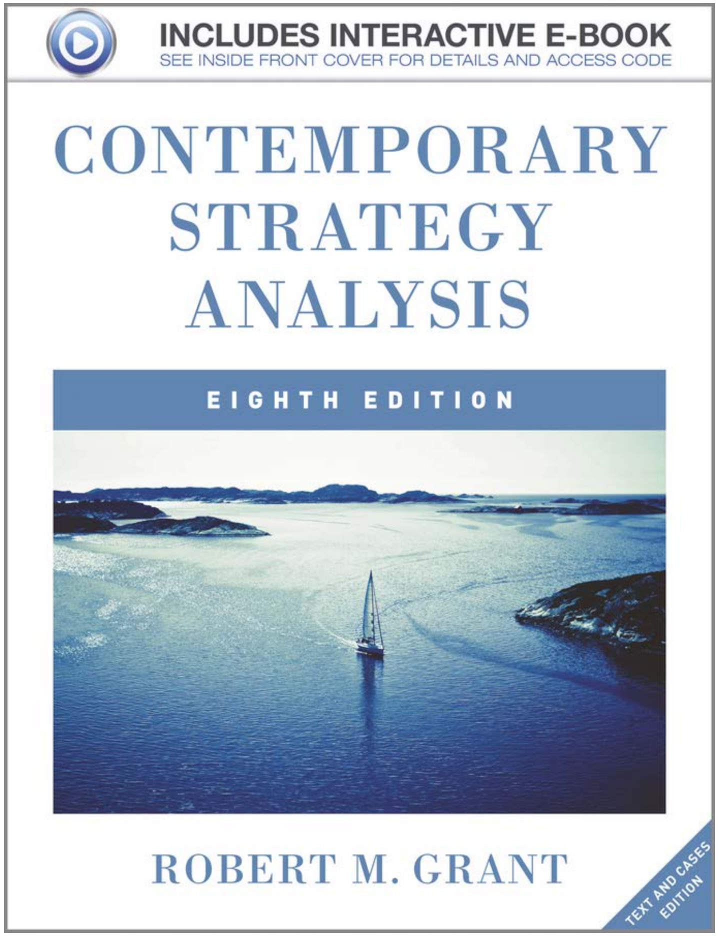




Chapter 13
Diversification Strategy

Diversification Strategy: Outline

Introduction: The basic issues

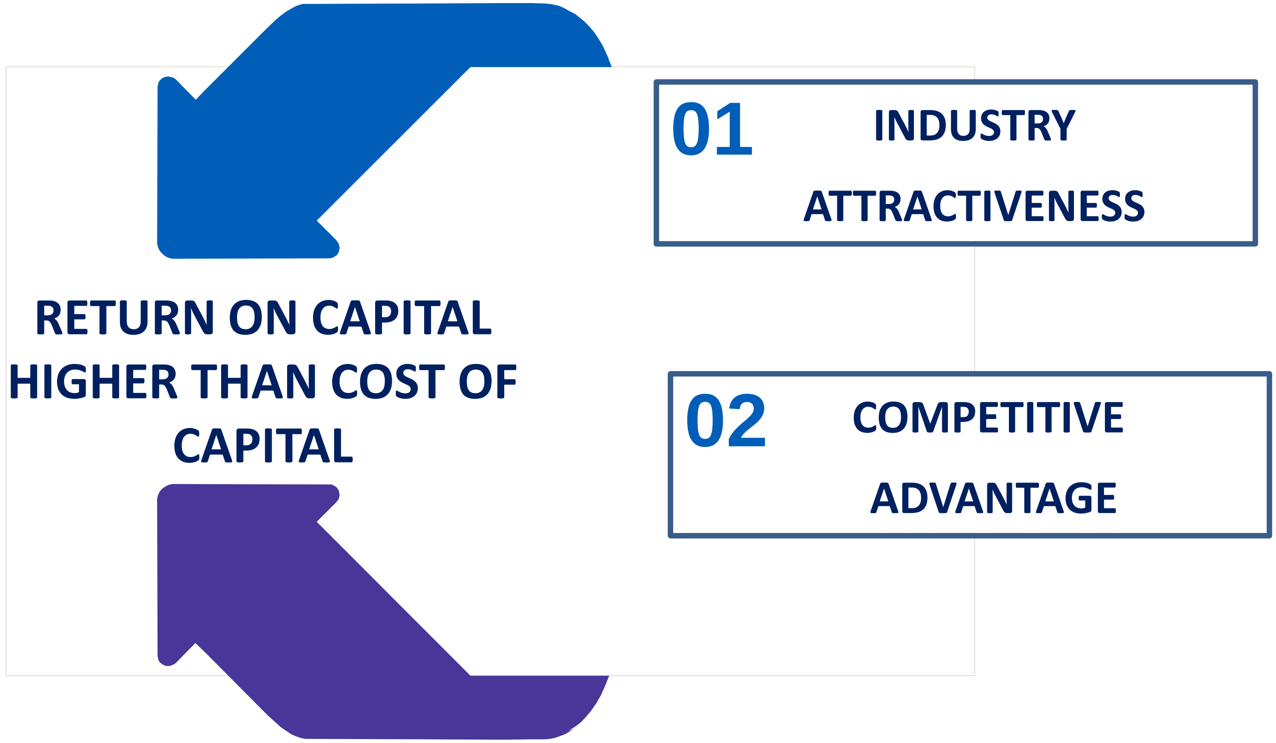
Trends in diversification over time

Incentives for diversification

Competitive advantage from diversification

Diversification and performance

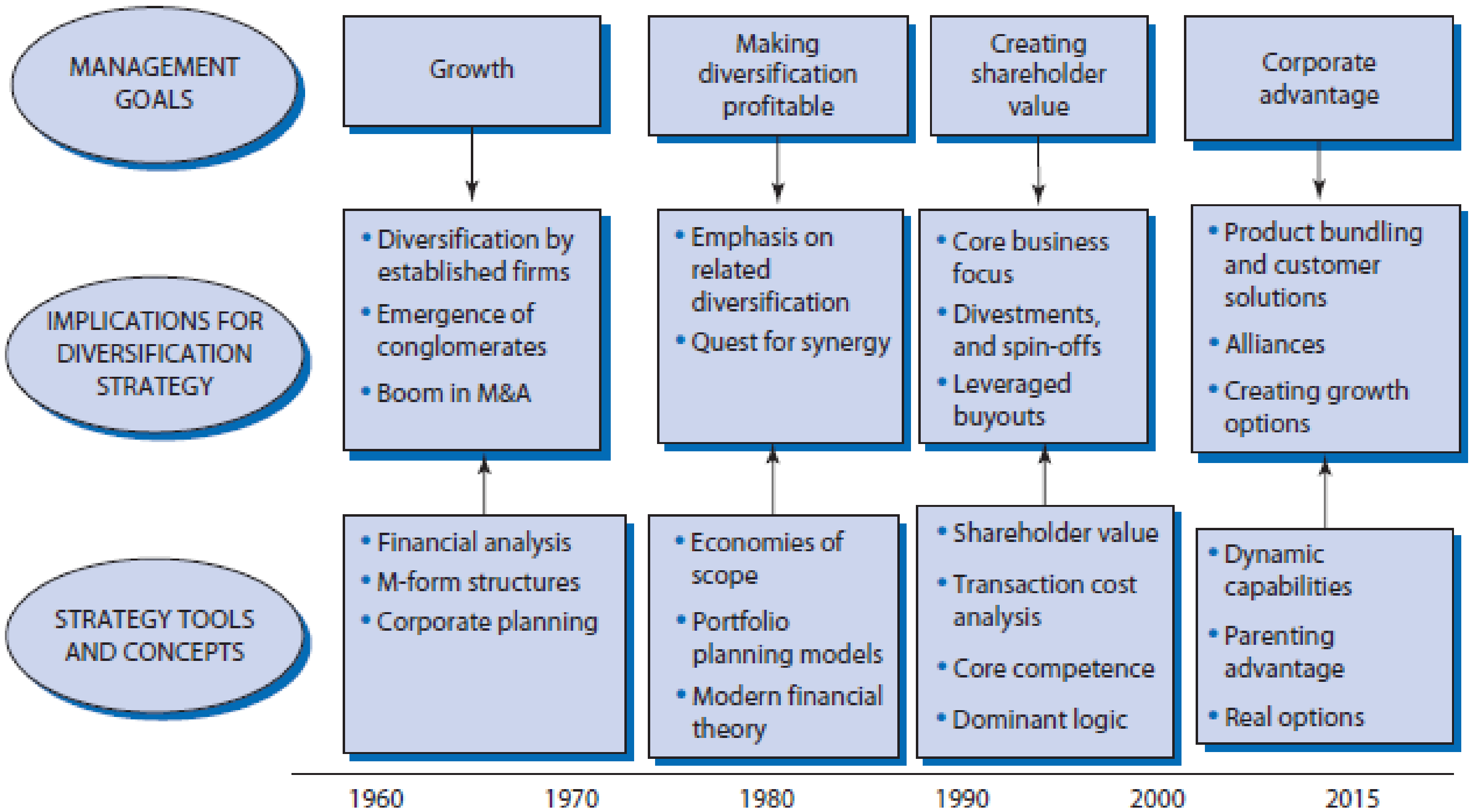
The Basic Issues in Diversification



Diversification decisions involve these two issues:

- How attractive is the industry to be entered?
- Can the firm achieve a competitive advantage?

Evolution of Diversification Strategies 1960-2015



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Incentives for Diversification

Growth

1) The desire to escape stagnant or declining industries a powerful motive for diversification (e.g. tobacco, oil)
***2)** But*, growth satisfies *managers* not *shareholders* Diversification in that achieves seeks growth (esp. by acquisition) tends to destroy shareholder value

Value Creation

For diversification to create shareholder value, owning different businesses must increase their total profitability

Risk Spreading

1)Diversification reduces the variance of profit flows
2)But, doesn't create value for shareholders—they can hold diversified portfolios of securities. (Capital Asset Pricing Model shows that diversification lowers only *unsystematic risk* not *systematic risk*)

Porter's Three Essential Tests

If diversification aims at creating shareholder value, it must meet **three** tests:

1 **The Attractiveness Test**

Diversification must be directed towards attractive industries (or have the potential to become attractive)

2 **The Cost of Entry Test**

The cost of entry must not capitalize all future profits

3 **The Better-Off Test**

Either the new unit must gain competitive advantage from its link with the company, or vice-versa. (i.e. some form of "*synergy*" must be present)

Competitive Advantage from Diversification

Economies of Scope

- Sharing tangible resources (research labs, distribution systems) across multiple businesses
- Sharing intangible resources (brands, technology) across multiple businesses
- Transferring functional capabilities (marketing, product development) across businesses
- Applying common general management capabilities to different businesses

Economies from Internalizing Transactions

- Economies of scope not a sufficient basis for diversification—must be supported by transaction costs in markets for resources
- Diversified firm can avoid external transactions by operating internal capital and labor markets
- Diversified firm has better information on resource characteristics than external markets

Relatedness in Diversification

Economics of scope in diversification derive from **two** types of relatedness:

01 **Operational readiness**

Synergies from sharing resources across businesses (common distribution facilities, brands, joint R&D)

02 **Strategic readiness**

Synergies at the corporate level deriving from the ability to apply common management capabilities to different businesses

Problem of operational relatedness:

The benefits in terms of economies of scope may decrease due to the administrative costs involved in their exploitation

Diversification and Performance:

Do diversified firms outperform specialized firms?

- No consistent relationship
- Some evidence of a curvilinear relationship: dn. first increases profitability, but beyond a point further dn. reduces profitability (increased complexity?)
- McKinsey & Co. identify benefits from moderate dn.—especially for firms that have run out of growth opportunities
- Question of direction of causation: does dn. drive profitability, or vice-versa?

What type of diversification is most profitable? Related dn. vs. unrelated dn.

- Most studies (but not all) show related dn. outperforms unrelated dn.
- Related dn. offers greater synergies—but also imposes higher management costs
- But what is "related dn."? Businesses can be related in many different ways (e.g. LMVH, GE, Virgin group)

The Sources of Strategic Relatedness Between Businesses

Corporate Management Tasks	Determinants of Strategic Similarity
Resource allocation	Similar sizes of capital investment projects Similar time spans of investment projects Similar sources of risk Similar general management skills required for business unit managers
Strategy formulation	Similar key success factors Similar stages of the industry life cycle Similar competitive positions occupied by each business within its industry
Performance management and control variables	Similar indicators for performance targets Similar time horizons for performance targets

Source: R. M. Grant, "On Dominant Logic, Relatedness, and the Link between Diversity and Performance," *Strategic Management Journal* 9 (1988): 641. Reused by permission of John Wiley & Sons, Ltd.

CASE STUDY

01

Task

Considering infos at your disposal, identifie principal differences between Specialisation and Diversification strategies, showing their main strenghts and weaknesses

02

Task

Explain then, how Nokia and General Electric, both achieved competitive advantage while adopting two complete different strategies.

NOKIA
Connecting People

General Electric