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Chapter 7 Corporate-Level Strategy, pages 255 - 275

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EVALUATING THE BENEFITS OF DIVERSIFICATION

Theorists commonly cite six reasons as benefits of diversification. We evaluate these reasons in light of our standard for good corporate management developed in Chapter 1 and in the opening section of this chapter: creating value for stockholders that they cannot create for themselves. We begin with the most powerful reasons for diversifying and then move on to those that are less defensible but still commonly cited as motives for diversification. Exhibit 7.3 arranges the six according to their power to create value.

Capitalizing on Core Competencies

Core competencies are the most significant value-creating skills within a corporation. These skills can often be extended to products or markets beyond those in which they were originally developed. [51] Such extensions represent excellent opportunities for diversification. For example, when it considered diversification targets, Philip Morris believed that the core competence it had developed in marketing cigarettes could apply to other, similar markets. Based on this idea, the company purchased Miller' Brewing and then used the Philip Morris marketing skills to move the Miller brand from seventh place to second in its market.

Any core competence that meets the following three requirements provides a viable basis for the corporation to strengthen a new business unit. [52]

The core competence must translate into a meaningful competitive advantage. In other words, the competence must help the business establish some strength relative to its competitors. Every core process and each of the major activities in the value chain is a viable basis for building on a core competence. For instance, Black & Decker enjoys a core competence in developing products with small electric motors and rechargeable batteries, and has successfully diversified this competence from small power tools for woodworking into higher-margin items such as electric kitchen appliances, miniaturized vacuum cleaners, and rechargeable flashlights.

The new business must have enough similarity to existing businesses to benefit from the corporation's core competencies. This is one reason related diversification is more profitable than unrelated diversification on average. However, this does not necessarily mean that the products themselves must be similar. Rather, at least one element of their value chains must require similar skills in creating competitive advantage in order for the corporation to capitalize on its core competencies. An example is Coca-Cola's move into leisure clothing. At first glance, one might think that soft drinks and sweatshirts have little in common, but in an important strategic sense they are, in fact, closely related; the marketing of both can be based on selling a trademark and an image as much as on selling the product itself. In soft drinks, its core business, Coca-Cola emphasizes marketing as a key component of its value chain by building demand through strong customer awareness. Coke used this same expertise in marketing an image to successfully introduce a line of clothing bearing various Coca-Cola trademarks. In its first full year of business, Coca-Cola Clothes generated $100 million in wholesale revenue - impressive growth in any industry and by far the best in the clothing industry.[53]

The bundle of competencies should be difficult for competition to imitate. As explained in Chapter 4, if the transferred skills are widely available or easily replicated, they are unlikely to provide the basis of a sustainable competitive advantage. [54] An individual core competence need not be unique; rather, it is the *collection* of competencies that should be unique, or at least difficult to replicate. For example, Canon, the Japanese diversified manufacturer, has demonstrated an unmatched ability to enter and dominate markets stretching from photocopiers and cameras to laser printers. Its dominance in these varied markets rests on mastery of crucial technologies for successful engineering and design of all these products. Canon is a world leader in its core competencies of optics, imaging, and microprocessor controls. Other companies are good at one or another of these technologies, but Canon is arguably the best overall. This provides the company with a basis for diversification that competitors cannot easily match.

A corporation that builds on core competencies utilizes skills that combine to strengthen value chains and build greater competitive advantages. This leads to *synergies* among business units, whereby they become more productive together than independently. The collection of skills used in this situation is largely intangible, but, as we discuss in the next section, corporations can also build synergies by sharing tangible resources.

Increasing Market Power

To understand the impact corporate diversification can have on a business unit's market power, compare the structural position of an independent business unit against what it would enjoy as part of a larger corporation. For instance, consider the position of an independent confectioner versus the same business as part of, say, Procter & Gamble on each of the five competitive forces

introduced in Chapter 3. Membership in the P&G family can provide the business unit with greater bargaining power vis-avis both its suppliers and its customers, as the large corporation carries more clout. With the resources available from the "deep pockets" of a firm like P&G, the individual business unit is also in a much stronger position relative not only to its rivals, but also to threats from substitutes and new entrants. Any competing firm evaluating the strength of our hypothetical Candy maker is likely to view it as a much more significant rival if it is part of the P&G corporate behemoth than if it is a single, stand-alone business. Association with the larger corporation may also bring the individual business unit increased visibility and an improved image. If so, this could have a favorable impact on any or all of the five forces affecting the business unit's structural position and ultimately on its competitive advantage.

Corporations may also increase market power by using mergers and acquisitions to consolidate their industries. For instance, Maytag, a leading U.S. manufacturer of domestic appliances, sought to improve its power with suppliers and customers by acquiring a number of business units that both extended and supplemented its core product line. Many of Maytag's acquisitions entailed horizontal diversification in that they moved the firm further into parts of the value chain it had already had a position in; for example, Maytag already manufactured domestic kitchen appliances, but acquisitions gave it a stronger position in manufacturing commercial kitchen appliances. However, a firm can also use diversification to become more vertically integrated and thereby increase its power over suppliers and/or customers by making them a "captive" part of the same corporation. Maytag purchased firms that had once been outside suppliers of component parts such as heating elements for stoves and dishwashers.

Finally, membership in a larger corporate enterprise may provide a business with markets or distribution channels it could not access on its own. A number of attempts to enter the U.S. soft drink market failed because the businesses could not overcome the entry barriers created by that\industry's tightly controlled distribution channels. However, the soft drink business unit created inside the Wal-Mart corporation found a ready-made distribution channel provided by the thousands of Wal-Mart retail outlets scattered around the United States. In this way, that soft drink business enjoyed a much more f3vorable structural position and greater market power as part of the WalMart Corporation than a similar business would have had as a stand-alone entity. Government agencies that oversee industry competitiveness (such as the U.S. Federal Trade Commission) often place limits on how far a corporation can diversify to gain power, and a move that is believed to place too much power in the hands of a single corporation may be prohibited. For example, government regulators are carefully considering Microsoft's move into on-line services. This diversification move would allow Microsoft to increase its market power by vertically integrating forward; subscribers would be able to download Microsoft software without going through a traditional retailer. Regulators are concerned that this might place too much power in Microsoft's hands, and they are considering stopping the move. However, within such limits, diversification that improves the market power of the various business units constituting the corporation clearly meets our criteria of creating value for stockholders in a way that they cannot replicate themselves.

Sharing Infrastructures

To capitalize on core competencies, firms must share intangible resources, such as skills, know-how, and talent, across business units. Infrastructures, on the other hand, are tangible resources, such as production facilities, marketing programs, purchasing procedures, and delivery routes. [55] These are the basic "nuts and bolts" of any business, and the ability to share these resources can be an important benefit of diversification. Procter & Gamble, for example, uses a common delivery system for various business units. P&G sells a wide range of products that are manufactured in facilities spread over an equally wide geographic area. Yet many of these items share two characteristics: they are destined for the same retail outlets, and they are fairly expensive to ship. Because of this, it is more efficient for P&G's various businesses to share delivery systems. Rather than send an entire truckload of cookies to a single retail outlet, P&G mixes its truckloads to provide the product blend each customer desires. Thus P &G can use one truck with a mix of items to do what otherwise might require a dozen trucks. In addition, because it is inefficient to ship "pure" loads of very light but bulky items (such as potato chips) or very dense goods (such as liquid laundry detergent), P&G saves on fuel bills and road taxes.

Note the two features that allow P&G to benefit from sharing infrastructures. First, the businesses have similar needs-they use the same retail outlets. This is another benefit of related diversification; without similar needs, businesses have no opportunity to share infrastructures. Second, delivery expenses represent a significant part of the value chain for these products, so they help determine the competitiveness of P&G's products. In other words, to be useful, resource sharing must improve competitiveness.

Balancing financial Resources

Different businesses (even within the same corporation) generate dramatically different levels of cash. Some businesses produce more cash than necessary to continue operating, while others need more than they can produce. Historically, managers in diversified corporations emphasized efficiently balancing cash flows among a corporation's business units. By combining cash producers and cash users in the same corporation, managers can meet the needs of both.

In such a corporation, the sibling businesses become a portfolio of investments, and managers balance cash flow across the family of businesses rather than merely within each individual business. This approach, called *portfolio management,* first became popular in the 1970s, when a number of leading corporations and consulting firms developed several similar frameworks to guide managers in allocating cash among diverse business units. [56] Some of the decisions involved in portfolio management are presented in Application 7.3, which looks at General Electric's efforts to balance the cash flows of its various business ventures. We shall briefly consider three popular variations of portfolio management and then look at the general benefits and limitations of this approach. [57] The various versions of the portfolio approach are named according to the labels of their grids' axes.

The Growth - Share Matrix

According to the growth-share matrix, developed during the 1970s by the Boston Consulting Group (BCG), two relatively simple factors predict whether an individual business will be a cash producer or a cash user: (1) the growth rate of the market within which the business competes and (2) its share of that market. Businesses in fast-growing markets usually need more cash to scale up production, open new facilities, advertise, develop new products, and so on. On the other hand, businesses in declining markets may have already lived through their peak periods of product demand and are more likely to have sufficient assets to serve the present dwindling demand. Businesses in this situation generally produce considerable cash but do not have a ready place to invest it. Thus, businesses in growing markets may need more cash than they have, while businesses in mature or declining markets may have more cash than they need. Additionally, businesses with large market shares more likely enjoy economies of scale and greater experience curve benefits. Lower costs mean higher profits, and higher profits mean greater cash flows. In short, the BCG's framework suggests that higher market shares are associated with greater cash flows. Exhibit 7.5 (BCG Growth Share matrix) shows the combined effects of market growth and market share, and we can see how each of the four cells of the matrix indicates a different strategy.

Cash cows usually produce far more cash than they can usefully employ in house. Corporations often "milk" such businesses to finance other businesses on which the corporation's future may depend. ***Dogs*** hold small shares of slow-growing (or even declining) markets and they are unlikely ever to become important sources of cash. In fact, they may be greater users of cash for which there is little likely return. Experts often suggest that such businesses be "harvested" by not investing in them and instead shifting cash flows to more promising businesses. ***Problem children*** have low market shares of rapidly growing markets. They represent a potential opportunity; if their market shares can be increased, they might become cash cows. However, if they cannot increase market shares before market growth slows, they will, in effect, become dogs. Developing a strategy for problem children means either investing large sums in hope of gaining a viable market share or not investing and possibly missing a growth market. *Stars* are often the hope of the future. They currently hold large market shares in rapidly growing markets, so their cash flows may be minimal or even negative. Recommended strategy dictates that they be nurtured, maintaining their health and waiting for market growth to slow so that net cash flows will increase. Theoretically, the cash-hungry stars will be transformed into cash-rich cows that can be milked to nurture still another generation of businesses.

The Market Life Cycle-Competitive Strength Matrix

Critics of the growth-share matrix contend that it fails to consider the wide range of factors that affect cash flow beyond market growth and market share. A somewhat more involved picture of the situation facing a business can be depicted by adding a judgmental assessment of the overall competitive strength of the strategic business unit (SBU). A second refinement utilizes the richer concept of the market life cycle as a replacement for market growth. Recall from Chapter 6 that growth rates vary predictably across stages of the market life cycle, but that the life cycle model depicts various strategic issues beyond simply growth. The explicit consideration of the market life cycle found in this portfolio management framework provides a useful bridge between strategy formulation at the business level and at the corporate level. Exhibit 7.6

EXHIBIT 7.6
The Market Life Cycle-Competitive Strength Matrix

Source: This type of matrix was originally developed by Arthur D. Little, a consulting firm that coupled the matrix to a comprehensive methodology for developing strategic plans.

shows the cash flows and investment requirements at various combinations of competitive strength and market life cycle stages.

While the market life cycle-competitive strength framework obviously provides a richer description than the growth-share matrix its central message is the same. To see the relationship between these two frameworks, redraw the market life cycle-competitive strength matrix with the growth-share matrix superimposed. This will reveal the similarities of the strategies suggested by the corresponding positions on the two grids. Cash cows will still be in the upper right-hand quadrant, dogs in the lower right-hand quadrant, and so on. The reason for this similarity becomes clear if you remember that market growth is closely linked to the market life cycle and that market share is at once both a cause and an effect of competitive strength.

The Industry Attractiveness-Business Position Matrix

While the market life cycle-competitive strength matrix is more refined than the growth-share matrix, some have found that its coverage of important issues remains limited. An alternative, the broadest portfolio management framework we will consider, is the industry attractiveness-business position matrix. This approach considers matters raised in the other two frameworks and incorporates a range of other considerations, such as those shown in Exhibit 7.7.

Analysts typically combine information about such factors to reach a subjective evaluation of overall industry attractiveness and business position. The strategic implications suggested by combining the resulting evaluation in a matrix are identified in Exhibit 7.8.

Clearly, while this framework entails a very broad set of considerations, it is fundamentally similar to the simpler frameworks described above. All these frameworks share three characteristics: (1) they consider some dimensions of both the external environment and internal capabilities of a business; (2) they simplify information about environmental conditions and business strengths by locating business units graphically on a two-dimensional matrix or grid; and (3) a business unit's position in the matrix is treated as indicative of its likely need for, or ability to provide, financial resources (cash). Given these commonalities, we can evaluate the usefulness of these portfolio management techniques as a group.

Benefits and Limits of Portfolio Management

Portfolio matrices offer useful frameworks for managers to consider potential differences among businesses in the same corporation, and experience shows that they offer several potential benefits:[58] (1) they summarize large amounts of general information about individual business units and overall corporate plans; (2) they focus important differences among businesses and help illustrate the rationale behind corporate plans to invest funds in business A that have been obtained from business B; (3) they provide simple but useful guidelines for checking consistency between a business's requests for resources and opportunities for using these resources effectively; and (4) they suggest reasonable performance levels for business units facing the various

***EXHIBIT* 7.7**

Examples of Factors Considered In Constructing an Industry Attractiveness-Business Position Matrix

strategic situations (obviously, the growth and profitability expected of a "star" are quite different from those expected of a "dog"). While these benefits are important, portfolio management should not be considered the sole, or even the primary, basis for formulating corporate-level plans. It is more appropriately used as a tool that can help initiate a complete corporate strategy.[59] One commonly cited problem is that the simple matrices tend to trivialize

***EXHIBIT* 7.8**

The Industry Attractiveness-Business Position Matrix

thinking. To be fair, this criticism should probably be laid at the feet of those who have misused them; they were never intended to replace careful thought, although in practice they sometimes have done so.

Another problem with portfolio management is that individual businesses can be indistinguishable from one another.[60] No exact principles dictate what constitutes a separate market or an individual product line. For example, should a beverage company treat its coffee and tea operations as two businesses or one? Often yearly planning cycles don't allow enough time for detailed analysis of every SBU in many large diversified firms. Therefore, even the most ardent supporters of portfolio approaches to corporate management "fudge" a little on what constitutes an SBU in their portfolio planning. Firms usually recognize no more than about thirty entities in their portfolios, regardless of how many businesses must be combined to reach this manageable number.[61]

Finally, simple models of portfolio management are generally not very accurate. After 2 decades of use, it is now obvious that models such as the BCG matrix have often led to inappropriate strategic moves because of their inaccuracy. For instance, one study reported that more than half of all businesses that should have been cash users according to the BCG matrix were, in fact, cash providers.[62] On the other hand, roughly one-fourth of all businesses expected to be cash providers were, in fact, cash users. "While no similar studies have been carried out for the other portfolio frameworks described here, any framework that reduces a strategic situation to two dimensions will not be highly accurate in its prescriptions.

Thus, portfolio management has become one of the most involved and elaborate approaches to developing corporate strategy. Consequently, our discussion of balancing cash flows has been considerably more extensive than that devoted to the other benefits of diversification. We are now ready to turn to the last two of the six most commonly cited benefits of diversification.

Maintaining Growth

Diversification also provides continued growth. Especially among larger firms, diversification undoubtedly offers one of the most common sources of growth. Using diversification, BASF, the giant German chemical company, was able to maintain a level of growth through the 1980s more typical of rapidly growing start-up businesses, even though it was a mature, multibillion-dollar multinational corporation. In the last half of that decade, BASF grew at an average of 36 percent per year, roughly doubling in size every 2 years, from a base that was already huge.[63]

Is growth always desirable? Considerable argument revolves around the idea that corporations should pursue only moderate levels of growth to generate the best return on stockholder investments. Beyond that, profitability likely declines as the pursuit of high

growth levels drives the corporation into more marginal businesses and the cost of operating the increasingly large corporation outstrips the growth in profits that additional businesses might provide. Exhibit 7.9 helps us visualize this relationship.

***EXHIBIT** 7.9*
Typical Trade-off Between Corporate Growth Rate and Corporate Profitability

Reducing Risk

Corporate managers sometimes justify diversification on the basis of risk reduction.[64] To understand how diversification relates to risk, first note that different businesses respond differently to particular economic cycles: the demand for luxury cruise vacations typically declines during recessions as consumers look for less expensive recreation, while demand for bus travel typically increases, as this is a relatively inexpensive mode of transportation. We call businesses such as these two *countercyclical.* In order to reduce the risk associated with volatile earnings, a single corporation might decide to diversify its portfolio by holding-both a cruise ship line and a bus line. If such countercyclical businesses exist within the same diversified corporation, a bad year for one business can be offset by a better year for the other. In this way, the variability of the overall corporation's earnings would decrease, and stockholder investments less risky.[65]

However, investors do not need corporate managers to achieve this risk-reducing effect. They can simply invest their individual funds in the different businesses (cruise ship operators and bus operators in this example) to achieve the same risk-reducing effect: a bad year for one of their investments will be offset by the improved performance of their other investment, and the risk associated with their overall portfolio of investments will decrease. In fact, individual investors can usually achieve such risk reduction through diversification at a lower cost than corporate managers can because they do not have to pay the takeover premium a corporation normally has to pay. This being the case, diversification for risk reduction alone hardly meets the goal of having corporate managers create value for an investor in some way that the investor cannot accomplish alone. *As* we shall see in the next section, forces at play can limit any of the six possible benefits of diversification listed in Exhibit 7.3.

MANAGERIAL BEHAVIOR THAT LIMITS THE BENEFITS OF DIVERSIFICATION

Creating value for stockholders in ways that they cannot do on their own is complicated by the fact that corporate managers do not always benefit from diversification in the same way stockholders do.[66] To appreciate this important point, understand the relationship between corporate managers and the corporation's stockholders. Theoretically, corporate managers are to act as the agents for the stockholders, whose interests they are hired to represent.[67] However, an area of research known as **agency theory** leads us to ask whether managers always act in stockholders' best interest.[68]

Agency theory suggests that managers will not always place stockholders' interests above their own.[69] In fact, stockholders have been dubbed the "least important constituency" by researchers who have examined how corporate executives manage the diversification process.[70] In managing diversification, corporate managers face a dilemma as they attempt to balance their own interests against those of stockholders. For instance, stockholders often enjoy high profits from the sale of their stock when the firm is taken over. On the other hand, managers of firms that have been taken over often lose their jobs. Critics contend that corporate managers sometimes protect their jobs by using various anti-takeover tactics, even though avoiding the takeover often *reduces* the value of stockholders' investments. Such controversial takeover tactics are described in Application 7.4.[72]
In the following sections, we consider how each of the potential benefits of diversification can decrease because of conflicts between the interests of managers and those of stockhoiders.

Capitalizing on Core Competencies

Managers in newly acquired businesses often resent and oppose transferring skills from the core business. Managers good enough at their work to make their business an attractive acquisition may wonder why the new corporate parent presumes to know better. In the case of Philip Morris and the Miller Brewing acquisition, Philip Morris ended up replacing several key Miller executives who resisted the transfer of marketing skills from Philip Morris, even though Philip Morris was undoubtedly one of the best marketers in the world. Philip Morris eventually overcame this obstacle, but other corporations are less fortunate and face continued resistance from their acquisitions.

Increasing Market Power

Any corporate attempt to improve a business unit's market power by enhancing its structural position entails some loss of autonomy or control on the part of the business's managers. To return to our earlier example of a confectioner acquired by Procter & Gamble, to the extent that the candy maker is treated as part of the P&G family, it no longer controls its own destiny. For example, its sales force may no longer be necessary; in order to give the business unit the greatest possible market power, its sales will probably be handled as part of a centralized sales department's responsibilities, with each salesperson handling candy sales along with sales of a variety of other P&G products. This diminished role for managers in the candy business is likely to meet

considerable resistance, and they may try to maintain independence from the larger corporation even though doing so will limit the favorable impact on market power the corporate parent offers.

Sharing Infrastructures

Managers may feel threatened when a corporation attempts to have businesses share resources. A corporation may decide to have one set of managers or one set of facilities serve two businesses; in this case, the other managers or facilities will no longer be needed and some managers will lose their jobs. Clearly, managers have good reason to resist such efforts at making the corporation more efficient.

Balancing Financial Resources

While balancing cash flows across businesses sounds logical, consider how managers might respond to having their businesses labeled "dogs." How often are careers advanced by killing off a business efficiently, even if it is done for the good of the corporation? Individual managers often believe that their success depends more on the performance of their particular businesses rather than on the performance of the corporation. In such circumstances, managers find it difficult to sacrifice their businesses for the good of others in the portfolio, even if the corporation as a whole would benefit.

Maintaining Growth

Corporate growth seems to have at least as much to do with improving the welfare of managers as the welfare of stockholders. Managers may be in favor of growth because they expect personal benefits from increasing the size of the corporation. For example, managers in larger corporations typically get paid more than their counterparts in smallercorporations.[73] One study found that, other things being equal, for every 10 percent increase in company size, U.S. CEOs could expect a 2 percent increase in annual pay[74] This holds true even though larger corporations are not necessarily more profitable.

Larger corporations offer managers more prestige and more perquisites, or ~perks;" Every year the popular business press celebrates corporate size with listings such as the *Fortune* 500, the 500 largest corporations in the United States. Business professionals consider being :1 top-ranking executive at a large corporation more prestigious than holding a similar rank in a smaller firm. Corporate jets, executive townhouses, lavish corporate headquarters, and so on, are all expensive perks. Larger corporations are more able to afford such perks, because they represent a smaller percentage of overall corporate assets and expenses.

Managers may also believe that larger corporations offer greater job security. Larger corporations were traditionally more difficult to acquire by takeover, so, by increasing the size of their corporations, managers may think they are reducing the threat of being replaced. With the ever-increasing size of takeover targets, this tactic may no longer work, but for most managers, it remains a major consideration for acquisition.

Both corporations and stockholders can benefit from growth. However, the relationship between corporate size and corporate financial performance is tenuous, and the benefits to growth appear to accrue more directly to managers than to the stockholders they are presumably hired to serve.[75] This suggests that growth alone is not a strong argument for diversifying. It is probably more appropriate to consider growth as a by-product of diversification rather than as a reason for diversifying.

Reducing Risk

As we have seen, individual investors can diversify their stock portfolios using countercyclical stocks to reduce their overall risks, so corporate diversification for the sake of risk reduction does not meet our standards for good strategy. However, some corporate managers may pursue this tactic because it effectively reduces their own risks.[76] When a corporation is involved in a variety of industries, its total earnings are less volatile, which means that the earnings for which corporate managers are responsible are more assured.'

Clearly, managers do not benefit from diversification in the same way owners do, and this difference often limits the benefits owners derive from corporate diversification. In fact, if you return to Exhibit 7.3 and compare the things that benefit stockholders and the things that benefit managers, you may reach the conclusion that the two have precisely opposite railings for the six reasons we have discussed. While stockholders have much to gain from capitalizing on core competencies, improving market power, and sharing infrastructure, managers have much to lose from the same. On the other hand, managers may benefit from maintaining growth and reducing risk, although, as we have seen, there is little opportunity for stockholders to benefit from corporations diversifying for these reasons alone. Balancing cash flows appears to offer mixed results for both parties.

All this suggests that one of the greatest challenges to corporate strategy is overcoming the differences in the motives of owners and managers. One common way of doing this is to tie manager compensation to stock performance. This can be accomplished by granting stock options (options to buy stock at pre-specified prices) to managers or by selling stock to all employees on favorable terms. Either option is meant to increase managers' and employees' interest in creating greater value for stockholders, the goal of corporate strategy.

Summary of Managerial Practices to Adopt from This Chapter

Remember that the key responsibility for managers at the corporate level is to see that stockholders' funds are invested in such a way that they generate more value for the stockholders than stockholders could generate for themselves.

Corporate managers can continue to invest in their present businesses, or they can invest in different businesses, an option that entails some form of diversification.

Use the relatively simple three-by-three matrix of "forms by means" to help you son out options for diversification. The most common forms of diversification are vertical integration, horizontal diversification, and global diversification. Diversification is usually carried out through acquisitions, strategic alliances, or internal development.

A corporation's level of diversification can also be influenced through divestments as its sells off businesses. Divestments are often poorly managed, but remember that, if they are approached correctly, they too offer opportunities to create value for stockholders in ways that stockholders cannot replicate for themselves.

As a manager, you should be aware that the benefits you personally receive from diversification are often different from, and sometimes in conflict with, those realized by stockholders. You should consider the needs of both parties carefully in order to reach an appropriately balanced approach to managing at the corporate level.

Perhaps the best justification for diversification is to be able to capitalize further on core competencies a corporation has already developed, and your organization's core competencies should play an important role in shaping its diversification strategy. Other good reasons for diversifying are opportunities to increase a business's market power, to utilize corporate infrastructures more fully, and to facilitate shifting cash flows from businesses generating excess cash to those needing additional cash.

Other reasons frequently given for diversification are maintenance of growth and reduction of risk, but it is usually easier to see how managers benefit from these than how stockholders do.

Questions for Discussion and Review

1. Explain the meaning of this statement: "Firms should base decisions on diversification according to the criterion of generating greater returns to stockholders than those stockholders would likely achieve if acting independently."
2. Describe the different forms of diversification and give an example of each.
3. Describe the different means of diversification and give an example of each.
4. Evaluate the most common reasons for diversifying in terms of their impact on competitive advantage and financial performance.
5. Explain how managerial behavior can effectively limit stockholders' benefits from diversification.

Notes

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3. Michael Lubatkin, "Value-Creating Mergers: Fact or Folklore?," *Academy of Management Executive,* 2 (November 1988), 295-302.
4. You may recall that this is the basic idea behind the notion of economic value added described in Chapter 4; see also Shawn Tully, "The Real Key to Creating Wealth," *Fortune* (September 20, 1993),38.
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13. J. B. Barney, "Returns to Bidding Firms in Mergers and Acquisitions: Reconsidering the Related Hypotheses," *Strategic ManagementJournal,* 9 (special issue, 1988), 71-78; V. Part Three Strategy Fonnulation Ramanujam and P. Varadarajan, "Research on Corporate Diversification: A Synthesis," *Strategic Management Journal, 10* (1989), 523-551.
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16. To learn the fascinating story of how such a corporation was built, read the entertaining *How to Lose $1,000,000,000 and Other Valuable Advice* by Royal Little, Boston: Little, Brown, 1979.
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