CORPORATE LEVEL STRATEGY: THE RATIONALE FOR CONCENTRATION AND DIVERSIFICATION STRATEGIES

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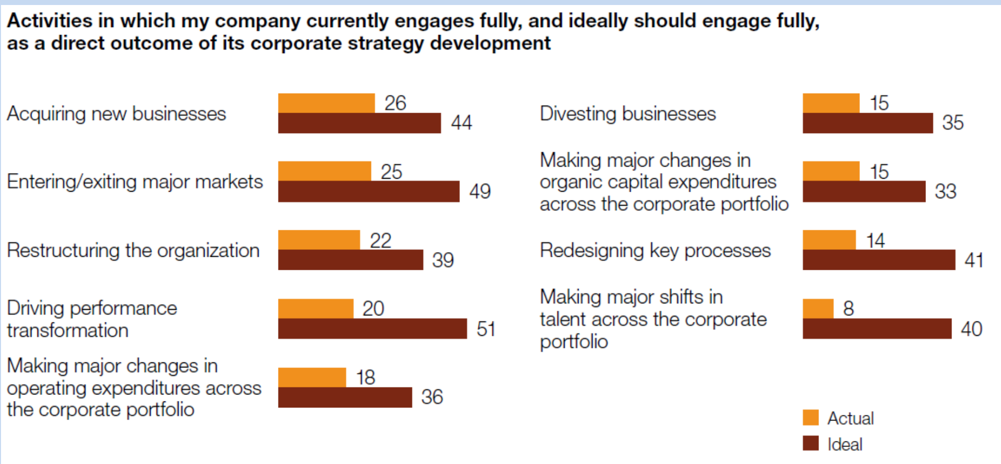
> *The fit between a parent and its businesses is a two-edged sword: a good fit can create value; a bad one can destroy it.*
>
> Campbell, Goold and Alexander

Introduction

The senior management of a firm confronts a number of fundamental issues about the underpinning nature of the firm. Including, for example, the appropriate level of firm internationalisation, the amount of vertical integration the firm will pursue, the divestment of underperforming or non-core businesses, and even if the firm should split – as Hewlett Packard recently decided to do by splitting off its business solutions are into a new firm, HP Enterprises. However, most fundamentally, senior management must decide the business, or businesses, in which the firm will compete. In other words, senior management must decide the appropriate scale and scope of the firm. The choice made will depend on many things, and similarly will evolve over time.

While the nature of corporate level decisions is relatively clear, according to McKinsey (2011) the effective implementation of strategic decisions can be frustrating. For example, as illustrated in Figure A below, no outcome activity from corporate strategy development, whether it is acquiring or divesting businesses, driving performance transformation, or even shifting talent across the firm's portfolio, is done as frequently as senior management in the firm would ideally think is necessary.

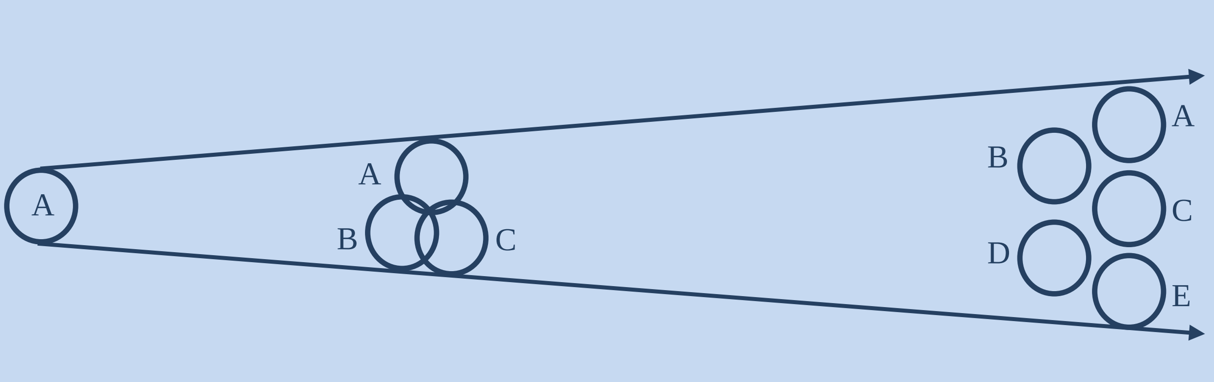
Figure A



Source: McKinsey & Company. 2011. Creating More Value with Corporate Strategy. *McKinsey Global Survey Results.*

A firm may concentrate on one business or it may diversify and widen its scope. As Figure B illustrates though, inevitably as it widens its scope, the links among the firm's businesses become weaker, until, where if the firm is sufficiently diversified, there are few if any links, and the firm's businesses are quite independent of one another. This is illustrated on the right of the Figure B. This evolution, if it occurs, has a fundamental impact on the coherency and nature of the firm, and must be considered carefully by senior management.

Figure B



This article looks at corporate level decision-making and in particular if a firm should concentrate on a single product market, or whether it should diversify into multiple product markets. The article will focus on the factors that influence senior management in making the decision on the firm's scope: concentration or diversification. In particular, it will address the various rationale that senior management must consider and balance when making this fundamental strategic choice.

The Concentration / Single Business Strategy

The 'concentration' or 'single business' corporate strategy is quite straightforward to understand. Many firms, particularly smaller firms, use a concentration or single business corporate strategy. A concentration corporate strategy describes where the firm focuses its resources and capabilities on competing successfully within one particular product market sector. Ryanair plc, for example, uses a single business corporate strategy – it runs a pan EU airline, as does Delata plc, which operates hotels around Ireland. Ryanair plc also generates some revenue from activities other than the airline, including reselling travel insurance, booking hotel rooms and renting cars. However, these are relatively minor and secondary activities, and Ryanair plc is still best described as having a concentrated corporate strategy. Generally, a single business corporate strategy generates 95%, or more, of its sales revenue from its core business area.

When compared to a diversified firm, there are clear benefits for those firms that follow a single business corporate strategy.

1. Organisations will always have less resources than needed: a critical role of senior management is to allocate the available resources as effectively as possible. The resources in question may obviously be money, but would also include key people, senior management time and technology. In a single business firm, there is less probability that

resources will be stretched thinly over too many competing activities, as there are likely to be less activities and they will all be focused on the one sector in any case.

2. There is usually less ambiguity about "who we are" in a concentrated firm. In the concentrated firm, everyone – investors, customers, suppliers, employees, etc – can more easily understand the nature and the strategic direction of the firm. Senior management can more effectively communicate to the firm's stakeholders the processes, structures and the firms priorities. On the other hand, where the firm competes in multiple product market sectors, this understanding and communication is much more complex and involved. For example, there is little ambiguity about the nature and the emphasis of Ryanair plc, while at the same time it can be argued that the identify of DCC plc, a widely diversified firm, is more confused – due to its multi-business nature.

3. In the single business firm, everyone, including the senior management can more easily maintain hands-on contact with the core business. As a consequence of this, important competencies are more likely to emerge. Senior management, researchers, production engineers, marketing managers, etc, have the opportunity to spend all their work time focused on the one product market sector. The accumulation of this undiluted investment of time, focus and effort should mean that over time the firm is more likely to be innovative and successful.

In summary, in a single business firm, there is less dilution: of resources, expertise, management, energy, and even time, when compared to a multi-business firm.

That said, there is a significant problem associated with the single business corporate strategy (where the firm is locked into that sector). The performance of the firm and the evolution of the sector, and of the general economy, are very closely linked. For example, as the sector matures the firm will find it increasingly difficult to grow, and the sector will become increasingly competitive as rivals fight for the growth that exists. Relatedly, the firm runs the risk that over time its primary product or service may become obsolete, and as a consequence the firm becomes unsustainable.

The Corporate Diversification Strategy

If, and when, senior management decides that a single business corporate strategy is no longer likely to be successful, it may decide to diversify the firm's business. Thompson *et al* (2007) describe diversification as the process of entering one or more industries that are distinct or different from a firm's core or original industry. They conclude that diversification creates added value for shareholders by building a multibusiness firm where the firm as a whole is more competitive and valuable than the sum of its businesses. Porter (1987) identifies three "tests", or conditions, where diversification will create shareholder value:

1. The sector chosen for diversification must be competitively attractive and profitable.
2. The cost of entering the sector must be relatively reasonable, bearing in mind the profit potential.
3. The new business and the firm must gain competitive advantage through being linked.

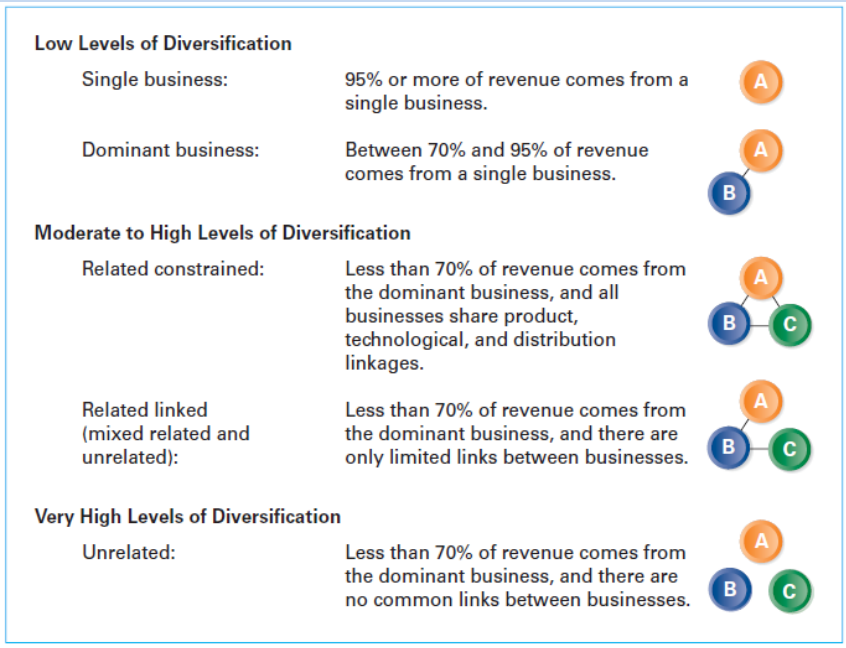
However, once a firm has become diversified, a range of new, and ongoing strategic issues confront face senior management. Firstly, senior corporate management must ensure that not only is the firm well managed, with a clear and effective strategy, each of the business units in the firm must also be effectively managed and have a strategy coherent with the firm. Senior management must also manage the firm's portfolio of businesses, for example, by picking new businesses to enter, or deciding to exit existing businesses, as well as establishing investment priorities. Overall, senior management, as alluded to by Porter, must boost the combined performance of the firm's businesses, for example, by leveraging cross-business synergies and strategic fits, to ensure that the firm is, in fact, "better off". Senior management must decide where the firm has the resources and competencies that may allow it to compete successfully.

Degrees of Corporate Diversification

There is a range, or levels, of corporate diversification that firms may pursue. At one level, firms may have limited diversification, and be closely linked to the original business, while at the other extreme, a firm may have a wide range of businesses, many of which have no link to the firm's other businesses. Figure C below, from Hitt *et al*, (2009) illustrates the range of diversification alternatives. A firm has a low level of diversification where it pursues either a single, or a dominant business, corporate-level diversification strategy. For example, as mentioned previously, Ryanair plc is an airline: the vast proportion of Ryanair's revenues derives from the airline business, although it also generates revenue as a reseller. The AA Ireland Ltd is similar: the firm has diversified into motor, home and travel insurance, but its dominant area of activity remains the motor breakdown and service business.

As the firm increases its level of diversification, it may reach the point where no one business dominates the firm's revenues and profits, and therefore no one business has a dominant political influence within the firm. Glanbia plc has four business segments driving results – although the Performance Nutrition segment has become the most important due to its growth and potential. In the context of Figure C, Glanbia plc would be described as a 'related constrained diversification'.

Figure C



Low Levels of Diversification		
	Single business:	95% or more 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.

Source: Hitt *et al*. 2009. *Strategic Management: Concepts and Cases (8th Edition)*. Mason, Ohio: South Western Cengage. Page 156.

Lastly, firms may pursue very high levels of diversification, where there may be few or even no links among the business units. Until its collapse, the Quinn Group would have been such a firm. The Quinn Group had interests in business sectors as diverse and cement, quarrying, general and life insurance, building insulation and real estate.

Forms of Relatedness

As referred to in Figure B, firms frequently seek to diversify into linked – or related – businesses. Related corporate diversification involves diversifying into businesses whose value chains possess competitively valuable 'strategic fits', or 'synergies' with the value chains of the firm's present businesses (Thompson et al, 2007: 272). It is important to recognise that these synergies may not be obvious or customer facing and may exist anywhere along the firm's value chain: for example, operational activities, R&D, shared technologies, supply chain activities, and so on. For example, DCC plc describes itself as an international sales, marketing, distribution and business support services group. Even though its four business units are in very different areas - technologies, energy, healthcare and environment - DCC plc would argue that it pursues related corporate diversification. Similarly, Tesco plc uses its facilities, brand name, selling competences and market and financial power to sell everything from groceries, motor fuel, banking services and mobile phones services.

The Strategic Rationale [for Related Diversification]

There is a clear and powerful rationale for firms to decide to concentrate on one sector, as outlined above. However, as also shown, many firms still diversify to a greater or lesser extent. Again, there are a number of persuasive reasons for firms to make the strategic choice to diversify, and one, two or more may be a factor in any particular diversification decision. Some of these are referred to below:

1. The first, and obvious reason, for a firm to diversify is to grow in size and to increase its profits. Senior management would hope to increase the firm's value by improving its overall performance using diversification. This need to continuously grow revenues and increase profits is particularly the case for publically traded firms, where investors, 'the market', are constantly looking for an increasing share price and greater returns on their investment. In a sense this is the reason that should underpin any strategic decision.
2. Through diversification a firm can reduce its level of business risk. When a firm competes in only one sector, its performance, even survival, is tied to the growth and performance of that sector. In the event that an external shock, for example, a disruptive technology or economic recession, undermines the sector, the firm is also undermined. Diversification allows a firm to dilute its exposure to the circumstances of any one sector and therefore reduces its overall business risk. It should be noted that for publically quoted firms, an investor can diversify his own risk by diversifying his portfolio of shares, and theoretically therefore the firm does not need to diversify.
3. Over time, firms develop a range of resources and capabilities: this is the logic that underpins the resource based view of the firm. Diversification allows a firm to leverage its existing resources and capabilities, by utilizing them in new product markets. The existing resources and capabilities a firm may be able to use is varied: a well-known brand name; design or engineering expertise; existing distribution network; existing technology; facilities; and so on.
4. Corporate diversification is a frequent means for firms to increase organisational size. Size tends to bring inherent advantages to firms, including greater financial resources,

market visibility and brand recognition, and a wider range of organisational capabilities, including negotiation power and expertise. This can bring such diversified firms a means to generate competitive advantage, when compared to rivals with a single business strategy.

5. The general business environment is always evolving: for example, as technology changes or new firms enter the globalised market. In response to such environmental change, firms may seek to reduce their exposure to a particular sector where the competitive landscape and sectoral environment is becoming less attractive. For example, firms such as Dell and HP have developed and diversified into business services and 'cloud solutions' as their core business of PCs and IT hardware has become less attractive and profitable.
6. Senior management in firms are frequently attracted to a diversification strategies – and the 'deals' that sometimes have to be negotiated to make them happen, for reasons of self-interest. For example, diversification may bring financial rewards for senior management, especially when the firm chooses acquisitions as a means of diversification: the bonus for 'closing the deal'. In addition, as firms become larger and more diversified, the 'managerial employment risk' is reduced. Lastly, senior management may also pursue a diversification deal merely because of perceived status and ego reasons.
7. Successful firms will tend to generate substantial free cash flow. When the cash generated is greater than is reasonably needed for reinvestment in the current business, senior management have to decide what to do with the surplus. There are a number of options. The firm can firstly return the cash to shareholders, either by means of a once off dividend or perhaps a share buyback. Alternatively, it can invest the cash in liquid investments – for example, an interest bearing account in a bank. The return on this second alternative tends to be low. Lastly however, senior management may decide that the best use of the cash is to pursue an attractive, higher return, diversification opportunity, and instead use the firm's surplus cash to enter that new sector.

Unrelated Corporate Diversification

Unrelated corporate diversification refers to the development of product markets outside of the current capabilities or resources of the core firm (Johnson *et al*, 2005). There is little or no meaningful strategic fits among the businesses of an unrelated diversified firm, and the diversity tends to be place unusual demands on corporate managers. The investment logic for unrelated corporate diversification tends to mostly financial rather than strategic. In essence, a firm that can be acquired on attractive financial terms and offers good prospects for profitability growth is a good business target for diversification.

The quintessential unrelated corporate diversified firm is Berkshire Hathaway Inc. Berkshire Hathaway Inc is run by Warren Buffet, one of the richest people in the world, and owns a hugely diverse range of businesses. While more than 300,000 people work for Berkshire Hathaway in its various subsidiaries, the firm is overseen by a mere 25 people, including Buffett, from corporate head office. This illustrates the low levels of interdependencies and corporate head office oversight among the firm's businesses. From an Irish perspective, Three Ltd, the telecommunications firm, which recently acquired the O2 business in Ireland, is a business unit of CK Hutchison, a firm from Hong Kong. CK Hutchison has five core, but very different, businesses: ports and related services, retail, infrastructure, energy and telecommunications – this last being the parent of Three.

As described by Hitt *et al*, (2009), an unrelated diversification strategy may create shareholder value through two types of financial economies. Firstly, the efficient internal allocation of capital can reduce risk among the firm's businesses through the development of a portfolio of businesses with different risk profiles. Secondly, the efficient restructuring of acquired assets leads to acquired firms being operated more profitably and therefore becoming more valuable. Relatedly, the corporate head office of a diversified company can more effectively discipline underperforming management teams through resource allocations compared to 'the market' as senior management have access to more internal and up-to-date information.

History and Performance

The nature and underlying approaches to firms' diversification strategies has evolved over time. Goold and Luchs (1993) detail how this evolution has unfolded. In the 1950s and 1960s for example, large diversified conglomerates developed based on the belief that general management skills were transferrable from one business to another. However, the performance of conglomerates was questioned in the 1960s and portfolio management techniques were developed to better allocate scarce resources during the 1970s. This led, in the 1980s, to firms being restructured as it became clear that there were difficulties in effectively managing such diverse firms: core portfolios of businesses were retained, while non-core businesses were divested or closed. The underpinning theme for diversified firms since the 1990s has been to build a more coherent and focused diversified firm using strategic building blocks such as synergy, core competences and even management's dominant logic and style to link and relate the firm's businesses.

While the popularity of highly diversified firms, in particular firms where there is little relatedness has diminished, there is still a question mark over the link between diversification and firm performance and valuation. For example, Hitt *et al* (2009: 176) describes the 'conglomerate discount.' The conglomerate discount is the consequence of market analysts being unable to effectively value a large diversified business with its related complex financial reports. Therefore, instead of determining the firm's 'true value', the marketplace undervalues it. Related, Hill and Jones (2013: 354) refer to the idea that the bureaucratic costs of diversification may in fact exceed the benefits created by the strategy, thus diversification reduces the value of the firm. However, in a study of 180 firms in the Fortune 500, Dihaime *et al* (2012: 235) shows that the market does not necessarily 'punish' or undervalue all diversified firms - see Figure D. In the study, there was a very balanced level of performance and diversification: the level of diversification did not seem to impact on performance to any significant level.

Figure D

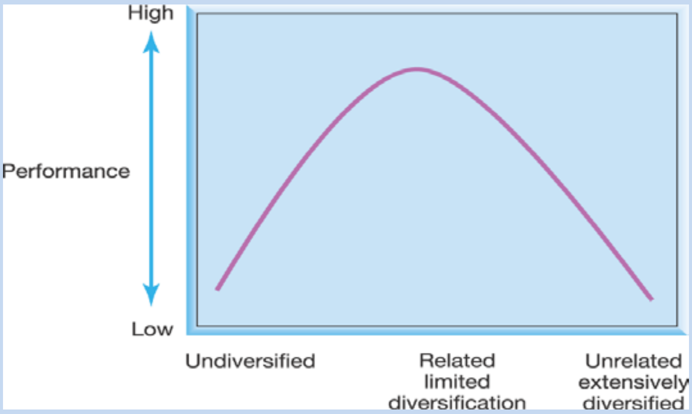
	Low Performing Firms	High Performing Firms
Less Diversified	47	46
More Diversified	46	47

Source: Duhaime *et al*. 2012. *Strategic Thinking: Todays Business Imperative*. New York: Routledge. Page 235.

The most generalisable finding seems to be that the diversification-performance relationship seems to follow an "inverted U" shape (Johnson *et al*, 2005). This is illustrated in Figure E.

The diagram indicates that single business firms and those firms that are widely and unrelatedly diversified, underperform compared to firms that have a limited and related level of diversification. As Johnson *et al* state: "some diversification is good for you"! However, when the performance of Ryanair plc or Berkshire Hathaway Inc is reviewed, it is clear that firms can also be very successful even if they do not fit this profile.

Figure E



Source: Johnson *et al*. 2005. *Exploring Corporate Strategy (7th Edition)*. Harlow: Pearson Education. Page 269.

Conclusion

The senior management of a firm confronts a number of choices about the fundamental structure and scope of the firm. Perhaps the most fundamental decision senior management must make is the choice of which business, or businesses, in which to compete. Many firms, in particular smaller firms, follow a single – or dominant – business strategy. There are clear benefits to this approach. However, there is a significant risk associated with this strategy also: the firm is locked into that one sector and the firm's performance is completely dependent upon the performance of that sector. Many firms, in particular larger ones, therefore diversify into new, alternative business sectors. Again there are several reasons that underpin the strategic logic of the corporate diversification decision. That said however, 'the market' frequently does not understand or value corporate diversification in the same way as the firm's senior management. Ultimately, it seems clear that there is no one appropriate level of corporate diversification: the firm needs to be able to effectively manage and leverage the corporate diversification strategy it has chosen.

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