# Strategic Management

## Undergraduate course in Management

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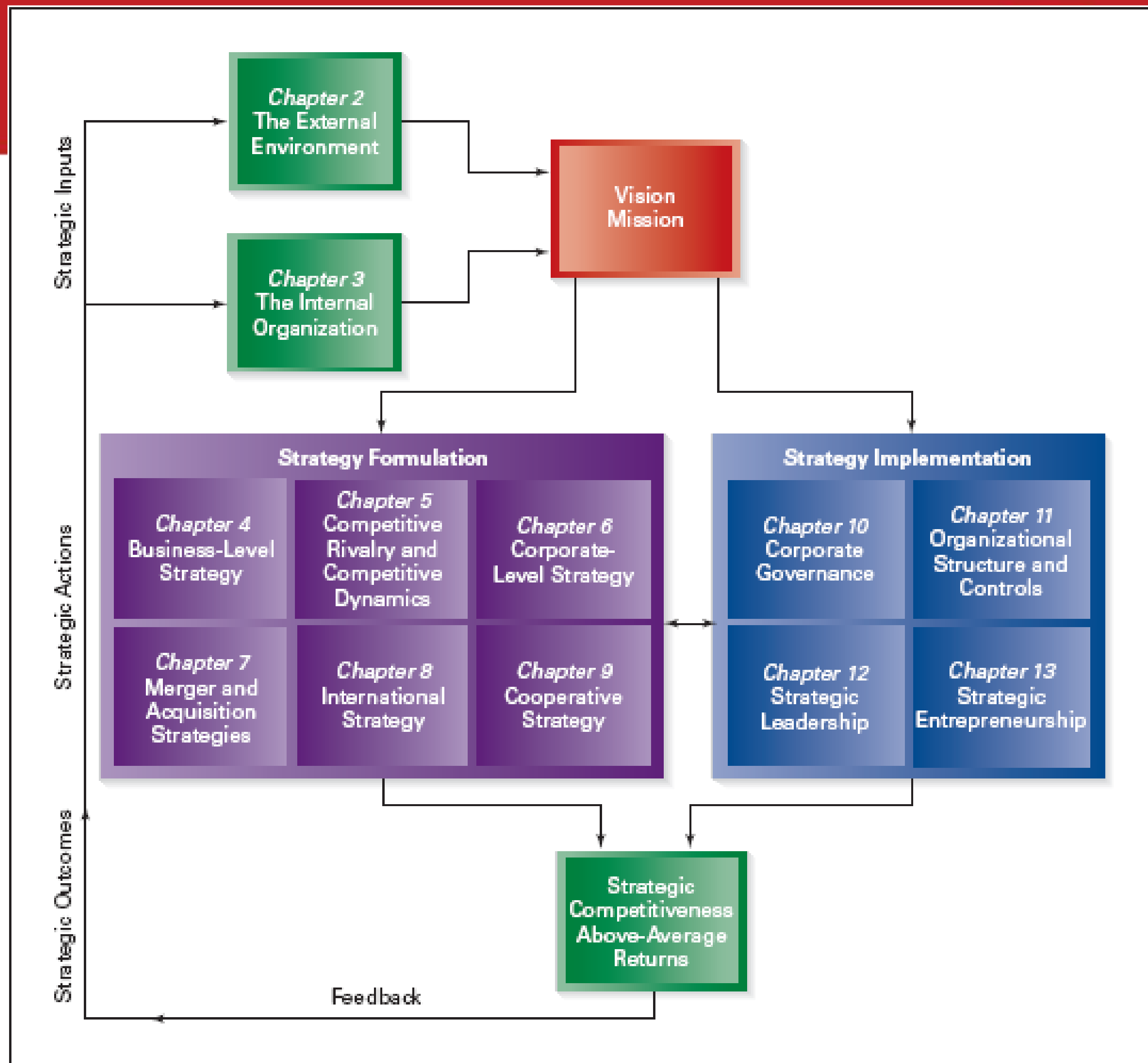
# The Strategic Management Process



## Seven content areas

**Define and discuss corporate-level strategy**

Different levels of diversification

Three primary reasons firms diversify

Value creation: related diversification strategy

Value creation: unrelated diversification strategy

Incentives and resources encouraging value-neutral diversification

Management motives encouraging firm over-diversification

# Introduction

## Corporate-level strategy

Specifies actions a firm takes to gain a competitive advantage by selecting and managing a group of different businesses competing in different product markets

- Expected to help firm earn above-average returns
- Value ultimately determined by degree to which "the businesses in the portfolio are worth more under the management of the company than they would be under any other ownership

## Product diversification (PD) is a primary form of corporate-level strategy

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# Levels of Diversification

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## 1. Low Levels

- Single Business Strategy: Corporate-level strategy in which the firm generates 95% or more of its sales revenue from its core business area

- Dominant Business Diversification Strategy: Corporate-level strategy whereby firm generates 70-95% of total sales revenue within a single business area

# Levels of Diversification

## 2. Moderate to High Levels

- Related Constrained Diversification Strategy
  - Less than 70% of revenue comes from the dominant business
  - Direct links (i.e., share products, technology and distribution linkages) between the firm's businesses

- Related Linked Diversification Strategy (Mixed related and unrelated)
  - Less than 70% of revenue comes from the dominant business
  - Mixed: Linked firms sharing fewer resources and assets among their businesses (compared with related constrained, above), concentrating on the transfer of knowledge and competencies among the businesses

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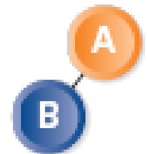
## 3. Very High Levels: Unrelated

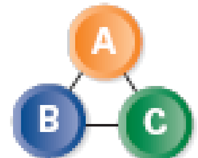
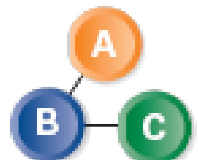
- Less than 70% of revenue comes from dominant business
- No relationships between businesses

# Levels and Types of Diversification

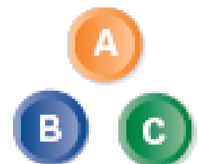
**Low Levels of Diversification**

| | | |
|---|---|---|
| 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. |   |

# Reasons for Diversification

**Value-creating**

- Operational relatedness: sharing activities between businesses
- Corporate relatedness: transferring core competencies into business

**Value-neutral**

**Value-reducing**

# Value-Creating Diversification Strategies: Operational and Corporate Relatedness

| Operational Relatedness: Sharing Activities Between Businesses | | Corporate Relatedness: Low | Corporate Relatedness: High |
|---|---|---|---|
| | High | Related Constrained Diversification | Both Operational and Corporate Relatedness |
| | Low | Unrelated Diversification | Related Linked Diversification |

Corporate Relatedness:
Transferring Core Competencies into Businesses

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# Value-Creating Diversification (VCD): Related Strategies

- Purpose: Gain market power relative to competitors
- Related diversification wants to develop and exploit economies of scope between its businesses
  - Economies of scope: Cost savings firm creates by successfully sharing some of its resources and capabilities or transferring one or more corporate-level core competencies that were developed in one of its businesses to another of its businesses
- VCD: Composed of 'related' diversification strategies including Operational and Corporate relatedness

# Value-Creating Diversification (VCD): Related Strategies

## 1. Operational Relatedness: Sharing activities

- Can gain economies of scope
- Share primary or support activities (in value chain) (this is risky as ties create links between outcomes)
- Related constrained share activities in order to create value
- Not easy, often synergies not realized as planned

# Value-Creating Diversification (VCD): Related Strategies

## 2. Corporate Relatedness: Core competency transfer

- Complex sets of resources and capabilities linking different businesses through managerial and technological knowledge, experience and expertise
- Two sources of value creation: 1) expense incurred in first business and knowledge transfer reduces resource allocation for second business; and 2) intangible resources difficult for competitors to understand and imitate, so immediate competitive advantage over competition
- Use related-linked diversification strategy

# Value-Creating Diversification (VCD): Related Strategies

## Market Power

- Exists when a firm is able to sell its products above the existing competitive level, to reduce costs of primary and support activities below the competitive level, or both.
- Multimarket (or Multipoint) Competition: exists when 2 or more diversified firms simultaneously compete in the same product or geographic markets.
- Related diversification strategy may include:
  - Vertical Integration
  - Virtual integration

# Value-Creating Diversification (VCD): Unrelated Strategies

## Creates value through two types of financial economies

- Cost savings realized through improved allocations of financial resources based on investments inside or outside firm (e.g. efficient internal capital market allocation
- Restructuring of acquired assets: firm A buys firm B and restructures assets so it can operate more profitably, then A sells B for a profit in the external market

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# Value-Neutral Diversification: Incentives and Resources

## Incentives to Diversify

- Antitrust Regulation and Tax Laws
- Low Performance
- Uncertain Future Cash Flows
- Synergy and Firm Risk Reduction
- Resources and Diversification

# The Curvilinear Relationship between Diversification and Performance

Performance

Dominant Business

Related Constrained

Unrelated Business

Level of Diversification

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# Value-Reducing Diversification: Managerial Motives to Diversify

**Top-level executives may diversify in order to reduce their own employment risk, as long as profitability does not suffer excessively**

- Diversification adds benefits to top-level managers but not shareholders
- This strategy may be held in check by governance mechanisms or concerns for one’s reputation

# Summary Model of the Relationship Between Diversification and Firm Performance