Managing Diversification

Introduction

Jindals, the Indian steel group have moved into various new businesses in recent years. After having set up a captive power plant to support their Vijayanagar steel plant in the mid-1990s, the group has been looking at electricity as a separate revenue stream and started supplying power to the Karnataka Power Transmission Corporation through an independent entity, JSW Energy. The Jindals are also expanding their power capacity with the aim of selling surplus power especially when the spot rates are high. The other sectors Jindal is looking seriously at, are cement and aluminium. Jindal is clearly betting on diversification to generate growth.

Should companies concentrate on one business or should they be holding a portfolio of businesses? That is the topic which we will discuss in this article. Concentration enables a company to focus on the business it knows best. Yet, concentration beyond a point is a risky strategy. Indeed, most firms are diversified to some extent. Rare is the firm which is focused only on one business.

Almost 40 years back, Peter Drucker mentioned,[1] "Every business needs a core – an area where it leads. Every business must therefore specialize. But every business must also try to obtain the most from its specialization. It must diversify." Drucker argued that while the central core of a business should decide which businesses it enters, diversification would be needed in an era of fast changing markets and technologies.

Today, the business environment has become much more volatile and dynamic. So, the key issue, more often than not, is not whether to diversify, but when and how to diversify. A related issue is for management to decide when the company is straying too far from the core and get back the focus.

Understanding Diversification

Contrary to general perception, *few businesses can be called completely focused*. It is useful to understand what is diversification and how we can measure diversification. Rumelt has classified firms into four business groups:

- Single business firm: Such a firm generates 95% or more of its revenues from one business.
- Dominant business firm: Such a firm generates 70–95% of its revenues from its principal activity.

[1] Managing for Results, pp. 208-209.

- Related business firm: Such a firm generates less than 70% of revenues from its principal activity but other lines of business are related.
- Conglomerate firm: Such a firm generates less than 70% of its revenues from the principal activity and has other unrelated businesses.

Of course, the key to implementing Rumelt's framework lies in appropriate definition of terms like "business," "principal activity," and "related business." Rather than embracing rigid definitions or using arguments of convenience, managers must interpret these terms in their business context with objectivity and clear logic.

The pros and cons of diversification

We are all aware of the famous saying: "Don't put all your eggs in one basket." When a firm operates in many businesses, the downs in one can be compensated by the ups in another. According to portfolio theory, unsystematic risk, the risk particular to a company or an industry, can be eliminated by building a diversified basket of stocks. In fact, Harry Markowitz, William Sharpe and Merton Miller won the Nobel prize in 1987 for their theory of portfolio diversification. But the debate continues. Is it better for companies to be in many businesses or for investors to maintain a diversified portfolio? For example, as the sub prime crisis has grown in scale and scope, people are asking whether Citigroup, the global financial conglomerate has become too unwieldy to manage. In the case of another global bank, analysts are debating whether investment banking and wealth management can be handled simultaneously by the same organization. Similar questions have been raised about some of the other global financial services firms as well.

A bit of history is in order here to understand how our thinking on diversification has evolved in the past 50 years. In the 1950s, the development of management principles and the professional education of managers led to the belief that general management skills provided the justification for diversification. Diversified companies and conglomerates were seen to add value through the skills of their professional top managers, who applied modern management techniques and generalized approaches to a wide variety of businesses across different industries.

During the late 1960s, however, the performance of many conglomerates weakened, and a new approach to the corporate management of diversity was sought. Portfolio planning techniques helped many companies improve capital allocation across businesses with different strategic positions, and led to the idea of balanced portfolio management. But managing businesses facing different strategic issues, this way, proved fairly complex and challenging.

In the 1980s, many consultants and academicians argued that risk reduction could be better achieved by individual investors. There was no need for companies to diversify as they were not creating shareholder value. They were in favour of diversified businesses being broken into smaller units, each of which could concentrate on the industry and activities it knew best. Poor corporate performance became a critical issue. There was a wave of takeovers, corporate break-ups, and restructuring back to core businesses driven by a resolve to *stick to the knitting*.

Two other themes became associated with diversification - *synergy* and *core competence*. Synergy dealt with the fit between the existing and new businesses. By moving into a new business, could costs be cut or revenues increased? Core competence referred to the bundle of skills and expertise which an organization had developed over time. Diversification seemed to make a lot of sense when the core competencies could be leveraged and extended to manage the new business.

Management gurus also mooted the concept of the *dominant strategic logic* of a portfolio, and its compatibility with the approaches of top management. The core of the argument was that there should be a strategic logic tying all the businesses together.

The businesses in the portfolio had to be worth more under the management of the company in question than they would be under any other ownership. Achieving this goal, might involve restructuring of portfolios to allow more uniformity in dominant logic and management style, more effective means of realizing synergies and more sharing of core competences.

How do we sum up all these arguments? Clearly, even at the risk of sounding bookish, it would be correct to say that diversification is advisable only if it is likely to have a beneficial impact on the existing businesses. Benefits may come in various forms - better distribution, improved company image, defense against competitive threats and improved earnings stability. When entering a new business, the firm must be able to offer a distinct value proposition in the form of lower prices, better quality or more attractive features. Alternatively, it should have discovered a new niche or found a way to market the product in an innovative way. Jumping into a new business just because it is growing fast or current profitability is high, is a risk that is best avoided. Indeed, opportunistic diversification has been the main reason for the downfall of several Indian entrepreneurs in various businesses including financial services, granite, aquaculture and floriculture.

Related and unrelated diversification

Drucker once mentioned: "A company should either be diversified in products, markets and end-uses and highly concentrated in its basic knowledge area; or it should be diversified in its knowledge areas and highly concentrated in its products, markets and end-uses. Anything in between is likely to be unsatisfactory[2]." This can be a useful starting point in differentiating between related and unrelated diversification.

But before we pass judgment on what is related and what is unrelated diversification, it is good to remember that the dividing line between core and non-core activities, related and unrelated businesses is tenuous. Consider Microsoft. Starting with operating systems, it diversified into applications software. In recent times, it has moved aggressively into businesses such as enterprise software, web hosting and management services and video games. Today, the Internet is becoming increasingly central to Microsoft's business model. In short, while software may be the common thread running through these activities, the technical and management capabilities required to manage these different business activities are obviously diverse and the markets are quite different. Yet, Microsoft sees entry into these new businesses as a means of maintaining growth and profitability.

Similarly, the highly successful Silicon Valley company, Cisco has one of the broadest portfolios in the data networking business. Cisco is far less dependent on the fortunes of any single technology than its competitors. Google started off as an internet search engine. But today it offers a wide range of services including email, desktop search, etc.

Take India's own Network 18 promoted by Raghav Bahl, formerly an anchor with the state controlled Doordarshan in the late 1980s. In three years, Bahl has taken his group from a single channel operation, CNBC TV 18 with turnover of Rs. 15 crores to a Rs. 1000 crore media group that includes news, music entertainment channels, finance websites, newswires, print publications, a tele shopping venture and a film company. As Business World put it, "Networks 18 has become India's most diversified and "converged" media company. It is one of the few companies that has been successful in monetizing its real time news content by making it available across television, the wire and the Internet." Responding to investor concerns about lack of focus, CEO Haresh Chawla has

2 Managing for Results, pp. 208-209.

mentioned" We are in the business of creating ecosystems through a network of media properties. We will move in whatever direction that takes us."

Pros & cons of Diversification

Pros

Economies of scale and scope

- Operational synergies can be realized.
- Spreading the firm's unutilised organizational resources to other areas can create value.
- Leveraging skills across businesses can create value.

Transaction costs

- Coordination among independent firms may involve higher transaction costs.

Internal capital market

- Cash from some businesses can be used to make profitable investments.
- External finance may be more costly due to transaction costs, monitoring costs, etc.

Diversifying shareholders' portfolios

- Individual shareholders may benefit from investing in a diversified portfolio.

Identifying undervalued firms

- Shareholders may benefit from diversification if its managers are able to identify undervalued firms

Cons

- Combining two businesses in a single firm is likely to result in substantial influence costs.
- Resource allocation can be influenced by lobbying.
- Costly control systems may be needed that reward managers based on division profits
- Internal capital markets may not work well in practice.
- Shareholders can diversify their own personal portfolios
- Identifying undervalued firms may not be as easy as it sounds.

The risks associated with entering a new related business should be weighed against the opportunities it provides. Indeed, some companies have missed great opportunities by not embracing a new business. A good example is AT&T, which refused an offer from the National Science Foundation (NSF) of the US to transfer its internet operations at no cost. AT&T thought the Internet was an inferior technology with an insignificant role to play in telephony. AT&T effectively gave up a golden opportunity to build a business that could have operated across the value chain, combining the operations of a telecom company, Internet service provider and switching equipment manufacturer.

Does unrelated diversification pay off?

There are some examples of successful unrelated diversification. Wipro is a good example. When the young Azim Premji took charge of the group after the untimely demise of his father, Wipro was essentially involved in the vegetable oils business. Premji had the vision to take Wipro into new unrelated businesses including computer hardware, lighting soaps, medical equipment and computer software.

GE is probably the best known example of a successful conglomerate diversification. GE's financial services business, is as different as one can imagine from its traditional engineering businesses. GE's businesses, range from medical devices to aircraft engines. Its diversified portfolio has lent a degree of stability to earnings, which may not have been possible had it focused on one single industry. Few large companies have been able to match GE's ability to maximise value for shareholders.

While taking heart from the success of Wipro and GE, the dangers of unrelated diversification should not be underestimated. A good example, though a little dated, is Metal Box (India) Ltd, the metal packaging company which diversified into bearings. This move destroyed the company. Similarly, Zapmail cost Federal Express $600 million before the new fax service was withdrawn. Polaroid lost heavily (about $200 million) when it diversified into instant movies. And we have seen earlier how opportunistic diversification led to the downfall of many Indian entrepreneurs in the 1990s.

Identifying Adjacencies

Traditional management literature has divided diversification into two categories: Related & Unrelated. But this kind of categorization is too broad and sweeping. Moreover, it provides few clues for how to go about identifying and developing new businesses. Management consultant and writer, Chris Zook[3], argues that the most sustained, profitable growth comes when a company pushes out the boundaries of its core business into an adjacent space. Zook calls these new businesses, *adjacencies*.

Companies can move into adjacencies in various ways:

- *Expand along the value chain*. A company may move from manufacturing into retailing. This is what many oil companies have been doing in recent years.
- *Grow new products and services*. IBM moved into global services, which now constitutes 50% of the company's revenue and pretax profits. Indian IT services companies are trying to enter management consulting in a big way. Jain Irrigation

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Systems[4], the world's second largest drip irrigation company has moved into piping systems, plastic sheets and more recently food processing. The group is also planning to supply clean drinking water to households. Alternative energy is another area the group is looking at seriously.

- *Use new distribution channels*. Barnes & Noble, traditionally a brick-and-mortar store has been attempting to increase its online retailing presence. Dell, too has leveraged the Internet to strengthen its distributions capabilities.
- *Enter new geographies*. Vodafone expanded from the UK to Europe, the United States, Germany, and Japan. Same is the case with many Indian IT services companies. Tesco, the UK retailer is seriously looking at the US.
- *Address new customer segments, often by modifying a proven product or technology*. Charles Schwab expanded its advisory services for discount brokerage customers to target high-net worth individuals.
- *Move into the "white space" with a new business built around a strong capability*. American Airlines created the Sabre reservation system, a spin-off now worth more than the airline itself. Sabre, in turn, went on to create a new business adjacency of its own in the online travel agent Travelocity. Harvard Business School has a strong publishing division which generates a significant portion of the revenues of the world's most well known business school.
- *Applying a superior business model to new segments*. Dell has repeatedly adapted its direct-to-customer model to new customer segments and new product categories.
- *Developing hybrid approaches*. Nike, has expanded into adjacent customer segments, introduced new products, developed new distribution channels, and then moved into adjacent geographic markets.

Many companies prematurely abandon their core and do not exploit it enough. They chase some hot market or new idea, only to falter. But no core endures forever. Companies tend to misjudge the point their core business has reached in its life cycle and whether it is time to stay focused, expand, or move on.

How does a company know when the core needs to change in some fundamental way? And how does the company determine what the new core should be? Zook mentions that a new core may make sense for three reasons.

The first has to do with *profits.* When the profitability of a business is in secular decline, a new core makes sense. Apple's share of the market for personal computers plummeted and profitability steadily declined. So Apple moved its business toward

[4] Krishna Gopalan, "The winner that came in from the cold," Business Today, April 6, 2008, pp. 60-64.

digital music. General Dynamics was in a similar situation in the 1990s, when defense spending declined sharply. The company sold off many of its units and redefined itself around just three core businesses where it held a competitive advantage: submarines, electronics, and information systems.

The second reason is inherently *inferior economics.* This becomes more apparent when a new competitor enters with a different cost structure. General Motors saw this in competition with Toyota, just as Compaq (now a part of Hewlett Packard) did with Dell. Other well-known examples include Kmart (vis-à-vis Wal-Mart) and Xerox (vis-à-vis Canon).

The third reason for moving into a new core is an *unsustainable growth formula*. The market may be reaching saturation or competitors may have started to replicate a once unique source of differentiation. A company that has prospered by simply reproducing its business model may have limited scope for further geographic expansion. In all such circumstances, a new formula for growth depends on finding a new core.

The companies which successfully pursue adjacencies seem to apply rigorous screens before they make an adjacency move. This discipline pays off in the form of learning-curve benefits, increased speed, and lower complexity. Such companies also develop their repeatable formulas by studying the needs and economics of their customers carefully.

Developing a new core

When the core business is under severe threat, some companies go into denial and decide to defend the status quo. Others try to transform their companies all at once through a big merger or by leaping into a hot new market. Such strategies are inordinately risky. In contrast, the most successful companies proceed more systematically. A few examples will illustrate the point.

Consider the Swedish company Dometic[5], which in the 1920s, applied absorption technology to refrigeration. Whereas most household refrigerators used compressors driven by electric motors, Dometic used the absorption technology with no moving parts and no need for electricity. Only a source of heat, was required. The new technology was particularly useful in places like boats and recreational vehicles (RV), where electric current was hard to come by.

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[5] Based on the article by Chris Zook

In 1925, AB Electrolux acquired the patent rights. The division responsible for absorption refrigerators later became the independent Dometic Group. By 1973, Dometic was still a small company and losing money. Then the company moved aggressively into the hotel minibar market, where the absorption refrigerator's silent operation had a real advantage over conventional technology. Instead of merely selling more refrigerators to the RV segment, (The company's market share within that segment was already nearly 100%). Dometic started to offer other products, such as air-conditioning, generators, and systems for cooking, lighting, sanitation, and water purification. As a result, the company's core shifted far beyond absorption refrigeration.

By selling all its products through the same dealers and installers, Dometic also gained formidable channel power and improved its cost structure dramatically. By 2005, Dometic's sales had grown to roughly $1.2 billion. No longer part of Electrolux (the private equity firm EQT bought it in 2001 and sold it to the investment firm BC Partners a few years later), the company was highly profitable and commanded 75% of the world market share for RV interior systems.

American Can is an example of a business which completely reinvented itself to cope with threats in the environment and limited growth opportunities in existing businesses. The company moved away from can manufacturing into financial services. American Can initially manufactured cans/containers for the beverage industry. In an industry which used a simple technology, commoditization and intensifying competition were inevitable. Forward integration by aluminum producers and backward integration by food companies eroded the company's ability to raise prices. Plastics emerged as an important substitute. American Can diversified into paper, musical records retailing and direct mail marketing. In 1980, it started to refocus and entered the financial services business in a big way through acquisitions. The can business was sold off. In 1987, the company changed its name to Primerica. In 1997, it acquired Salomon for $9.2 billion. About a year later, it merged with Citicorp.

Barrick[6], the world's biggest gold mining firm today was originally not involved in the gold business. Barrick's founder, Peter Munk ran a television manufacturing business, then a hotel business and later on a property business. Subsequently he moved into oil and gas and finally gold mining. But Munk's moves into gold were calculated and well thought out. Based in Canada, he saw that the country had a pool of mineral deposits, readily available capital and talented engineers. Munk was also determined to modernize mines and improve productivity. Munk decided to grow by acquisitions. The

[6] "Jolly gold giant," The Economist, April 19, 2008, p. 76.

purchase of Canada's PlacerDome for $10 billion in 2006 made Barrick the world's biggest gold miner.

A good example of an Indian company attempting to diversify and develop a new core is ITC. Though it is a subsidiary of the UK based BAT, ITC has operated with considerable autonomy. Among the businesses which ITC has entered in recent years are apparel retailing and branding, ready-to-eat packaged foods, confectionery items, infotech, paper and boards. Earlier ITC had set up the Welcome Group hotel chain.

Over the years, the cigarette business has been quite profitable for ITC. ITC has retired much of its debt taking full advantage of its healthy cash flows. But it still has a lot of cash that can be invested to generate faster growth. Moreover, there are major question marks about the cigarette business, as public opinion continues to swell against smoking. In late 2001, the Indian Supreme court banned smoking in public places and public transport. The ITC share fell by 10% on the NSE as soon as the judgement was made. All these reasons prompted the company to take a serious look at new businesses.

Can ITC successfully manage this wide portfolio of businesses? The company is confident that it can use its existing skills and competencies to manage new businesses. In the lifestyle retailing business, ITC feels its strong branding capabilities backed by good quality will help it to stay ahead of competition. On the other hand, in the foods business, ITC's strong distribution capabilities may be a useful asset. ITC hopes to take full advantage of its formidable expertise in distribution and the Wills brand name. Similarly, the company hopes to leverage the paper division's capabilities in manufacturing high quality paper for the greeting cards business. ITC is also counting on its brand management expertise as it moves into businesses like confectionery.

ITC has been using its agri sourcing network to source raw materials for its biscuits and atta businesses. It has used the e choupal network to distribute products in areas where channels do not exist. ITC Hotels has tapped the expertise of its master chefs to help the foods division create 16 distinct taste platforms for Bingo and a number of other branded packaged foods.

Making diversification work

How does a company effectively manage a portfolio of businesses? Under what circumstances does diversification work? Milton Lauenstein[7] has an interesting

[7] Sloan Management Review, Fall 1985.

explanation for the success of some diversified companies. He argues that in well-managed conglomerates, the mediocre performance of unit managers is not tolerated. On the other hand, in focused firms, the CEO, who is effectively the business manager, is rarely sacked unless the performance is disastrous. Moreover, well managed conglomerates tend to have a corporate staff who go through the annual budgets and long range plans of the operating units with a microscope. In contrast, directors of a focused company often do not spend enough time, going into details. As he puts it: "When conglomerates succeed, it is not because of their strengths. It is in spite of their weaknesses. The hidden reason why diversification can work and often does, lies in the operation of the system of governance of independent corporations. Boards of directors are not prepared to improve performance standards in a manner comparable to that required by a corporate management." If a conglomerate selects able unit managers, energises them with a strong corporate purpose, monitors their progress and provides guidance and support when needed, it can outperform the boards of many independent companies.

But the dividing line between governance and bureaucratic interference from the top can be very thin. As Lauenstein puts it: "If it begins trying to coordinate the activities of various units, it will be drawn into operating management functions. The corporate office will expand and begin making decisions which would be better made by executives in operating units." Lauenstein also points out that in focused firms, the top management's role must be to understand the industry, make the key operating decisions and run the business. In a conglomerate on the other hand, the top management must govern, not run operations. Its focus must be on selecting, motivating and mentoring the general managers of individual units.

This is exactly what GE, the most successful large diversified company in corporate history, did under the leadership of Jack Welch and now seems to be doing under his successor Jeffrey Immelt. Welch killed bureaucracy, encouraged innovation and selected extraordinarily talented managers to manage each of the diverse businesses. Welch was also ruthless with non-performers. Immelt has also been quite successful in holding GE's disparate business units together. Like Welch, Immelt too has divested some unpromising businesses.

In India, the mild mannered and impeccably behaved legendary businessman, JRD Tata successfully built a portfolio of diverse businesses, even though his management style was quite different from that of Welch. But Tata had the extraordinary knack of selecting some truly outstanding managers to run the different companies. He kept

Russi Mody at Tata Steel, Sumant Mulgaonkar at Telco, Darbari Seth at Tata Chemicals and Ajit Kerkar at India Hotels. Some of these managers like Russi Modi had a higher profile than JRD himself. But the visionary Tata did not have any problems in providing space to these gifted managers. Azim Premji, the widely admired Chairman of Wipro has attempted to do this on a smaller scale in his business group.

Conclusion

Several research studies have been done on the impact of diversification on financial performance. The relationship between performance and diversification is still not clear. Firms with highly specialised resources to diversify seem to achieve superior results compared to firms that use unspecialised resources, such as cash or general management capabilities. But what is related and what is not, what is a specialized resource and what is not, is always a matter of debate and often better understood in hindsight. One problem affecting research studies is the assumption that different types of relatedness have an equal impact on firm performance. Valuation studies show that shares of diversified firms trade at a discount relative to those of their undiversified counterparts. But part of the diversification discount can be explained by the fact that firms that elect to combine appear to be those whose shares traded at discounts even before the combination. Diversified firms with shares trading at large discounts are also more likely to be taken over.

In short, firms that diversify to exploit existing specialized core resources and focus on integrating old and new businesses, tend to outperform firms that make use of general resources and do not leverage interrelationships among their units. Successful diversification involves exploiting economies of scope that make it efficient to organize diverse businesses within a single firm, relative to joint ventures, contracts, alliances or other governance mechanisms.

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