Notes on Topic #5: Corporate Strategy

In Topic #4, we talked about business strategy – how to compete head-to-head in an industry via competitive positioning. The goal of business strategy is to get a competitive advantage, which translates to above-average performance over peers.

Multi-business companies such as Disney and Procter & Gamble (P&G) have to ensure that every business in their portfolio has a viable business strategy to get a competitive advantage. For example, Disney's theme parks business has to position itself in the industry to get a competitive advantage over rivals such as Universal Studios and Sea World. But both Disney and P&G have to also ensure that they have the right portfolio of businesses to begin with. In short, they have to address their corporate strategy.

The notion of "***corporate advantage***" (also referred to as the "parenting advantage") is important here. Think of it this way: in 2017, Disney reported that its corporate expenses was $582 million. This means that the cost to Disney of running its corporate office (salaries of employees, utilities, travel, etc.) and managing its portfolio of businesses is quite a sizeable amount. This cost has to be less than the benefits that Disney's various businesses get from being owned by a common parent, as otherwise there wouldn't a financial reason for one company owning a portfolio. Corporate advantage is the benefit that arises from such a structure that is significantly greater than the cost of owning the portfolio. Corporate strategy relates to how such an advantage can be obtained.

A single-business company acquires a portfolio of businesses (if it chooses to do so) via a process called ***diversification***. When a company diversifies, it expands beyond its core (aka its single business) into other industries. When it does this repeatedly, it acquires a portfolio and, following this, is structured with a corporate office running its business portfolio.

Richard Rumelt, a strategy scholar, viewed diversification as a function of a single factor: a company's source of revenue. According to him, a ***single-business*** company was one that got 95 percent or more of its revenues from a single line of business. For example, McDonald's gets 100% of its revenues either as franchise fees or from company owned fast food restaurants and so is a single-business company. In contrast, a ***dominant business*** is one that gets 70 percent or more of its total revenues from one business and the rest from other businesses. Harley-Davidson gets 80% of its total revenues from selling motor cycles and about 20% from licensing the Harley logo.

Neither a single-business company nor a dominant business company is classified a diversified company. The idea here is that both these two are either completely or almost completely dependent on a single line of business.

To Rumelt, a diversified firm is one that has a portfolio of businesses and no one business in the portfolio accounts for 70 percent or more of total revenues. For example, the breakdown for Disney in 2017 was as follows:

- Media Networks 43% of total revenues
- Parks & Resorts 33%
- Studio Entertainment 15%
- Consumer Products and Interactive Media 9%

Per Rumelt's classification, since none of Disney's four businesses accounts for 70 percent of total revenues, it is a diversified firm.

Types of Diversification

Once a firm decides to diversify and build a portfolio of businesses, the key question is the form of the portfolio. Should the businesses in the portfolio be all in related industries so that they can benefit from sharing common resources? If the answer to the question is a "yes," then the diversification path that the firm chooses is called "related" diversification. Looking at Disney's portfolio above, the four businesses are in the entertainment industry and there are plenty of avenues for sharing resources: the Disney brand name can be used across these businesses as also the creative talent and the creative output of this talent. For example, the studio entertainment business produces and releases *Moana* (that can be advertised in a cost effective way via Disney's television business), the toys can be sold by the consumer products division, and the *Moana* character can be used to create theme park attractions in the parks and resorts unit.

In contrast, a firm may choose to have an unrelated portfolio, or follow a path of unrelated diversification. For example, Berkshire Hathaway (the company controlled by the famed investor, Warren Buffet) has a portfolio that consists of businesses like Fruit of the Loom (undergarments), Geico (insurance), See's Candies (confectionery), and Tupperware (storage products). None of these businesses can and do share any common resources; in fact, Berkshire Hathaway runs them as independent businesses answerable only to the corporate office. An unrelated diversified firm like Berkshire Hathaway is called a "***conglomerate***."

The Economic Logic of Conglomerates

Remember the earlier discussion about corporate advantage and the cost versus benefits of owning a portfolio? So, what is the economic rationale for a conglomerate? One economic rationale is to keep the cost of running the corporate office really low so that the economic benefits from the portfolio businesses (via, say, more efficient capital allocation) is maximized. Of the 377,000 employees of Berkshire Hathaway, only 26 work in the corporate office in Omaha, Nebraska. The cost of running the company's corporate office is really, really low. The benefits for the company comes from efficiently allocating capital to portfolio companies, managing them with clear performance expectations, and using the surplus cash produced by these businesses to make lucrative investments. In general, conglomerates make the argument for their unrelated portfolio as:

1. More efficient capital allocation: because the corporate office of a conglomerate has complete information (more than what investors have about their investments in, say, a bunch of single-business companies) about each of their businesses, they argue that they are better able to allocate capital among their business and, hence, run them more efficiently.
2. Risk reduction for investors: an unrelated portfolio has the benefit of businesses being dissimilar and so are unlikely to be affected by the same external trends (for example, in the case of Berkshire Hathaway, the sales of undergarments may not be affected by the same external trends that may adversely impact the sales of confectionery). Their argument is that investors are better off investing in a conglomerate because they are reducing their risk of their investment being adversely affected by the same external trends.
3. Ability to pick undervalued businesses to include in their portfolio. In short, conglomerates are saying that their expertise is in the old stock market adage, "buy low, sell high." Their argument is that they are good at spotting undervalued businesses and buying them at a low price. Once under their management, they add value to these businesses by providing them capital to grow and efficient managers to run the business.

In spite of the above advantages claimed by conglomerates, historically, most conglomerates do poorly. The everyday difficulties of running vastly different businesses and the constant battle between corporate costs and the putative benefits of their portfolio seem to weigh conglomerates and show in their performance. Most importantly, conglomerates seem to have difficulty in clearly conveying to Wall Street the benefits of their unrelated portfolio [https://www.aol.com/2013/04/11/loews-corporation-takes-whimsical-approach-to-comm/ is an article that looks at how Loews Corporation went to extreme lengths to avoid the conglomerate discount]. Needless to say, with exceptions (such as Berkshire Hathaway), conglomerates are generally penalized by Wall Street analysts. Conglomerates are typically hit with the "***conglomerate discount***," a term that denotes that a conglomerate is less than the sum of its parts. For example, Trian, a hedge fund, argued that PepsiCo was a conglomerate (they made the case, arguable of course, that beverages and snack foods are unrelated) and that its break up price was about $140 a share and that PepsiCo's stock price (in late December 2018 it was around $110 a share) reflected a $30 conglomerate discount. Conglomerates have to respond to this penalty as otherwise they would not be able to attract investors.

The Economic Logic of Related Diversification

Related diversified firms make the opposite case for their portfolio: that the sum is greater than the total of their parts. This is because of what is referred to as the "***synergy premium***," which is the opposite of the "conglomerate discount." So, how does this synergy premium occur? The following are common ways:

1. Increased market power: P&G has a portfolio of brands in seemingly unrelated businesses such as personal care (soaps and shampoos), laundry detergents, and over-the-counter pharmaceuticals (Pepto Bismol, Metamucil). However, there is synergy among them because they are all sold through the same channels. P&G gets significant market power in negotiating shelf space with retailers because they own a number of "must have" powerful brands. Each of these businesses would not have the same market power if they were separate and independent businesses.
2. Economies of scope: when various businesses share the cost of a common activity (such as, say, warehousing for P&G), each business benefits from lower costs. This increases the benefits of common ownership.
3. Leveraging competencies across businesses: because the businesses are similar in a related diversified firm, expertise identified in one business can be used to strengthen other businesses in the portfolio.

Managing a Diversified Portfolio

A key role that the corporate office plays in a diversified firm is capital allocation. As proposals for capital expenditure (commonly referred to as "capex") come periodically from the businesses to the corporate office, it becomes hard for the corporate office to allocate scarce capital in a way that benefits the entire portfolio. As a portfolio gets larger and more diverse, the corporate office may get the feeling of losing control over its portfolio businesses.

To address this issue of capital allocation, in the 1960s, the Boston Consulting Group developed the growth/share matrix. The matrix is shown below.

The matrix uses 2 factors: market growth rate for each business in the portfolio (this factor is a proxy for how much cash is needed to be invested in the business on a continuous basis; the higher the growth, the more cash it needs) AND relative market share of each business in the portfolio (a proxy for how much cash is generated by the business; the higher the market share, the more cash it generates).

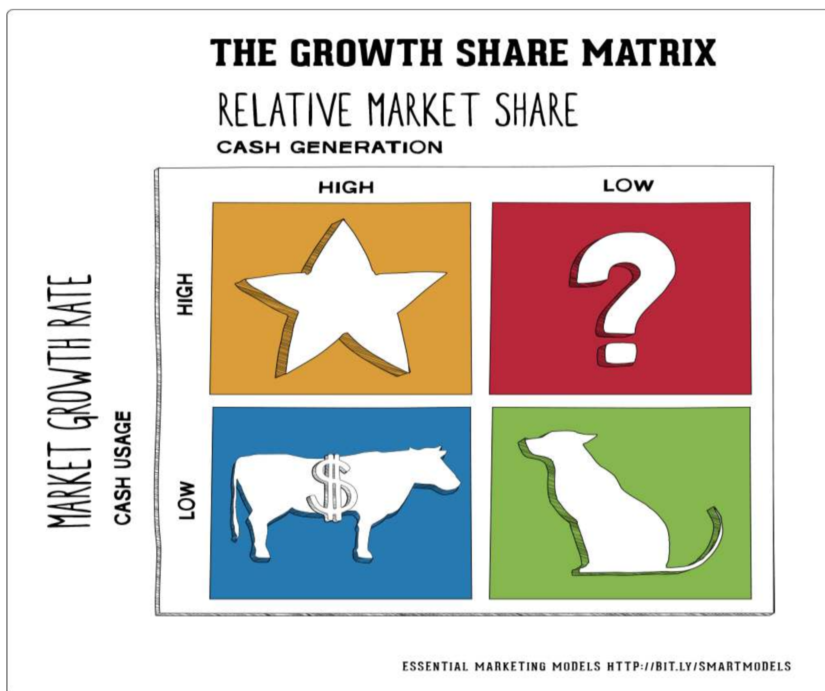
A high/high business is called a "***star***." Stars generate a lot of cash AND require a lot of cash for reinvestment to maintain their position. Stars are net cash users.

A business that is low in relative market share and high in growth rate is a "***question mark***." They don't generate a lot of cash but need reinvestment because they are in high growth markets. Like the stars, question marks are also net cash users.

A "***cash cow***" is a business with a high relative market share in a low growth market. They produce a lot of cash and since they don't require much reinvestment, they are net cash producers.

A "***dog***" is a business with low relative market share in a low growth business. They are typically cash neutral, in that they produce a small amount of excess cash but don't need a lot of reinvestment.

The matrix makes the job of a corporate office simple. Capex proposals from stars are generally approved (as long as they have a positive net present value), while proposals from cash cows are generally rejected unless they are absolutely necessary to maintain the cash cow's dominant position. Proposals from question marks are carefully considered with the long-term idea that some of them may have to be divested. Proposals from dogs are generally rejected; in fact, such businesses are typically divested to provide capital for the other businesses in the portfolio.



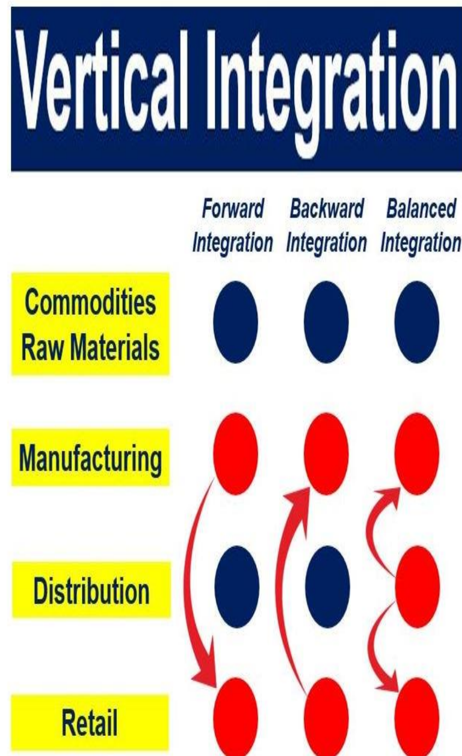
While the growth/share matrix makes the capital allocation processes seemingly simple, it suffers from a fundamental shortcoming: it assumes that each business in a portfolio is independent of the others and so, divesting one does not affect the others. While this assumption is true in conglomerates, it is not valid in the case of a related diversified firm. Treating each business as independent goes against the synergy principle in such firms.

VERTICAL INTEGRATION

A second topic in corporate strategy (the first being diversification) involves ***vertical integration***: what parts of an industry's value chain should a firm compete? In other words, where should a firm draw its

boundaries? When Apple, a device designer and seller, opened its own Apple stores, it vertically integrated into retailing. In short, it expanded its boundaries to now include retailing.

The picture below captures the concept of vertical integration graphically:



The opposite of vertical integration (where a firm performs an activity inside its own boundaries) is sourcing the activity/product/service from the market. This decision is commonly posed as the "make or buy" decision? Should we make it in house or buy it from the market?

The way to approach the make or buy decision was often thought as being dependent on ***transaction costs***. Each decision to transact something from the market involves costs. Take, as an example, General Motors' decision to buy paint for its automobiles. To source this from the market, the following costs are involved:

- Search costs – the costs of searching for paint suppliers, getting details on their capacity, product offerings, prices, and delivery terms
- Evaluation costs – the costs of evaluating the offerings from a number of paint suppliers
- Monitoring costs – the costs of monitoring the selected paint vendor to ensure that the vendor adheres to terms agreed upon

The argument is that, if the transaction costs are high, then vertically integrating into that activity is the way forward. The problem with this approach is that it assumes that the only option to vertical integration is spot market buying – going through the buying process from scratch each time something has to be bought. But in looking at the GM paint option, what if GM goes through the search process once, identifies, say, two or three paint sellers and enters into a long-term contract with them? This way, the transaction costs are significantly minimized (GM still has to monitor the supplier to ensure that the supplier is sticking to the contract terms) and therefore, sourcing from the market is the better option.

The other problem with using just transaction costs to make the decision is that it disregards the importance of skills/resources that suppliers may possess. GM may not have the resources/skills to make high quality paints efficiently. Specialist paint manufacturers, by focusing on the paint industry, may be able to produce better quality paint at a lower price than GM can.

In general, the decision whether or not to vertically integrate rests on the following 3 C's:

- Capabilities – do you have the capabilities to perform this activity better than the market?
- Coordination – how important is coordinating sequential activities? Can these activities (such as news gathering and printing for a daily newspaper) be coordinated best if they are owned rather than transacted via the market?
- Control – how important is control of an activity for product quality or as a barrier to entry for competition?

The table below provides an overview of the pros and cons of vertical integration:

Advantages and Disadvantages of Vertical Integration

- Internal Benefits
  - Integration economies can eliminate steps, reduce duplication and cut costs
  - Improved coordination reduces inventorying and other costs
  - Avoids time-consuming tasks, such as price shopping, communicating design details and negotiating contracts
- Internal Costs
  - Need for overhead to coordinate vertical integration
  - Burden of excess capacity if not all output is used
  - Poorly organized firms do not enjoy enough synergy to compensate for the higher costs

KEY CONCEPTS

- Corporate advantage
- Diversification
- Single-business
- Dominant business
- Conglomerate
- Conglomerate discount
- Synergy premium
- Star
- Question mark
- Cash cow
- Dog
- Vertical integration
- Transaction cost

NOTE

This topic – corporate strategy – is not applicable to the semester-long simulation. Since the simulation involves managing a single-business (sensors) company, you are not asked to make corporate strategy decisions. However, we cover this topic as part of the MGMT 495 capstone course since corporate strategy is relevant to multi-business firms.