

The related diversification in a business



Since the pioneering study of Rumelt (1947) an extensive research has focused on the effects of diversification on firm performance. Two types of diversification are generally selected by then firms. Variables of investigation like firm size, industry performance and their effects on performance are not controlled. Typical studies always focus upon that how a firm diversifies? Managers take strategic decisions about product/industry diversification and always choose the appropriate strategies. Current study reveals that much diversification has reduced the risk leading to a better performance. More diversification need not to improve the performance of firms. It can be argued that current thinking encourages the broad diversification which is warranted, suggesting that unrelated diversification selection has poorer managers on average.

In this paper we examine an alternative explanation of the difference between the two types of the diversifications across the different firms impacting on their performances. Porter's thinking on corporate strategies is focused on the diversification and its effects on the firms. Hamel and Prahalad advocate the diversified corporations must be not looked only the portfolio of discrete business but a collection of important competencies used in market for different products.

Literature on diversification and performance represents the sustainable work in the business strategy. Rumelt's (1947) has tested the hypothesis that companies adopting the strategy other than related diversification has not performed well. Another avenue taken in the efforts marks linear versus non-linear structure of diversification-modeling relationship (Palich, Cardinal and Miller, 2000). Three main important perspectives are identified by the

Montgomery (1994) which helps to know that why a firm selects to diversify: market power, resource based view and agency theory. Agency theory says that diversification is due to the managerial interests at the expense of stakeholders. Managers seek the diversification because they want to increase the compensation and also provide the ways to make the firms more secure and also reduce the dangers of their personal investment portfolio. Diversified firms are more consolidated and form the organizing of economic activities in more effective ways (Penrose, 1959). Market power is third theoretical perspective from which corporate diversification is motivated.

Why the Firms Diversify?

Firms exist due to their products and managers maximize the profits. An entity called Marshall's "representative firm" has resemblance with the real business firms and more than one products are integrated. Business transactions are key role player which determine distribution of the firm's activities in industries.

Related Diversification

It is claimed that multi-business firms having the same business portfolios may get advantages which non-diversifies business firms cannot achieve. This raises the two main questions. Firstly the kinds of similarity and secondly the circumstances under which similar business portfolios give the efficient advantages. It is seen that relevant similarities imply the resources substitution and complement the resources in other company. First we look the situation in which involving resources substitute across the industries. Teece (1980, 1982) has pointed out that there exist such indivisibilities

which explain the joint production but did not explain that why joint production is organized in a single firm. In case when the excess capacity is created and traded in well established markets, then single firm and unrelated diversifier have opportunity to sell out their excess products. They can also buy the products according to their capacity from other companies. Two separate companies can contact each other to share the input facilities. Joint production may have fewer benefits as compared to the dangers which are greater in numbers and their impacts. Firm integration depends upon the comparative benefits of contacting and costs.

Only the resource substitutability is not the source of efficiency gains but it also needed the resource complementarily (Teece, Rumelt, Dosi, & Winter, 1994). The process of complementary increases as the investment in another company is increased. Also the resource use in one industry affects the resource use in another industry. These qualitative and quantitative coordination problems are well controlled by the diversified firms (Richardson, 1972; Milgrom & Roberts, 1992). All kinds of supply chain use the process of complementarities but only a few are integrated.

Diversification exploits the complementarities only when specialized firms are prevented by the transaction costs to recognize the benefits of contacts. Complementary products are also main type of the relatedness. The products of every company are used with the conjunction of other complementary products of same company or another company. For example computers are used with software, cars are purchased with loans, and electronic equipments are purchased with other accessories; hence

these strategic practices concerning the complements are distinguished (Porter, 1985).

Unrelated Diversification

So for the arguments presented mainly focus upon the decisions which exploit the valuable resources across the industries. A prediction that related diversification should outperform the unrelated diversification or conglomerate diversification exists in the literature about the diversification. In US the conglomerates that arose during 1960s did not disappear from corporate scene. As the Rumelt (1982) has reported that number of "single business" firms decreased very rapidly during the 1950s which resulted in increase the "unrelated business" firms. However the major US companies continued to be diversified during the 1990s. Montgomery (1994) reported that from 1985 to 1992 more than two third of 500 Fortune companies were interested in five distinct business lines.

Companies having slow growth industry need to use the excess cash to initiate the diversifying. Business firms can leverage their core using the best strategy. But unrelated businesses only need the diversification when attractive profit prospects are offered by the related business opportunities. Joint venture is logically possible with other organizations into areas of business. Strategic sense makes a sizeable profit in companies adopting the diversification. A strong company with slow-growth industry needs to curtail the new investment in present facilities.

A concept about the diversification is the strategic fit in the field of strategic management. This concept also implies that when the weaknesses and

strengths of companies are realized and top management begins considering the need of diversification through the process of acquisition. The purpose of this model is not only acquiring through the diversification but also identifying the strengths which are transferable into other markets. This model is useful for the firms with distinctive capabilities entering into new market through the acquisition (Salter & Weinhold, 1979). Finally companies try to manage the interdependence through the acquisition or diversification and also sustain their growth.

Objectives of Diversification

Trends and contingencies provide the analysis which indicates that a company must diversify and avail the diversification opportunities. What are the diversification opportunities? Three main opportunities are included here in this paper which significantly impacts the firm's performance.

Diversification due to unique products ensures that material used for the manufacturing is composed of the functional components, basic materials and other parts which form the final shape of the product. A big lot of material is purchased from the suppliers from outside. Vertical diversification branches out the all production into its components, parts and materials. One of outstanding example of vertical diversification is the Ford Empire. This vertical diversification not only introduces the new products but also caters the new mission. We have already given a touch to horizontal diversification that introduces the new products which are not inline; cater to those missions in company's knowledge also experience in marketing, technology and finance. Third way of diversification is lateral diversification that moves beyond the limits of the firms which a firm belongs. Horizontal

and vertical diversifications are restrictive because horizontal and vertical diversifications delimit the field of interest while lateral diversification is more extensive.

Premises of Corporate Strategy

Numbers of premises are required to build the successful corporate strategy. Facts of diversification can't be altered and when these are ignored the corporate strategy fails. The diversification at Marriott has exploited the food services and hospitality due to well-developed skills. Marriott earns a great margin due to its services in nine regional procurement centers. The diversification in Marriott has balanced the start-ups and acquisitions. The start-up is used for the acquisition of small companies. Marriott has expanded its geographic base; acquires the companies and disposes those parts which do not fit.

Companies need sharing activities when diversify across the business evolving the similar evolutionary paths. Many industries in the market share the activities. Wal-Mart performs such activities of sharing and distributes at its discount stores and Sam's Club warehouses. These companies get success through diversifying across the similar companies enough for their requirements. Companies compromise on activities which become generic when the divisions of companies grow in different in their core requirement.

Porter has worked on the business strategies for different industries, companies and concentrated on different aspects of the diversification in business. Porter has also worked on diversification and companies can spread risk and attain development by the diversification and acquisition.

Blue-Chip companies including the Boston Consulting Companies and McKinsey developed the models for discovering which companies will raise and fall. Porter has identified the three critical tests for the success.

An Attractive Test: Diversification adopting companies must be structurally attractive and attractive industries will produce better results and entry barriers will be high. Suppliers and customers will have very moderate bargaining power and very few products will substitute. Unattractive industries have high fixed costs and also high rivalry.

Cost of Entry Test: When cost of entry is high it will prejudice the potential investment and profitability which will also erode before the game starts.

Better-off test: It is required that how the acquiring will provide the advantage in acquiring and significant advantage to others.

Porter has tackled these issues by knowing the competition unit level. Identifying the core businesses based on the strategies. Core businesses include those which are found in attractive industries and competitive advantage is found in these industries. Interrelationships among the core businesses can be facilitated by creating the horizontal organizational mechanisms. Diversification opportunities are pursued based on the shared activities and pass the all three critical tests. Skills can be transferred through the shared activities pursuing the diversification. Porter has further addressed the assertion and says that internet is in infancy; too observes that lack of strategies like diversification will result in weak market penetration. He has argued that many internet companies are following to run on the unsustainable competitiveness. He further says that new rules of <https://assignbuster.com/the-related-diversification-in-a-business/>

competition will be thrown up by the re-emerging principles (Porter, 2001). Porter found that diversification strategies had failed in US as many companies were not successful to create the value (Porter, 1987). He provided the proof of his comments as he had seen that many companies in US cut costs and downsized their staff during the 1980s. However this strategy of diversification could not create value for these companies. Porter (1985) has also said that diversified company is nothing without synergy; it is only a mutual fund. Kanter (1989) has also argued that diversification's justification is only the achievement of synergy. However both of the Porter and Kanter have acknowledged that companies find it hard to achieve the synergy, therefore the high rate of failure is there for companies. Porter has vast experience to study the diversification from 1950 to 1986 for leading thirty-three companies of the US and concluded that track record of diversification remained poor and in many cases of acquisition was divested. During the 1970s many acquired business units were resold and established themselves as independent firms (Porter, 1987).

Prior to Porter strengths and weaknesses, opportunities and threats were framed on SWOT framework developed by the Harvard (Andrew, 1971). However this framework lacked an analytical foundation. Porter's Competitive strategy has changed the strategic management during his work in 1970; it has achieved high value in 1990 and still is shaping the thinking on competitive strategy.

“ His work is academic to a fault... Mr. Porter is about as likely to produce a blockbuster full of anecdotes and boosterish catch-phrases as he is to deliver a lecture dressed in bra and stockings.” (Porter, 1994).

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He abstracted his thinking into digestible chunks of business and he proved to be helpful for the business and academic world. In every organization of the world Porter's five forces are used more frequently. Later thinking of the Porter on corporate strategy rides runs on the new ways of evolutionary approach. Value chain model of Porter attempts to analyze those resources which are possessed by the companies; companies perform the activities linked together. Intrinsic factors like work morale, corporate culture, level of communication, team spirit, leadership and interpersonal skills exploit the maximum inherent power of employees. However Porter does not include these factors in analysis. Primary and supporting technologies are identified in competitive advantage. What are the core technologies which impact an organization in achieving the competitive advantage? The core functions consist of internal resources of a company such as company culture, management and organizational structure. Joint ventures or acquisition adds new skills to the corporation but in Competitive Advantage the intrinsic factors always lead to create or develop technology advancement. Merging or acquiring is also included in the advance technology of diversification.

Prahalad and Hamel (1990) have argued that diversified corporations must not be seen as portfolio of discrete business; but also the collection of the competitively necessary competencies; which are used in many markets and different products. Above arguments of Prahalad and Hamel are based on the Honda Company. The core competence theory of Hamel and Prahalad has identified the fundamentals of the core competencies in companies. Bundle of skills and technologies shape the core competence and not the single skill or the technology do it. Prahalad et. al (2001) argues that firms

achieve the core competencies when multiple technologies are harmonized along with the customer knowledge, skills and marketing institution to manage them synergistically. This is called the “ creative building” (Prahalad et. al, 2001). Both of Hamel and Prahalad have focused upon the production skills and corporate wide technologies to define the core competencies. The importance of the Prahalad arguments rests on the similarities found in the forms of relatedness as well as in unrelated business. However Hamel and Prahalad concede that approach adopted by the Porter embodies the concept of strategic fit; matching the external requirement with the organization’s resources is not so much wrong but it can be referred as unbalanced. Managers imply the concept of strategy that fits with the resources of an organization. According to Hamel and Prahalad the Porter’s approach is not wrong but it tends to vague the approach where strategic stretch supplements the strategic fit. Here the strategic means the creation of the gap between resources and ambition. We again come to the core competencies but now it comes from the school of Prahalad and Hamel. Hamel and Prahalad (1990) argued that management created organizational abilities of making the products according to the needs of the customers. They have argued as:

“ The skills that together constitute the core competence must coalesce around individuals whose efforts are not so narrowly focused that they cannot recognize the opportunities for blending their functional expertise with those of others in new and interesting ways (Prahalad & Hamel, 1990, p. 82)”.

The strategic capability brings the cluster of attributes which assist to achieve the competitive advantage. Toyota is a company which has adopted the diversification strategy and Toyota carmakers are happy with the preferred brands as Prius and hybrid cars. General Motors, BMW and DaimlerChrysler have scrambled to roll out their own hybrid products. Ford has also taken step to increase its products but Toyota is leading to produce the more diversified hybrid products. So far we have discussed the different aspects of the diversification across the different companies; theories of Hamel and Prahalad have focused upon the core competencies of the organizations. These core competencies make differentiation of firms adopting them. Porter has advocated that co-operation and collaboration are the means to retain the competitive advantage. Porter has seen that any sign of alliance may prove to be the source of erosion for the long term competitive advantage.

Conclusion:

We have tried in this paper to focus upon the corporate strategies in business. In most part of the paper we have focused upon the diversification strategy. Diversification with its two common types is described briefly. We have seen that most of the companies in the world operate on the related diversification. The relationship between the cash flow sensitivity and corporate diversification is also investigated in this paper. The cash flow of diversified companies is lower as compared to cash holding. Diversification objectives are also given in this paper. Arguments on the corporate strategy have focused the views of the Porter and other economists. Corporate strategy of Porter depends upon the competitive advantage. It is tried to

evaluate the arguments of porter that diversification destroys the value; but Hamel and Prahalad have contradicted the views of the Porter about the core competencies with examples. Quotes from the Porter's work are included in this paper which is based on corporate strategy.