Leadership at berkshire hathaway and general electric commerce essay

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Since, the researcher's interest was ' the effects of diversification on two American Conglomerates (Berkshire Hathaway and General Electric). First, it's important to look at why the researcher has chosen these two companies. Both companies have a wide range and diversity of product portfolios which are of particular interest. Following earlier research (Natter, Mild, Feurstein, Dorffner, & Taudes, 2001; Krishnan & Ulrich, 2001) the paper intends to narrow down area of focus to Berkshire Hathaway Inc and general Electric. Both companies are going against the trend of diversification, starting from the last decade the trend has been becoming less popular, but both corporations are still diversifying their business lines. Berkshire Hathaway currently has 80 businesses and one of the reasons for the company's success might be strong management, the CEO, Warren Buffett is a core resource for Berkshire Hathaway, he is known for " buying excellent businesses at a price that make business sense".

On the other hand, with so many businesses, diversification strategies might help companies in spreading market risks: adding products to the exiting lines of business can be viewed as analogous to an investor who invests in multiple stocks to " spread the risks". Diversification into other lines of business can especially make sense when the core product market is uncertain, which is the case for Berkshire Hathaway and General Electric.

4. 2. 2 Reasons for their success (Berkshire Hathaway and General Electric)

In order to achieve higher performance, GE generates great results from the people and process. This combination unlocks GE's business breadth,

revealing new paths to growth. The company has 2 councils that are responsible for achieving such high performance:

The Commercial Council that drives the Company's growth initiative: Growth as a Process. This initiative has yielded record-setting organic revenue growth for the last three years (Annual report, 2008). They also have ' Leadership, Innovation and Growth team training program', all are meant to achieve the long-term profitability and success of the Conglomerate and to develop communications expertise to create new ideas and foster existing ones. Also there is the Operating Council which was formed in 2007, which consisted of leaders from engineering, supply chain, sourcing, finance, and product management. The goal of the council was clear: create a $1 billion funnel of ideas, and improve the Company's operating profit margin rate by 100 basis points to a world-class level of 18% (Annual report, 2008). Also, The Council is focused on lowering product costs, reducing overhead, countering inflation, turning inventory, and improving price. It is a forum to share best practices on topics such as productivity, simplification, sourcing, restructuring, quality, and new products -all critical disciplines in an increasingly competitive and global environment. The Council uses a common scorecard to measure progress across the company and spreads its success to all businesses.

In addition, General Electric has been a leading source of corporate strategy concepts and innovations for more than half a century. The firm has been among the top five members of fortune magazine's " America's Most Admired corporations" since the listing began.

Considering the research question in this project which is “ the reasons for the success of two American conglomerates through diversification strategy and their achievements, the researcher refers diversification as a growth strategy and both 9Berkshire Hathaway and General electric) are known for their wide range of businesses and their growth through acquisitions.

Makron Associated identified several conglomerates with exceptional performance in terms of ten-year shareholder returns. Berkshire Hathaway and General electric were part of these identified firms. The common characteristics of these companies were: “ strict financial discipline, rigorous analysis and valuation, a refusal to overpay for acquisitions and a willingness to close or sell existing businesses (Kaye and Yuwono, 2003)

However, the case against conglomerates can be overstated and there are certainly potential advantages to unrelated diversification in some conditions: Exploiting dominant logics, rather than concrete operational relationships, can be a source of conglomerate value creation. As at Berkshire Hathaway, a skilled investor such as Warren Buffett, the so-called Oracle of Omaha and one of the richest men in the world, may be able to add value to diverse businesses within his dominant logic (Prahalad and Betis, 1986, 1995). Berkshire Hathaway includes businesses in different areas of manufacturing, insurance, distribution and retailing, but Buffet focuses on mature businesses that he can understand and whose managers he can trust. During the e-business boom of the late 1990s, Buffet deliberately avoided buying high-technology businesses because he knew they were outside his dominant logic.

Countries with underdeveloped markets can be fertile ground for conglomerates. Where external capital and labor markets do not yet work well, conglomerates offer a substitute mechanism for allocating and developing capital or managerial talent within their own organizational boundaries. For example, Korean conglomerates (the chaebol) were successful in the rapid growth phase of the Korean economy partly because they were able to mobilize investment and develop managers in a way that standalone companies in South Korea traditionally were unable to. Also, the strong cultural cohesion amongst managers in these chaebol reduced the coordination and monitoring costs that would be necessary in a Western conglomerate, where managers would be trusted less (Markides, 2002). The same may be true today in other fast-growing economies that still have underdeveloped capital and labor markets.

General electric has operations in many underdeveloped countries, For example, in 2008; GE completed the Hamma Seawater Desalination Plant, the largest desalination plant in northern Africa, which provides 2 million Algerian residents with a reliable source of fresh drinking water every day. Through innovatory thinking and cutting-edge technologies from GE’s Oil & Gas and Power & Water businesses, GE is able to solve some of the problems that Algeria faces under today’s harsh climate, while helping to position them for a brighter tomorrow.

Also, graduate students in US compete to get entry-level positions with diversified corporation such General electric and Berkshire Hathaway and this provides them opportunities like the hiring of high calibre of employees.

Other General Electric Success reason is the corporation’s strong core

values: which are the underlying principles that guide an organization's strategy. Collins and Porras (2002) have argued that the long- run success of many US corporates-such as General Electric and Disney can be attributed (at least in part) to strong core values. The company workers consider their culture as part of innovation, a culture that was built over decades by their leaders and which is still the unifying force for the many GE business units around the world.

While, communicating the strategy is an important within a company: Both corporation communications should be focused on the key components of the strategy, avoiding unnecessary detail or complex language. For example, CEO jack Welch's famous statement that General electric should ' either be number one or number two' in all its markets. This strategy clearly shows that General Electric is a company that always strives hard to be a dominant player wherever the company competed. On the other hand, some of the most important sources of value creation within diversified firms are the ability to apply common general management capabilities, strategic management systems, and resource allocations processes to different businesses. Such economies depend on the existence of strategic rather than Operational commonalities among the different businesses within the diversified corporation (Robins and wiersema, 2002).

Berkshire Hathaway is involved in insurance, candy stores, furniture, kitchen knives, jewellery, and footwear. Despite this diversity, all these businesses have been selected on the basis of their ability to benefit from the unique style of management established by warren buffet and CEO Charles Munger. The essence of such strategic-level linkage is the ability to apply similar

strategies, resource allocation procedures and control systems across the different businesses within the corporate portfolio (Grant, 1988).

While, GE participates in a wide variety of markets including the generation, transmission and distribution of electricity (e. g. nuclear, gas and solar), lighting, industrial automation, medical imaging equipment, motors, railway locomotives, aircraft jet engines, and aviation services. It co-owns NBC Universal with Vivendi (Annual Report, 2008). With all these many business divisions General electric remains still successful.

4. 2. 3 How the shareholders value is enhanced as the firm's product diversifies.

With so many ups and downs of corporate diversification, financial researchers have been worried with its benefits and costs.

Majority of the benefits of corporate diversification come all along with the advantages of internal capital markets over external financing.

By avoiding transaction cost and additional cost of informational asymmetries diversified firms with a bigger internal capital market allow for a more efficient capital allocation (Chandler 1977, Stein 1997).

Also there are other benefits such as risk reduction on corporate level for diversified firms: lower cash flow volatility may increase the debt capacity of the company and thereby the tax shield of debt without facing prohibitive cost of financial distress (Lewellen 1971). Additionally lower volatility helps to reduce underinvestment cost when external financing is not available or only at prohibitive cost (e. g. Stulz 1990).

In addition, Berkshire Hathaway and general Electric are companies that create Value by acquiring companies at favorable prices, and they closely monitor their financial performance, and operate through an effective internal capital market. At general Electric, Jack Welch was an especially effective example of corporate initiatives as a means of driving organizational change. His initiatives were built around communicable and compelling slogans such as " General Electric growth engine," " boundarylessness;" " six-sigma quality" and " destroy -your business-dot-com."

The research assumes that diversification is a means by which a firm expands from its core business into other product markets, and that is what the corporate management is actively engaged in, diversifying activities than ever before leading to a considerable amount of rise observed in diversified firms. As it was earlier stated, companies diversify for three main reasons, Growth, Risk reduction and Profitability in a simpler way. Normally, Growth and Risk reduction have been significant motives for diversification; they tend to be not consistent with the creation of shareholder value.

Therefore, both general electric and Berkshire Hathaway had and still have the desire to grow. Berkshire has been acquiring and owning stakes in companies since early 70's. We clearly see from the company's timeline that the Berkshire continued growing through acquiring stakes in many companies. The latest acquisition was in February 2010 which was the Corporation's purchase of the remaining shares of Burlington Northern Santa Fe Corporation for $26 billion, the company's biggest purchase ever. While General Electric has acquired Vital signs Inc for $860 in 2008 (Chicago

Tribune, 2008) and it also announce in 2009 that it will buy out Vivendi's stake in NBC Universal and sell a controlling interest of the company to Comcast, with General Electric retaining a 49& interest in joint venture (Goldman and Pepitone, 2009). With the Acquisitions history, Both Corporations have been growing and expanding their business with the objective of Maximizing Shareholder wealth.

Referring back to the next motive for diversification which is ' the desire to spread risks' To isolate the effects of diversification on risk, consider the case of ' pure' or conglomerate diversification, where separate businesses are brought under common ownership but the individual cash flows of the business remain unaffected. As long as the cash flow of the different businesses are imperfectly correlated, then the variance of the cash flow of the combined businesses is less than the average of that of the separate businesses, Hence Diversification reduces risk.

Both of the companies have engaged in numerous activities for decade, they have expanded their businesses. Rumelt (1974) discovered that companies that diversified into businesses closely related to their core activities were significantly more profitable than those that pursued unrelated diversification. According to Peters and Waterman (1982) " Virtually every academic study has concluded that unchanneled diversification is losing proposition". This observation provided the basis for one of peters and waterman's " golden rules of excellence" -stick to the knitting:

Our principle finding is clear and simple. Organizations that do branch out but stick very close to their knitting outperform the others. The most

successful are those diversified around a single skill, the coating and Bonding technology at 3M for example. The second group in descending order, comprise those companies that branch out into related fields, the leap from electric power generation turbines to jet engines from General electric. Least successful, as a general rule, are those companies that diversify into wide variety of fields. Acquisitions especially among this group tend to be wither on the vine (Peters and waterman, 1982).

Finally, the research paper postulates that shareholder value is increased when companies diversified in related businesses, since they share capabilities and core resources across the businesses. And the growth of such (GE and Berkshire Hathaway) conglomerates might improve the company’s profitability, since new related businesses means spreading of risks and increasing of profitability across each business segments.

4. 2. 4 The costs and benefits associated with undertaking product diversification.

In order to find out the costs and benefits of product diversification, the research paper looks at: the relative costs and benefits of corporate diversification are likely to depend on how the different business activities of a firm are related to one another. Where separate business activities use a common, indivisible input, a diversified firm can exploit economies of scope.

However, ‘ One of the benefits of diversification focuses on the presence of economies of scope in common resources: Economies of scope exist whenever there are cost savings from using a resource in multiple activities

carried out in combination rather than carrying out those activities independently’ (Baumol, panzer and willig, 1982).

Also Economies of scope can arise in finance, by combing an industrial company with a financial services company; General electric lowers its cost of capital to both sides of the company. Also, Economies of scope arise not just from tangible input like a common R & D department or a common distribution system but also from intangible assets like brand names and production know-how. For instance, general electric has the fourth most recognized brand in the world, worth almost $48 billion (Business week, 2009).

While businesses within diversified firms can therefore be related in at least one of two ways: They could be related either because they share markets, distribution systems, product and process technologies, or manufacturing facilities (Ansoff 1965, Rumelt 1974, Teece 1980), or because they rely on common technologies, managerial capabilities and routines and repertoires (Prahalad/Bettis 1986, Kazanjian/Drazin 1987, Winter 1987, Grant 1988). The use of these assets may be transferable at negligible marginal costs. For instance, General electric shares of its activities like R&D and Distribution channels across its wide range of businesses. Also, the companies engage in lots of transaction costs and it’s very complicated to manage such businesses but in the end they reap Benefits of high returns from their activities.

4. 2. 5 The incentives Top management expect as companies diversifies

In Berkshire Hathaway, managers are paid modest salaries and also receive very significant cash bonuses if performance goals are achieved. Buffett tailors the compensation plan to each business, based on its economics and competitive positioning.

Managers are compensated for elements of the business that are directly under their control (such as growth and profitability of insurance contracts). Major emphasis is placed on the capability to return free cash flow to headquarters. The company does not grant equity-based awards because their value cannot be as closely correlated to performance as can cash bonuses (meaning: In terms of value realized rather than expected value on the grant date).

Still, cash bonuses can reach extreme levels-tens of millions for superior performance. So, Here the compensation have no relation with the size of the Company and thus it doesn’t matter for Berkshire Hathaway whether they have many diversified business or not but the main focus is Achieving the targets and High performance is highly rewarded

However, on the contrary, Buffett and his vice-President Munger receive humble compensation. Their salaries are set at $100, 000. They receive no bonuses, options, or restricted grants. Instead, their economic incentive is driven by direct holdings of company stock which they purchased with their own money in the 1960s. As of year-end 2009, the values of those holdings were $40 billion of Buffett and $1. 3 billion for Munger. Similarly, board

members receive insignificant fees for their services and are encouraged to purchase substantial sums of company stock with their own money. To sum up, Berkshire's top management performance has no direct influence to how diversify businesses may be, Instead each manager is rewarded for the excellent achievement of his area of control.

On the other hand, General electric's CEO, Mr. Immelt earns higher salary than Warren Buffet. Immelt's Base salary is $3, 300, 000 plus Bonuses. While the managers are rewarded on the basis of a guiding principle of compensation program which ensures that the management has in place the right metrics and incentives, applied over the appropriate performance periods. The company rewards consistent performance and discourage short-term-oriented behaviour that may yield a single period of good results without regard for proper risk management or the long-term health of the business.

The committee uses a mix of compensation that balances rewards for current and long-term performance. Performance metrics include growth in earnings per share, revenue, and cash flow. Managers believe this is the best way to stimulate innovation and ensure solid execution, while guaranteeing that risks are recognized and managed appropriately over the long term. Although they have fine-tuned compensation programs as conditions change, the management believe it is important to maintain consistency in the compensation philosophy and approach.

There is also a recognition that value-creating performance by an executive or group of executives does not always translate immediately into

appreciation in GE’s stock price, particularly in periods of severe economic stress. Nonetheless, General Electric continues to reward such performances based on the firm’s belief that, over time, true value creation does translate into stock price appreciation.

4. 2. 4 Risks associated with the strategy of diversification

Buffett is also primarily responsible for enterprise risk management. Risk oversight is not delegated to a committee or risk management function. According to Buffett, “ I regard myself as the chief risk officer at Berkshire.” (Berkshire Hathaway, Annual meeting 20080

The company’s primary tool to mitigate enterprise risk is the delegation of responsibility to managers with proven skill and integrity. Munger explains :

“ A lot of people think if you just had more process and more compliance, you could create a better result in the world. Well, Berkshire has had practically no process. We had hardly any internal audit until they forced it on us. We just try to operate in a seamless web of deserved trust and be careful whom we trust.” (Wesco Financial, annual meeting 2007).

Due to the global economic crisis was the failure of many executives and businesses the ability to understand and adequately manage and price risk. At GE, the corporation has strategies and management processes that effectively manage risk and maximize opportunities across its many businesses. Its process includes long-term strategic planning, executive development and evaluation, regulatory and litigation compliance reviews, environmental compliance reviews, GE Capital’s corporate risk function and GE’s senior level Corporate Risk Committee.

And as a result of the current financial crisis; GE expects that managing risk will be even more important to competitive advantage and long-term success. The corporation's executive compensation program is designed to reward those executives who demonstrate an ability to assess and manage risk effectively. At the same time as over the past year, General electric leaders have demonstrated the ability to identify risks and adapt strategies in order to protect the Company. GE acted quickly to improve liquidity, raise capital, and transform the financial businesses. The company has also exited businesses with unacceptable rates of risk-adjusted return. Similarly, Berkshire Hathaway believe that ' it is important to continue to reward those who demonstrate this disciplined ability to protect the firm; s businesses, but it's only appropriate that certain components of compensation will decline during periods of economic stress and reduced earnings.

Both General Electric and Berkshire Hathaway, have techniques to spread risks and overcome challenges and thus their activities of diversified businesses. As it was explained earlier, Berkshire's CEO considers himself as a chief risk officer and while the managers of both corporations have responsibilities in reducing the risks involved in the activities under their control.

In addition, both General electric and Berkshire Hathaway fits in the Prospector strategy of Miles and Snow. Since both firms have highly diversified businesses. This is the most aggressive of all the four strategies. It typically involves active programs to expand into new markets and stimulate new opportunities. Innovative product development is vigorously pursued and attacks on competitors are a common way of obtaining

additional market share. The both corporations have a way to respond quickly to any signs of market opportunity, and they do so with little research. A large proportion of their revenue comes from new products or new markets.

They are often highly leveraged sometimes with a substantial equity position held by venture capitalists. The risk of product failure or market rejection is high with the prospector strategy. Their market domain is constantly in flux as new opportunities arise and past product offerings atrophy. They value being the first in an industry, thinking that their " first mover advantage" will provide them with premium pricing opportunities and high margins. Price skimming is a common way of recapturing the cost of development. General Electric and Berkshire Hathaway are known for being opportunistic in headhunting key employees, both technical and managerial. Thus this explains why both firms spend so much on advertising, sales promotion, and their personal selling costs are a high percentage of sales.

Typically firms who fit in the prospector strategy are structured with each strategic business unit having considerable autonomy. With Berkshire Hathaway trusting responsibility of business performance entirely in the hands of local managers and General Electric decentralising decisions within each business units, Risks might be reduced. And Firms in these industries tend to be in the introduction or growth stage of their life cycle with few competitors and evolving technology which also provides opportunities such as less competition to both companies Products.

Example of GE acquired firms includes Vivendi in 2009,(which is a French international media conglomerate with activities ranging from filming, publishing, telecommunication, music, television and it also have Internet, and video games. The acquired firm had financial troubles due to over-expansion in the late 1990s and the early 2000s. In addition, General electric acquire Vital Signs Inc. for US$860 million in 2008 (Appendix 6. 2, GE timeline). The acquired firm makes disposable medical products used to help patients during surgery to breath.

Berkshire acquired several companies the last 2-3 years, for instance: the company purchased 80 percent stake in Iscar Metalworking for $4 billion in 2006, which was the firm's first purchase of a foreign subsidiary.

Johns Manville Corp, a business unit of Berkshire Hathaway Inc acquired Corbond Corp, a manufacturer of polyurethane spray foam insulation products in august 2009.