

Corporate diversification strategy of hyundai



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The following paper is an analysis of the corporate diversification strategy of one the largest chaebol, or Korean business groups in existence. The purpose of this paper is to make a comprehensive analysis focusing on the level and implementation of corporate strategy. The potential advantages that occur when diversifying are described using strategic management theory.

The estimation that is made when taking the actual structure of the business group into account will be done simultaneously or at least per individual advantage or opportunity. The reader can therefore not expect two separate chapters in this respect, but an easily readable text in my opinion.

The final goal is obviously to make a real assessment of the performance implications that the corporate diversification strategy of Hyundai business group have. This will be followed by a conclusion that is more or less incorporated in the final part which serves as a conclusion in its own right.

But before we move on to the theory of corporate diversification strategies, you will find a short introduction of the business group that will be discussed.

Hyundai was founded by Chung Ju-Yung in the 1940's a small auto-repair shop and grew exponentially in the last half of the previous century. Being granted large project funded by the Korean government in order to rebuilt the country and improve infrastructure, Hyundai group grew to the largest chaebol in Korea. A chaebol is a Korean version of the business group which is founded and ruled by a family. Hyundai was the largest chaebol until 2001 when large parts of the group were divested, but it is still an important player in the Korean economy. (Park 2002)

Theoretical and practical advantages

First of all it seems appropriate to start off at the very basis of the business group; the diversification of a companies' business portfolio, referred to as corporate diversification. There are several types of corporate diversification that I would like to discuss, in order to get a firm grasp of the subject at hand. Furthermore the implications as well as potential and theoretical advantages of corporate diversification will be discussed. It is most off all vital to understand the motivation a business group, or chaebol like Hyundai, has to diversify in order to understand the very existence of such groups, in this chapter I will aim at clarifying this important basis.

Corporate diversification is the diversification of a companies' portfolio into either different industries of different geographic regions. The first type is called product diversification and the second geographic market diversification. The type of diversification strategy that is implemented by business groups such as Hyundai is the hybrid or combination version, namely product-market diversification.

There are roughly five types of corporate diversification that can be divided under the follow three headers. The first is limited diversification; this can be either a single-business, or a dominant-business strategy, which fluctuates between ninety-five and seventy percent of a corporation that consists of one business. This is clearly not comparable to the chaebol discussed in this paper. The second type is related diversification, which is divided into related-constrained and related linked, both having revenues of less than seventy percent from a single business, but the second having far less links and common attributes. The last type is called unrelated diversification

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which refers to a company which of course acquires its revenues for less than seventy percent from one business and has barely any common attributes or links that connect the different businesses that fall under the corporate headquarters.

For this paper it is obviously vital to understand in which of these levels of corporate diversification we might find the average business group or chaebol, but even more importantly where we can place Hyundai. In order to attempt a proper classification of Hyundai as such the overview of companies that are part of the Hyundai group should be summed up very briefly in order to give the possibility to form an initial idea as to where Hyundai group belongs, which is perhaps based on intuition concerning the level of diversification. When visiting the website of the Hyundai group, Hyundaigroup.com, The affiliated companies that are mentioned are the following: Hyundai Merchant Marine; Hyundai Securities; Hyundai Elevator; Hyundai Logiem; Hyundai Asan; Hyundai U&I; Hyundai Research Institute and Hyundai Investment Network.

Some of the names are quite auto explanatory, such as ' Merchant Marine' and ' Elevator', very briefly I will give an explanation about each of the ' affiliated companies', as they are referred to by Hyundai.

Hyundai Merchant Marine

" It is a multi-modal marine transportation company that has undergone rapid growth to its present standing of 6th in the world, and 1st in Korea. It commands a fleet of over 200 ships that include full container carriers, LNG carriers, oil tankers, bulk carriers, and others". (Hyundai)

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Hyundai Securities

“ It has been leading the Korean financial market since its establishment in 1962. One of its many prominent feats is the “ BUY KOREA” fund, through which it played a major role in restoring the Korean economy after the IMF bailout”. (Hyundai)

Hyundai Elevator

“ Hyundai Elevator, the holding company of Hyundai Group, is a high-tech manufacturing company that supplies a full series of elevators and escalators, various parts and components, automated parking systems, material handling systems and platform screen doors (POSD)”. (Hyundai)

Hyundai Logiem

“ Logiem is a global comprehensive logistics company that wants to achieve a domestic market share of 25% by 2010”. (Hyundai)

Hyundai Asan

“ Asan was established for the purpose of promoting national reunification and inter-Korean economic cooperation”. (Hyundai)

Since Hyundai Asan is perhaps the odd one out, as well as difficult to immediately understand as to its purpose, here are its main activities:

Lead Hyundai Group’s businesses promoting

Inter- Korean economic cooperation

Unified and single office for communication

With the North

Mt. Kumgang tourism and development

Construction of Kesong Industrial Complex

SOC programs of the North

Sports and cultural exchange programs

Hyundai U&I

“ Over the past three decades Hyundai U&I has provided global standard IT service in logistics industry and now is opening the ubiquitous era with RFID technology”. (Hyundai)

The main products are: logistics solutions in container, bulk, terminals as well as IT outsourcing and ubiquitous R&D project.

Hyundai Research Institute

“ Hyundai research institute is the first domestic research institute to integrate education and research functions where new knowledge is created and shared effectively”. (Hyundai)

Hyundai Investment Network

The main products and services are the following:

Organization and management of alternative

investment funds

Business strategy consultancy focusing on

development of new business opportunities

Investment advisory and direct investment in

mergers and acquisitions (Hyundai)

The level of attributes and/or links between the different companies seems quite slim. When looking at the description of Hyundai Elevator it is stressed that it is in fact a high-tech manufacturing company that is specialized in multiple systems that seem to be very much interlinked, especially concerning research and development. Overall there are several businesses that can be viewed as high-tech manufacturing companies such as Hyundai U&I.

Another logical link between the companies is the fact that the transportation and logistics expertise of Merchant Marine and Logiem can be used for transporting products, materials, perhaps even personal of other companies that are part of the Hyundai group, by doing so creating an obvious cost-advantage as well as making sure that there is some interaction between the affiliates which can contribute to cooperation and synergies in other cases.

The logistics solutions that are developed in Hyundai U&I seem to be perfectly applicable to Marine Merchant for instance, seeing as it is a company that transports containers. The bulk and terminal solutions seem

applicable also, and the same holds for the Logiem Company. In this way multiple synergies and links can be found that give potential for theoretical advantages for this particular chaebol.

The Hyundai Research institute provides the business group with the unique opportunity to educate their researchers and have them implement their knowledge and expertise to the different companies. The development of products of basically all companies could originate from the research institute since the institute focuses on the following fields: Consulting; Economic research; Human Resource Development related works, which are applicable to any company.

Number eight on the list, the Hyundai Investment network could contribute to the group as a whole when any investment-, acquisition- or new business opportunities are concerned. Hyundai has got all the expertise it needs within the group and will most likely use it instead of outsourcing these tasks. The reasons for this are the obvious cost advantages as well as the bad impression it would make to hire an outside firm to solve problems they help others with themselves.

The following quotation was taken from the book ' Strategic Management and competitive advantage' by Barney and Hesterley. The definition gives a clear and comprehensive understanding of this concept, and since it is so vital to the understanding of the information that follows, I decided to incorporate it in this paper.

“ Economies of scope exist in a firm when the value of the products or services it sells increases as a function of the number of businesses in which

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that firm operates. In this definition, the term 'scope' refers to the range of businesses in which a diversified firm operates. For this reason, only diversified firms can, by definition, exploit economies of scope. Economies of scope are valuable to the extent that they increase a firm's revenues or decrease its costs, compared to what would be the case if these economies of scope were not exploited". (Barney & Hesterley 2009)

The economies of scope are divided in the following four groups: Operational economies of scope, which consists of 'shared activities' and 'core competencies'; Financial economies of scope, which can be divided up into 'internal capital allocation', 'risk reduction' and 'tax advantages'; Anticompetitive economies of scope, which consists of 'multipoint competition' and 'exploiting market power'; and finally Employee and stakeholder incentives for diversification, which is aimed at 'maximizing management compensation'.

The types that are applicable to the diversification strategy of Hyundai will be discussed shortly; the overview above is mainly for the purpose of drawing a picture which contains all the different varieties so that it is clear in which particular areas of economies of scope this particular chaebol operates.

The Hyundai chaebol is seemingly well fit for the operational economies of scope when it concerns several of its industries; in particular the ones discussed earlier concerning the types of corporate diversification. Shared activities have in this sense been explained, for the Research and Development as well as the logistics network has been discussed. Core

competencies have been defined by Prahalad and Hamel in the following way, which I have chosen to use: “ the collective learning in the organization, especially how to coordinate diverse production skills and integrate multiple streams of technologies”. It seems when viewing the business portfolio of Hyundai that the core competencies have a large potential in implementation, especially the integration of multiple streams of technology seems to have materialized in the form of Hyundai U&I and Hyundai Research Institute.

The financial economies of scope seem to have a positive effect on the chaebol, as explained before this particular economy of scope is subject to three different types; the performance implications for the Hyundai group are explained separately.

Internal capital allocation can be viewed as a potential substitute for an external capital market, since it can create an internal capital market within the group if you will. The companies or businesses that are part of the group compete for the capital influx provided by the headquarters, instead of the comparable influx from external investors and shareholders. In some countries the capital market does not function accordingly to the western model that has been standardized by the United States of America and England and that has been introduced on the continent of Europe also. A capital market that does not function as well as these western examples, such as South-Korea for instance, are especially suitable environments for business groups, for they provide that capital market themselves, instead of relying on a perhaps poorly functioning external market. The Internal capital allocation can therefore be viewed as a positive asset of the chaebol.

Risk reduction is an obvious example when it comes to diversified groups such as Hyundai. When a business group is highly diversified the sensitivity to tendency of the market, one business might perform very poorly due to a decrease in demand, while another business could perform extremely well at the same time. This is also beneficial when concerning tax advantages, which will be discussed in the next paragraph. The fact that in some cases the business group is unrelated diversified amplifies this effect, because in the case of strongly related or at least related diversification, the difference in tendency of the market demand will be significantly less. This can be attributed to the fact that related businesses that for instance supply each other are both affected by a fluctuation in the level of market demand.

Tax advantages can be created by using losses that might have been made in one of the businesses to counterbalance the profit that has been made by another affiliate company, by doing so reducing the total amount of profit that the group is liable for. This method can save a lot of money, especially when concerning a large business group like Hyundai. I would therefore assume that the financial economy of scope that is acquired by tax advantages can and will be used in this particular case. Because of the sheer size of the business group the debt capacity will grow accordingly. In the case that interest payments on debt are deductible, the increase in debt capacity will also create a tax advantage for the chaebol. (Barney & Hesterley 2009)

Anticompetitive economies of scope relate to the fact that each company is better off when the business environment or market conditions improve. In the case of perfect competition this will most likely not be the case when

there is a high level of competitiveness amongst firms within the industry. The companies are all better off when the level of competition decreases, but price deals, collusion and so on are illegal, for they fall under the header of illegal anticompetitive conduct. The diversified business group can serve as a solution to this problem especially when competing against companies that are part of a diversified firm also. This can be done in two manners, explained below in further detail. (Scherer, & Ross, 1990)

Multipoint competition, multipoint can be most easily explained on the basis of two firms. A product produced by group 1 that competes with a product produced with group 2 changes its price in a highly competitive way, by doing so threatening the product produced by group 2. Group 1 also competes on a different market with group 2, as a reaction group 2 retaliates by dropping prices in that market and damaging group 1. The end result is that both group 1 and 2 are worse off, an undesirable situation for both. The result will be that both groups will be very careful in challenging the other, causing above market-price prices, this is a desirable situation for both business groups.

Exploiting market power is mostly described as the deep-pockets model. (Barney & Hesterley 2009) As the name suggests, the deep-pockets or large financial capabilities of the chaebol are exploited. It works as follows: In the previous example of multipoint competition we already discussed the fact that an as little competitive environment as possible is desirable for companies. Exploiting market power by use of the deep-pockets model is based on that very assumption, decreasing competition by eliminating or scaring off competitors. The company can use its capital to decrease prices

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to such a level that smaller companies cannot survive the level of competition and have to exit the market; the other situation is of course that the other company does not even decide to enter at all.

Employee and stakeholder incentives for diversification are mostly demonstrated by the maximizing of management compensation. The incentives of top management are in most cases subject to the size of the company, not its profit. This is easily explained by the fact that the incentives of top management are largely influenced by the salary they receive, which is also subject to the size of the company and tends to grow accordingly. The conclusion in this matter is thus that the incentives provided by companies do not match with the aim of the company which is maximization of profit in most cases. Because of the fact that a larger company increases both salary and status of the Chief Executive Officer for instance, the company could diversify without the proper economic motivation. In the case of Hyundai group this is hardly unthinkable. The company was founded by an exemplary person, building his companies from the ground without a rich family while building Korea from the ground simultaneously. Whether this tale that oozes of heroism is one hundred percent accurate is not important. This epic beginning of the Hyundai group asks for the ambition to make it the largest and most successful business group of the nation, and the largest it has at least become.

In order to secure the fact that economic value is created by a corporate diversification strategy, the business group must adhere to two conditions. The first one is that the strategy has to make use of valuable economies of scope; the several strategies that could prove to be successful were

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discussed previously. The second condition is the following: “ it has to be more cost-efficient for managers in a firm to realize an economy of scope than for outside equity holders on their own”. (Barney & Hesterley 2009) In the case of good cooperation between the different companies within the group this should be possible, especially taking the incredible size of the chaebol into account. However, we will see in the assessment of the performance implications that the cooperation between divisions is sometimes far from perfect.

Performance implications

The diversification of Hyundai on a geographic and product level has already been discussed on conceptual bases concerning the geographic aspect and practical bases concerning the product level. The product-market diversification strategy that is applied by Hyundai is typical for chaebol and has seen major development through the years. Yoon-Shik Park illustrates this fact in his book *The Chaebol and Labour in Korea: the Development of Management Strategy in Hyundai*, stressing the labor intensive past of the Korean chaebol and Hyundai in particular. The important reality that should not be left out, especially in this light, is that Hyundai has evolved from a labor-intensive company that specialized in low value addition to its products, to a company which is specialized in knowledge and technology intensive products. In order to decrease costs Hyundai has also chosen for a geographic market diversification strategy, making use of cheaper labor forces in order to achieve a competitive cost advantage, which can improve Hyundai's position on the world market. (Park 2002)

In his book Yoon-Shik Park explains the difference of approach in the beginning of the business group, as compared to the current situation. The following quotation gives an impression: “ HHI workers had to build ships which were marketed in the early years on the basis of cost and speed of delivery, rather than quality or technology, and thus the employees were forced to work long hours at meager wages, a hot combination of potential labor troubles”. (Park 2002)

Moon Ihlwan describes the rise of Hyundai in which it made use of several economies of scope amongst which increasing its anticompetitive economies of scope by growing and entering more and more industries. The debt-based investments and growth of the company were largely facilitated by the Korean government, this diversification strategy proved successful at the time, increased by the political climate. This very strategy however, proved very challenging and even destructive to the Hyundai group in a more recent setting, this becomes apparent in the next paragraph. (Ihlwan 2003)

The Hyundai group has its origin as a family company as mentioned before, the many sons of the late chairman took over the group, but rivalry amongst them caused several companies to be separated from the group, continuing as a single company. Moon Ihlwan illustrates this in the following way: “ By September, 2000, Hyundai Motor — controlled by the elder brother — formally severed links to the rest of Hyundai. Freed from the debt-besotted chaebol, Hyundai Motor emerged as a dynamic, profitable company. Another moneymaking piece of the group, Hyundai Heavy Industries Co., the world’s largest shipbuilder, controlled by the sixth brother, Mong Joon, became

independent, too: Analysts expect it to turn a big profit this year”. (Ihlwan 2003)

Min Sang Kee, who is a BA professor at Seoul National University, even referred to the development in relation to Hyundai Motor and Hyundai Heavy Industries Co. and their independency as: “ A blessing for the country.”

The logical follow-up question is whether the Hyundai group still lives up to the conditions that a corporate diversification strategy must live up to, in order to secure the fact that economic value is created. There are at least two ways of approaching this issue, the first is the following: If the diversification would have worked, there would not have been so many companies that had left the group, therefore the Hyundai group does not live up to the conditions. This could be viewed as incomprehensible with reference to the family feud and so on, nevertheless, the implications of the very independency of several of Hyundai’s companies does imply that the level of economies of scope and its security to create economic value for its affiliates has decreased with its size.

Conclusion

In order to conclude the discussion a propos the performance implications of the Hyundai group, it seemed interesting to me to address the incredible power and influence of the chaebol in general one more time. Dominic Jones has described in “ Won flew over the Chaebol nest” how the chaebol have done anything in their power to prevent the efforts of both the Korean government and the IMF to open up the financial market in Korea and bring in foreign investors. The following quotation is a good illustration of is

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development: “ Korean observers also say the Chaebol have used the recent liberalization of the financial markets to raise money to support weak businesses and avoid sale of assets as demanded by the government. The top five Chaebol - the Hyundai, Samsung, Daewoo, LG and SK groups now own 39 financial companies, including investment banks, insurers and asset management funds that provide financing to affiliate companies.” (Jones 2000)

The recognition of the power of the chaebol in Korea is vital in understanding its resilience and its capacity to diversify. The Hyundai business group has been divested for a significant part, but it is important to realize that the size and influence of a chaebol can prove to be a major factor in its survival on the long run. Demand will always fluctuate and the environment may change, but the chaebol has proven to strong enough to withstand these challenges so far.