a. If your company's product is personal computers, do you think it would make better strategic sense to employ a multicountry strategy or a global strategy? Why?

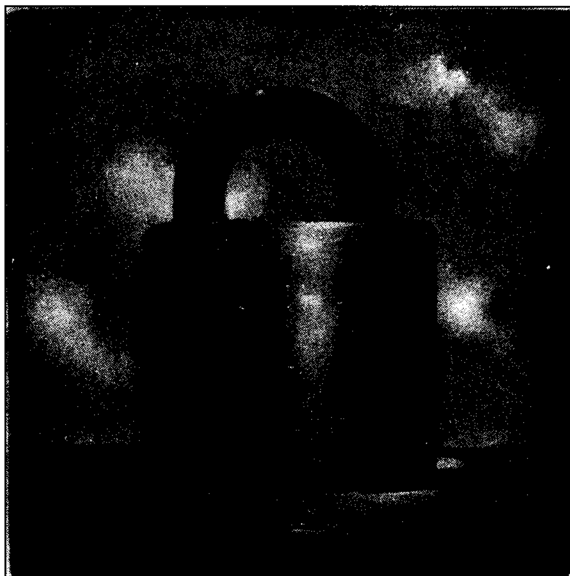
b. If your company's product is dry soup mixes and canned soups, would a multicountry strategy seem to be more advisable than a global strategy? Why?

c. If your company's product is washing machines, would it seem to make more sense to pursue a multicountry strategy or a global strategy? Why?

d. If your company's product is basic work tools (hammers, screwdrivers, pliers, wrenches, saws), would a multicountry strategy or a global strategy seem to have more appeal? Why?

chapter | eight

Tailoring Strategy to Fit Specific Industry and Company Situations



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The best strategy for a given firm is ultimately a unique construction reflecting its particular circumstances.
—Michael E. Porter

Competing in the marketplace is like war. You have injuries and casualties, and the best strategy wins.
—John Collins

It is much better to make your own products obsolete than allow a competitor to do it.
—Michael A. Cusamano and Richard W. Selby

In a turbulent age, the only dependable advantage is reinventing your business model before circumstances force you to.
—Gary Hamel and Liisa Välikangas

Prior chapters have emphasized the analysis and options that go into matching a company's choice of strategy to (1) industry and competitive conditions and (2) its own resource strengths and weaknesses, competitive capabilities, opportunities and threats, and market position. But there's more to be revealed about the hows of matching the choices of strategy to a company's circumstances. This chapter looks at the strategy-making task in nine other commonly encountered situations:

1. Companies competing in emerging industries.
2. Companies competing in turbulent, high-velocity markets.
3. Companies competing in mature, slow-growth industries.
4. Companies competing in stagnant or declining industries.
5. Companies competing in fragmented industries.
6. Companies pursuing rapid growth.
7. Companies in industry leadership positions.
8. Companies in runner-up positions.
9. Companies in competitively weak positions or plagued by crisis conditions.

We selected these situations to shed still more light on the factors that managers need to consider in tailoring a company's strategy. When you finish this chapter, you will have a stronger grasp of the factors that managers have to weigh in choosing a strategy and what the pros and cons are for some of the heretofore unexplored strategic options that are open to a company.

STRATEGIES FOR COMPETING IN EMERGING INDUSTRIES

An *emerging industry* is one in the formative stage. Examples include wireless Internet communications, high-definition TV and liquid crystal display (LCD) TV screens, assisted living for the elderly, online education, organic food products, e-book publishing, and electronic banking. Many companies striving to establish a strong foothold in an emerging industry are in a start-up mode; they are busily perfecting technology, adding people, acquiring or constructing facilities, gearing up operations, and

trying to broaden distribution and gain buyer acceptance. The business models and strategies of companies in an emerging industry are unproved—what appears to be a promising business concept and strategy may never generate attractive bottom-line profitability. Often, there are important product design problems and technological problems that remain to be worked out.

Challenges When Competing in Emerging Industries

Competing in emerging industries presents managers with some unique strategy-making challenges:[1]

- Because the market is new and unproved, there may be much speculation about how it will function, how fast it will grow, and how big it will get. The little historical information available is virtually useless in making sales and profit projections. There's lots of guesswork about how rapidly buyers will be attracted and how much they will be willing to pay. For example, there is still uncertainty about how quickly the demand for high-definition TV sets will grow following the 2003 law requiring all U.S. TV stations to broadcast digital programs.
- In many cases, much of the technological know-how underlying the products of emerging industries is proprietary and closely guarded, having been developed in-house by pioneering firms; patents and unique technical expertise are key factors in securing competitive advantage. In other cases, the technology is multifaceted, entailing parallel or collaborative efforts on the part of several enterprises and perhaps competing technological approaches.
- Often, there is no consensus regarding which of several competing technologies will win out or which product attributes will prove decisive in winning buyer favor—as is the case in high-speed Internet access where cable modems, digital subscriber line (DSL), and wireless technologies are competing vigorously. Until market forces sort these things out, wide differences in product quality and performance are typical. Rivalry therefore centers on each firm's efforts to get the market to ratify its own strategic approach to technology, product design, marketing, and distribution.
- Entry barriers tend to be relatively low, even for entrepreneurial start-up companies. Large, well-known, opportunity-seeking companies with ample resources and competitive capabilities are likely to enter if the industry has promise for explosive growth or if its emergence threatens their present business. For instance, many traditional local telephone companies, seeing the potent threat of wireless communications technology, have opted to enter the mobile communications business in one way or another.
- Strong learning and experience curve effects may be present, allowing significant price reductions as volume builds and costs fall.
- Since in an emerging industry all buyers are first-time users, the marketing task is to induce initial purchase and to overcome customer concerns about product features, performance reliability, and conflicting claims of rival firms.
- Many potential buyers expect first-generation products to be rapidly improved, so they delay purchase until technology and product design mature and second- or third-generation products appear on the market.

- Sometimes, firms have trouble securing ample supplies of raw materials and components (until suppliers gear up to meet the industry's needs).
- Undercapitalized companies, finding themselves short of funds to support needed R&D and get through several lean years until the product catches on, end up merging with competitors or being acquired by financially strong outsiders looking to invest in a growth market.

The two critical strategic issues confronting firms in an emerging industry are (1) how to finance initial operations until sales and revenues take off, and (2) what market segments and competitive advantages to go after in trying to secure a front-runner position.[2] Competitive strategies keyed either to low cost or differentiation are usually viable. Focusing makes good sense when resources and capabilities are limited and the industry has too many technological frontiers or too many buyer segments to pursue at once. The lack of established "rules of the game" gives industry participants considerable freedom to experiment with a variety of different strategic approaches. Nonetheless, a firm with solid resource capabilities, an appealing business model, and a good strategy has a golden opportunity to shape the rules and establish itself as the recognized industry front-runner.

Strategic Avenues for Competing in an Emerging Industry

Dealing with all the risks and opportunities of an emerging industry is one of the most challenging business strategy problems. To be successful in an emerging industry, companies usually have to pursue one or more of the following strategic avenues:[3]

1. Try to win the early race for industry leadership with risk-taking entrepreneurship and a bold creative strategy. Broad or focused differentiation strategies keyed to technological or product superiority typically offer the best chance for early competitive advantage.
2. Push to perfect the technology, improve product quality, and develop additional attractive performance features.
3. As technological uncertainty clears and a dominant technology emerges, adopt it quickly. (However, while there's merit in trying to be the industry standard-bearer on technology and to pioneer the dominant product design, firms have to beware of betting too heavily on their own preferred technological approach or product design—especially when there are many competing technologies, R&D is costly, and technological developments can quickly move in surprising new directions.)

> Strategic success in an emerging industry calls for bold entrepreneurship, a willingness to pioneer and take risks, an intuitive feel for what buyers will like, quick response to new developments, and opportunistic strategy making.

4. Form strategic alliances with key suppliers to gain access to specialized skills, technological capabilities, and critical materials or components.
5. Acquire or form alliances with companies that have related or complementary technological expertise as a means of helping outcompete rivals on the basis of technological superiority.
6. Try to capture any first-mover advantages associated with early commitments to promising technologies.
7. Pursue new customer groups, new user applications, and entry into new geographical areas (perhaps using strategic partnerships or joint ventures if financial resources are constrained).

8. Make it easy and cheap for first-time buyers to try the industry's first-generation product. Then, as the product becomes familiar to a wide portion of the market, begin to shift the advertising emphasis from creating product awareness to increasing frequency of use and building brand loyalty.
9. Use price cuts to attract the next layer of price-sensitive buyers into the market.

The short-term value of winning the early race for growth and market share leadership has to be balanced against the longer-range need to build a durable competitive edge and a defendable market position.[4] Well-financed outsiders are certain to move in with aggressive strategies as industry sales start to take off and the perceived risk of investing in the industry lessens. A rush of new entrants, attracted by the growth and profit potential, may crowd the market and force industry consolidation to a smaller number of players. Resource-rich latecomers, aspiring to industry leadership, may be able to become major players by acquiring and merging the operations of weaker competitors and then launching strategic offensives to build market share and gain quick brand-name recognition. Strategies must be aimed at competing for the long haul; often, this means sacrificing some degree of short-term profitability in order to invest in the resources, capabilities, and market recognition needed to sustain early successes.

The early leaders in an emerging industry cannot rest on their laurels; they must drive hard to strengthen their resource capabilities and build a position strong enough to ward off newcomers and compete successfully for the long haul.

Young companies in fast-growing markets face three strategic hurdles: (1) managing their own rapid expansion, (2) defending against competitors trying to horn in on their success, and (3) building a competitive position extending beyond their initial product or market. Up-and-coming companies can help their cause by selecting knowledgeable members for their boards of directors, by hiring entrepreneurial managers with experience in guiding young businesses through the start-up and takeoff stages, by concentrating on out-innovating the competition, and perhaps by merging with or acquiring another firm to gain added expertise and a stronger resource base.

STRATEGIES FOR COMPETING IN TURBULENT, HIGH-VELOCITY MARKETS

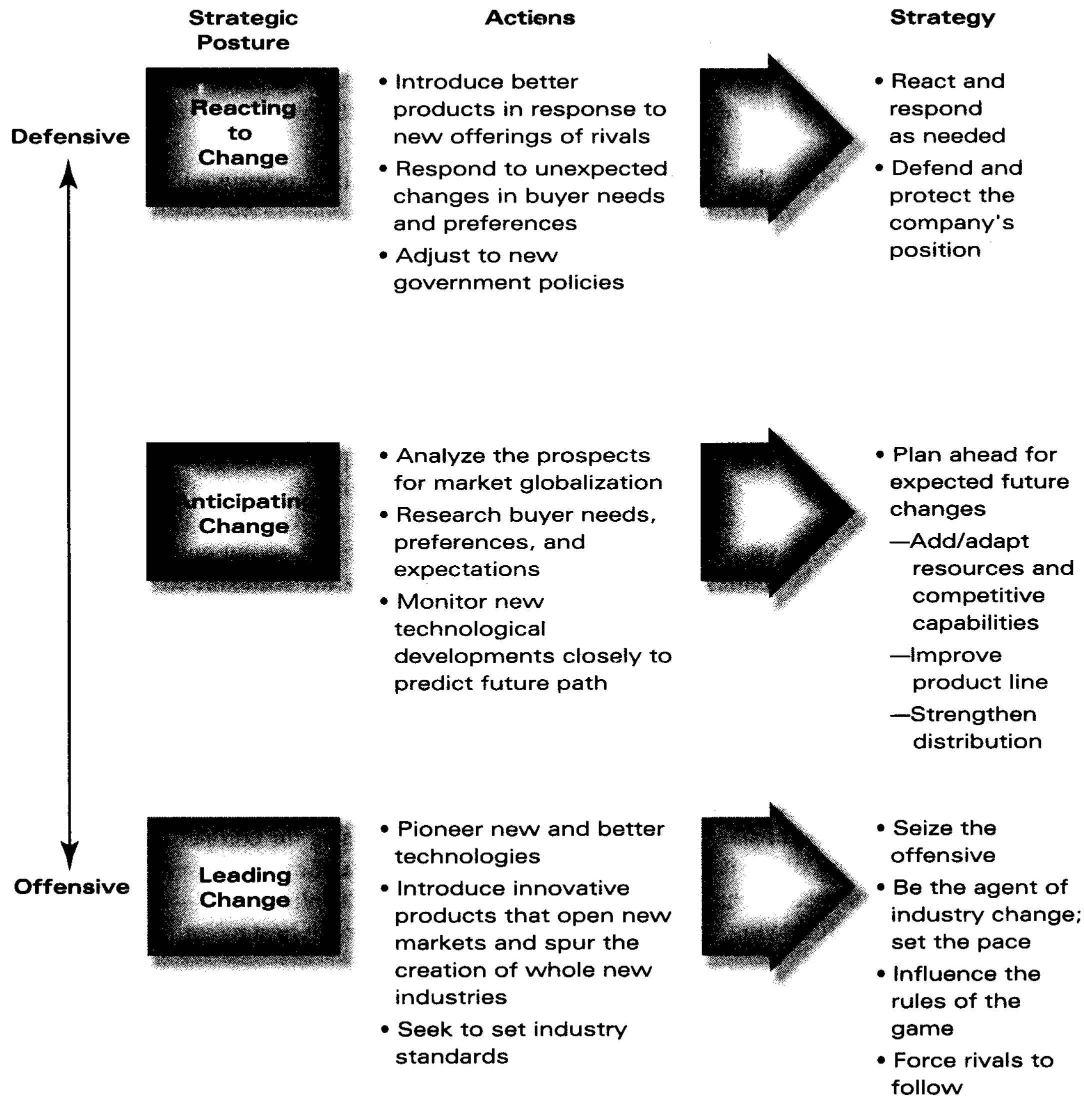
More and more companies are finding themselves in industry situations characterized by rapid technological change, short product life cycles because of entry of important new rivals into the marketplace, frequent launches of new competitive moves by rivals, and fast-evolving customer requirements and expectations—all occurring at once. Since news of this or that important competitive development arrives daily, it is an imposing task just to monitor and assess developing events. High-velocity change is plainly the prevailing condition in personal computer hardware and software, video games, networking, wireless telecommunications, medical equipment, biotechnology, prescription drugs, and virtually all Internet industries.

Strategic Postures for Coping with Rapid Change

The central strategy-making challenge in a turbulent market environment is managing change.[5] As illustrated in Figure 8.1, a company can assume any of three strategic postures in dealing with high-velocity change:[6]

- *It can react to change.* The company can respond to a rival's new product with a better product. It can counter an unexpected shift in buyer tastes and buyer demand by redesigning or repackaging its

figure 8.1 **Meeting the Challenge of High-Velocity Change**



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product, or shifting its advertising emphasis to different product attributes. Reacting is a defensive strategy and is therefore unlikely to create fresh opportunity, but it is nonetheless a necessary component in a company's arsenal of options.

- *It can anticipate change, make plans for dealing with the expected changes, and follow its plans as changes occur (fine-tuning them as may be needed).* Anticipation entails looking ahead to analyze what is likely to occur and then preparing and positioning for that future. It entails studying buyer

Reacting to change and anticipating change are basically defensive postures; leading change is an offensive posture.

behavior, buyer needs, and buyer expectations to get insight into how the market will evolve, then lining up the necessary production and distribution capabilities ahead of time. Like reacting to change, anticipating change is still fundamentally defensive in that forces outside the enterprise are in the driver's seat. Anticipation, however, can open up new opportunities and thus is a better way to manage change than just pure reaction.

- *It can lead change.* Leading change entails initiating the market and competitive forces that others must respond to—*it is an offensive strategy aimed at putting a company in the driver's seat.* Leading change means being first to market with an important new product or service. It means being the technological leader, rushing next-generation products to market ahead of rivals, and having products whose features and attributes shape customer preferences and expectations. It means proactively seeking to shape the rules of the game.

Industry leaders are proactive agents of change, not reactive followers and analyzers. Moreover, they improvise, experiment, develop options, and adapt rapidly.

As a practical matter, a company's approach to managing change should, ideally, incorporate all three postures (though not in the same proportion). The best-performing companies in high-velocity markets consistently seek to lead change with proactive strategies that often entail the flexibility to pursue any of several strategic options, depending on how the market actually evolves. Even so, an environment of relentless change makes it incumbent on any company to anticipate and prepare for the future and to react quickly to unpredictable or uncontrollable new developments.

Strategic Moves for Fast-Changing Markets

Competitive success in fast-changing markets tends to hinge on a company's ability to improvise, experiment, adapt, reinvent, and regenerate as market and competitive conditions shift rapidly and sometimes unpredictably.[7] It has to constantly reshape its strategy and its basis for competitive advantage. While the process of altering offensive and defensive moves every few months or weeks to keep the overall strategy closely matched to changing conditions is inefficient, the alternative—a fast-obsolescing strategy—is worse. The following five strategic moves seem to offer the best payoffs:

1. *Invest aggressively in R&D to stay on the leading edge of technological know-how.* Translating technological advances into innovative new products (and remaining close on the heels of whatever advances and features are pioneered by rivals) is a necessity in industries where technology is the primary driver of change. But it is often desirable to focus the R&D effort on a few critical areas, not only to avoid stretching the company's resources too thin but also to deepen the firm's expertise, master the technology, fully capture learning-curve effects, and become the dominant leader in a particular technology or product category.[8] When a fast-evolving market environment entails many technological areas and product categories, competitors have little choice but to employ some type of focus strategy and concentrate on being the leader in a particular product/technology category.
2. *Develop quick-response capability.* Because no company can predict all of the changes that will occur, it is crucial to have the organizational capability to be able to react quickly, improvising if necessary. This means shifting resources internally, adapting existing competencies and capabilities, creating new competencies and capabilities, and not falling far behind rivals. Companies that are habitual late-movers are destined to be industry also-rans.

3. *Rely on strategic partnerships with outside suppliers and with companies making tie-in products.* In many high-velocity industries, technology is branching off to create so many new technological paths and product categories that no company has the resources and competencies to pursue them all. Specialization (to promote the necessary technical depth) and focus (to preserve organizational agility and leverage the firm's expertise) are desirable strategies. Companies build their competitive position not just by strengthening their own internal resource base but also by partnering with those suppliers making state-of-the-art parts and components and by collaborating closely with both the developers of related technologies and the makers of tie-in products. For example, personal computer companies like Gateway, Dell, Compaq, and Acer rely heavily on the developers and manufacturers of chips, monitors, hard drives, DVD players, and software for innovative advances in PCs. None of the PC makers have done much in the way of integrating backward into parts and components because they have learned that the most effective way to provide PC users with a state-of-the-art product is to outsource the latest, most advanced components from technologically sophisticated suppliers who make it their business to stay on the cutting edge of their specialization and who can achieve economies of scale by mass-producing components for many PC assemblers. An outsourcing strategy also allows a company the flexibility to replace suppliers that fall behind on technology or product features or that cease to be competitive on price. The managerial challenge here is to strike a good balance between building a rich internal resource base that, on the one hand, keeps the firm from being at the mercy of its suppliers and allies and, on the other hand, maintains organizational agility by relying on the resources and expertise of capable (and perhaps "best-in-world") outsiders.
4. *Initiate fresh actions every few months, not just when a competitive response is needed.* In some sense, change is partly triggered by the passage of time rather than solely by the occurrence of events. A company can be proactive by making *time-paced moves*—introducing a new or improved product every four months, rather than when the market tapers off or a rival introduces a next-generation model.[9] Similarly, a company can expand into a new geographic market every six months rather than waiting for a new market opportunity to present itself; it can also refresh existing brands every two years rather than waiting until their popularity wanes. The keys to successfully using time pacing as a strategic weapon are choosing intervals that make sense internally and externally, establishing an internal organizational rhythm for change, and choreographing the transitions. 3M Corporation has long pursued an objective of having 25 percent of its revenues come from products less than four years old, a force that established the rhythm of change and created a relentless push for new products. Recently, the firm's CEO upped the tempo of change at 3M by increasing the percentage from 25 percent to 30 percent.
5. *Keep the company's products and services fresh and exciting enough to stand out in the midst of all the change that is taking place.* One of the risks of rapid change is that products and even companies can get lost in the shuffle. The marketing challenge here is to keep the firm's products and services in the limelight and, further, to keep them innovative and well matched to the changes that are occurring in the marketplace.

Cutting-edge know-how and first-to-market capabilities are very valuable competitive assets in fast-evolving markets. Moreover, action-packed competition demands that a company have quick reaction times and flexible, adaptable resources—organizational agility is a huge competitive asset. Even so, com-

In fast-paced markets, in-depth expertise, speed, agility, innovativeness, opportunism, and resource flexibility are critical organizational capabilities.

panies will make mistakes and some things a company does are going to work better than others. When a company's strategy doesn't seem to be working well, it has to quickly regroup—probing, experimenting, improvising, and trying again and again until it finds something that strikes the right chord with buyers and that puts it in sync with market and competitive realities.

STRATEGIES FOR COMPETING IN MATURING INDUSTRIES

A maturing industry is one that is moving from rapid growth to significantly slower growth. An industry is said to be mature when nearly all potential buyers are already users of the industry's products. In a mature market, demand consists mainly of replacement sales to existing users, with growth hinging on the industry's abilities to attract the few remaining new buyers and to convince existing buyers to up their usage. Consumer goods industries that are mature typically have a growth rate under 5 percent—roughly equal to the growth of the customer base or economy as a whole.

Industry Changes Resulting from Market Maturity

An industry's transition to maturity does not begin on an easily predicted schedule. Industry maturity can be forestalled by the emergence of new technological advances, product innovations, or other driving forces that keep rejuvenating market demand. Nonetheless, when growth rates do slacken, the onset of market maturity usually produces fundamental changes in the industry's competitive environment:[10]

1. *Slowing growth in buyer demand generates more head-to-head competition for market share.* Firms that want to continue on a rapid-growth track start looking for ways to take customers away from competitors. Outbreaks of price cutting, increased advertising, and other aggressive tactics to gain market share are common.
2. *Buyers become more sophisticated, often driving a harder bargain on repeat purchases.* Since buyers have experience with the product and are familiar with competing brands, they are better able to evaluate different brands and can use their knowledge to negotiate a better deal with sellers.
3. *Competition often produces a greater emphasis on cost and service.* As sellers all begin to offer the product attributes buyers prefer, buyer choices increasingly depend on which seller offers the best combination of price and service.
4. *Firms have a "topping-out" problem in adding new facilities.* Reduced rates of industry growth mean slowdowns in capacity expansion for manufacturers and slowdowns in new store growth for retail chains. With slower industry growth, adding too much capacity too soon can create oversupply conditions that adversely affect company profits well into the future.
5. *Product innovation and new end-use applications are harder to come by.* Producers find it increasingly difficult to create new product features, find further uses for the product, and sustain buyer excitement.
6. *International competition increases.* Growth-minded domestic firms start to seek out sales opportunities in foreign markets. Some companies, looking for ways to cut costs, relocate plants to countries with lower wage rates. Greater product standardization and diffusion of technological

know-how reduce entry barriers and make it possible for enterprising foreign companies to become serious market contenders in more countries. Industry leadership passes to companies that succeed in building strong competitive positions in most of the world's major geographic markets and in winning the biggest global market shares.

7. *Industry profitability falls temporarily or permanently.* Slower growth, increased competition, more sophisticated buyers, and occasional periods of overcapacity put pressure on industry profit margins. Weaker, less-efficient firms are usually the hardest hit.
8. *Stiffening competition induces a number of mergers and acquisitions among former competitors, drives the weakest firms out of the industry, and produces industry consolidation in general.* Inefficient firms and firms with weak competitive strategies can achieve respectable results in a fast-growing industry with booming sales. But the intensifying competition that accompanies industry maturity exposes competitive weakness and throws second- and third-tier competitors into a survival-of-the-fittest contest.

Strategic Moves in Maturing Industries

As the new competitive character of industry maturity begins to hit full force, any of several strategic moves can strengthen a firm's competitive position: pruning the product line, improving value chain efficiency, trimming costs, increasing sales to present customers, acquiring rival firms, expanding internationally, and strengthening capabilities.[11]

Pruning Marginal Products and Models A wide selection of models, features, and product options sometimes has competitive value during the growth stage, when buyers' needs are still evolving. But such variety can become too costly as price competition stiffens and profit margins are squeezed. Maintaining many product versions works against achieving design, parts inventory, and production economies at the manufacturing levels and can increase inventory stocking costs for distributors and retailers. In addition, the prices of slow-selling versions may not cover their true costs. Pruning marginal products from the line opens the door for cost savings and permits more concentration on items whose margins are highest and/or where a firm has a competitive advantage.

More Emphasis on Value Chain Innovation Efforts to reinvent the industry value chain can have a fourfold payoff: lower costs, better product or service quality, greater capability to turn out multiple or customized product versions, and shorter design-to-market cycles. Manufacturers can mechanize high-cost activities, redesign production lines to improve labor efficiency, build flexibility into the assembly process so that customized product versions can be easily produced, and increase use of advanced technology (robotics, computerized controls, and automatic guided vehicles). Suppliers of parts and components, manufacturers, and distributors can collaborate on the use of Internet technology and e-commerce techniques to streamline various value chain activities and implement cost-saving innovations.

Trimming Costs Stiffening price competition gives firms extra incentive to drive down unit costs. Company cost-reduction initiatives can cover a broad front. Some of the most frequently pursued options are pushing suppliers for better prices, implementing tighter supply chain management practices, cutting low-value activities out of the value chain, developing more economical product designs, reengineering

internal processes using e-commerce technology, and shifting to more economical distribution arrangements.

Increasing Sales to Present Customers In a mature market, growing by taking customers away from rivals may not be as appealing as expanding sales to existing customers. Strategies to increase purchases by existing customers can involve adding more sales promotions, providing complementary items and ancillary services, and finding more ways for customers to use the product. Convenience stores, for example, have boosted average sales per customer by adding video rentals, automated teller machines, gasoline pumps, and deli counters.

Acquiring Rival Firms at Bargain Prices Sometimes a firm can acquire the facilities and assets of struggling rivals quite cheaply. Bargain-priced acquisitions can help create a low-cost position if they also present opportunities for greater operating efficiency. In addition, an acquired firm's customer base can provide expanded market coverage and opportunities for greater scale economies. The most desirable acquisitions are those that will significantly enhance the acquiring firm's competitive strength.

Expanding Internationally As its domestic market matures, a firm may seek to enter foreign markets where attractive growth potential still exists and competitive pressures are not so strong. Many multinational companies are expanding into such emerging markets as China, India, Brazil, Argentina, and the Philippines, where the long-term growth prospects are quite attractive. Strategies to expand internationally also make sense when a domestic firm's skills, reputation, and product are readily transferable to foreign markets. For example, even though the U.S. market for soft drinks is mature, Coca-Cola has remained a growth company by upping its efforts to penetrate emerging markets where soft-drink sales are expanding rapidly.

Building New or More Flexible Capabilities The stiffening pressures of competition in a maturing or already mature market can often be combated by strengthening the company's resource base and competitive capabilities. This can mean adding new competencies or capabilities, deepening existing competencies to make them harder to imitate, or striving to make core competencies more adaptable to changing customer requirements and expectations. Microsoft has responded to competitors' challenges by expanding its already large cadre of talented programmers. Chevron has developed a best-practices discovery team and a best-practices resource map to enhance the speed and effectiveness with which it is able to transfer efficiency improvements from one oil refinery to another.

Strategic Pitfalls in Maturing Industries

One of the greatest strategic mistakes a firm can make in a maturing industry is pursuing a compromise strategy that leaves it stuck in the middle.

Perhaps the biggest strategic mistake a company can make as an industry matures is steering a middle course between low cost, differentiation, and focusing—blending efforts to achieve low cost with efforts to incorporate differentiating features and efforts to focus on a limited target market. Such strategic compromises typically leave the firm stuck in the middle with a fuzzy strategy, too little commitment to winning a competitive advantage, an average image with buyers, and little chance of springing into the ranks of the industry leaders.

Other strategic pitfalls include being slow to mount a defense against stiffening competitive pressures, concentrating more on protecting short-term profitability than on building or maintaining long-term competitive position, waiting too long to respond to price cutting by rivals, overexpanding in the

face of slowing growth, overspending on advertising and sales promotion efforts in a losing effort to combat the growth slowdown, and failing to pursue cost reduction soon enough or aggressively enough.

STRATEGIES FOR FIRMS IN STAGNANT OR DECLINING INDUSTRIES

Many firms operate in industries where demand is growing more slowly than the economy-wide average or is even declining. Although harvesting the business to obtain the greatest cash flow, selling out, or preparing for closedown are obvious end-game strategies for uncommitted competitors with dim long-term prospects, strong competitors may be able to achieve good performance even in a stagnant market environment.[12] Stagnant demand by itself is not enough to make an industry unattractive. Selling out may or may not be practical, and closing operations is always a last resort.

Businesses competing in stagnant or declining industries must resign themselves to performance targets consistent with available market opportunities. Cash flow and return-on-investment criteria are more appropriate than growth-oriented performance measures, but sales and market-share growth are by no means ruled out. Strong competitors may be able to take sales from weaker rivals, and the acquisition or exit of weaker firms creates opportunities for the remaining companies to capture greater market share.

In general, companies that succeed in stagnant industries employ one or more of three strategic themes:[13]

Achieving competitive advantage in stagnant or declining industries usually requires pursuing one of three competitive approaches: focusing on growing market segments within the industry, differentiating on the basis of better quality and frequent product innovation, or becoming a lower-cost producer.

1. *Pursue a focused strategy aimed at the fastest-growing market segments within the industry.* Stagnant or declining markets, like other markets, are composed of numerous segments or niches. Frequently, one or more of these segments is growing rapidly, despite stagnation in the industry as a whole. An astute competitor who zeroes in on fast-growing segments and does a first-rate job of meeting the needs of buyers comprising these segments can often escape stagnating sales and profits and even gain decided competitive advantage. For instance, both Ben & Jerry's and Häagen-Dazs have achieved success by focusing on the growing luxury or superpremium segment of the otherwise stagnant market for ice cream; revenue growth and profit margins are substantially higher for high-end ice creams sold in supermarkets and in scoop shops than is the case in other segments of the ice cream market.
2. *Stress differentiation based on quality improvement and product innovation.* Either enhanced quality or innovation can rejuvenate demand by creating important new growth segments or inducing buyers to trade up. Successful product innovation opens up an avenue for competing that bypasses meeting or beating rivals' prices. Differentiation based on successful innovation has the additional advantage of being difficult and expensive for rival firms to imitate. Sony has built a solid business selling high-quality multifeatured TVs, an industry where market demand has been relatively flat in the world's industrialized nations for some years. New Covent Garden Soup has met with success by introducing packaged fresh soups for sale in major supermarkets, where the typical soup offerings are canned or dry mixes.

3. *Strive to drive costs down and become the industry's low-cost leader.* Companies in stagnant industries can improve profit margins and return on investment by pursuing innovative cost reduction year after year. Potential cost-saving actions include (*a*) cutting marginally beneficial activities out of the value chain; (*b*) outsourcing functions and activities that can be performed more cheaply by outsiders; (*c*) redesigning internal business processes to exploit cost-reducing e-commerce technologies; (*d*) consolidating underutilized production facilities; (*e*) adding more distribution channels to ensure the unit volume needed for low-cost production; (*f*) closing low-volume, high-cost retail outlets; and (*g*) pruning marginal products from the firm's offerings. Japan-based Asahi Glass (a low-cost producer of flat glass), PotashCorp and IMC Global (two low-cost leaders in potash production), Alcan Aluminum, Nucor Steel, and Safety Components International (a low-cost producer of air bags for motor vehicles) have all been successful in driving costs down in competitively tough and largely stagnant industry environments.

These three strategic themes are not mutually exclusive.[14] Introducing innovative versions of a product can *create* a fast-growing market segment. Similarly, relentless pursuit of greater operating efficiencies permits price reductions that create price-conscious growth segments. Note that all three themes are spinoffs of the generic competitive strategies, adjusted to fit the circumstances of a tough industry environment. The most attractive declining industries are those in which sales are eroding only slowly, there is large built-in demand, and some profitable niches remain.

The most common strategic mistakes companies make in stagnating or declining markets are (1) getting trapped in a profitless war of attrition, (2) diverting too much cash out of the business too quickly (thus further eroding performance), and (3) being overly optimistic about the industry's future and spending too much on improvements in anticipation that things will get better.

Illustration Capsule 8.1 describes the creative approach taken by Yamaha to combat the declining demand in the piano market.

STRATEGIES FOR COMPETING IN FRAGMENTED INDUSTRIES

A number of industries are populated by hundreds, even thousands, of small and medium-sized companies, many privately held and none with a substantial share of total industry sales.[15] The standout competitive feature of a fragmented industry is the absence of market leaders with king-sized market shares or widespread buyer recognition. Examples of fragmented industries include book publishing, landscaping and plant nurseries, real estate development, convenience stores, banking, health and medical care, mail order catalog sales, computer software development, custom printing, kitchen cabinets, trucking, auto repair, restaurants and fast food, public accounting, apparel manufacture and apparel retailing, paperboard boxes, hotels and motels, and furniture.

Reasons for Supply-Side Fragmentation

Any of several reasons can account for why the supply side of an industry is fragmented:

- Market demand is so extensive and so diverse that very large numbers of firms can easily coexist trying to accommodate the range and variety of buyer preferences and requirements and to cover all

illustration capsule 8.1

Yamaha's Strategy in the Stagnant Piano Industry

For some years now, worldwide demand for pianos has been declining—in the mid-1980s the decline was 10 percent annually. Modern-day parents have not put the same stress on music lessons for their children as prior generations of parents did. In an effort to see if it could revitalize its piano business, Yamaha conducted a market research survey to learn what use was being made of pianos in households that owned one. The survey revealed that the overwhelming majority of the 40 million pianos in American, European, and Japanese households were seldom used. In most cases, the reasons the piano had been purchased no longer applied. Children had either stopped taking piano lessons or were grown and had left the household; adult household members played their pianos sparingly, if at all—only a small percentage were accomplished piano players. Most pianos were serving as a piece of fine furniture and were in good condition despite not being tuned regularly. The survey also confirmed that the income levels of piano owners were well above average.

Beginning in the late 1980s, Yamaha's piano strategists saw the idle pianos in these upscale households as a potential market opportunity. The strategy that emerged entailed marketing an attachment that would convert the piano into an old-fashioned automatic player piano capable of playing a wide number of selections recorded on disks. Concurrently, Yamaha introduced Disklavier, an upright acoustic player piano model that could record and play back performances up to 90 minutes long, making it simple to monitor student progress.

Over the past 15 years, Yamaha has introduced a host of Disklavier pianos—grand pianos, minigrand, upright, and console designs in a variety of styles and finishes. It has partnered with recording artists and music studios to make thousands of digital disks available for Yamaha piano owners, allowing them to enjoy concert-caliber performances in their home. And it has created a global music education program for both teachers and students—in 2003 Yamaha had about 750,000 students enrolled in its music education programs at some 7,500 locations across the world. Together, these efforts have helped rejuvenate and sustain Yamaha's piano business.

Source: www.yamaha.com.

the needed geographic locations. This is true in the hotel and restaurant industry in New York City, London, or Tokyo, and the market for apparel. Likewise, there is ample room in the marketplace for numerous auto repair outlets, gasoline and convenience store retailers, and real estate firms.

- Low entry barriers allow small firms to enter quickly and cheaply.
- An absence of scale economies permits small companies to compete on an equal cost footing with larger firms.
- Buyers require relatively small quantities of customized products (as in business forms, interior design, kitchen cabinets, and advertising). Because demand for any particular product version is small, sales volumes are not adequate to support producing, distributing, or marketing on a scale that yields advantages to a large firm.
- The market for the industry's product or service is becoming more global, putting companies in more and more countries in the same competitive market arena (as in apparel manufacture).
- The technologies embodied in the industry's value chain are exploding into so many new areas and along so many different paths that specialization is essential just to keep abreast in any one area of expertise.
- The industry is young and crowded with aspiring contenders, with no firm having yet developed the resource base, competitive capabilities, and market recognition to command a significant market share (as in business-to-consumer retailing via the Internet).

Some fragmented industries consolidate over time as growth slows and the market matures. The stiffer competition that accompanies slower growth produces a shake-out of weak, inefficient firms and a greater concentration of larger, more visible sellers. Others remain atomistic because it is inherent in the nature of their businesses. And still others remain stuck in a fragmented state because existing firms lack the resources or ingenuity to employ a strategy powerful enough to drive industry consolidation.

Competitive rivalry in fragmented industries can vary from moderately strong to fierce. Low barriers tend to make entry of new competitors an ongoing threat. Competition from substitutes may or may not be a major factor. The relatively small size of companies in fragmented industries puts them in a relatively weak position to bargain with powerful suppliers and buyers, although sometimes they can become members of a cooperative formed for the purpose of using their combined leverage to negotiate better sales and purchase terms. In such an environment, the best a firm can expect is to cultivate a loyal customer base and grow a bit faster than the industry average. Competitive strategies based on either low cost or product differentiation are viable unless the industry's product is highly standardized or a commodity (like sand, concrete blocks, or paperboard boxes). Focusing on a well-defined market niche or buyer segment usually offers more competitive advantage potential than striving for broad market appeal.

In fragmented industries competitors usually have wide enough strategic latitude (1) to either compete broadly or focus and (2) to pursue a low-cost, differentiation-based, or best-cost competitive advantage.

Strategy Options for a Fragmented Industry

Suitable competitive strategy options in a fragmented industry include:

- *Constructing and operating "formula" facilities*—This strategic approach is frequently employed in restaurant and retailing businesses operating at multiple locations. It involves constructing standardized outlets in favorable locations at minimum cost and then operating them cost-effectively. Yum! Brands (the parent of Pizza Hut, Taco Bell, KFC, Long John Silver's, and A&W restaurants), Home Depot, Staples, and 7-Eleven pursue this strategy.
- *Becoming a low-cost operator*—When price competition is intense and profit margins are under constant pressure, companies can stress no-frills operations featuring low overhead, high-productivity/low-cost labor, lean capital budgets, and dedicated pursuit of total operating efficiency. Successful low-cost producers in a fragmented industry can play the price-discounting game and still earn profits above the industry average. Many e-tailers compete on the basis of bargain prices; so do local tire retailers and supermarkets and off-brand gasoline stations.
- *Specializing by product type*—When a fragmented industry's products include a range of styles or services, a strategy to focus on one product or service category can be effective. Some firms in the furniture industry specialize in only one furniture type such as brass beds, rattan and wicker, lawn and garden, or early American. In auto repair, companies specialize in transmission repair, body work, or speedy oil changes.
- *Specializing by customer type*—A firm can stake out a market niche in a fragmented industry by catering to those customers who are interested in low prices, unique product attributes, customized features, carefree service, or other extras. A number of restaurants cater to take-out customers; others specialize in fine dining, and still others cater to the sports bar crowd.

- *Focusing on a limited geographic area*—Even though a firm in a fragmented industry can't win a big share of total industrywide sales, it can still try to dominate a local or regional geographic area. Concentrating company efforts on a limited territory can produce greater operating efficiency, speed delivery and customer services, promote strong brand awareness, and permit saturation advertising, while avoiding the diseconomies of stretching operations out over a much wider area. Supermarkets, banks, convenience stores, and sporting goods retailers successfully operate multiple locations within a limited geographic area.

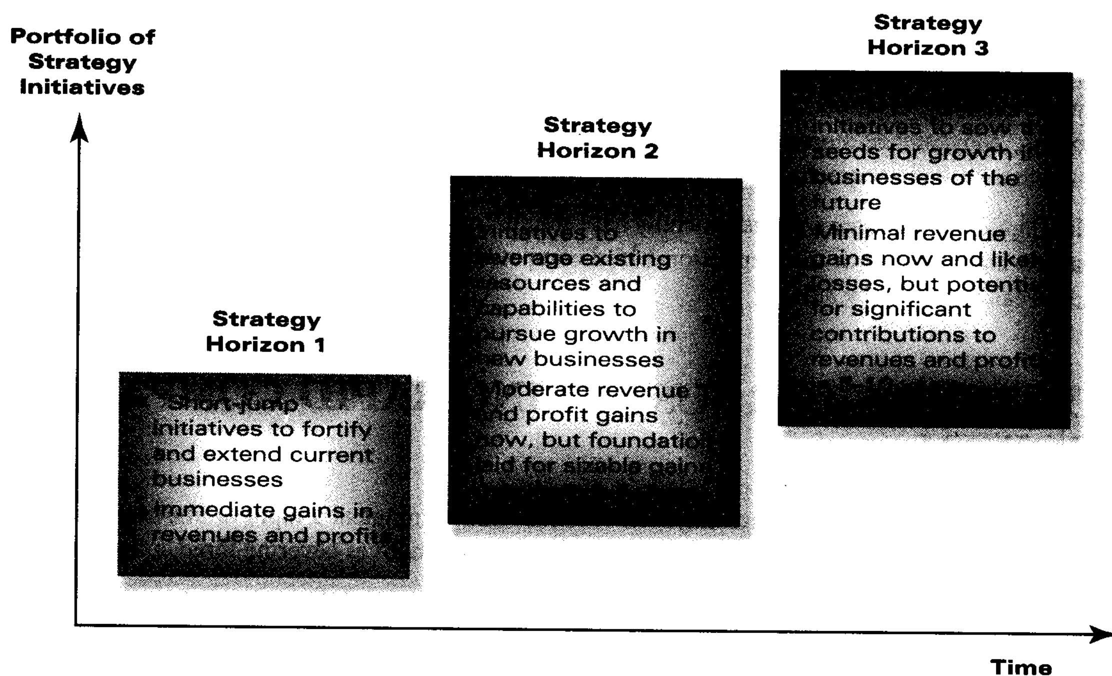
In fragmented industries, firms generally have the strategic freedom to pursue broad or narrow market targets and low-cost or differentiation-based competitive advantages. Many different strategic approaches can exist side by side.

STRATEGIES FOR SUSTAINING RAPID COMPANY GROWTH

Companies that are focused on growing their revenues and earnings at a rapid or above-average pace year after year generally have to craft a portfolio of strategic initiatives covering three horizons:[16]

- *Horizon 1: "Short-jump" strategic initiatives to fortify and extend the company's position in existing businesses*—Short-jump initiatives typically include adding new items to the company's present product line, expanding into new geographic areas where the company does not yet have a market presence, and launching offensives to take market share away from rivals. The objective is to capitalize fully on whatever growth potential exists in the company's present business arenas.
- *Horizon 2: "Medium-jump" strategic initiatives to leverage existing resources and capabilities by entering new businesses with promising growth potential*—Growth companies have to be alert for opportunities to jump into new businesses where there is promise of rapid growth and where their experience, intellectual capital, and technological know-how will prove valuable in gaining rapid market penetration. While Horizon 2 initiatives may take a back seat to Horizon 1 initiatives as long as there is plenty of untapped growth in the company's present businesses, they move to the front as the onset of market maturity dims the company's growth prospects in its present business(es).
- *Horizon 3: "Long-jump" strategic initiatives to plant the seeds for ventures in businesses that do not yet exist*—Long-jump initiatives can entail pumping funds into long-range R&D projects, setting up an internal venture capital fund to invest in promising start-up companies attempting to create the industries of the future, or acquiring a number of small start-up companies experimenting with technologies and product ideas that complement the company's present businesses. Intel, for example, set up a multibillion-dollar venture fund to invest in over 100 different projects and start-up companies, the intent being to plant seeds for Intel's future, broadening its base as a global leader in supplying building blocks for PCs and the worldwide Internet economy. Royal Dutch/Shell, with over $140 billion in revenues and over 100,000 employees, spent over $20 million on rule-breaking, game-changing ideas put forth by free-thinking employees; the objective was to inject a new spirit of entrepreneurship into the company and sow the seeds of faster growth.[17]

figure 8.2 **The Three Strategy Horizons for Sustaining Rapid Growth**



Source: Adapted from Eric D. Beinhocker, "Robust Adaptive Strategies," *Sloan Management Review* 40, No. 3 (Spring 1999), p. 101.

The three strategy horizons are illustrated in Figure 8.2. Managing such a portfolio of strategic initiatives to sustain rapid growth is not easy, however. The tendency of most companies is to focus on Horizon 1 strategies and devote only sporadic and uneven attention to Horizon 2 and 3 strategies. But a recent McKinsey & Company study of 30 of the world's leading growth companies revealed a relatively balanced portfolio of strategic initiatives covering all three horizons. The lesson of successful growth companies is that keeping a company's record of rapid growth intact over the long term entails crafting a diverse population of strategies, ranging from short-jump incremental strategies to grow present businesses to long-jump initiatives with a 5- to 10-year growth payoff horizon.[18] Having a mixture of short-jump, medium-jump, and long-jump initiatives not only increases the odds of hitting a few home runs but also provides some protection against unexpected adversity in present or newly entered businesses.

The Risks of Pursuing Multiple Strategy Horizons

There are, of course, risks to pursuing a diverse strategy portfolio aimed at sustained growth. A company cannot, of course, place bets on every opportunity that appears on its radar screen, lest it stretch its resources too thin. And medium-jump and long-jump initiatives can cause a company to stray far from its core competencies and end up trying to compete in businesses for which it is ill-suited. Moreover, it can be difficult to achieve competitive advantage in medium- and long-jump product families and businesses

that prove not to mesh well with a company's present businesses and resource strengths. The payoffs of long-jump initiatives often prove elusive; not all of the seeds a company sows will bear fruit, and only a few may evolve into truly significant contributors to the company's revenue and profit growth. The losses from those long-jump ventures that do not take root may significantly erode the gains from those that do, resulting in disappointingly modest gains in overall profits.

STRATEGIES FOR INDUSTRY LEADERS

The competitive positions of industry leaders normally range from "stronger than average" to "powerful." Leaders typically are well known, and strongly entrenched leaders have proven strategies (keyed either to low-cost leadership or to differentiation). Some of the best-known industry leaders are Anheuser-Busch (beer), Starbucks (coffee drinks), Microsoft (computer software), Callaway (golf clubs), McDonald's (fast food), Gillette (razor blades), Campbell's Soup (canned soups), Gerber (baby food), Hewlett-Packard (printers), Nokia (cell phones), AT&T (long-distance telephone service), Eastman Kodak (camera film), Wal-Mart (discount retailing), Amazon.com (online shopping), eBay (online auctions), and Levi Strauss (jeans).

The main strategic concern for a leader revolves around how to defend and strengthen its leadership position, perhaps becoming the *dominant* leader as opposed to just *a* leader. However, the pursuit of industry leadership and large market share is primarily important because of the competitive advantage and profitability that accrue to being the industry's biggest company. Three contrasting strategic postures are open to industry leaders:[19]

1. Stay-on-the-offensive strategy—The central goal of a stay-on-the-offensive strategy is to be a first-mover and a proactive market leader.[20] It rests on the principle that staying a step ahead and forcing rivals into a catch-up mode is the surest path to industry prominence and potential market dominance—as the saying goes, the best defense is a good offense. Being the industry standard setter entails relentless pursuit of continuous improvement and innovation—being out front with technological improvements, new or better products, more attractive performance features, quality enhancements, improved customer service, ways to cut operating costs, and ways to make it easier and less costly for potential customers to switch their purchases from runner-up firms to its own products. A low-cost leader must set the pace for cost reduction, and a differentiator must constantly initiate new ways to keep its product set apart from the brands of imitative rivals in order to be the standard against which rivals' products are judged. The array of options for a potent stay-on-the-offensive strategy can also include initiatives to expand overall industry demand—spurring the creation of new families of products, making the product more suitable for consumers in emerging-country markets, discovering new uses for the product, attracting new users of the product, and promoting more frequent use.

The two best tests of success of a stay-on-the-offensive strategy are (1) the extent to which it keeps rivals in a reactive mode, scrambling to keep up, and (2) whether the leader is growing faster than the industry as a whole and wresting market share from rivals.

Furthermore, unless a leader's market share is already so dominant that it presents a threat of antitrust action (a market share under 60 percent is usually safe), a potent stay-on-the-offensive strategy entails actions aimed at growing faster than the industry as a whole and wresting market share from rivals. A leader whose growth does not equal or outpace the industry average is losing ground to competitors.

2. Fortify-and-defend strategy—The essence of "fortify and defend" is to make it harder for challengers to gain ground and for new firms to enter. The goals of a strong defense are to hold on to the present market share, strengthen current market position, and protect whatever competitive advantage the firm has. Specific defensive actions can include:

- Attempting to raise the competitive ante for challengers and new entrants via increased spending for advertising, higher levels of customer service, and bigger R&D outlays.
- Introducing more product versions or brands to match the product attributes that challenger brands have or to fill vacant niches that competitors could slip into.
- Adding personalized services and other extras that boost customer loyalty and make it harder or more costly for customers to switch to rival products.
- Keeping prices reasonable and quality attractive.
- Building new capacity ahead of market demand to discourage smaller competitors from adding capacity of their own.
- Investing enough to remain cost-competitive and technologically progressive.
- Patenting the feasible alternative technologies.
- Signing exclusive contracts with the best suppliers and dealer distributors.

Industry leaders can strengthen their long-term competitive positions with strategies keyed to aggressive offense, aggressive defense, or muscling smaller rivals and customers into behaviors that bolster its own market standing.

A fortify-and-defend strategy best suits firms that have already achieved industry dominance and don't wish to risk antitrust action. It is also well suited to situations where a firm wishes to milk its present position for profits and cash flow because the industry's prospects for growth are low or because further gains in market share do not appear profitable enough to go after. But a fortify-and-defend strategy always entails trying to grow as fast as the market as a whole (to stave off market-share slippage) and requires reinvesting enough capital in the business to protect the leader's ability to compete.

3. Muscle-flexing strategy—Here a dominant leader plays competitive hardball (presumably in an ethical and competitively legal manner) when smaller rivals rock the boat with price cuts or mount new market offensives that directly threaten its position. Specific responses can include quickly matching and perhaps exceeding challengers' price cuts, using large promotional campaigns to counter challengers' moves to gain market share, and offering better deals to their major customers. Dominant leaders may also court distributors assiduously to dissuade them from carrying rivals' products, provide salespersons with documented information about the weaknesses of competing products, or try to fill any vacant positions in their own firms by making attractive offers to the better executives of rivals that get out of line.

The leader may also use various arm-twisting tactics to pressure present customers not to use the products of rivals. This can range from simply forcefully communicating its displeasure should customers opt to use the products of rivals to pushing them to agree to exclusive arrangements in return for better prices to charging them a higher price if they use any competitors' products. As a final resort, a leader may grant certain customers special discounts or preferred treatment if they do not use any products of rivals.

The obvious risks of a muscle-flexing strategy are running afoul of the antitrust laws (as Microsoft did—see Illustration Capsule 8.2), alienating customers with bullying tactics, and arousing adverse public opinion. A company that tries to throw its weight around to protect and enhance its market dominance has got to be judicious, lest it cross the line from allowable tactics to unethical or illegal competitive practices.

illustration capsule 8.2

How Microsoft Uses Its Muscle to Maintain Its Market Leadership

U.S. district judge Thomas Penfield Jackson concluded in 1999 in *U.S. v. Microsoft* that Microsoft repeatedly had used heavy-handed tactics to routinely pressure customers, crush competitors, and throttle competition. Judge Jackson painted Microsoft as a domineering company that rewarded its friends and punished its enemies, pointing to the following examples:

- Gateway and IBM, both of which resisted Microsoft's efforts to dissuade them from using or promoting competitors' products on their PCs, were forced to pay higher prices for installing Microsoft's Windows operating system on their PCs than several other PC makers had to pay.
- Microsoft tried to persuade Netscape to halt its development of platform-level technologies for Windows 95, arguing that Netscape's Navigator browser should be designed to run on Windows 95 only rather than be designed in a way that could serve as an alternative operating system platform and substitute for use of Windows. Microsoft wanted Netscape to agree to a special alliance with Microsoft that would allow Microsoft to incorporate Navigator's functionality into Windows. When Netscape refused, Microsoft withheld information about its Windows 95 code until after it released the new operating system and its own new version of Internet Explorer. Microsoft also refused to give Netscape a license to one of its scripting tools, thereby preventing Netscape from doing business with certain Internet service providers for a time. Simultaneously, Microsoft pressured PC makers to install Internet Explorer as the preferred alternative to Netscape Navigator. When Compaq removed the Internet Explorer icon from the opening screen of its computers and preinstalled the Navigator icon, Microsoft threatened to revoke Compaq's license to install Windows 95.
- Microsoft tried to convince Intel not to ship its newly developed Native Signal Processing (NSP) software (intended to help spark demand for Intel's most advanced microprocessors) because Microsoft felt that NSP represented an incursion into Microsoft's operating system platform territory. It also asked Intel to reduce the number of people working on software at Intel. Microsoft assured Intel that if it would stop promoting NSP, Microsoft would accelerate its own work to incorporate the functions of NSP into Windows. At the same time, Microsoft pressured PC makers not to install Intel's NSP software on their PCs.
- When Compaq Computer entered into an agreement with America Online (AOL) to promote AOL above all other online services and began to ship its computers with the Microsoft Network (MSN) icon removed and the AOL icon installed, Microsoft wrote Compaq a letter stating its intention to terminate Compaq's license for Windows 95 if it did not restore the MSN icon to its original position on the opening screen.

Despite the 1999 decision, Microsoft has continued to flex its muscles. In 2001, the company reduced its support for the language Java in its release of the new Windows XP operating system—Java is favored by Microsoft's longtime rival Sun Microsystems. Microsoft also pressured PC makers to display three of its own icons—for MSN online, Windows Media player, and Internet Explorer—on the Windows XP desktop. And it has consistently used harassing tactics against RealNetworks, a maker of media software that competes directly with Microsoft's Windows Media Player.

Sources: Don Clark, "Microsoft Raises Requirements on Icon Use by Computer Makers," *The Wall Street Journal* (www.wsj.com), August 9, 2001; D. Ian Hopper, "Microsoft Appeals to Supreme Court," Associated Press, August 8, 2001; John R. Wilke and Don Clark, "Senate Judiciary Committee Plans Microsoft Hearings," *The Wall Street Journal* (http://public.wsj.com), July 24, 2001; John R. Wilke and Don Clark, "Microsoft Pulls Back Support for Java," *The Wall Street Journal* (www.wsj.com), July 19, 2001; and transcript of Judge Jackson's findings of fact in *U.S. v. Microsoft*, November 5, 1999.

STRATEGIES FOR RUNNER-UP FIRMS

Runner-up or "second-tier" firms have smaller market shares than "first-tier" industry leaders. Some runner-up firms are up-and-coming *market challengers,* employing offensive strategies to gain market share and build a stronger market position. Other runner-up competitors are *focusers*, seeking to im-

prove their lot by concentrating their attention on serving a limited portion of the market. There are, of course, always a number of firms in any industry that are destined to be *perennial runners-up*, lacking the resources and competitive strengths to do more than continue in trailing positions and/or content to follow the trendsetting moves of the market leaders.

Obstacles for Firms with Small Market Shares

In industries where big size is definitely a key success factor, firms with small market shares have some obstacles to overcome: (1) less access to economies of scale in manufacturing, distribution, or marketing and sales promotion; (2) difficulty in gaining customer recognition; (3) weaker ability to use mass media advertising; and (4) difficulty in funding capital requirements.[21] When significant scale economies give large-volume competitors a *dominating* cost advantage, small-share firms have only two viable strategic options: initiate offensive moves to gain sales and market share (so as to build the volume of business needed to approach the scale economies enjoyed by larger rivals) or withdraw from the business (gradually or quickly).

The competitive strategies most underdogs use to build market share and achieve critical scale economies are based on (1) using lower prices to win customers from weak higher-cost rivals; (2) merging with or acquiring rival firms to achieve the size needed to capture greater scale economies; (3) investing in new cost-saving facilities and equipment, perhaps relocating operations to countries where costs are significantly lower; and (4) pursuing technological innovations or radical value chain revamping to achieve dramatic cost savings.

But *it is erroneous to view runner-up firms as inherently less profitable or unable to hold their own against the biggest firms.* Many small and medium-sized firms earn healthy profits and enjoy good reputations with customers.

Strategic Approaches for Runner-Up Companies

Assuming that scale economies or learning-curve effects are relatively small and result in no important cost advantage for big-share firms, runner-up companies have considerable strategic flexibility and can consider any of the following seven approaches.

Offensive Strategies to Build Market Share A challenger firm needs a strategy aimed at building a competitive advantage of its own. Rarely can a runner-up improve its competitive position by imitating the strategies of leading firms. A cardinal rule in offensive strategy is to avoid attacking a leader head-on with an imitative strategy, regardless of the resources and staying power an underdog may have.[22] Moreover, if a challenger has a 5 percent market share and needs a 20 percent share to earn attractive returns, it needs a more creative approach to competing than just "Try harder."

Rarely can a runner-up firm successfully challenge an industry leader with a copycat strategy.

Ambitious runner-up companies have to make some waves in the marketplace if they want to make big market share gains. The best "mover-and-shaker" offensives usually involve one of the following approaches:

- Pioneering a leapfrog technological breakthrough.
- Getting new or better products into the market consistently ahead of rivals and building a reputation for product leadership.

- Being more agile and innovative in adapting to evolving market conditions and customer expectations than slower-to-change market leaders.
- Forging attractive strategic alliances with key distributors, dealers, or marketers of complementary products.
- Finding innovative ways to dramatically drive down costs and then using the attraction of lower prices to win customers from higher-cost, higher-priced rivals. A challenger firm can pursue aggressive cost reduction by eliminating marginal activities from its value chain, streamlining supply chain relationships, improving internal operating efficiency, using various e-commerce techniques, and merging with or acquiring rival firms to achieve the size needed to capture greater scale economies.
- Crafting an attractive differentiation strategy based on premium quality, technological superiority, outstanding customer service, rapid product innovation, or convenient online shopping options.

Without a potent offensive strategy to capture added market share, runner-up companies have to patiently nibble away at the lead of market leaders and build sales at a moderate pace over time.

Growth-via-Acquisition Strategy One of the most frequently used strategies employed by ambitious runner-up companies is merging with or acquiring rivals to form an enterprise that has greater competitive strength and a larger share of the overall market. For an enterprise to succeed with this strategic approach, senior management must have the skills to assimilate the operations of the acquired companies, eliminating duplication and overlap, generating efficiencies and cost savings, and structuring the combined resources in ways that create substantially stronger competitive capabilities. Many banks owe their growth during the past decade to acquisition of smaller regional and local banks. Likewise, a number of book publishers have grown by acquiring small publishers. Cisco Systems has used acquisitions to become a leader in Internet networking products.

Vacant-Niche Strategy This version of a focused strategy involves concentrating on specific customer groups or end-use applications that market leaders have bypassed or neglected. An ideal vacant niche is of sufficient size and scope to be profitable, has some growth potential, is well suited to a firm's own capabilities, and for one reason or another is hard for leading firms to serve. Two examples where vacant-niche strategies have worked successfully are (1) regional commuter airlines serving cities with too few passengers to fill the large jets flown by major airlines and (2) health-food producers (like Health Valley, Hain, and Tree of Life) that cater to local health-food stores—a market segment traditionally given little attention by Kraft, General Mills, Nestlé, Unilever, Campbell Soup, and other leading food products firms.

Specialist Strategy A specialist firm trains its competitive effort on one technology, product or product family, end use, or market segment (often one in which buyers have special needs). The aim is to train the company's resource strengths and capabilities on building competitive advantage through leadership in a specific area. Smaller companies that successfully use this focused strategy include Formby's (a specialist in stains and finishes for wood furniture, especially refinishing); Blue Diamond (a California-based grower and marketer of almonds); Canada Dry (known for its ginger ale, tonic wa-

ter, and carbonated soda water); and American Tobacco (a leader in chewing tobacco and snuff). Many companies in high-tech industries concentrate their energies on being the clear leader in a particular technological niche; their competitive advantage is superior technological depth, technical expertise that is highly valued by customers, and the capability to consistently beat out rivals in pioneering technological advances.

Superior Product Strategy The approach here is to use a differentiation-based focused strategy keyed to superior product quality or unique attributes. Sales and marketing efforts are aimed directly at quality-conscious and performance-oriented buyers. Fine craftsmanship, prestige quality, frequent product innovations, and/or close contact with customers to solicit their input in developing a better product usually undergird the superior product approach. Some examples include Samuel Adams in beer, Tiffany in diamonds and jewelry, Chicago Cutlery in premium-quality kitchen knives, Baccarat in fine crystal, Cannondale in mountain bikes, Bally in shoes, and Patagonia in apparel for outdoor recreation enthusiasts.

Distinctive-Image Strategy Some runner-up companies build their strategies around ways to make themselves stand out from competitors. A variety of distinctive-image strategies can be used: creating a reputation for charging the lowest prices, providing prestige quality at a good price, going all-out to give superior customer service, designing unique product attributes, being a leader in new product introduction, or devising unusually creative advertising. Examples include Dr Pepper's strategy in calling attention to its distinctive taste, Apple Computer's making it easier and more interesting for people to use its Macintosh PCs, and Mary Kay Cosmetics' distinctive use of the color pink.

Content Follower Strategy Content followers deliberately refrain from initiating trendsetting strategic moves and from aggressive attempts to steal customers away from the leaders. Followers prefer approaches that will not provoke competitive retaliation, often opting for focus and differentiation strategies that keep them out of the leaders' paths. They react and respond rather than initiate and challenge. They prefer defense to offense. And they rarely get out of line with the leaders on price. They are content to simply maintain their market position, albeit sometimes struggling to do so. Followers have no urgent strategic questions to confront beyond "What strategic changes are the leaders initiating and what do we need to do to follow along and maintain our present position?" The marketers of private-label products tend to be followers, imitating many of the features of name-brand products and content to sell to price-conscious buyers at prices modestly below those of well-known brands.

STRATEGIES FOR WEAK AND CRISIS-RIDDEN BUSINESSES

A firm in an also-ran or declining competitive position has four basic strategic options. If it can come up with the financial resources, it can launch an *offensive turnaround strategy* keyed either to low-cost or "new" differentiation themes, pouring enough money and talent into the effort to move up a notch or two in the industry rankings and become a respectable market contender within five years or so. It can employ a *fortify-and-defend strategy,* using variations of its present strategy and fighting hard to keep

sales, market share, profitability, and competitive position at current levels. It can opt for a *fast-exit strategy* and get out of the business, either by selling out to another firm or by closing down operations if a buyer cannot be found. Or it can employ an *end-game or slow-exit strategy,* keeping reinvestment to a bare-bones minimum and taking actions to maximize short-term cash flows in preparation for an orderly market exit.

The strategic options for a competitively weak company include waging a modest offensive to improve its position, defending its present position, being acquired by another company, or employing an end-game strategy.

Turnaround Strategies for Businesses in Crisis

Turnaround strategies are needed when a business worth rescuing goes into crisis; the objective is to arrest and reverse the sources of competitive and financial weakness as quickly as possible. Management's first task in formulating a suitable turnaround strategy is to diagnose what lies at the root of poor performance. Is it an unexpected downturn in sales brought on by a weak economy? An ill-chosen competitive strategy? Poor execution of an otherwise workable strategy? High operating costs? Important resource deficiencies? An overload of debt? The next task is to decide whether the business can be saved or whether the situation is hopeless. Understanding what is wrong with the business and how serious its strategic problems are is essential because different diagnoses lead to different turnaround strategies.

Some of the most common causes of business trouble are taking on too much debt, overestimating the potential for sales growth, ignoring the profit-depressing effects of an overly aggressive effort to "buy" market share with deep price cuts, being burdened with heavy fixed costs because of an inability to use plant capacity, betting on R&D efforts but failing to come up with effective innovations, betting on technological long shots, being too optimistic about the ability to penetrate new markets, making frequent changes in strategy (because the previous strategy didn't work out), and being overpowered by more successful rivals. Curing these kinds of problems and achieving a successful business turnaround can involve any of the following actions:

- Selling off assets to raise cash to save the remaining part of the business.
- Revising the existing strategy.
- Launching efforts to boost revenues.
- Pursuing cost reduction.
- Using a combination of these efforts.

Selling Off Assets Asset-reduction strategies are essential when cash flow is a critical consideration and when the most practical ways to generate cash are (1) through sale of some of the firm's assets (plant and equipment, land, patents, inventories, or profitable subsidiaries) and (2) through retrenchment (pruning of marginal products from the product line, closing or selling older plants, reducing the workforce, withdrawing from outlying markets, cutting back customer service). Sometimes crisis-ridden companies sell off assets not so much to unload losing operations as to raise funds to save and strengthen the remaining business activities. In such cases, the choice is usually to dispose of noncore business assets to support strategy renewal in the firm's core businesses.

Strategy Revision When weak performance is caused by bad strategy, the task of strategy overhaul can proceed along any of several paths: (1) shifting to a new competitive approach to rebuild the firm's market position; (2) overhauling internal operations and functional-area strategies to better support the

same overall business strategy; (3) merging with another firm in the industry and forging a new strategy keyed to the newly merged firm's strengths; and (4) retrenching into a reduced core of products and customers more closely matched to the firm's strengths. The most appealing path depends on prevailing industry conditions, the firm's particular strengths and weaknesses, its competitive capabilities vis-à-vis rival firms, and the severity of the crisis. A situation analysis of the industry, the major competitors, and the firm's own competitive position is a prerequisite for action. As a rule, successful strategy revision must be tied to the ailing firm's strengths and near-term competitive capabilities and directed at its best market opportunities.

Boosting Revenues Revenue-increasing turnaround efforts aim at generating increased sales volume. There are a number of revenue-building options: price cuts, increased promotion, a bigger sales force, added customer services, and quickly achieved product improvements. Attempts to increase revenues and sales volumes are necessary (1) when there is little or no room in the operating budget to cut expenses and still break even, and (2) when the key to restoring profitability is increased use of existing capacity. If buyers are not especially price-sensitive because of differentiating features, the quickest way to boost short-term revenues may be to raise prices rather than opt for volume-building price cuts.

Cutting Costs Cost-reducing turnaround strategies work best when an ailing firm's value chain and cost structure are flexible enough to permit radical surgery, when operating inefficiencies are identifiable and readily correctable, when the firm's costs are obviously bloated, and when the firm is relatively close to its break-even point. Accompanying a general belt-tightening can be an increased emphasis on paring administrative overheads, elimination of nonessential and low-value-added activities in the firm's value chain, modernization of existing plant and equipment to gain greater productivity, delay of nonessential capital expenditures, and debt restructuring to reduce interest costs and stretch out repayments.

Combination Efforts Combination turnaround strategies are usually essential in grim situations that require fast action on a broad front. Likewise, combination actions frequently come into play when new managers are brought in and given a free hand to make whatever changes they see fit. The tougher the problems, the more likely it is that the solutions will involve multiple strategic initiatives—see the story of turnaround efforts at Lucent Technologies in Illustration Capsule 8.3.

Turnaround efforts tend to be high-risk undertakings, and they often fail. A landmark study of 64 companies found no successful turnarounds among the most troubled companies in eight basic industries.[23] Many of the troubled businesses waited too long to begin a turnaround. Others found themselves short of both the cash and entrepreneurial talent needed to compete in a slow-growth industry characterized by a fierce battle for market share. Better-positioned rivals simply proved too strong to defeat in a long, head-to-head contest. Even when successful, turnaround may involve numerous attempts and management changes before long-term competitive viability and profitability are finally restored. A recent study found that troubled companies that did nothing and elected to wait out hard times had only a 10 percent chance of recovery.[24] This same study also found that, of the companies studied, the chances

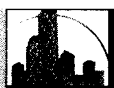


illustration capsule 8.3

Lucent Technologies' Turnaround Strategy: Slow to Produce Results

In the fall of 2001, the situation was becoming desperate at Lucent Technologies, an AT&T spinoff that had been heralded as a superstar of the telecommunications equipment industry. The combination of lost sales to competitors and a steep downturn in capital spending for telecommunications equipment had thrown the company into a nosedive, driving its stock price from over $80 a share down to under $10. Revenues had dropped from $38 billion in the fiscal year ending September 1999 to just $21 billion in fiscal year ending September 2001; profits had declined even more precipitously, falling from a positive $3.5 billion to a stunning $14.2 billion loss. Some observers predicted the company could not survive, and most everyone agreed that Lucent's recovery would be slow at best because of a capacity glut in fiber-optic telecommunications systems.

To bolster its sagging outlook, top executives engineered a turnaround strategy that featured:

- Eliminating 15,000 to 20,000 jobs worldwide immediately and eventually cutting the workforce by more than half, from 150,000 to 60,000.
- Consolidating production at a fewer plants and closing the unneeded plants.
- Selling the company's fiber-optic business (for about $4 billion).
- Raising additional cash by selling $1.8 billion in convertible preferred stock.
- Reaching an agreement with its group of banks to realign the terms of $4 billion in loans.
- Dropping certain product lines.
- Spinning off its microelectronics business, Agere Systems, as a separate company.
- Pursuing a number of cost-cutting initiatives aimed at making Lucent a leaner, more efficient maker of telecommunications equipment.

Top executives were confident in predicting that these moves would return Lucent to profitability in 2002, even without a recovery in telecommunications spending. But Lucent's turnaround proved considerably more problematic than expected. In fiscal 2002 (ending September 2002), revenues fell further, to $12.3 billion, and losses amounted to $12 billion. Lucent's struggles to get its business back on track included restoring lost confidence in top management by brining in a new president and CEO, Pat Russo. Russo continued with the restructuring efforts previously announced but also spurred company efforts to grow the company's revenues and reduce the company's break-even sales volumes via additional streamlining of operations.

In the fall of 2003, the company was continuing to lose money and was also experiencing further revenue declines. In the third quarter of fiscal 2003, Lucent reported revenues of $1.96 billion and a loss of $254 million. The company's stock was trading in the $2.00–$2.50 range. Russo forecast that the company would not return to profitability until sometime in 2004. The bright spot in Lucent's outlook was its strong position in third-generation (3G) wireless technology. Lucent management expected that the company would get a major boost from sales of 3G technology products as wireless communications companies began to more aggressively upgrade their networks.

Sources: www.lucent.com, accessed September 22, 2003; Yuki Noguchi, "Lucent Closes Herndon's Chromatis," *Washington Post* (www.washingtonpost.com), August 29, 2001; Simon Romero, "Lucent Maps Out Route to Profit by the End of Next Year," *New York Times* (www.nytimes.com), August 24, 2001; Peter J. Howe, "Lucent Fires 290 More at Massachusetts Sites," *Boston Globe* (www.boston.com), August 24, 2001; and Sara Silver, "Lucent Cuts 2,200 Jobs," Associated Press, August 23, 2001.

of recovery were boosted 190 percent if the turnaround strategy involved buying assets that strengthened the company's business in its core markets; companies that both bought assets or companies in their core markets and sold off noncore assets increased their chances of recovery by 250 percent.

Liquidation—the Strategy of Last Resort

Sometimes a business in crisis is too far gone to be salvaged. The problem, of course, is determining when a turnaround is achievable and when it isn't. It is easy for owners or managers to let their emotions and pride overcome sound judgment when a business gets in such deep trouble that a successful turnaround is remote. Closing down a crisis-ridden business and liquidating its assets, however, is sometimes the best and wisest strategy. Of all the strategic alternatives, liquidation is the most unpleasant and painful because of the hardships of job eliminations and the effects of business closings on local communities. Nonetheless, in hopeless situations, an early liquidation effort usually serves owner-stockholder interests better than an inevitable bankruptcy. Prolonging the pursuit of a lost cause merely exhausts an organization's resources further and leaves less to salvage, not to mention the added stress and potential career impairment for all the people involved.

End-Game Strategies

An *end-game, slow-exit,* or *harvesting strategy* steers a middle course between preserving the status quo and exiting as soon as possible. This type of strategy involves a gradual phasing down of the business and even sacrificing market position in return for bigger near-term cash flows or current profitability. The overriding financial objective of a slow-exit or harvest strategy is to reap the greatest possible harvest of cash to deploy to other business endeavors. The operating budget is chopped to a rock-bottom level; reinvestment in the business is held to a bare minimum. Capital expenditures for new equipment are put on hold or given low financial priority (unless replacement needs are unusually urgent); instead, efforts are made to stretch the life of existing equipment and make do with present facilities as long as possible. Promotional expenses may be cut gradually, quality reduced in not-so-visible ways, nonessential customer services curtailed, and the like. Although such actions may result in shrinking sales and market share, if cash expenses can be cut even faster, then after-tax profits and cash flows are bigger (at least temporarily). The business gradually declines, but not before sizable amounts of cash have been harvested.

An end-game, slow-exit, or harvest strategy is a reasonable strategic option for a weak business in the following circumstances:[25]

1. *When the industry's long-term prospects are unattractive*—as seems to be the case for the cigarette industry, for the manufacture and sale of VCRs and videocassettes (which are now being replaced by DVD players and both CDs and DVDs), and for the 3.5-inch floppy disk business.
2. *When rejuvenating the business would be too costly or at best marginally profitable*—as could be the case at Iomega, which is struggling to maintain sales of its Zip drives in the face of rapidly expanding hard disk drives on PCs, or at Polaroid, which has experienced stagnant sales for its instant cameras and film.
3. *When the firm's market share is becoming increasingly costly to maintain or defend*—as could be the case with the makers of film for traditional cameras.
4. *When reduced levels of competitive effort will not trigger an immediate or rapid falloff in sales*—the makers of printers will not likely experience much of a decline in sales of either dot-matrix printers or ribbons if they spend all of their ad budgets on promoting their lines of laser printers.

5. *When the enterprise can redeploy the freed resources in higher-opportunity areas*—the makers of CD players and CDs are better off devoting their resources to the production and sale of DVD players/recorders and DVDs.
6. *When the business is not a crucial or core component of a diversified company's overall lineup of businesses*—gradually letting a sideline business decay is strategically preferable to deliberately letting a mainline or core business decline.
7. *When the business does not contribute other desired features to a company's overall business portfolio*—such features include sales stability, prestige, and a well-rounded product line.

The more of these seven conditions that are present, the more ideal the business is for harvesting and a slow-exit or end-game strategy.

End-game strategies make the most sense for diversified companies that have sideline or noncore business units in weak competitive positions or in unattractive industries. Such companies can withdraw the cash flows from unattractive, noncore business units and reallocate them to business units with greater profit potential or spend them on the acquisition of new businesses.

10 COMMANDMENTS FOR CRAFTING SUCCESSFUL BUSINESS STRATEGIES

Company experiences over the years prove again and again that disastrous strategies can be avoided by adhering to good strategy-making principles. We've distilled the lessons learned from the strategic mistakes companies most often make into 10 commandments that serve as useful guides for developing sound strategies:

1. *Place top priority on crafting and executing strategic moves that enhance the company's competitive position for the long term.* The glory of meeting one quarter's or one year's financial performance targets quickly fades, but an ever-stronger competitive position pays off year after year. Shareholders are never well served by managers who let short-term financial performance considerations rule out strategic initiatives that will meaningfully bolster the company's longer-term competitive position and competitive strength. The best way to ensure a company's long-term profitability is with a strategy that strengthens the company's long-term competitiveness and market position.
2. *Be prompt in adapting to changing market conditions, unmet customer needs, buyer wishes for something better, emerging technological alternatives, and new initiatives of competitors.* Responding late or with too little often puts a company in the precarious position of having to play catch-up. While pursuit of a consistent strategy has its virtues, adapting strategy to changing circumstances is normal and necessary. Moreover, long-term strategic commitments to achieve top quality or lowest cost should be interpreted relative to competitors' products as well as customers' needs and expectations; the company should avoid singlemindedly striving to make the absolute highest-quality or lowest-cost product no matter what.
3. *Invest in creating a sustainable competitive advantage.* Having a competitive edge over rivals is the single most dependable contributor to above-average profitability. As a general rule, a company must play aggressive offense to build competitive advantage and aggressive defense to protect it.

4. *Avoid strategies capable of succeeding only in the most optimistic circumstances.* Expect competitors to employ countermeasures and expect times of unfavorable market conditions. A good strategy works reasonably well and produces tolerable results even in the worst of times.
5. *Don't underestimate the reactions and the commitment of rival firms.* Rivals are most dangerous when they are pushed into a corner and their well-being is threatened.
6. *Consider that attacking competitive weakness is usually more profitable and less risky than attacking competitive strength.* Attacking capable, resourceful rivals is likely to fail unless the attacker has deep financial pockets and a solid basis for competitive advantage over stronger rivals.
7. *Be judicious in cutting prices without an established cost advantage.* Only a low-cost producer can win at price cutting over the long term.
8. *Strive to open up very meaningful gaps in quality or service or performance features when pursuing a differentiation strategy.* Tiny differences between rivals' product offerings may not be visible or important to buyers.
9. *Avoid stuck-in-the-middle strategies that represent compromises between lower costs and greater differentiation and between broad and narrow market appeal.* Compromise strategies rarely produce sustainable competitive advantage or a distinctive competitive position—a well-executed best-cost producer strategy is the only exception where a compromise between low cost and differentiation succeeds. Usually, companies with compromise strategies end up with average costs, average differentiation, an average image and reputation, a middle-of-the-pack industry ranking, and little prospect of industry leadership.
10. *Be aware that aggressive moves to wrest market share away from rivals often provoke retaliation in the form of a price war—to the detriment of everyone's profits.* Aggressive moves to capture a bigger market share invite cutthroat competition, particularly when the market is plagued with high inventories and excess production capacity.

MATCHING STRATEGY TO ANY INDUSTRY AND COMPANY SITUATION

It is not enough to understand a company's basic competitive strategy options—overall low-cost leadership, broad differentiation, best-cost, focused low-cost, and focused differentiation—and that there are a variety of offensive, defensive, first-mover, and late-mover initiatives and actions to choose from. The lessons of this chapter are (1) that some strategic options are better suited to certain specific industry and competitive environments than others and (2) that some strategic options are better suited to certain specific company situations than others. This chapter portrays the multifaceted task of matching strategy to a firm's external and internal circumstances in nine types of situations.

Rather than try to summarize the main points we made about choosing strategies for these nine sets of circumstances (the relevant principles are not readily capsuled in three or four sentences each), we think it more useful to conclude this chapter by outlining a broader framework for matching strategy to *any* industry and company situation. Aligning a company's strategy with its overall situation starts with a quick diagnosis of the industry environment and the firm's competitive standing in the industry:

1. What basic type of industry environment (emerging, rapid-growth, high-velocity, mature, global, commodity-product) does the company operate in? What strategic options and strategic postures are usually best suited to this generic type of environment?
2. What position does the firm have in the industry (leader, runner-up, or also-ran; strong, weak, or crisis-ridden)? How does the firm's market standing influence its strategic options given the industry and competitive environment—in particular, which courses of action have to be ruled out?

Next, strategists need to factor in the primary external and internal situational considerations (as discussed in Chapters 3 and 4) and decide how all the factors add up. Nearly always, weighing the various considerations makes it clear that some strategic options can be ruled out. Listing the pros and cons of the remaining options can help managers choose the best overall strategy.

The final step is to custom-tailor the chosen generic competitive strategy approach (low-cost, broad differentiation, best-cost, focused low-cost, focused differentiation) to fit *both* the industry environment and the firm's standing vis-à-vis competitors. Here, it is important to be sure that (1) the customized aspects of the proposed strategy are well matched to the firm's competencies and competitive capabilities, and (2) the strategy addresses all issues and problems the firm confronts.

In weeding out less-attractive strategic alternatives and weighing the pros and cons of the most attractive ones, the answers to the following questions often help point to the best course of action:

- What kind of competitive edge can the company *realistically* achieve? Can the company execute the strategic moves necessary to secure this edge?
- Does the company have the organizational capabilities and financial resources to succeed in these moves and approaches? If not, can they be acquired?
- Once built, how can the competitive advantage be protected? Is the company in a position to lead industry change and set the rules by which rivals must compete? What defensive strategies need to be employed? Will rivals counterattack? What will it take to blunt their efforts?
- Are any rivals particularly vulnerable? Should the firm mount an offensive to capitalize on these vulnerabilities? What offensive moves need to be employed?
- What additional strategic moves are needed to deal with driving forces in the industry, specific threats and weaknesses, and any other issues/problems unique to the firm?

table 8.1 **Sample Format for a Strategic Action Plan**

1. Strategic Vision and Mission	5. Supporting Functional Strategies
2. Strategic Objectives	• Production
• Short-term	• Marketing/sales
• Long-term	• Finance
3. Financial Objectives	• Personnel/human resources
• Short-term	• Other
• Long-term	6. Recommended Actions to Improve Company Performance
4. Overall Business Strategy	• Immediate
	• Longer-range

In crafting the overall strategy, there are several pitfalls to avoid:

- Designing an overly ambitious strategic plan—one that overtaxes the company's resources and capabilities.
- Selecting a strategy that represents a radical departure from or abandonment of the cornerstones of the company's prior success—a radical strategy change need not be rejected automatically, but it should be pursued only after careful risk assessment.
- Choosing a strategy that goes against the grain of the organization's culture or conflicts with the values and philosophies of the most senior executives.
- Being unwilling to *commit wholeheartedly* to one of the five competitive strategies—picking and choosing features of the different strategies usually produces so many compromises between low cost, best cost, differentiation, and focusing that the company fails to achieve any kind of advantage and ends up stuck in the middle.

Table 8.1 provides a generic format for outlining a strategic action plan for a single-business enterprise. It contains all of the pieces of a comprehensive strategic action plan that we discussed at various places in these first eight chapters.

exercises

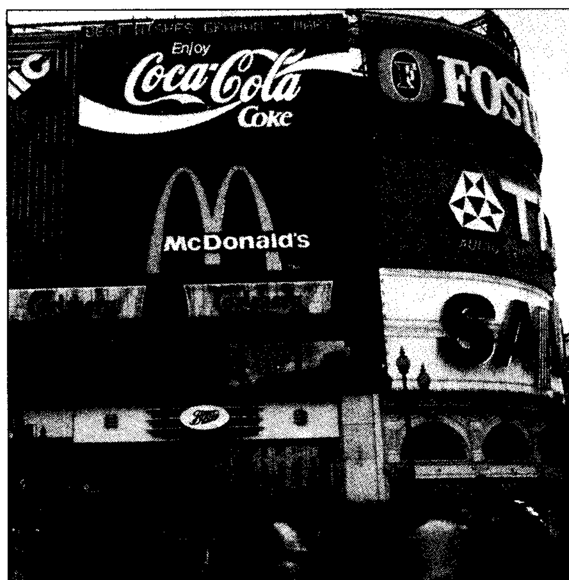
1. Listed below are eight industries. Classify each one as (a) emerging, (b) turbulent or high-velocity, (c) mature/slow-growth, (d) stagnant/declining, or (e) fragmented. Do research on the Internet, if needed, to locate information on industry conditions and reach a conclusion on what classification to assign each of the following:
   (1) DVD player industry
   (2) Dry cleaning industry
   (3) Poultry industry
   (4) Camera film and film-developing industry
   (5) Wine, beer, and liquor retailing
   (6) Personal computer industry
   (7) Cell phone industry
   (8) Recorded music industry (DVDs, CDs, tapes)

2. Toyota overtook Ford Motor Company in 2003 to become the second largest maker of motor vehicles, behind General Motors. Toyota is widely regarded as having aspirations to overtake General Motors as the global leader in motor vehicles within the next 10 years. Do research on the Internet or in the library to determine what strategy General Motors is pursuing to maintain its status as the industry leader. Then research Toyota's strategy to overtake General Motors.

chapter | nine 9

Diversification

Strategies for Managing a Group of Businesses



(©Royalty-Free/CORBIS)

To acquire or not to acquire: that is the question.
—**Robert J. Terry**

Fit between a parent and its businesses is a two-edged sword: a good fit can create value; a bad one can destroy it.
—**Andrew Campbell, Michael Goold, and Marcus Alexander**

Achieving superior performance through diversification is largely based on relatedness.
—**Philippe Very**

Make winners out of every business in your company. Don't carry losers.
—**Jack Welch**
Former CEO, General Electric

We measure each of our businesses against strict criteria: growth, margin, and return-on-capital hurdle rate, and does it have the ability to become number one or two in its industry? We are quite pragmatic. If a business does not contribute to our overall vision, it has to go.
—**Richard Wambold**
CEO, Pactiv

In this chapter we move up one level in the strategy-making hierarchy, from strategy making in a single-business enterprise to strategy making in a diversified enterprise. Because a diversified company is a collection of individual businesses, the strategy-making task is a more complicated exercise. In a one-business company, managers have to contend with assessing only one industry environment and the question of how to compete successfully in it—the result is what we labeled in Chapter 2 as *business strategy* (or *business-level strategy*). But in a diversified company, the strategy-making challenge involves assessing multiple industry environments and coming up with a *set* of business strategies, one for each industry arena in which the diversified company operates. And top executives at a diversified company must still go one step further and devise a companywide or *corporate strategy*.

In most diversified companies, corporate-level executives delegate considerable strategy-making authority to the heads of each business, usually giving them the latitude to craft a business strategy suited to their particular industry and competitive circumstances and holding them accountable for producing good results. But the task of crafting a diversified company's overall or corporate strategy falls squarely on the shoulders of top-level executives.

Devising a corporate strategy has four distinct facets:

1. *Picking new industries to enter and deciding on the means of entry*—The first concerns in diversifying are what new industries to get into and whether to enter by starting a new business from the ground up, acquiring a company already in the target industry, or forming a joint venture or strategic alliance with another company. A company can diversify narrowly into a few industries or broadly into many industries. These choices shape what positions the company will initially stake out for itself.
2. *Initiating actions to boost the combined performance of the businesses the firm has entered*—As positions are created in the chosen industries, corporate strategists typically zero in on ways to strengthen the long-term competitive positions and profits of the businesses the firm has invested in. Corporate parents can help their business subsidiaries by providing financial resources, by supplying missing skills or technological know-how or managerial expertise to better perform key

value chain activities, and by providing new avenues for cost reduction. They can also acquire another company in the same industry and merge the two operations into a stronger business, or acquire new businesses that strongly complement existing businesses. Typically, a company will pursue rapid-growth strategies in its most promising businesses, initiate turnaround efforts in weak-performing businesses with potential, and divest businesses that are no longer attractive or that don't fit into management's long-range plans.

3. *Pursuing opportunities to leverage cross-business value chain relationships and strategic fits into competitive advantage*—A company that diversifies into businesses with related value chain activities (pertaining to technology, supply chain logistics, production, overlapping distribution channels, or common customers) gains competitive advantage potential not open to a company that diversifies into businesses whose value chains are totally unrelated. Related diversification presents opportunities to transfer skills, share expertise, share facilities, or share a common brand name, thereby reducing overall costs, strengthening the competitiveness of some of the company's products, and enhancing the capabilities of particular business units.
4. *Establishing investment priorities and steering corporate resources into the most attractive business units*—A diversified company's different businesses are usually not equally attractive from the standpoint of investing additional funds. It is incumbent on corporate management to (*a*) decide on the priorities for investing capital in the company's different businesses, (*b*) channel resources into areas where earnings potentials are higher, and (*c*) divest business units that are chronically poor performers or are in an increasingly unattractive industry. Divesting poor performers and businesses in unattractive industries frees up unproductive investments either for redeployment to promising business units or for financing attractive new acquisitions.

The demanding and time-consuming nature of these four tasks explains why corporate executives generally refrain from becoming immersed in the details of crafting and implementing business-level strategies, preferring instead to delegate lead responsibility for business strategy to the heads of each business unit.

In the first portion of this chapter, we describe the various paths through which a company can become diversified and explain how a company can use diversification to create or compound competitive advantage for its business units. In the second part of the chapter, we examine the techniques and procedures for assessing the strategic attractiveness of a diversified company's business portfolio and survey the strategic options open to already-diversified companies.

WHEN TO DIVERSIFY

So long as a company has its hands full trying to capitalize on profitable growth opportunities in its present industry, there is no urgency to pursue diversification. Companies that concentrate on a single business can achieve enviable success over many decades—good examples include McDonald's, Southwest Airlines, Domino's Pizza, Apple Computer, Wal-Mart, FedEx, Hershey, Timex, Anheuser-Busch, Xerox, and Ford Motor Company. In the nonprofit sector, continued emphasis on a single activity has proved

successful for the Red Cross, the Salvation Army, the Christian Children's Fund, the Girl Scouts, Phi Beta Kappa, and the American Civil Liberties Union. Concentrating on a single line of business (totally or with a small dose of diversification) has important advantages. A single-business company has less ambiguity about who it is, what it does, and where it is headed. It can devote the full force of its resources to improving its competitiveness, expanding into geographic markets it doesn't serve, and responding to changing market conditions and evolving customer preferences. The more successful a single-business enterprise is, the more able it is to parlay its accumulated know-how, competitive capabilities, and reputation into a sustainable position as a leading firm in its industry.

The big risk of a single-business company, of course, is having all of the firm's eggs in one industry basket. If the market is eroded by the appearance of new technologies, new products, or fast-shifting buyer preferences, then a company's prospects can quickly dim. Consider, for example, what digital cameras are doing to the market for film and film processing, what CD and DVD technology has done to the market for cassette tapes and floppy disks, and what mobile phones are doing to the local and long-distance landline businesses. Where there are substantial risks that a single-business company's market will dry up or when opportunities to grow revenues and earnings in the company's mainstay business begin to peter out, managers usually have to make diversifying into other businesses a top consideration.

Factors That Signal It Is Time to Diversify

Diversification merits strong consideration whenever a single-business company is faced with diminishing market opportunities and stagnating sales in its principal business.[1] But there are four other instances in which a company becomes a prime candidate for diversifying:

1. When it can expand into industries whose technologies and products complement its present business.
2. When it can leverage existing competencies and capabilities by expanding into businesses where these same resource strengths are valuable competitive assets.
3. When diversifying into closely related businesses opens new avenues for reducing costs.
4. When it has a powerful and well-known brand name that can be transferred to the products of other businesses.

As part of the decision to diversify, the company must ask itself, "What kind and how much diversification?" The strategic possibilities are wide open. A company can diversify into closely related businesses or into totally unrelated businesses. It can diversify its present revenue and earning base to a small extent (such that new businesses account for less than 15 percent of companywide revenues and profits) or to a major extent (such that new businesses produce 30 or more percent of revenues and profits). It can move into one or two large new businesses or a greater number of small ones. It can achieve diversification by acquiring an existing company, creating an internal start-up, or entering a joint venture. There's no tried-and-true method for determining when it is time for a company to diversify. Judgments about the timing of a company's diversification effort are best made case by case, according to the company's own unique situation.

Building Shareholder Value: The Ultimate Justification for Diversifying

Diversification must do more for a company than simply spread its business risk across various industries. Shareholders can easily diversify risk on their own by purchasing stock in companies in different industries or investing in mutual funds, so they don't need a company to diversify merely to spread their risk across different industries. In principle, diversification makes good strategic and business sense only if it results in added shareholder value—value that shareholders cannot capture through their ownership of different companies in different industries.

For there to be reasonable expectations that a diversification move can produce added value for shareholders, the move must pass three tests:[2]

1. *The industry attractiveness test*—The industry chosen for diversification must be attractive enough to yield consistently good returns on investment. Industry attractiveness depends chiefly on favorable competitive conditions and a market environment conducive to earning profits that are as good or better than the company is earning in its present business(es). It is hard to imagine declaring an industry to be attractive if profit expectations are *lower* than in the company's present businesses.
2. *The cost-of-entry test*—The cost to enter the target industry must not be so high as to erode the potential for profitability. A catch-22 can prevail here, however. The more attractive an industry's prospects are for growth and good long-term profitability, the more expensive it can be to get into. Entry barriers for start-up companies are likely to be high in attractive industries; were barriers low, a rush of new entrants would soon erode the potential for high profitability. And buying an existing, well-positioned company in an appealing industry often entails a high acquisition cost. Paying too much to acquire a company in an attractive industry reduces a company's rate of return on the acquisition price and erodes the potential for enhanced shareholder value.
3. *The better-off test*—Diversifying into a new business must offer potential for the company's existing businesses and the new business to perform better together under a single corporate umbrella than they would perform operating as independent, stand-alone businesses. For example, let's say that company A diversifies by purchasing company B in another industry. If A and B's consolidated profits in the years to come prove no greater than what each could have earned on its own, then A's diversification won't provide its shareholders with added value. Company A's shareholders could have achieved the same 1 + 1 = 2 result by merely purchasing stock in company B. Diversification does not create shareholder value unless it produces a 1 + 1 = 3 effect where sister businesses perform better together as part of the same firm than they could have performed as independent companies. The best chance of a 1 + 1 = 3 outcome occurs when a company diversifies into businesses that have competitively important value chain matchups with its existing businesses—matchups that offer opportunities to reduce costs, to transfer skills or technology from one business to another, to create valuable new competencies and capabilities, or to leverage existing resources (such as brand-name reputation).

Diversification moves that satisfy all three tests have the greatest potential to grow shareholder value over the long term. Diversification moves that can pass only one or two tests are suspect.

STRATEGIES FOR ENTERING NEW BUSINESSES

Entry into new businesses can take any of three forms: acquisition, internal start-up, or joint ventures/strategic partnerships.

Acquisition of an Existing Business

Acquisition is the most popular means of diversifying into another industry. Not only is it quicker than trying to launch a brand-new operation, but it also offers an effective way to hurdle such entry barriers as acquiring technological know-how, establishing supplier relationships, becoming big enough to match rivals' efficiency and unit costs, having to spend large sums on introductory advertising and promotions, and securing adequate distribution. Whether friendly or hostile, acquisitions allow the acquirer to move directly to the task of building a strong market position in the target industry, rather than getting bogged down in going the internal start-up route and trying to develop the knowledge, resources, scale of operation, and market reputation necessary to become an effective competitor within a few years.

However, finding the right kind of company to acquire sometimes presents a challenge.[3] The big dilemma an acquisition-minded firm faces is whether to pay a premium price for a successful company or to buy a struggling company at a bargain price. If the buying firm has little knowledge of the industry but ample capital, it is often better off purchasing a capable, strongly positioned firm—unless the price of such an acquisition is prohibitive and flunks the cost-of-entry test. However, when the acquirer sees promising ways to transform a weak firm into a strong one and has the resources, the know-how, and the patience to do it, a struggling company can be the better long-term investment.

The cost-of-entry test requires that the expected profit stream of an acquired business provide an attractive return on the total acquisition cost and on any new capital investment needed to sustain or expand its operations. A high acquisition price can make meeting that test improbable or difficult. For instance, suppose that the price to purchase a company is $3 million and that the company is earning after-tax profits of $200,000 on an equity investment of $1 million (a 20 percent annual return). Simple arithmetic requires that the profits be tripled if the purchaser is to earn the same 20 percent return. Building the acquired firm's annual earnings from $200,000 to $600,000 could take several years—and require additional investment, on which the purchaser would also have to earn a 20 percent return. Since the owners of a successful and growing company usually demand a price that reflects their business's profit prospects, it's easy for such an acquisition to fail the cost-of-entry test. A would-be diversifier can't count on being able to acquire a desirable company in an appealing industry at a price that still permits attractive returns on investment.

Internal Start-Up

Achieving diversification through internal start-up involves building a new business subsidiary from scratch. This entry option takes longer than the acquisition option and poses some hurdles. A newly formed business unit not only has to overcome entry barriers but also has to invest in new production capacity, develop sources of supply, hire and train employees, build channels of distribution, grow a customer base, and so on. Generally, forming a start-up subsidiary to enter a new business has appeal only when (1) the parent company already has most or

The biggest drawbacks to entering an industry by forming an internal start-up are the costs of overcoming entry barriers and the extra time it takes to build a strong and profitable competitive position.

all of the skills and resources it needs to piece together a new business and compete effectively; (2) there is ample time to launch the business; (3) the costs are lower than those of acquiring another firm; (4) the targeted industry is populated with many relatively small firms such that the new start-up does not have to compete head-to-head against larger, more powerful rivals; (5) adding new production capacity will not adversely impact the supply–demand balance in the industry; and (6) incumbent firms are likely to be slow or ineffective in responding to a new entrant's efforts to crack the market.[4]

Joint Ventures and Strategic Partnerships

Joint ventures typically entail forming a new corporate entity owned by the partners, whereas strategic partnerships usually can be terminated whenever one of the partners so chooses. Most joint ventures involve two partners and, historically, were formed to pursue opportunities that were somewhat peripheral to the strategic interests of the partners; very few companies have used joint ventures to enter new industries central to their diversification strategy. In recent years, strategic partnerships/alliances have replaced joint ventures as the favored mechanism for joining forces to pursue strategically important diversification opportunities because they can readily accommodate multiple partners and are more adaptable to rapidly changing technological and market conditions than a formal joint venture.

A strategic partnership or joint venture can be useful in at least three types of situations.[5] First, a strategic partnership/joint venture is a good way to pursue an opportunity that is too complex, uneconomical, or risky for a single organization to pursue alone. Second, strategic partnerships/joint ventures make sense when the opportunities in a new industry require a broader range of competencies and know-how than any one organization can marshal. Many of the opportunities in satellite-based telecommunications, biotechnology, and network-based systems that blend hardware, software, and services, for example, call for the coordinated development of complementary innovations and integrating a host of financial, technical, political, and regulatory factors. In such cases, pooling the resources and competencies of two or more independent organizations is essential to generate the capabilities needed for success.

Third, joint ventures are sometimes the only way to gain entry into a desirable foreign market, especially when the foreign government requires companies wishing to enter the market to secure a local partner; for example, the Chinese government closed entry in the automotive industry to all but a few select automakers, and in the elevator industry it originally permitted only Otis, Schindler, and Mitsubishi to establish joint ventures with local partners. Although permission was later granted to other companies, the three early entrants were able to retain a market advantage.[6] Alliances with local partners have become a favorite mechanism for global companies not only to establish footholds in desirable foreign country markets but also to surmount tariff barriers and import quotas. Local partners offer outside companies the benefits of local knowledge about market conditions, local customs and cultural factors, and customer buying habits; they can also be a source of managerial and marketing personnel and provide access to distribution outlets. The foreign partner's role is usually to provide specialized skills, technological know-how, and other resources needed to crack the local market and serve it efficiently.

However, strategic alliances/joint ventures have their difficulties, often posing complicated questions about how to divide efforts among the partners and about who has effective control.[7] Conflicts between foreign and domestic partners can arise over whether to use local sourcing of components, how much production to export, whether operating procedures should conform to the local partner's or the

foreign company's standards, and to what extent the local partner is entitled to make use of the foreign partner's technology and intellectual property. As the foreign partner acquires experience, its need for the local partner typically diminishes, posing the strategic issue of whether the partnership should be dissolved. This happens frequently in alliances between global manufacturers and local distributors.[8]

Joint ventures are generally the least durable of the entry options, usually lasting only until the partners decide to go their own ways. Japanese automakers have abandoned their European distribution partners and set up their own dealer networks; BMW did the same in Japan. However, the temporary character of joint ventures is not always bad. Several ambitious local partners have used their alliances with global companies to master technologies and build key competitive skills, then capitalized on the acquired know-how to launch their own entry into the international arena. Taiwan's Acer Computer Group used its alliance with Texas Instruments as a stepping-stone for entering the world market for desktop and laptop computers.

CHOOSING THE DIVERSIFICATION PATH: RELATED VERSUS UNRELATED BUSINESSES

Once the decision is made to pursue diversification, the firm must choose whether to diversify into **related businesses, unrelated businesses,** or some mix of both (see Figure 9.1). *Businesses are said to be related when their value chains possess competitively valuable cross-business value chain matchups or strategic fits.* The appeal of related diversification is exploiting these matchups to realize a 1 + 1 = 3 performance outcome and thus build shareholder value. *Businesses are said to be unrelated when the activities comprising their respective value chains are so dissimilar that no competitively valuable cross-business relationships are present.*

> **core concept**
> ***Related businesses*** possess competitively valuable cross-business value chain matchups; ***unrelated businesses*** have dissimilar value chains, containing no competitively useful cross-business relationships.

Most companies favor related diversification strategies because of the performance-enhancing potential of cross-business synergies. However, some companies have, for one reason or another, opted to try to build shareholder value with unrelated diversification strategies. And a few have diversified into both related and unrelated businesses. The next two sections explore the ins and outs of related and unrelated diversification.

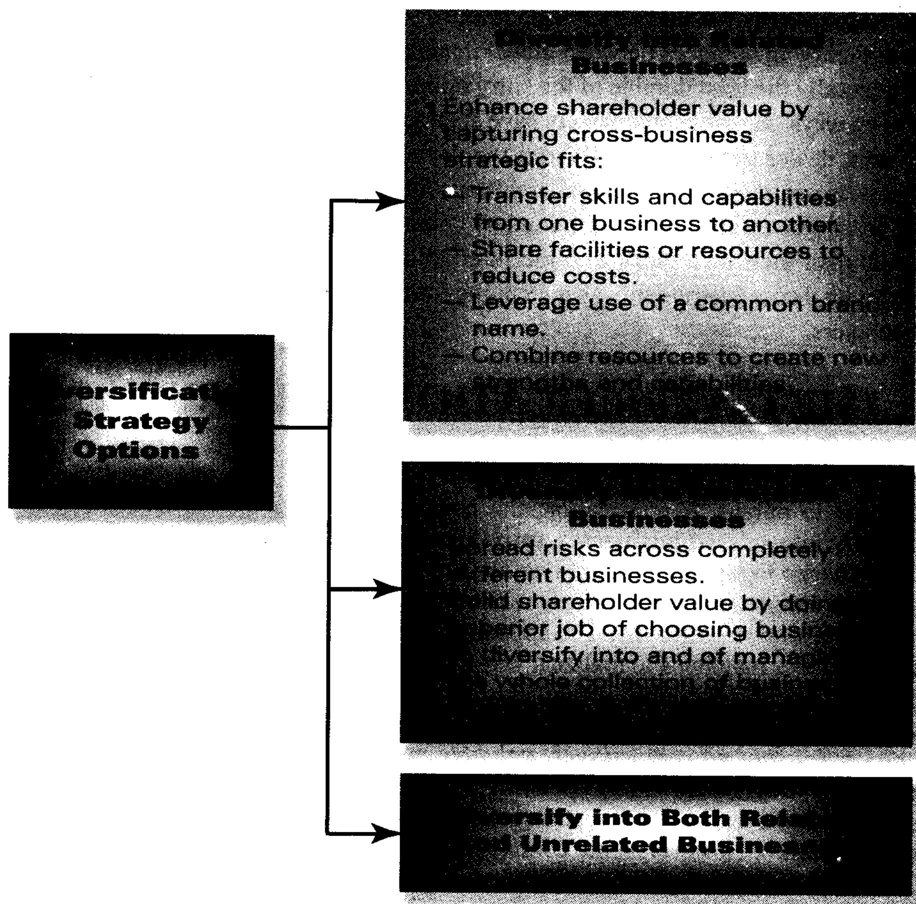
THE CASE FOR DIVERSIFYING INTO RELATED BUSINESSES

> **core concept**
> ***Strategic fit*** exists when the value chains of different businesses present opportunities for cross-business resource transfer, lower costs through combining the performance of related value chain activities, cross-business use of a potent brand name, and cross-business collaboration to build new or stronger competitive capabilities.

A related diversification strategy involves building the company around businesses whose value chains possess competitively valuable strategic fits, as shown in Figure 9.2. **Strategic fit** exists whenever one or more activities comprising the value chains of different businesses are sufficiently similar as to present opportunities for:[9]

- Transferring competitively valuable expertise, technological know-how, or other capabilities from one business to another.
- Combining the related activities of separate businesses into a single operation to achieve lower costs.

figure 9.1 **Strategy Alternatives for a Company Looking to Diversify**



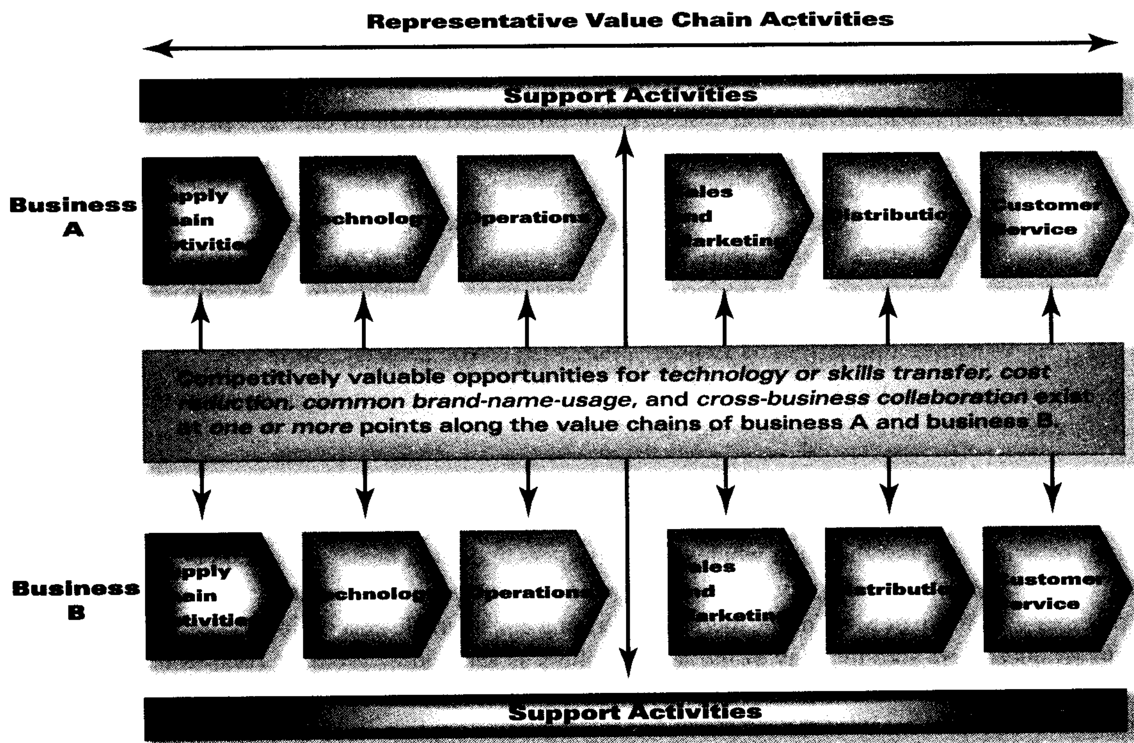
- Exploiting common use of a well-known brand name.
- Cross-business collaboration to create competitively valuable resource strengths and capabilities.

Related diversification thus has strategic appeal from several angles. It allows a firm to reap the competitive advantage benefits of skills transfer, lower costs, common brand names, and/or stronger competitive capabilities and still spread investor risks over a broad business base. Furthermore, the relatedness among the different businesses provides sharper focus for managing diversification and a useful degree of strategic unity across the company's various business activities.

Cross-Business Strategic Fits along the Value Chain

Cross-business strategic fits can exist anywhere along the value chain—in R&D and technology activities, in supply chain activities and relationships with suppliers, in manufacturing, in sales and marketing, in distribution activities, or in administrative support activities.[10]

figure 9.2 **Related Businesses Possess Related Value Chain Activities and Competitively Valuable Strategic Fits**



Strategic Fits in R&D and Technology Activities Diversifying into businesses where there is potential for sharing common technology, exploiting the full range of business opportunities associated with a particular technology and its derivatives, or transferring technological know-how from one business to another has considerable appeal. Businesses with technology-sharing benefits can perform better together than apart because of potential cost savings in R&D and potentially shorter times in getting new products to market; also, technological advances in one business can lead to increased sales for both. Technological innovations have been the driver behind the efforts of cable TV companies to diversify into high-speed Internet access (via the use of cable modems) and, further, to explore providing local and long-distance telephone service to residential and commercial customers in a single wire.

Strategic Fits in Supply Chain Activities Businesses that have supply chain strategic fits can perform better together because of the potential for skills transfer in procuring materials, greater bargaining power in negotiating with common suppliers, the benefits of added collaboration with common supply chain partners, and/or added leverage with shippers in securing volume discounts on incoming parts and components. Dell Computer's strategic partnerships with leading suppliers of microprocessors, motherboards, disk drives, memory chips, monitors, modems, flat-panel displays, long-life batteries, and other desktop and laptop components have been an important component of the company's strategy to

diversify into servers, data storage devices, and LCD TVs—products that include many components common to PCs and that can be sourced from the same strategic partners that provide Dell with PC components.

Manufacturing-Related Strategic Fits Cross-business strategic fits in manufacturing-related activities can represent an important source of competitive advantage in situations where a diversifier's expertise in quality manufacture and cost-efficient production methods can be transferred to another business. When Emerson Electric diversified into the chain-saw business, it transferred its expertise in low-cost manufacture to its newly acquired Beaird-Poulan business division; the transfer drove Beaird-Poulan's new strategy—to be the low-cost provider of chain-saw products—and fundamentally changed the way Beaird-Poulan chain saws were designed and manufactured. Another benefit of value chain matchups comes from the ability to perform manufacturing or assembly activities jointly in the same facility rather than independently, thus making it feasible to consolidate production into a smaller number of plants and significantly reduce overall production costs. When snowmobile maker Bombardier diversified into motorcycles, it was able to set up motorcycle assembly lines in the same manufacturing facility where it was assembling snowmobiles.

Distribution-Related Strategic Fits Businesses with closely related distribution activities can perform better together than apart because of potential cost savings in sharing the same distribution facilities or using many of the same wholesale distributors and retail dealers to access customers. When Sunbeam acquired Mr. Coffee, it was able to consolidate its own distribution centers for small household appliances with those of Mr. Coffee, thereby generating considerable cost savings. Likewise, since Sunbeam products were sold to many of the same retailers as Mr. Coffee products (Wal-Mart, Kmart, department stores, home centers, hardware chains, supermarket chains, and drugstore chains), Sunbeam was able to convince many of the retailers carrying Sunbeam appliances to also take on the Mr. Coffee line and vice versa.

Strategic Fits in Sales and Marketing Activities Various cost-saving opportunities spring from diversifying into businesses with closely related sales and marketing activities. Sales costs can often be reduced by using a single sales force for the products of both businesses rather than having separate sales forces for each business. When the products are distributed through many of the same wholesale and retail dealers or are sold directly to the same customers, it is usually feasible to give one salesperson the responsibility for handling the sales of both products. The products of related businesses can be promoted at the same Web site and included in the same media ads and sales brochures.

After-sale service and repair organizations for the products of closely related businesses can often be consolidated into a single operation. There may be opportunities to reduce costs by coordinating delivery and shipping, consolidating order processing and billing, and using common promotional tie-ins (cents-off couponing, free samples and trial offers, seasonal specials, and the like). When global power-tool maker Black & Decker acquired General Electric's domestic small-appliance business, it was able to use its own global sales force and distribution facilities to sell and distribute toasters, irons, mixers, and coffeemakers because the types of customers that carried its power tools (discounters like Wal-Mart and Kmart, home centers, and hardware stores) also stocked small appliances. The economies Black & Decker achieved for both product lines were substantial.

A second category of benefits arises when different businesses use similar sales and marketing approaches; in such cases, there may be competitively valuable opportunities to transfer selling, merchandising, advertising, and product differentiation skills from one business to another. Procter & Gamble's product lineup includes Folgers coffee, Tide laundry detergent, Crest toothpaste, Ivory soap, Charmin toilet tissue, and Head & Shoulders shampoo. All of these have different competitors and different supply chain and production requirements, but they all move through the same wholesale distribution systems, are sold in common retail settings to the same shoppers, are advertised and promoted in much the same ways, and require the same marketing and merchandising skills.

A third set of benefits arises from related sales and marketing activities when a company's brand name and reputation in one business is transferable to other businesses. Honda's name in motorcycles and automobiles gave it instant credibility and recognition in entering the lawn-mower business, allowing it to achieve a significant market share without spending large sums on advertising to establish a brand identity for its lawn mowers. Canon's reputation in photographic equipment was a competitive asset that facilitated the company's diversification into copying equipment. Panasonic's name in consumer electronics (radios, TVs) was readily transferred to microwave ovens, making it easier and cheaper for Panasonic to diversify into the microwave oven market.

Strategic Fits in Managerial and Administrative Support Activities Often, different businesses require comparable types of skills, competencies, and managerial know-how, thereby allowing know-how in one line of business to be transferred to another. At General Electric (GE), managers who were involved in the company's expansion into Russia were able to expedite entry because of information they gained from GE managers involved in expansions into other emerging markets. The lessons GE managers learned in China were passed along to GE managers in Russia, allowing them to anticipate that the Russian government would demand that GE build production capacity in the country rather than enter the market through exporting or licensing. In addition, GE's managers in Russia were better able to develop realistic performance expectations and make tough up-front decisions since experience in China and elsewhere warned them (1) that there would likely be increased short-term costs during the early years of start-up and (2) that if GE committed to the Russian market for the long term and aided the country's economic development it could eventually expect to be given the freedom to pursue profitable penetration of the Russian market.[11]

Likewise, different businesses sometimes use the same sorts of administrative support facilities. For instance, an electric utility that diversifies into natural gas, appliance sales and repair services, and power line broadband can use the same customer data network, the same customer call centers and local offices, the same billing and customer accounting systems, and the same customer service infrastructure to support all of its products and services.

Illustration Capsule 9.1 lists the businesses of five companies that have pursued a strategy of related diversification.

Strategic Fit, Economies of Scope, and Competitive Advantage

What makes related diversification an attractive strategy is the opportunity to convert the strategic fit between the value chains of different businesses into a competitive advantage. The greater the relatedness

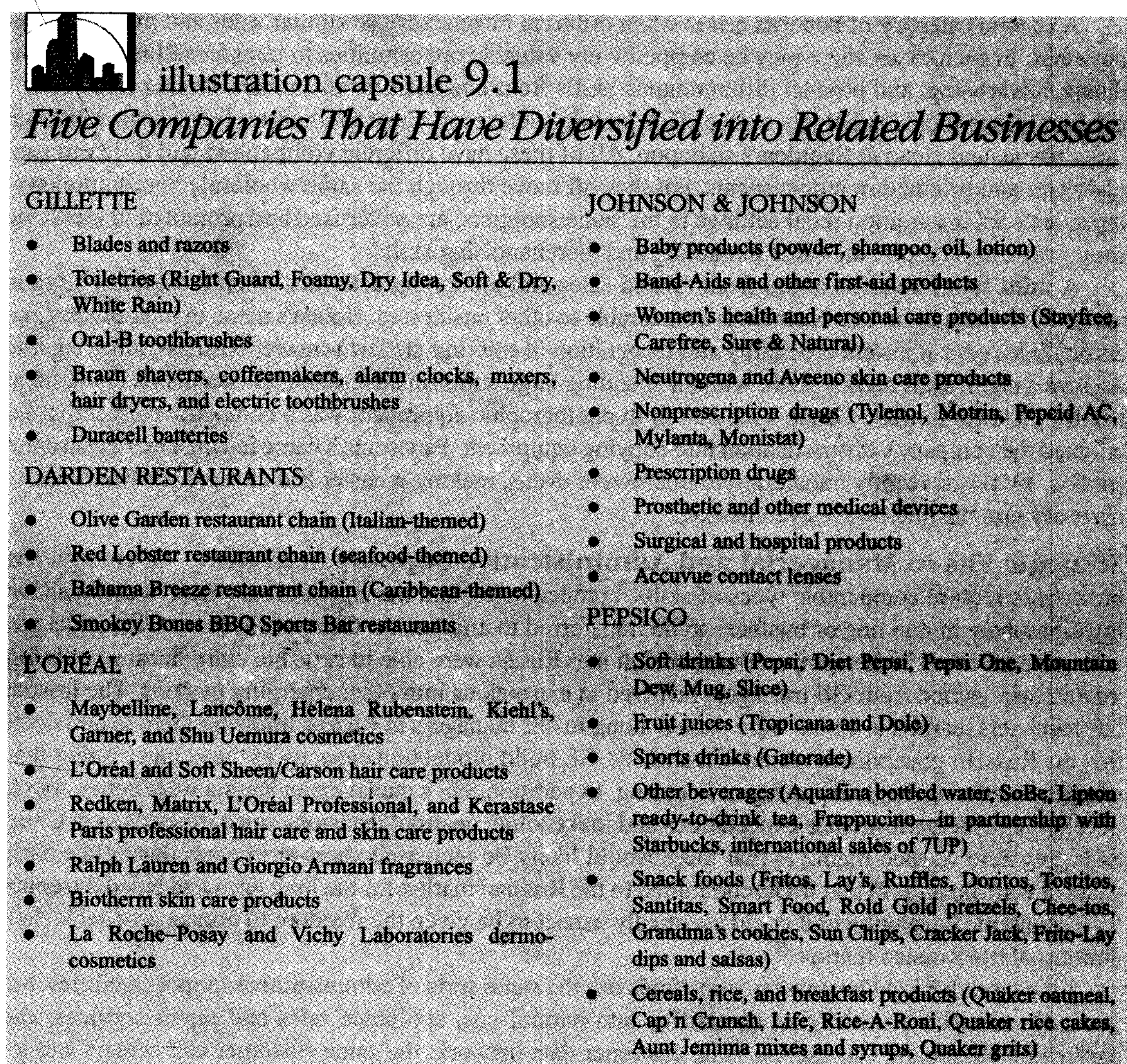


illustration capsule 9.1

Five Companies That Have Diversified into Related Businesses

GILLETTE

- Blades and razors
- Toiletries (Right Guard, Foamy, Dry Idea, Soft & Dry, White Rain)
- Oral-B toothbrushes
- Braun shavers, coffeemakers, alarm clocks, mixers, hair dryers, and electric toothbrushes
- Duracell batteries

DARDEN RESTAURANTS

- Olive Garden restaurant chain (Italian-themed)
- Red Lobster restaurant chain (seafood-themed)
- Bahama Breeze restaurant chain (Caribbean-themed)
- Smokey Bones BBQ Sports Bar restaurants

L'ORÉAL

- Maybelline, Lancôme, Helena Rubenstein, Kiehl's, Garner, and Shu Uemura cosmetics
- L'Oréal and Soft Sheen/Carson hair care products
- Redken, Matrix, L'Oréal Professional, and Kerastase Paris professional hair care and skin care products
- Ralph Lauren and Giorgio Armani fragrances
- Biotherm skin care products
- La Roche-Posay and Vichy Laboratories dermo-cosmetics

JOHNSON & JOHNSON

- Baby products (powder, shampoo, oil, lotion)
- Band-Aids and other first-aid products
- Women's health and personal care products (Stayfree, Carefree, Sure & Natural)
- Neutrogena and Aveeno skin care products
- Nonprescription drugs (Tylenol, Motrin, Pepcid AC, Mylanta, Monistat)
- Prescription drugs
- Prosthetic and other medical devices
- Surgical and hospital products
- Accuvue contact lenses

PEPSICO

- Soft drinks (Pepsi, Diet Pepsi, Pepsi One, Mountain Dew, Mug, Slice)
- Fruit juices (Tropicana and Dole)
- Sports drinks (Gatorade)
- Other beverages (Aquafina bottled water, SoBe, Lipton ready-to-drink tea, Frappucino—in partnership with Starbucks, international sales of 7UP)
- Snack foods (Fritos, Lay's, Ruffles, Doritos, Tostitos, Santitas, Smart Food, Rold Gold pretzels, Chee-tos, Grandma's cookies, Sun Chips, Cracker Jack, Frito-Lay dips and salsas)
- Cereals, rice, and breakfast products (Quaker oatmeal, Cap'n Crunch, Life, Rice-A-Roni, Quaker rice cakes, Aunt Jemima mixes and syrups, Quaker grits)

Source: Company annual reports.

among the businesses of a diversified company, the greater the opportunities for combining related value chain activities, leveraging use of a respected brand name and/or collaborating to create new resource strengths and capabilities. The more competitively important the strategic fit relationships across related businesses, the bigger the window for converting strategic fits into competitive advantage over rivals lacking comparable strategic fits in their own operations.

Economies of Scope: A Path to Competitive Advantage One of the most important competitive advantages that a related diversification strategy can produce is lower costs than competitors. Related businesses often present opportunities to consolidate certain value chain activities or use common resources, and thereby eliminate costs. Such cost savings are termed **economies of scope**—a

concept distinct from *economies of scale*. Economies of *scale* are cost savings that accrue directly from a larger-sized operation; for example, unit costs may be lower in a large plant than in a small plant, lower in a large distribution center than in a small one, lower for large-volume purchases of components than for small-volume purchases. Economies of *scope*, however, stem directly from cost-saving strategic fits along the value chains of related businesses; such economies are open only to multibusiness enterprises and are very much a phenomenon of related diversification. Most usually, economies of scope are the result of two or more businesses sharing technology, performing R&D together, using common manufacturing or distribution facilities, sharing a common sales force or distributor/dealer network, using the same established brand name, and/or sharing the same administrative infrastructure. *The greater the economies associated with cost-saving strategic fits, the greater the potential for a related diversification strategy to yield a competitive advantage based on lower costs.*

> **core concept**
> ***Economies of scope*** **are cost reductions that flow from operating in multiple businesses; such economies stem directly from strategic-fit efficiencies along the value chains of related businesses.**

From Competitive Advantage to Added Profitability and Gains in Shareholder Value Armed with the competitive advantages that come from economies of scope and the capture of other strategic-fit benefits, a company with a portfolio of related businesses is poised to achieve a 1 + 1 = 3 financial performance and the hoped-for gains in shareholder value. The business logic is compelling: A company that succeeds in capturing strategic fits along the value chains of its related businesses has a clear path to achieving competitive advantage over undiversified competitors and competitors whose own diversification efforts don't offer equivalent strategic-fit benefits. With such competitive advantage, a company then has a dependable basis for earning better-than-average profits—in particular, profits and a return on investment that exceed what the company's businesses could earn as stand-alone enterprises. In turn, above-average profitability is what fuels 1 + 1 = 3 gains in shareholder value—the necessary outcome for satisfying the better-off test and proving the business merit of a company's diversification effort.

> **core concept**
> **A company that leverages the strategic fit of its related businesses into competitive advantage has a clear avenue to producing gains in shareholder value.**

Consequently, a strategy of diversifying into related businesses where competitively valuable strategic fit benefits can be captured has strong potential for putting sister businesses in position to perform better financially as part of the same company than they could have performed as independent enterprises. This makes a strategy of related diversification a very appealing vehicle for building shareholder value in ways that shareholders cannot undertake by simply owning a portfolio of stocks of companies in different industries. The capture of strategic-fit benefits is possible only via a strategy of related diversification.[12]

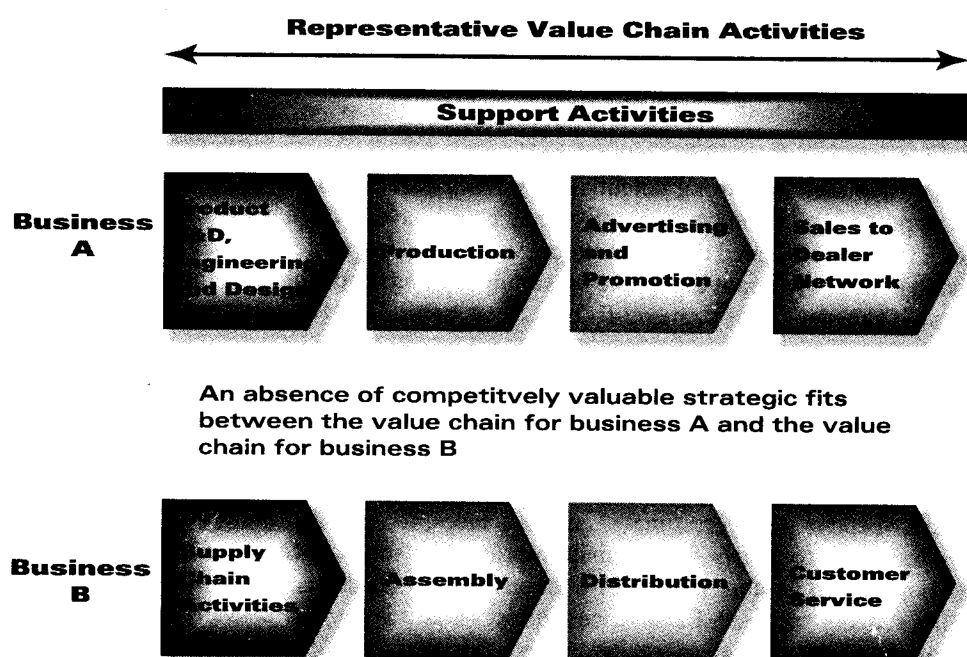
A Word of Caution Diversifying into related businesses is no guarantee of gains in shareholder value. Many companies have stumbled with related diversification because they overpaid for the acquired companies, failing the cost-of-entry test. And two problems commonly arise in passing the better-off test: One occurs when the likely cost savings of combining related value chain activities and capturing economies of scope are overestimated; in such cases, the realized cost savings and gains in profitability prove too small to justify the acquisition price. The second occurs when transferring resources from one business to another is fraught with unforeseen obstacles that delay or diminish the strategic-fit benefits actually captured. Experience indicates that it is easy to be overly optimistic about the value of the cross-business synergies—realizing them is harder than first meets the eye.

THE CASE FOR DIVERSIFYING INTO UNRELATED BUSINESSES

A strategy of diversifying into unrelated businesses discounts the value and importance of the strategic-fit benefits associated with related diversification and instead focuses on building and managing a portfolio of business subsidiaries capable of delivering good financial performance in their respective industries. Companies that pursue a strategy of unrelated diversification generally exhibit a willingness to diversify into *any industry* where there's potential for a company to realize consistently good financial results. Decisions to diversify into one industry versus another are the product of an opportunistic search for good companies to acquire—*the basic premise of unrelated diversification is that any company that can be acquired on good financial terms and that has satisfactory earnings potential represents a good acquisition.* While companies pursuing unrelated diversification may well look for companies that can satisfy the industry attractiveness and cost-of-entry tests, they either disregard the better-off test or relegate it to secondary status. *A strategy of unrelated diversification involves no deliberate effort to seek out businesses having strategic fit with the firm's other businesses* (see Figure 9.3). Rather, the company spends much time and effort screening new acquisition candidates and deciding whether to keep or divest existing businesses, using such criteria as:

- Whether the business can meet corporate targets for profitability and return on investment.
- Whether the business will require substantial infusions of capital to replace out-of-date plants and equipment, fund expansion, and provide working capital.

figure 9.3 **Unrelated Businesses Have Unrelated Value Chains and No Strategic Fits**



- Whether the business is in an industry with significant growth potential.
- Whether the business is big enough to contribute *significantly* to the parent firm's bottom line.
- Whether there is a potential for union difficulties or adverse government regulations concerning product safety or the environment.
- Whether there is industry vulnerability to recession, inflation, high interest rates, or shifts in government policy.

Some acquisition candidates offer quick opportunities for financial gain because of their "special situation." Three types of businesses may hold such attraction:

- *Companies whose assets are undervalued*—Opportunities may exist to acquire undervalued companies and resell their assets for more than the acquisition costs.
- *Companies that are financially distressed*—Businesses in financial distress can often be purchased at a bargain price, their operations turned around with the aid of the parent company's financial resources and managerial know-how, and then either held as long-term investments in the acquirer's business portfolio (because of their strong earnings or cash flow potential) or sold at a profit, whichever is more attractive.
- *Companies that have bright growth prospects but are short on investment capital*—Cash-poor but opportunity-rich companies are usually coveted acquisition candidates for a financially strong opportunity-seeking firm.

Companies that pursue unrelated diversification nearly always enter new businesses by acquiring an established company rather than by forming a start-up subsidiary within their own corporate structures. The premise of acquisition-minded corporations is that growth by acquisition can deliver enhanced shareholder value through upward-trending corporate revenues and earnings and a stock price that *on average* rises enough year after year to amply reward and please shareholders.

A key issue in unrelated diversification is how wide a net to cast in building a portfolio of unrelated businesses. In other words, should a company pursuing unrelated diversification seek to have few or many unrelated businesses? How much business diversity can corporate executives successfully manage? A reasonable way to resolve the issue of how much diversification comes from answering two questions: "What is the least diversification it will take to achieve acceptable growth and profitability?" and "What is the most diversification that can be managed, given the complexity it adds?"[13] The optimal amount of diversification usually lies between these two extremes.

Illustration Capsule 9.2 lists the businesses of five companies that have pursued unrelated diversification. Such companies are frequently labeled *conglomerates* because their business interests range broadly across diverse industries.

The Merits of an Unrelated Diversification Strategy

A strategy of unrelated diversification has appeal from several angles:

1. Business risk is scattered over a set of truly *diverse* industries. In comparison to related diversification, unrelated diversification more closely approximates *pure* diversification of financial and business risk because the company's investments are spread over businesses whose technologies and value chain activities bear no close relationship and whose markets are largely disconnected.[14]

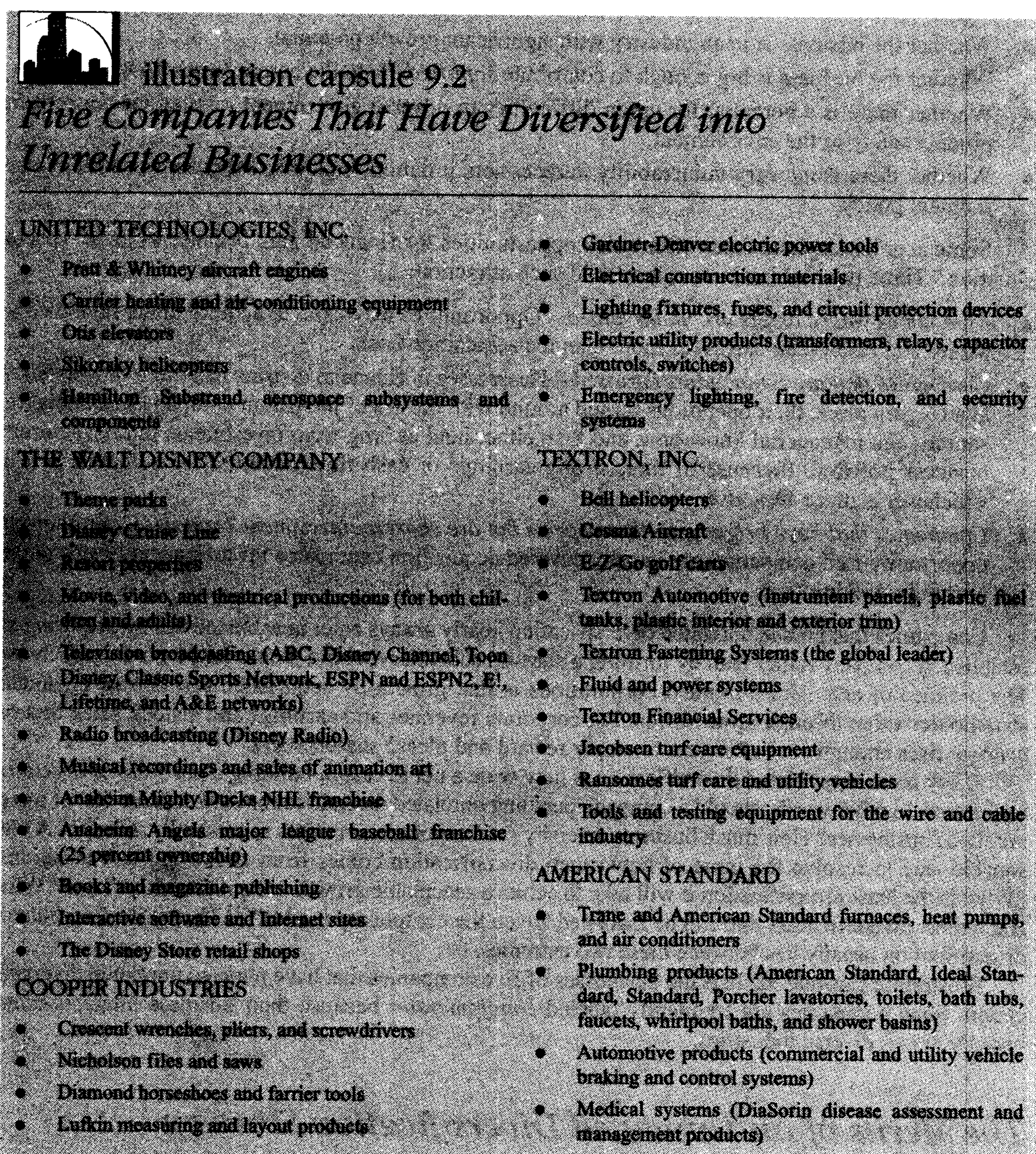


illustration capsule 9.2
Five Companies That Have Diversified into Unrelated Businesses

UNITED TECHNOLOGIES, INC.

- Pratt & Whitney aircraft engines
- Carrier heating and air-conditioning equipment
- Otis elevators
- Sikorsky helicopters
- Hamilton Substrand aerospace subsystems and components

THE WALT DISNEY COMPANY

- Theme parks
- Disney Cruise Line
- Resort properties
- Movie, video, and theatrical productions (for both children and adults)
- Television broadcasting (ABC, Disney Channel, Toon Disney, Classic Sports Network, ESPN and ESPN2, E!, Lifetime, and A&E networks)
- Radio broadcasting (Disney Radio)
- Musical recordings and sales of animation art
- Anaheim Mighty Ducks NHL franchise
- Anaheim Angels major league baseball franchise (25 percent ownership)
- Books and magazine publishing
- Interactive software and Internet sites
- The Disney Store retail shops

COOPER INDUSTRIES

- Crescent wrenches, pliers, and screwdrivers
- Nicholson files and saws
- Diamond horseshoes and farrier tools
- Lufkin measuring and layout products
- Gardner-Denver electric power tools
- Electrical construction materials
- Lighting fixtures, fuses, and circuit protection devices
- Electric utility products (transformers, relays, capacitor controls, switches)
- Emergency lighting, fire detection, and security systems

TEXTRON, INC.

- Bell helicopters
- Cessna Aircraft
- E-Z-Go golf cars
- Textron Automotive (instrument panels, plastic fuel tanks, plastic interior and exterior trim)
- Textron Fastening Systems (the global leader)
- Fluid and power systems
- Textron Financial Services
- Jacobsen turf care equipment
- Ransomes turf care and utility vehicles
- Tools and testing equipment for the wire and cable industry

AMERICAN STANDARD

- Trane and American Standard furnaces, heat pumps, and air conditioners
- Plumbing products (American Standard, Ideal Standard, Standard, Porcher lavatories, toilets, bath tubs, faucets, whirlpool baths, and shower basins)
- Automotive products (commercial and utility vehicle braking and control systems)
- Medical systems (DiaSorin disease assessment and management products)

Source: Company annual reports.

2. The company's financial resources can be employed to maximum advantage by investing in *whatever industries* offer the best profit prospects. Specifically, cash flows from company businesses with lower growth and profit prospects can be diverted to acquiring and expanding businesses with higher growth and profit potentials.

3. To the extent that corporate managers are exceptionally astute at spotting bargain-priced companies with big upside profit potential, shareholder wealth can be enhanced by buying distressed businesses at a low price, turning their operations around fairly quickly with infusions of cash and managerial know-how supplied by the parent company, and then riding the crest of the profit increases generated by the newly acquired businesses.
4. Company profitability may prove somewhat more stable over the course of economic upswings and downswings—in a broadly diversified company, there's a chance that market downtrends in some of the company's businesses will be partially offset by cyclical upswings in its other businesses, thus producing somewhat less earnings volatility. (In actual practice, however, there's no convincing evidence that the consolidated profits of firms with unrelated diversification strategies are more stable or less subject to reversal in periods of recession and economic stress than the profits of firms with related diversification strategies.)

Unrelated diversification can be appealing in several other circumstances. It certainly merits consideration when a firm needs to diversify away from an endangered or unattractive industry and has no distinctive competencies or capabilities it can transfer to an adjacent industry. There's also a rationale for unrelated diversification to the extent that owners have a strong preference for spreading business risks widely and not restricting themselves to investing in a family of closely related businesses.

Building Shareholder Value via Unrelated Diversification Building shareholder value via unrelated diversification is predicated on executive skill in managing a group of unrelated businesses. For a strategy of unrelated diversification to generate gains in shareholder value, corporate-level managers must produce companywide financial results above and beyond what business-level managers could produce if the businesses operated as stand-alone entities. Corporate executives add value to a diversified enterprise by shrewdly deciding which businesses to get into and which ones to get out of, cleverly allocating the corporate parent's financial resources to businesses with the best profit potential, and consistently providing high-caliber decision-making guidance to the general managers of the company's business subsidiaries. In more specific terms, this means corporate-level executives must:

- Do a superior job of diversifying into new businesses that can produce consistently good earnings and returns on investment (thereby satisfying the attractiveness test).
- Do an excellent job of negotiating favorable acquisition prices (thereby satisfying the cost-of-entry test).
- Discern when it is the "right" time to sell a particular business (when a business subsidiary is on the verge of confronting adverse industry and competitive conditions and probable declines in long-term profitability), and determine the "right" selling price—ideally one higher than the company's net investment in the business.
- Shift corporate financial resources out of businesses where profit opportunities are dim and into businesses with the potential for above-average earnings growth and returns on investment.
- Do such a good job overseeing the firm's business subsidiaries and contributing to how they are managed—by providing expert problem-solving skills, creative strategy suggestions, decision-making guidance to business-level managers, and needed infusions of investment capital—that the subsidiaries perform at a higher level than they would otherwise be able to do (a possible way to satisfy the better-off test).

To the extent that corporate executives are able to craft and execute a strategy of unrelated diversification that produces enough of the above outcomes to produce a stream of dividends and capital gains for stockholders greater than a 1 + 1 = 2 outcome, a case can be made that shareholder value has truly been enhanced.

The Drawbacks of Unrelated Diversification

Unrelated diversification strategies have two important negatives that undercut the positives: very demanding managerial requirements and limited competitive advantage potential.

Demanding Managerial Requirements Successfully managing a set of fundamentally different businesses operating in fundamentally different industry and competitive environments is a very challenging and exceptionally difficult proposition for corporate-level managers. Key executives at the corporate level, while perhaps having personally worked in one or two of the company's businesses, cannot possibly have in-depth familiarity with each of the company's businesses—the prevailing competitive market conditions, driving forces, industry key success factors, each business's competitive strengths and weaknesses, and so on. The greater the number of businesses a company is in and the more diverse those businesses are, the harder it is for corporate managers to (1) stay abreast of what's happening in each industry and each subsidiary and thus judge whether a particular business has bright prospects or is headed for trouble, (2) know enough about the issues and problems facing each subsidiary to pick business-unit heads having the requisite combination of managerial skills and know-how, (3) be able to tell the difference between those strategic proposals of business-unit managers that are prudent and those that are risky or unlikely to succeed, and (4) know what to do if a business unit stumbles and its results suddenly head downhill.[15]

core concept
The two biggest drawbacks to unrelated diversification are the difficulties of competently managing many different businesses and being without the added source of competitive advantage that cross-business strategic fit provides.

In a company like Walt Disney (see Illustration Capsule 6.2) or Tyco International (which acquired over 1,000 companies during the 1990–2001 period), corporate executives are constantly scrambling to stay on top of fresh industry developments and the strategic progress and plans of each subsidiary, often depending on briefings by business-level managers for many of the details. As a rule, the more unrelated businesses that a company has diversified into, the more corporate executives are reduced to "managing by the numbers"—that is, keeping a close track on the financial and operating results of each subsidiary and assuming that everything is under control in a business as long as the latest key financial and operating measures look good. Managing by the numbers can work if the heads of the various business units are quite capable, but there's still ample room for strategic issues to be glossed over and for impending downturns in some of the company's key businesses to go unnoticed. Just one or two unforeseen declines or big strategic mistakes (misjudging the importance of certain competitive forces or the impact of driving forces or key success factors, encountering unexpected problems in a newly acquired business, or being too optimistic about turning around a struggling subsidiary) can cause a precipitous drop in corporate earnings and crash the parent company's stock price. As the former chairman of a Fortune 500 company advised, "Never acquire a business you don't know how to run." Because every business tends to encounter rough sledding, a good way to gauge the merits of acquiring a company in an unrelated industry is to ask, "If the business got into trouble, is corporate management likely to know how to bail it out?" When the answer is no (or even maybe), growth via acquisition into unrelated businesses is a chancy strategy.[16]

Hence, overseeing a set of widely diverse businesses may turn out to be much harder than it sounds. In practice, comparatively few companies have proved that they have top management capabilities that are up to the task. Far more companies have failed at unrelated diversification than have succeeded. It is simply very difficult for corporate executives to build shareholder value based on their expertise in (1) picking which industries to diversify into and which companies in these industries to acquire, (2) shifting resources from low-performing business into high-performing businesses, and (3) giving high-caliber decision-making guidance to the general managers of their business subsidiaries. Instead of achieving 1 + 1 = 3 gains in shareholder value, the odds are that the result of unrelated diversification will be 1 + 1 = 2 or less.

Limited Competitive Advantage Potential The second big negative is that *unrelated diversification offers no potential for competitive advantage beyond that of what each individual business can generate on its own.* Unlike a related diversification strategy, there are no cross-business strategic fits to draw on for reducing costs, beneficially transferring skills and technology, leveraging use of a powerful brand name, or collaborating to build mutually beneficial competitive capabilities. Yes, a cash-rich corporate parent pursuing unrelated diversification can provide cash-short subsidiaries with much-needed capital, and maybe even added managerial know-how to help resolve problems in particular business units but otherwise it has little to offer in the way of enhancing the competitive strength of its individual business units. *Without the competitive advantage potential of strategic fits, consolidated performance of an unrelated group of businesses stands to be little or no better than the sum of what the individual business units could achieve if they were independent.*

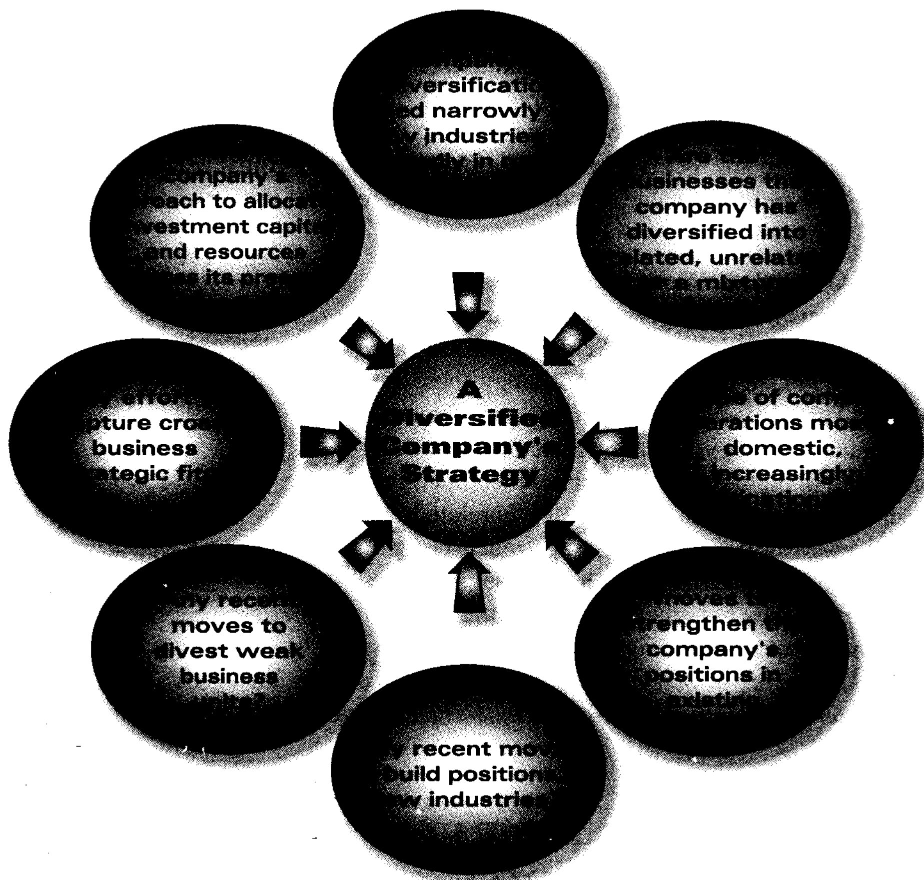
Relying solely on the expertise of corporate executives to wisely manage a set of unrelated businesses is *a much weaker foundation for enhancing shareholder value* than is a strategy of related diversification where corporate performance can be boosted by competitively valuable cross-business strategic fits.

COMBINATION RELATED–UNRELATED DIVERSIFICATION STRATEGIES

There's nothing to preclude a company from diversifying into both related and unrelated businesses. Indeed, in actual practice the business makeup of diversified companies varies considerably. Some diversified companies are really *dominant-business enterprises*—one major "core" business accounts for 50 to 80 percent of total revenues and a collection of small related or unrelated businesses accounts for the remainder. Some diversified companies are *narrowly diversified* around a few (two to five) related or unrelated businesses. Others are *broadly diversified* around a wide-ranging collection of related businesses, unrelated businesses, or a mixture of both. And a number of multibusiness enterprises have diversified into unrelated areas but have a collection of related businesses within each area—thus giving them a business portfolio consisting of *several unrelated groups of related businesses.* There's ample room for companies to customize their diversification strategies to incorporate elements of both related and unrelated diversification, as may suit their own risk preferences and strategic vision.

Figure 9.4 indicates what to look for in identifying the main elements of a company's diversification strategy. Having a clear fix on the company's current corporate strategy sets the stage for evaluating how good the strategy is and proposing strategic moves to boost the company's performance.

figure 9.4 **Identifying a Diversified Company's Strategy**



EVALUATING THE STRATEGY OF A DIVERSIFIED COMPANY

Strategic analysis of diversified companies builds on the concepts and methods used for single-business companies. But there are some additional aspects to consider and a couple of new analytical tools to master. The procedure for evaluating a diversified company's strategy and deciding how to improve the company's performance involves six steps:

1. Evaluating industry attractiveness.
2. Evaluating business-unit competitive strength.
3. Checking the competitive advantage potential of cross-business strategic fits.
4. Checking for resource fit.
5. Ranking the business units on the basis of performance and priority for resource allocation.
6. Crafting new strategic moves to improve overall corporate performance.

The core concepts and analytical techniques underlying each of these steps merit further discussion.

Step 1: Evaluating Industry Attractiveness

A principal consideration in evaluating a diversified company's business makeup and the caliber of its strategy is the attractiveness of the industries in which it has business operations. Answers to several questions are required:

1. *Does each industry the company has diversified into represent a good business for the company to be in?* Ideally, each industry in which the firm operates will pass the attractiveness test.
2. *Which of the company's industries are most attractive and which are least attractive?* Comparing the attractiveness of the industries and ranking them from most to least attractive is a prerequisite to deciding how to allocate corporate resources across the various businesses.
3. *How appealing is the whole group of industries in which the company has invested?* The answer to this question points to whether the group of industries holds promise for attractive growth and profitability or whether the company may be in too many slow-growing, intensely competitive, highly cyclical businesses. A company whose revenues and profits come chiefly from businesses in relatively unattractive industries probably needs to look at building positions in additional industries that qualify as highly attractive.

The more attractive the industries (both individually and as a group) a diversified company is in, the better its prospects for good long-term performance.

Calculating Industry Attractiveness Scores for Each Industry into Which the Company Has Diversified A simple and reliable analytical tool involves calculating quantitative industry attractiveness scores, which can then be used to gauge each industry's attractiveness, rank the industries from most to least attractive, and make judgments about the attractiveness of all the industries as a group. A sample calculation is shown in Table 9.1. The following measures of industry attractiveness are likely to come into play for most companies:

- *Market size and projected growth rate*—Big industries are more attractive than small industries, and fast-growing industries tend to be more attractive than slow-growing industries, other things being equal.
- *The intensity of competition*—Industries where competitive pressures are relatively weak are more attractive than industries where competitive pressures are strong.
- *Emerging opportunities and threats*—Industries with promising opportunities and minimal threats on the near horizon are more attractive than industries with modest opportunities and imposing threats.
- *The presence of cross-industry strategic fits*—The more the industry's value chain and resource requirements match up well with the value chain activities of other industries in which the company has operations, the more attractive the industry is to a firm pursuing related diversification. However, cross-industry strategic fits may be of no consequence to a company committed to a strategy of unrelated diversification.
- *Resource requirements*—Industries having resource requirements within the company's reach are more attractive than industries where capital and other resource requirements could strain corporate financial resources and organizational capabilities.

table 9.1 Calculating Weighted Industry Attractiveness Scores

Industry Attractiveness Measure	Importance Weight	Industry A Rating/ Score	Industry B Rating/ Score	Industry C Rating/ Score	Industry D Rating/ Score
Market size and projected growth rate	0.10	8/0.80	5/0.50	7/0.70	3/0.30
Intensity of competition	0.25	8/2.00	7/1.75	3/0.75	2/0.50
Emerging opportunities and threats	0.10	2/0.20	9/0.90	4/0.40	5/0.50
Cross-industry strategic fits	0.20	8/1.60	4/0.80	8/1.60	2/0.40
Resource requirements	0.10	9/0.90	7/0.70	10/1.00	5/0.50
Seasonal and cyclical influences	0.05	9/0.45	8/0.40	10/0.50	5/0.25
Societal, political, regulatory, and environmental factors	0.05	10/1.00	7/0.70	7/0.70	3/0.30
Industry profitability	0.10	5/0.50	10/1.00	3/0.30	3/0.30
Industry uncertainty and business risk	0.05	5/0.25	7/0.35	10/0.50	1/0.05
Sum of the assigned weights	1.00				
Overall industry attractiveness scores		**7.70**	**7.10**	**5.45**	**3.10**

Rating scale: 1 = Very unattractive to company; 10 = Very attractive to company

- *Seasonal and cyclical influences*—Industries where buyer demand is relatively steady year-round and not unduly vulnerable to economic ups and downs tend to be more attractive than industries where there are wide swings in buyer demand within or across years. However, seasonality may be a plus for a company that is in several seasonal industries, if the seasonal highs in one industry correspond to the lows in another industry, thus helping even out monthly sales levels. Likewise, cyclical market demand in one industry can be attractive if its up-cycle runs counter to the market down-cycles in another industry where the company operates, thus helping reduce revenue and earnings volatility.
- *Social, political, regulatory, and environmental factors*—Industries with significant problems in such areas as consumer health, safety, or environmental pollution or that are subject to intense regulation are less attractive than industries where such problems are not burning issues.
- *Industry profitability*—Industries with healthy profit margins and high rates of return on investment are generally more attractive than industries where profits have historically been low or unstable.
- *Industry uncertainty and business risk*—Industries with less uncertainty on the horizon and lower overall business risk are more attractive than industries whose prospects for one reason or another are quite uncertain, especially when the industry has formidable resource requirements.

After settling on a set of attractiveness measures that suit a diversified company's circumstances, each attractiveness measure is assigned a weight reflecting its relative importance in determining an industry's attractiveness—it is weak methodology to assume that the various attractiveness measures are equally important. The intensity of competition in an industry should nearly always carry a high weight (say, 0.20 to 0.30). Strategic-fit considerations should be assigned a high weight in the case of companies with related diversification strategies; but, for companies with an unrelated diversification strategy,

strategic fits with other industries may be given a low weight or even dropped from the list of attractiveness measures altogether. Seasonal and cyclical influences generally are assigned a low weight (or maybe even eliminated from the analysis) unless a company has diversified into industries strongly characterized by seasonal demand and/or heavy vulnerability to cyclical upswings and downswings. The importance weights must add up to 1.0.

Next, each industry is rated on each of the chosen industry attractiveness measures, using a rating scale of 1 to 10 (where a *high* rating signifies *high* attractiveness and a *low* rating signifies *low* attractiveness). Keep in mind here that the more intensely competitive an industry is, the *lower* the attractiveness rating for that industry. Likewise, the higher the capital and resource requirements associated with being in a particular industry, the lower the attractiveness rating. And an industry subject to stringent pollution control regulations or that causes societal problems (like cigarettes or alcoholic beverages) should be given a low attractiveness rating. Weighted attractiveness scores are then calculated by multiplying the industry's rating on each measure by the corresponding weight. For example, a rating of 8 times a weight of 0.25 gives a weighted attractiveness score of 2.00. The sum of the weighted scores for all the attractiveness measures provides an overall industry attractiveness score.

There are two hurdles to using this method of evaluating industry attractiveness. One is deciding on appropriate weights for the industry attractiveness measures. Not only may different analysts have different views about which weights are appropriate for the different attractiveness measures but also different weightings may be appropriate for different companies—based on their strategies, performance targets, and financial circumstances. For instance, placing a low weight on industry resource requirements may be justifiable for a cash-rich company, whereas a high weight may be more appropriate for a financially strapped company. The second hurdle is getting reliable data for use in assigning accurate and objective ratings. Without good information, the ratings necessarily become subjective, and their validity hinges on whether management has probed industry conditions sufficiently to make reliable judgments. Generally, a company can come up with the statistical data needed to compare its industries on such factors as market size, growth rate, seasonal and cyclical influences, and industry profitability. Cross-industry fits and resource requirements are also fairly easy to judge. But the attractiveness measure where judgment weighs most heavily is that of intensity of competition. It is not always easy to conclude whether competition in one industry is stronger or weaker than in another industry because of the different types of competitive influences that prevail and the differences in their relative importance. In the event that the available information is too skimpy to confidently assign a rating value to an industry on a particular attractiveness measure, then it is usually best to use a score of 5, which avoids biasing the overall attractiveness score either up or down.

Nonetheless, industry attractiveness scores are a reasonably reliable method for ranking a diversified company's industries from most to least attractive—quantitative ratings like those shown for the four industries in Table 9.1 tell a valuable story about just how and why some of the industries a company has diversified into are more attractive than others.

Interpreting the Industry Attractiveness Scores Industries with a score much below 5.0 probably do not pass the attractiveness test. If a company's industry attractiveness scores are all above 5.0, it is probably fair to conclude that the group of industries the company operates in is attractive as a whole. But the group of industries takes on a decidedly lower degree of attractiveness as the number of industries with

scores below 5.0 increases, especially if industries with low scores account for a sizable fraction of the company's revenues.

For a diversified company to be a strong performer, a substantial portion of its revenues and profits must come from business units with relatively high attractiveness scores. It is particularly important that a diversified company's principal businesses be in industries with a good outlook for growth and above-average profitability. Having a big fraction of the company's revenues and profits come from industries with slow growth, low profitability, or intense competition tends to drag overall company performance down. Business units in the least attractive industries are potential candidates for divestiture, unless they are positioned strongly enough to overcome the unattractive aspects of their industry environments or they are a strategically important component of the company's business makeup.

Step 2: Evaluating Business-Unit Competitive Strength

The second step in evaluating a diversified company is to appraise how strongly positioned each of its business units are in their respective industry. Doing an appraisal of each business unit's strength and competitive position in its industry not only reveals its chances for industry success but also provides a basis for ranking the units from competitively strongest to competitively weakest and sizing up the competitive strength of all the business units as a group.

Calculating Competitive Strength Scores for Each Business Unit Quantitative measures of each business unit's competitive strength can be calculated using a procedure similar to that for measuring industry attractiveness (see Table 9.2). There are a host of measures that can be used in assessing the competitive strength of a diversified company's business subsidiaries:

- *Relative market share*—A business unit's relative market share is defined as the ratio of its market share to the market share held by the largest rival firm in the industry, with market share measured in unit volume, not dollars. For instance, if business A has a market-leading share of 40 percent and its largest rival has 30 percent, A's relative market share is 1.33. (Note that only business units that are market share leaders in their respective industries can have relative market shares greater then 1.0.) If business B has a 15 percent market share and B's largest rival has 30 percent, B's relative market share is 0.5. The further below 1.0 a business unit's relative market share is, the weaker its competitive strength and market position vis-à-vis rivals. *Using relative market share is analytically superior to using straight-percentage market share to measure competitive strength.* A 10 percent market share, for example, does not signal much competitive strength if the leader's share is 50 percent (a 0.20 relative market share), but a 10 percent share is actually quite strong if the leader's share is 12 percent (a 0.83 relative market share).
- *Costs relative to competitors' costs*—Business units that have low costs relative to key competitors' costs tend to be more strongly positioned in their industries than business units struggling to maintain cost parity with major rivals. Assuming that the prices charged by industry rivals are about the same, business units with higher relative market shares should have lower unit costs than competitors of economies from larger-scale operations and the benefits of learning-curve effects. In contrast, a business unit with higher costs than its key rivals is likely to be competitively vulnerable unless its

table 9.2 Calculating Weighted Competitive Strength Scores for a Diversified Company's Business Units

Competitive Strength Measure	Importance Weight	Business A in Industry A Rating/ Score	Business B in Industry B Rating/ Score	Business C in Industry C Rating/ Score	Business D in Industry D Rating/ Score
Relative market share	0.15	10/1.50	1/0.15	6/0.90	2/0.30
Costs relative to competitors' costs	0.20	7/1.40	2/0.40	5/1.00	3/0.60
Ability to match or beat rivals on key product attributes	0.05	9/0.45	4/0.20	8/0.40	4/0.20
Ability to benefit from strategic fits with sister businesses	0.20	8/1.60	4/0.80	8/0.80	2/0.60
Bargaining leverage with suppliers/ buyers; caliber of alliances	0.05	9/0.90	3/0.30	6/0.30	2/0.10
Brand image and reputation	0.10	9/0.90	2/0.20	7/0.70	5/0.50
Competitively valuable capabilities	0.15	7/1.05	2/0.20	5/0.75	3/0.45
Profitability relative to competitors	0.10	5/0.50	1/0.10	4/0.40	4/0.40
Sum of the assigned weights	1.00				
Overall industry attractiveness scores		**8.30**	**2.35**	**5.25**	**3.15**

Rating scale: 1 = Very weak; 10 = Very strong

product is strongly differentiated from those of rivals and its customers are willing to pay premium prices for the differentiating features. Another indicator of low cost can be a business unit's supply chain management capabilities.

- *Ability to match or beat rivals on key product attributes*—A company's competitiveness depends in part on being able to satisfy buyer expectations with regard to features, product performance, reliability, service, and other important attributes.
- *Ability to benefit from strategic fits with sister businesses*—Strategic fits with other businesses within the company enhance a business unit's competitive strength and may provide a competitive edge.
- *Ability to exercise bargaining leverage with key suppliers or customers*—Having bargaining leverage signals competitive strength and can be a source of competitive advantage.
- *Caliber of strategic alliances and collaborative partnerships with suppliers and/or buyers*—Well-functioning alliances and partnerships may signal a potential competitive advantage and thus add to a business's competitive strength. Alliances with key suppliers are often the basis for competitive strength in supply chain management.
- *Brand image and reputation*—A strong brand name is a valuable competitive asset in most industries.
- *Competitively valuable capabilities*—Business units recognized for their technological leadership, product innovation, or marketing prowess are usually strong competitors in their industry. Skills in supply chain management can generate valuable cost or product differentiation advantages. So can unique production capabilities. Sometimes a company's business units gain competitive strength be-

cause of their knowledge of customers and markets and/or their proven managerial capabilities. *An important thing to look for here is how well a business unit's competitive assets match industry key success factors.* The more a business unit's resource strengths and competitive capabilities match the industry's key success factors, the stronger its competitive position tends to be.

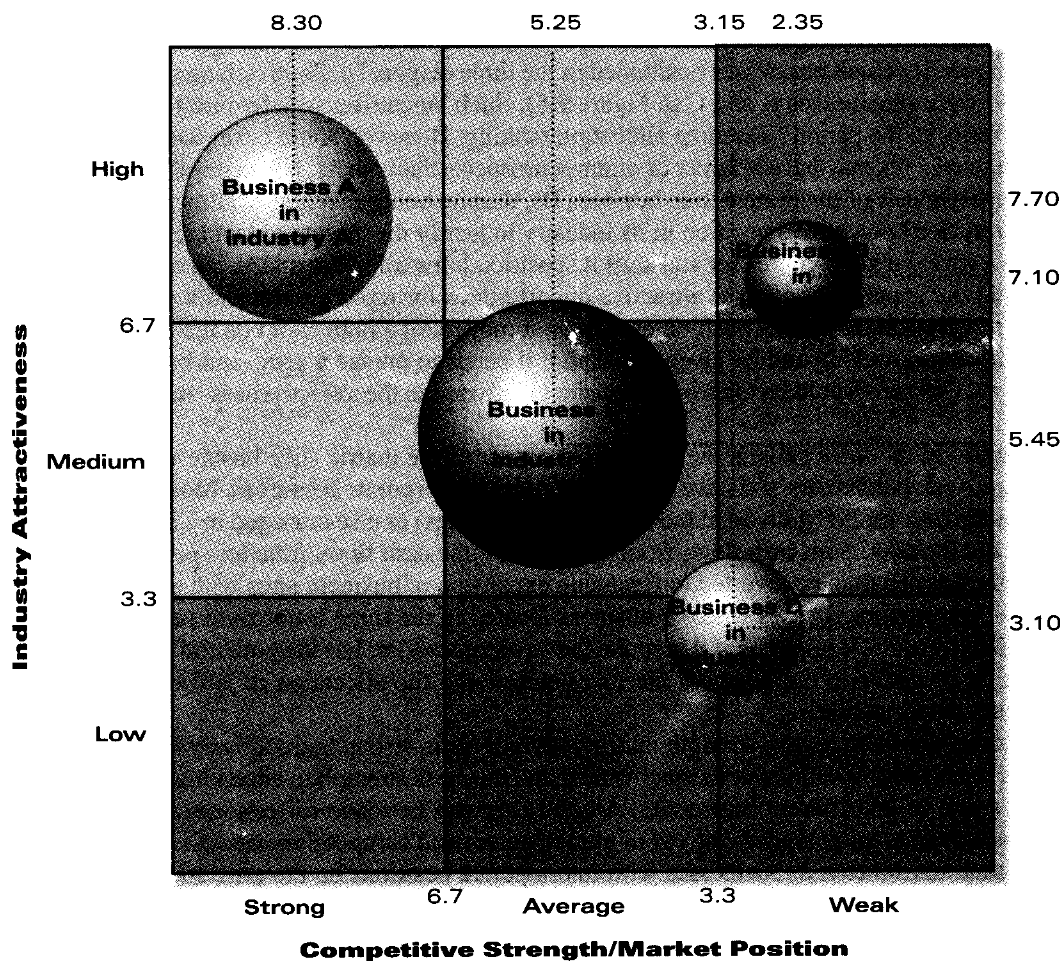
- *Profitability relative to competitors*—Business units that consistently earn above-average returns on investment and have bigger profit margins than their rivals usually have stronger competitive positions.

After settling on a set of competitive strength measures that are well matched to the circumstances of the various business units, weights indicating each measure's importance need to be assigned. A case can be made for using different weights for different business units whenever the importance of the strength measures differs significantly from business to business, but otherwise it is simpler just to go with a single set of weights and avoid the added complication of multiple weights. As before, the importance weights must add up to 1.0. Each business unit is then rated on each of the chosen strength measures, using a rating scale of 1 to 10 (where a *high* rating signifies competitive *strength* and a *low* rating signifies competitive *weakness*). In the event that the available information is too skimpy to confidently assign a rating value to a business unit on a particular strength measure, then it is usually best to use a score of 5, which avoids biasing the overall score either up or down. Weighted strength ratings are calculated by multiplying the business unit's rating on each strength measure by the assigned weight. For example, a strength score of 6 times a weight of 0.15 gives a weighted strength rating of 0.90. The sum of weighted ratings across all the strength measures provides a quantitative measure of a business unit's overall market strength and competitive standing.

Interpreting the Competitive Strength Scores Business units with competitive strength ratings above 6.7 (on a scale of 1 to 10) are strong market contenders in their industries. Businesses with ratings in the 3.3 to 6.7 range have moderate competitive strength. Businesses with ratings below 3.3 are in competitively weak market positions. If a diversified company's business units all have competitive strength scores above 5.0, it is fair to conclude that its business units are all fairly strong market contenders in their respective industries. But as the number of business units with scores below 5.0 increases, there's reason to question whether the company can perform well with so many businesses in relatively weak competitive positions. This concern takes on even more importance when business units with low scores account for a sizable fraction of the company's revenues.

Using a Nine-Cell Matrix to Simultaneously Portray Industry Attractiveness and Competitive Strength The industry attractiveness and business strength scores can be used to portray the strategic positions of each business in a diversified company. Industry attractiveness is plotted on the vertical axis, and competitive strength on the horizontal axis. A nine-cell grid emerges from dividing the vertical axis into three regions (high, medium, and low attractiveness) and the horizontal axis into three regions (strong, average, and weak competitive strength). As shown in Figure 9.5, high attractiveness is associated with scores of 6.7 or greater on a rating scale of 1 to 10, medium attractiveness to scores of 3.3 to 6.7, and low attractiveness to scores below 3.3. Likewise, high competitive strength is defined as a score greater than 6.7, average strength as scores of 3.3 to 6.7, and low strength as scores below 3.3. Each business unit is plotted on the nine-cell matrix according to its overall attractiveness score and strength score, and then shown as a bubble. The size of each bubble is scaled to what percentage of revenues the business

figure 9.5 **A Nine-Cell Industry Attractiveness–Competitive Strength Matrix**



High priority for resource allocation
Medium priority for resource allocation
Low priority for resource allocation

Note: Circle sizes are scaled to reflect the percentage of companywide revenues generated by the business unit.

generates relative to total corporate revenues. The bubbles in Figure 9.5 were located on the grid using the attractiveness scores from Table 9.1 and the strength scores for the four business units in Table 9.2.

The locations of the business units on the attractiveness–strength matrix provide valuable guidance in deploying corporate resources to the various business units. In general, *a diversified company's prospects for good overall performance are enhanced by concentrating corporate resources and strategic attention on those business units having the greatest competitive strength and positioned in highly attractive*

core concept
In a diversified company, businesses having the greatest competitive strength and positioned in attractive industries should generally have top priority in allocating corporate resources.

industries—specifically, businesses in the three cells in the upper left portion of the attractiveness–strength matrix, where industry attractiveness and competitive strength/market position are both favorable. The general strategic prescription for businesses falling in these three cells (for instance, business A in Figure 9.5) is "grow and build," with businesses in the high–strong cell standing first in line for resource allocations by the corporate parent.

Next in priority come businesses positioned in the three diagonal cells stretching from the lower left to the upper right (businesses B and C in Figure 9.5). Such businesses usually merit medium or intermediate priority in the parent's resource allocation ranking. However, some businesses in the medium-priority diagonal cells may have brighter or dimmer prospects than others. For example, a small business in the upper right cell of the matrix (like business B), despite being in a highly attractive industry, may occupy too weak a competitive position in its industry to justify the investment and resources needed to turn it into a strong market contender and shift its position leftward in the matrix over time. If, however, a business in the upper right cell has attractive opportunities for rapid growth and a good potential for winning a much stronger market position over time, it may merit a high claim on the corporate parent's resource allocation ranking and be given the capital it needs to pursue a grow-and-build strategy—the strategic objective here would be to move the business leftward in the attractiveness–strength matrix over time.

Businesses in the three cells in the lower right corner of the matrix (like business D in Figure 9.5) typically are weak performers and have the lowest claim on corporate resources. Most such businesses are good candidates for being divested (sold to other companies) or else managed in a manner calculated to squeeze out the maximum cash flows from operations—the cash flows from low-performing/low-potential businesses can then be diverted to financing expansion of business units with greater market opportunities. In exceptional cases where a business located in the three lower right cells is nonetheless fairly profitable (which it might be if it is in the low–average cell) or has the potential for good earnings and return on investment, the business merits retention and the allocation of sufficient resources to achieve better performance.

The nine-cell attractiveness–strength matrix provides clear, strong logic for why a diversified company needs to consider both industry attractiveness and business strength in allocating resources and investment capital to its different businesses. A good case can be made for concentrating resources in those businesses that enjoy higher degrees of attractiveness and competitive strength, being very selective in making investments in businesses with intermediate positions on the grid, and withdrawing resources from businesses that are lower in attractiveness and strength unless they offer exceptional profit or cash flow potential.

Step 3: Checking the Competitive Advantage Potential of Cross-Business Strategic Fits

A company's related diversification strategy derives its power in large part from competitively valuable strategic fits among its businesses. Checking the competitive advantage potential of cross-business strategic fits involves searching for and evaluating how much benefit a diversified company can gain from four types of value chain matchups:

1. *Opportunities to combine the performance of certain activities,* thereby reducing costs. Potential value chain matchups where economies of scope can be realized include purchasing (where combining materials purchases could lead to greater bargaining leverage with suppliers); manufacturing

(where it may be possible to share manufacturing facilities); or distribution (where it may be possible to share warehousing, sales forces, distributors, dealers, online sales channels, and after-sale service activities).

2. *Opportunities to transfer skills, technology, or intellectual capital from one business to another,* thereby leveraging use of existing resources. Good candidates for transfer include speed in bringing new products to market, proven R&D skills in generating new products or improving existing technologies, organizational agility in responding to shifting market conditions and emerging opportunities, and state-of-the-art systems for doing business via the Internet.
3. *Opportunities to share use of a well-respected brand name,* thereby gaining credibility with brand-conscious buyers and perhaps commanding prominent display space with retailers.
4. *Opportunities for businesses to collaborate in creating valuable new competitive capabilities* (enhanced quality control capabilities, quicker first-to-market capabilities, greater product innovation capabilities).

core concept
The greater the value of cross-business strategic fits in enhancing a company's performance in the marketplace or on the bottom line, the more competitively powerful is its strategy of related diversification.

Figure 9.6 illustrates the process of searching for competitively valuable cross-business strategic fits and value chain matchups. *But more than just strategic fit identification is needed. The real test is what competitive value can be generated from these fits.* To what extent can cost savings be realized? How much competitive value will come from cross-business transfer of skills, technology, or intellectual capital? Will transferring a potent brand name to the products of other businesses grow sales significantly? Will cross-business collaboration to create or strengthen competitive capabilities lead to significant gains in the marketplace or in financial performance? Without significant strategic fits and dedicated company efforts to capture the benefits, one has to be skeptical about the potential for a diversified company's businesses to perform better together than apart.

Step 4: Checking for Resource Fit

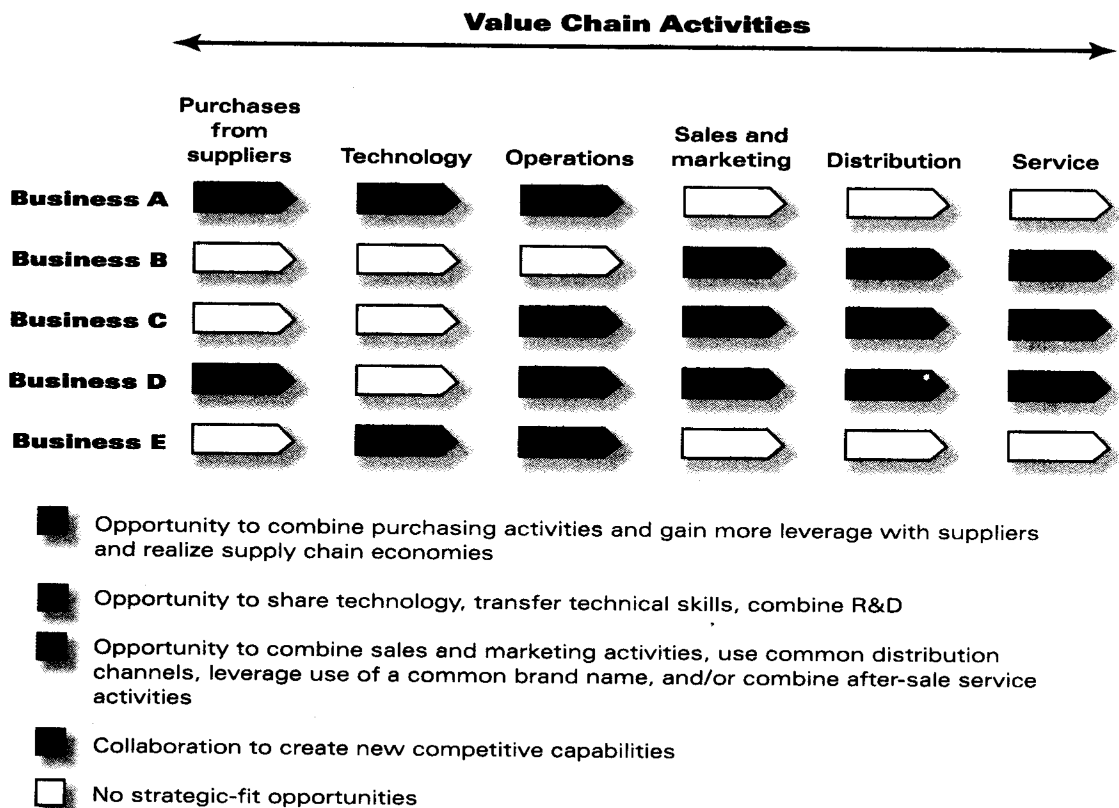
The businesses in a diversified company's lineup need to exhibit good *resource fit* as well as good strategic fit. Resource fit exists when (1) businesses add to a company's resource strengths, either financially or strategically, and (2) a company has the resources to adequately support its businesses as a group without spreading itself too thin. One important dimension of resource fit concerns whether a diversified company has the financial strength to satisfy the cash flow and investments of its different businesses.

Financial Resource Fits: Cash Cows versus Cash Hogs

core concept
A ***cash hog*** is a business whose internal cash flows are inadequate to fully fund its needs for working capital and new capital investment.

Different businesses have different cash flow and investment characteristics. For example, business units in rapidly growing industries are often **cash hogs**—the cash flows they are able to generate from internal operations aren't big enough to fund their expansion. To keep pace with rising buyer demand, rapid-growth businesses frequently need sizable annual capital investments—for new facilities and equipment, for new product development or technology improvements, and for additional working capital to support inventory expansion and a larger base of operations. A business in a fast-growing industry becomes an even bigger cash hog when it has a relatively low market share and is pursuing a strategy to become an industry leader. Because a cash hog's financial resources must be provided by the corporate parent,

figure 9.6 **Identifying the Competitive Advantage Potential of Cross-Business Strategic Fits**



corporate managers have to decide whether its investment requirements are strategically and financially worthwhile.

In contrast, business units with leading market positions in mature industries may, however, be **cash cows**—businesses that generate substantial cash surpluses over what is needed for capital reinvestment and competitive maneuvers to sustain their present market position. Market leaders in slow-growth industries often generate sizable positive cash flows *over and above what is needed for reinvestment in operations* because their industry-leading positions tend to give them the sales volumes and reputation to earn attractive profits and because the slow-growth nature of their industry often entails relatively modest annual investment requirements. Though not always attractive from a growth standpoint, cash cows are valuable businesses from a financial resource perspective. The surplus cash flows they generate can be used to pay corporate dividends, finance acquisitions, and provide funds for investing in the company's promising cash hogs. It makes good financial and strategic sense for diversified companies to keep cash cows in healthy condition, fortifying and defending their market position so as to preserve their cash-generating capability over the long term and thereby have an ongoing source of financial resources to deploy elsewhere.

core concept
A **cash cow** is a business that generates cash flows over and above its internal requirements, thus providing a corporate parent with funds for investing in cash hog businesses, financing new acquisitions, or paying dividends.

Viewing a diversified group of businesses as a collection of cash flows and cash requirements (present and future) is a major step forward in understanding what the financial ramifications of diversification are and why having businesses with good financial resource fit is so important. For instance, a diversified company's businesses exhibit good financial resource fit when the excess cash generated by its cash cow businesses is sufficient to fund the investment requirements of promising cash hog businesses. Ideally, investing in cash hogs over time results in growing the hogs into self-supporting "stars." *Star businesses* have strong or market-leading competitive positions in attractive, high-growth markets and high levels of profitability and are often the cash cows of the future—when the markets of star businesses begin to mature and their growth slows, their competitive strength should produce self-generated cash flows more than sufficient to cover their investment needs. The "success sequence" is thus cash hog to young star (but perhaps still a cash hog) to self-supporting star to cash cow.

If, however, a cash hog has questionable promise (either because of low industry attractiveness or a weak competitive position), then it becomes a logical candidate for divestiture. Pursuing an aggressive invest-and-expand strategy for cash hog with an uncertain future seldom makes sense. Such businesses are a financial drain and fail the resource fit test because they strain the corporate parent's ability to adequately fund its other businesses. Divesting a less attractive cash hog business is usually the best alternative unless (1) it has valuable strategic fits with other business units or (2) the capital infusions needed from the corporate parent are modest relative to the funds available and there's a decent chance of growing the business into a solid bottom-line contributor yielding a good return on invested capital.

Aside from cash flow considerations, a business has good financial fit when it contributes to the achievement of corporate performance objectives (growth in earnings per share, above-average return on investment, recognition as an industry leader, etc.) and when it materially enhances shareholder value via helping drive increases in the company's stock price. A business exhibits poor financial fit if it soaks up a disproportionate share of the company's financial resources, makes subpar or inconsistent bottom-line contributions, is unduly risky and failure would jeopardize the entire enterprise, or remains too small to make a material earnings contribution even though it performs well.

A diversified company's strategy also fails the resource fit test when its financial resources are stretched across so many businesses that its credit rating is impaired. Severe financial strain sometimes occurs when a company borrows so heavily to finance new acquisitions that it has to trim way back on capital expenditures for existing businesses and use the big majority of its financial resources to meet interest obligations and to pay down debt. Some diversified companies have found themselves so financially overextended that they have had to sell off certain businesses to raise the money to meet existing debt obligations and fund essential capital expenditures for the remaining businesses.

Competitive and Managerial Resource Fits A diversified company's strategy must aim at producing a good fit between its resource capability and the competitive and managerial requirements of its businesses.[17] Diversification is more likely to enhance shareholder value when the company has or can develop strong competitive and managerial capabilities. Sometimes the resource strengths crucial to succeeding in one particular business are a poor match with the key success factors in other businesses. For instance, BTR, a multibusiness company in Great Britain, discovered that the company's resources and managerial skills were quite well suited for parenting industrial manufacturing businesses but not for parenting its distribution businesses (National Tyre Services

> A close match between industry key success factors and company resources and capabilities is a solid sign of good resource fit.

and Texas-based Summers Group); as a consequence, BTR decided to divest its distribution businesses and focus exclusively on diversifying around small industrial manufacturing.[18] One company with businesses in restaurants and retailing decided that its resource capabilities in site selection, controlling operating costs, management selection and training, and supply chain logistics would enable it to succeed in the hotel business and in property management; but what management missed was that these businesses had some significantly different key success factors—namely, skills in controlling property development costs, maintaining low overheads, product branding (hotels), and ability to recruit a sufficient volume of business to maintain high levels of facility utilization.[19] A mismatch between the company's resource strengths and the key success factors in a particular business can be serious enough to warrant divesting an existing business or not acquiring a new business. In contrast, when a company's resources and capabilities are a good match with the key success factors of industries it is not presently in, it makes sense to take a hard look at acquiring companies in these industries and expanding the company's business lineup.

A second instance in which a diversified company can fail the resource fit test is by not having sufficient *resource depth* to support all of its businesses. A diversified company has to guard against stretching its resource base too thin and trying to do too many things. The broader the diversification, the greater the concern about whether the company has sufficient managerial depth to cope with the diverse range of operating problems its wide business lineup presents (plus those it may be contemplating getting into). The more a company's diversification strategy is tied to leveraging its resources and capabilities in new businesses, the more it has to develop a big enough and deep enough resource pool to supply these businesses with sufficient capability to create competitive advantage.[20] Otherwise its strengths end up being stretched too thin across too many businesses and the opportunity for competitive advantage is lost.

A Note of Caution Hitting a home run in one business doesn't mean a company can easily enter a new business with similar resource requirements and hit a second home run.[21] Noted British retailer Marks & Spencer—despite possessing a range of impressive resource capabilities (ability to choose excellent store locations, a supply chain that allows both low costs and high merchandise quality, loyal employees, an excellent reputation with consumers, and strong management expertise) that have made it one of Britain's premier retailers for 100 years—has failed repeatedly in its efforts to diversify into department store retailing in the United States. Even though Philip Morris (now named Altria) had built powerful consumer marketing capabilities in its cigarette and beer businesses, it floundered in soft drinks and ended up divesting its acquisition of 7UP after several frustrating years of competing against strongly entrenched, resource-capable rivals like Coca-Cola and PepsiCo.

Step 5: Ranking the Business Units on the Basis of Performance and Priority for Resource Allocation

Once a diversified company's strategy has been evaluated from the perspective of industry attractiveness, competitive strength, strategic fit, and resource fit, the next step is to rank the performance prospects of the businesses from best to worst and determine which businesses merit top priority for new investments by the corporate parent.

The most important considerations in judging business-unit performance are sales growth, profit growth, contribution to company earnings, and return on capital. Sometimes, cash flow is a big

consideration. Information on each business's past performance can be gleaned from a company's financial records. While past performance is not necessarily a good predictor of future performance, it does signal whether a business is in a strong position or a weak one.

The industry attractiveness/business strength evaluations also provide a basis for judging a business's prospects. Normally, strong business units in attractive industries have significantly better prospects than weak businesses in unattractive industries. And, normally, the revenue and earnings outlook for businesses in fast-growing industries is better than for businesses in slow-growing industries—one important exception is when a business has the competitive strength to draw sales and market share away from its rivals and thus achieve much faster growth than the industry as whole. As a rule, the prior analyses, taken together, signal which business units are likely to be strong performers on the road ahead and which are likely to be laggards. And it is a short step from ranking the prospects of business units to drawing conclusions about whether the company as a whole is capable of strong, mediocre, or weak performance in upcoming years.

The rankings of future performance generally determine what priority the corporate parent should give to each business in terms of resource allocation. The task here is to decide which business units should have top priority for corporate resource support and new capital investment and which should carry the lowest priority. ***Business subsidiaries with the brightest profit and growth prospects and solid strategic and resource fits generally should head the list for corporate resource support.*** However, corporate executives need to give special attention to whether and how corporate resources and capabilities can be used to enhance the competitiveness of particular business units. Opportunities for resource transfer, activity combining, or infusions of new financial capital become especially important when improvement in some key success area could make a big difference to a particular business unit's performance.

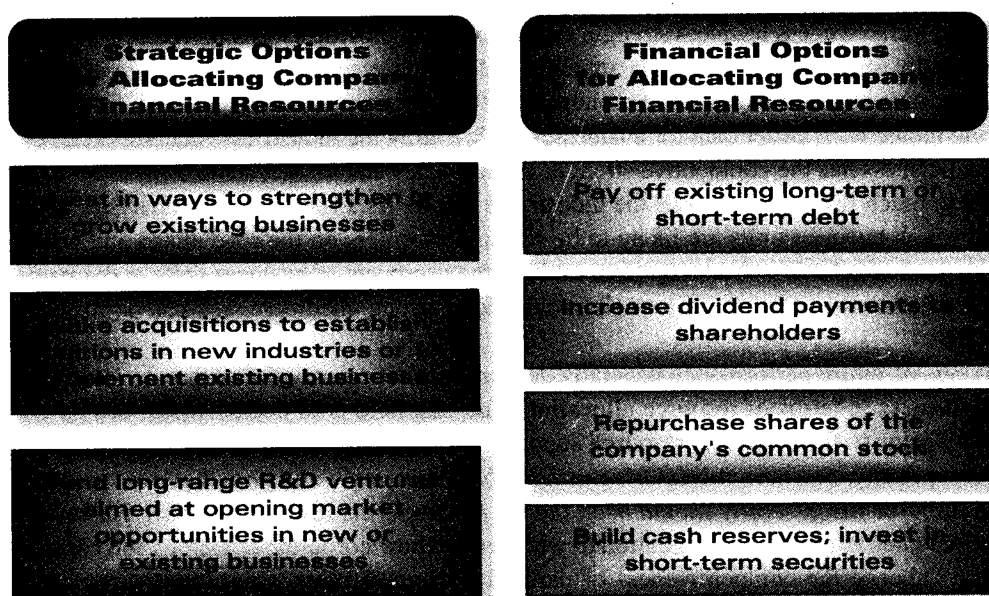
For a company's diversification strategy to generate ever-higher levels of performance, corporate managers have to do an effective job of steering resources out of low-opportunity areas into high-opportunity areas. Divesting marginal businesses is one of the best ways of freeing unproductive assets for redeployment. Surplus funds from cash cows also add to the corporate treasury. Figure 9.7 shows the chief strategic and financial options for allocating a diversified company's financial resources. Ideally, a company will have enough funds to do what is needed, both strategically and financially. If not, strategic uses of corporate resources should usually take precedence unless there is a compelling reason to strengthen the firm's balance sheet or divert financial resources to pacify shareholders.

Step 6: Crafting New Strategic Moves to Improve Overall Corporate Performance

The diagnosis and conclusions flowing from the five preceding analytical steps set the agenda for crafting strategic moves to improve a diversified company's overall performance. The strategic options boil down to five broad categories of actions:

1. Sticking closely with the existing business lineup and pursuing the opportunities it presents.
2. Broadening the company's diversification base by making new acquisitions in new industries.

figure 9.7 **The Chief Strategic and Financial Options for Allocating a Diversified Company's Financial Resources**

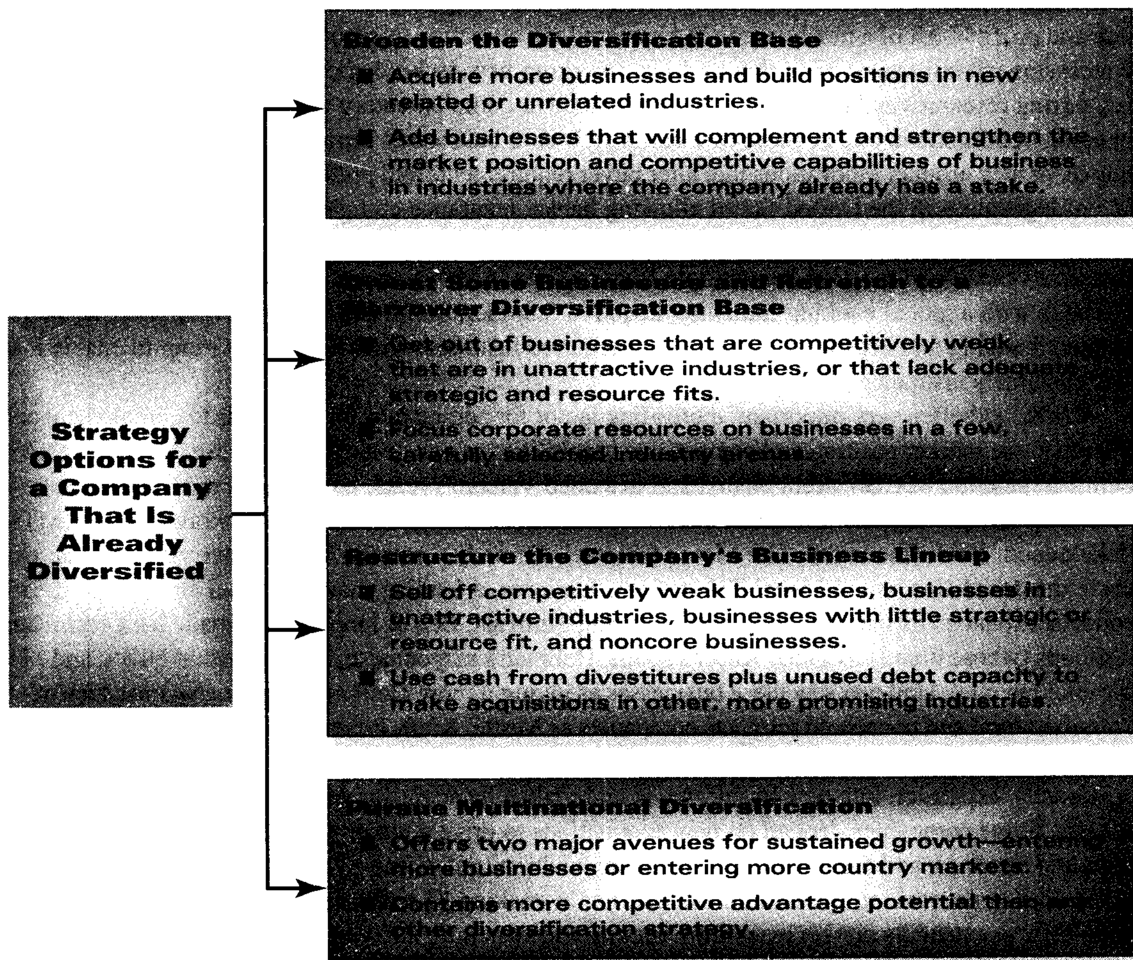


3. Divesting certain businesses and retrenching to a narrower diversification base.
4. Restructuring the company's business lineup and putting a whole new face on the company's business makeup.
5. Pursuing multinational diversification and striving to globalize the operations of several of the company's business units.

The option of sticking with the current business lineup makes sense when the company's present businesses offer attractive growth opportunities and can be counted on to generate dependable earnings and cash flows. As long as the company's set of existing businesses puts it in good position for the future and these businesses have good strategic and/or resource fits, then rocking the boat with major changes in the company's business mix is usually unnecessary. Corporate executives can concentrate their attention on getting the best performance from each of its businesses, steering corporate resources into those areas of greatest potential and profitability. Exactly how to wring better performance from the present business lineup will be dictated by each business's circumstances and the preceding analysis of the corporate parent's diversification strategy.

However, in the event that corporate executives are not entirely satisfied with the opportunities they see in the company's present set of businesses and conclude that changes in the company's direction and business makeup are in order, they can opt for any of the four other strategic alternatives listed above. These options are discussed in the following section.

figure 9.8 **A Company's Four Main Strategic Alternatives After It Diversifies**



AFTER A COMPANY DIVERSIFIES: THE FOUR MAIN STRATEGY ALTERNATIVES

Diversifying is by no means the final stage in the evolution of a company's strategy. Once a company has diversified into a collection of related or unrelated businesses and concludes that some overhaul is needed in the company's present lineup and diversification strategy, it can pursue any of the four main strategic paths listed in the preceding section. These four paths are detailed in Figure 9.8 and discussed in the following sections.

Strategies to Broaden a Diversified Company's Business Base

Diversified companies sometimes find it desirable to build positions in new industries, whether related or unrelated. There are several motivating factors. One is sluggish growth that makes the potential revenue and profit boost of a newly acquired business look attractive. A second is vulnerability to seasonal or recessionary influences or to threats from emerging new technologies. A third is the potential for transferring resources and capabilities to other related or complementary businesses. A fourth is rapidly changing conditions in one or more of a company's core businesses brought on by technological, legislative, or new product innovations that alter buyer requirements and preferences. For instance, the passage of legislation in the United States allowing banks, insurance companies, and stock brokerages to enter each other's businesses spurred a raft of acquisitions and mergers to create full-service financial enterprises capable of meeting the multiple financial needs of customers. Citigroup, already the largest U.S. bank with a global banking franchise, acquired Salomon Smith Barney to position itself in the investment banking and brokerage business and acquired insurance giant Travelers Group to enable it to offer customers insurance products.

A fifth, and often very important, motivating factor for adding new businesses is to complement and strengthen the market position and competitive capabilities of one or more of its present businesses. Viacom's acquisition of CBS strengthened and extended Viacom's reach into various media businesses—it became the parent of Paramount Pictures, an assortment of cable TV networks (UPN, MTV, Nickelodeon, VH1, Showtime, The Movie Channel, Comedy Central), Blockbuster video stores, two movie theater chains, and 19 local TV stations. Unilever, a leading maker of food and personal care products, expanded its business lineup by acquiring SlimFast, Ben & Jerry's Homemade Ice Cream, and Bestfoods (whose brands included Knorr's soups, Hellman's mayonnaise, Skippy peanut butter, and Mazola cooking oils). Unilever saw these businesses as giving it more clout in competing against such other diversified food and household products companies as Nestlé, Kraft, Procter & Gamble, Danone, Campbell Soup, and General Mills.

Usually, expansion into new businesses is undertaken by acquiring companies already in the target industry. Some companies depend on new acquisitions to drive a major portion of their growth in revenues and earnings, and thus are always on the acquisition trail. Cisco Systems built itself into a worldwide leader in networking systems for the Internet by making 75 technology-based acquisitions during 1993–2002 to extend its market reach from routing and switching into voice and video over Internet protocol, optical networking, wireless, storage networking, security, broadband, and content networking. Tyco International, recently beset with charges of looting on the part of several top executives, transformed itself from an obscure company in the early 1990s into a $36 billion global manufacturing enterprise with operations in over 100 countries as of 2003 by making over 1,000 acquisitions. The company's far-flung diversification includes businesses in electronics, electrical components, fire and security systems, health care products, valves, undersea telecommunications systems, plastics, and adhesives. Tyco made over 700 acquisitions of small companies in the 1999–2001 period alone. Illustration Capsule 9.3 describes how Johnson & Johnson has used acquisitions to diversify far beyond its well-known Band-Aid and baby care businesses and become a major player in pharmaceuticals, medical devices, and medical diagnostics.

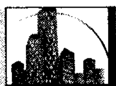


illustration capsule 9.3

Managing Diversification at Johnson & Johnson—The Benefits of Cross-Business Strategic Fits

Johnson & Johnson (J&J), once a consumer products company known for its Band-Aid line and its baby care products, has evolved into a $36 billion diversified enterprise consisting of some 204 different businesses organized into three divisions: drugs, medical devices and diagnostics, and consumer products. Over the past decade J&J has acquired 52 businesses at a cost of about $30 billion; about 10 to 15 percent of J&J's annual growth in revenues has come from acquisitions. Much of the company's recent growth has been in the pharmaceutical division, which in 2002 accounted for about 50 percent of J&J's revenues and 61 percent of its operating profits.

Competitors view J&J as a fierce rival with both scientific expertise and marketing savvy. Each of J&J's business units operates pretty much as an independent enterprise, setting its own strategies and operating with its own finance and human resource departments—such decentralization has resulted in relatively high overhead costs, but corporate management has felt such costs were worth the benefits gained in entrepreneurial attitudes at the business-unit level and the added competitiveness that such attitudes have fostered.

However, corporate management is beginning to champion greater cross-business cooperation and collaboration, believing that many of the advances in 21st century medicine will come from applying advances in one discipline to another. J&J had 9,300 scientists working in 40 research labs in 2003, and the frequency of cross-disciplinary collaboration was increasing. One of J&J's new drug-coated stents grew out of a discussion between a drug researcher and a researcher in the company's stent business. (When stents are inserted to prop open arteries following angioplasty, the drug coating helps prevent infection.) A gene technology database compiled by the company's gene research lab was shared with personnel from the diagnostics division, who developed a test that the drug R&D people could use to predict which patients would most benefit from an experimental cancer therapy. J&J experts in various diseases have been meeting quarterly for the past five years to share information, and top management is setting up cross-disciplinary groups to focus on new treatments for particular diseases. J&J's new liquid Band-Aid product (a liquid coating applied to hard-to-cover places like fingers and knuckles) is based on a material used in a wound-closing product sold by the company's hospital products company.

J&J's corporate management believes that close collaboration among people in its diagnostics, medical devices, and pharmaceuticals businesses—where numerous cross-business strategic fits exist—will give J&J an edge on competitors, most of whom cannot match the company's breadth and depth of expertise.

Source: Amy Barrett, "Staying on Top," *Business Week*, May 5, 2003, pp. 60–68.

Divestiture Strategies Aimed at Retrenching to a Narrower Diversification Base

A number of diversified firms have had difficulty managing a diverse group of businesses and have elected to get out of some of them. Retrenching to a narrower diversification base is usually undertaken when top management concludes that its diversification strategy has ranged too far afield and that the company can improve long-term performance by concentrating on building stronger positions in a smaller number of core businesses and industries. Hewlett-Packard spun off its testing and measurement businesses into a stand-alone company called Agilent Technologies so that it could better concentrate on its PC, workstation, server, printer and peripherals, and electronics businesses. PepsiCo divested its cash-hog group of restaurant businesses, consisting of KFC, Pizza Hut, Taco Bell, and California Pizza Kitchens, to provide more resources for

Focusing corporate resources on a few core and mostly related businesses avoids the mistake of diversifying so broadly that resources and management attention are stretched too thin.

strengthening its soft-drink business (which was losing market share to Coca-Cola) and growing its more profitable Frito-Lay snack foods business. Kmart divested OfficeMax, Sports Authority, and Borders Bookstores in order to refocus management attention and all of the company's resources on restoring luster to its distressed discount retailing business. (However, Kmart is still being totally outclassed in discount retailing by Wal-Mart and Target.)

But there are other important reasons for divesting one or more of a company's present businesses. Sometimes divesting a business has to be considered because market conditions in a once-attractive industry have badly deteriorated. A business can become a prime candidate for divestiture because it lacks adequate strategic or resource fit, because it is a cash hog with questionable long-term potential, or because it is weakly positioned in its industry with little prospect the corporate parent can realize a decent return on its investment in the business. Sometimes a company acquires businesses that, down the road, just do not work out as expected even though management has tried all it can think of to make them profitable—mistakes cannot be completely avoided because it is hard to foresee how getting into a new line of business will actually work out. Subpar performance by some business units is bound to occur, thereby raising questions of whether to divest them or keep them and attempt a turnaround. Other business units, despite adequate financial performance, may not mesh as well with the rest of the firm as was originally thought.

On occasion, a diversification move that seems sensible from a strategic-fit standpoint turns out to be a poor *cultural fit*.[22] Several pharmaceutical companies had just this experience. When they diversified into cosmetics and perfume, they discovered their personnel had little respect for the "frivolous" nature of such products compared to the far nobler task of developing miracle drugs to cure the ill. The absence of shared values and cultural compatibility between the medical research and chemical-compounding expertise of the pharmaceutical companies and the fashion/marketing orientation of the cosmetics business was the undoing of what otherwise was diversification into businesses with technology-sharing potential, product-development fit, and some overlap in distribution channels.

Recent research indicates that pruning businesses and narrowing a firm's diversification base improves corporate performance.[23] Corporate parents often end up selling off businesses too late and at too low a price, sacrificing shareholder value.[24] A useful guide to determine whether or when to divest a business subsidiary is to ask, "If we were not in this business today, would we want to get into it now?"[25] When the answer is no or probably not, divestiture should be considered. Another signal that a business should become a divestiture candidate is whether it is worth more to another company than to the present parent; in such cases, shareholders would be well served if the company sells the business and collects a premium price from the buyer for whom the business is a valuable fit.[26]

The Two Options for Divesting a Business: Selling It or Spinning It Off as an Independent Company Selling a business outright to another company is far and away the most frequently used option for divesting a business. But sometimes a business selected for divestiture has ample resource strengths to compete successfully on its own. In such cases, a corporate parent may elect to spin the unwanted business off as a financially and managerially independent company, either by selling shares to the investing public via an initial public offering or by distributing shares in the new company to existing shareholders of the corporate parent. When a corporate parent decides to spin off one of its businesses as a separate company, there's the issue of whether or not to retain partial ownership.

Retaining partial ownership makes sense when the business to be divested has a hot product or technological capabilities that give it good profit prospects. When 3Com elected to divest its PalmPilot business, which investors then saw as having very promising profit potential, it elected to retain a substantial ownership interest so as to provide 3Com shareholders a way of participating in whatever future market success that PalmPilot (now Palm, Inc.) might have on its own.

Selling a business outright requires finding a buyer. This can prove hard or easy, depending on the business. As a rule, a company selling a troubled business should not ask, "How can we pawn this business off on someone, and what is the most we can get for it?"[27] Instead, it is wiser to ask, "For what sort of company would this business be a good fit, and under what conditions would it be viewed as a good deal?" Enterprises for which the business is a good fit are likely to pay the highest price. Of course, if a buyer willing to pay an acceptable price cannot be found, then a company must decide whether to keep the business until a buyer appears; spin it off as a separate company; or, in the case of a crisis-ridden business that is losing substantial sums, simply close it down and liquidate the remaining assets. Liquidation is obviously a last resort.

Strategies to Restructure a Company's Business Lineup

Restructuring strategies involve divesting some businesses and acquiring others so as to put a whole new face on the company's business lineup. Performing radical surgery on the group of businesses a company is in becomes an appealing strategy alternative when a diversified company's financial performance is being squeezed or eroded by:

> **core concept**
> ***Restructuring*** involves divesting some businesses and acquiring others so as to put a whole new face on the company's business lineup.

- Too many businesses in slow-growth, declining, low-margin, or otherwise unattractive industries (a condition indicated by the number and size of businesses with industry attractiveness ratings below 5 and located on the bottom half of the attractiveness–strength matrix—see Figure 9.5).
- Too many competitively weak businesses (a condition indicated by the number and size of businesses with competitive strength ratings below 5 and located on the right half of the attractiveness–strength matrix).
- Ongoing declines in the market shares of one or more major business units that are falling prey to more market-savvy competitors.
- An excessive debt burden with interest costs that eat deeply into profitability.
- Ill-chosen acquisitions that haven't lived up to expectations.

Restructuring can also be mandated by the emergence of new technologies that threaten the survival of one or more of a diversified company's important businesses or by the appointment of a new CEO who decides to redirect the company. On occasion, restructuring can be prompted by special circumstances—as when a firm has a unique opportunity to make an acquisition so big and important that it has to sell several existing business units to finance the new acquisition or when a company needs to sell off some businesses in order to raise the cash for entering a potentially big industry with wave-of-the-future technologies or products.

Candidates for divestiture in a corporate restructuring effort typically include not only weak or up-and-down performers or those in unattractive industries but also business units that lack strategic fit with the businesses to be retained, businesses that are cash hogs or that lack other types of resource fit, and

businesses incompatible with the company's revised diversification strategy (even though they may be profitable or in an attractive industry). As businesses are divested, corporate restructuring generally involves aligning the remaining business units into groups with the best strategic fits and then redeploying the cash flows from the divested business to either pay down debt or make new acquisitions to strengthen the parent company's business position in the industries it has chosen to emphasize.[28]

Over the past decade, corporate restructuring has become a popular strategy at many diversified companies, especially those that had diversified broadly into many different industries and lines of business. For instance, one struggling diversified company over a two-year period divested four business units, closed down the operations of four others, and added 25 new lines of business to its portfolio (16 through acquisition and 9 through internal start-up). During Jack Welch's first four years as CEO of General Electric (GE), the company divested 117 business units, accounting for about 20 percent of GE's assets; these divestitures, coupled with several important acquisitions, provided GE with 14 major business divisions and led to Welch's challenge to the managers of GE's divisions to become number one or number two in their industry. Ten years after Welch became CEO, GE was a different company, having divested operations worth $9 billion, made new acquisitions totaling $24 billion, and cut its workforce by 100,000 people. Then, during the 1990–2001 period, GE continued to reshuffle its business lineup, acquiring over 600 new companies, including 108 in 1998 and 64 during a 90-day period in 1999. Most of the new acquisitions were in Europe, Asia, and Latin America and were aimed at transforming GE into a truly global enterprise. PerkinElmer used a series of divestitures and new acquisitions to transform itself from a supplier of low-margin services sold to government agencies into an innovative high-tech company with operations in over 125 countries and businesses in four industry groups—life sciences (drug research and clinical screening), optoelectronics, instruments, and fluid control and containment (for customers in aerospace, power generation, and semiconductors).

Several broadly diversified companies have pursued restructuring by splitting into two or more independent companies. In 1996, AT&T divided itself into three companies—one (which retained the AT&T name) for long-distance and other telecommunications services, one (called Lucent Technologies) for manufacturing telecommunications equipment, and one (called NCR) for computer systems that essentially represented the divestiture of AT&T's earlier acquisition of National Cash Register. A few years after the split-up, AT&T acquired TCI Communications and MediaOne, both leading cable TV providers, in an attempt to restructure itself into a new-age telecommunications company offering bundled local and long-distance service, cable TV, and high-speed Internet access. In 2000, after its bundled services concept flopped and its debt had become excessive, AT&T began splitting itself once again, this time into four businesses—cable TV (later acquired by Comcast), wireless communications (acquired by Cingular in 2004), landlines communications for businesses, and landlines communications for consumers. Before beginning a restructuring effort in 1995, British-based Hanson PLC owned companies with more than $20 billion in revenues in industries as diverse as beer, exercise equipment, tools, construction cranes, tobacco, cement, chemicals, coal mining, electricity, hot tubs and whirlpools, cookware, rock and gravel, bricks, and asphalt. By early 1997, Hanson had restructured itself into a $3.8 billion enterprise focused more narrowly on gravel, crushed rock, cement, asphalt, bricks, and construction cranes; the remaining businesses were divided into four groups and divested.

In a study of the performance of the 200 largest U.S. corporations from 1990 to 2000, McKinsey & Company found that those companies that actively managed their business portfolios through

acquisitions and divestitures created substantially more shareholder value than those that kept a fixed lineup of businesses.[29]

Multinational Diversification Strategies

The distinguishing characteristics of a multinational diversification strategy are a *diversity of businesses* and a *diversity of national markets.*[30] Such diversity makes multinational diversification a particularly challenging and complex strategy to conceive and execute. Managers have to develop business strategies for each industry (with as many multinational variations as conditions in each country market dictate). Then they have to pursue and manage opportunities for cross-business and cross-country collaboration and strategic coordination in ways calculated to result in competitive advantage and enhanced profitability.

Moreover, the geographic operating scope of individual businesses within a diversified multinational company can range from one country only to several countries to many countries to global. Thus, each business unit within such a company often competes in a somewhat different combination of geographic markets than the other businesses do—adding another element of strategic complexity, and perhaps an element of opportunity.

Illustration Capsule 9.4 shows the scope of four prominent diversified multinational companies.

The Appeal of Multinational Diversification: More Opportunities for Sustained Growth and Maximum Competitive Advantage Potential Despite their complexity, multinational diversification strategies have great appeal. They contain two major avenues for growing revenues and profits: (1) to grow by entering additional businesses, and (2) to grow by extending the operations of existing businesses into additional country markets. Moreover, a strategy of multinational diversification also contains six attractive paths to competitive advantage, *all of which can be pursued simultaneously:*

1. *Full capture of economies of scale and experience and learning-curve effects.* In some businesses, the volume of sales needed to realize full economies of scale and/or benefit fully from experience and learning-curve effects is rather sizable, often exceeding the volume that can be achieved operating within the boundaries of a single country market, especially a small one. *The ability to drive down unit costs by expanding sales to additional country markets is one reason why a diversified multinational may seek to acquire a business and then rapidly expand its operations into more and more foreign markets.*
2. *Opportunities to capitalize on cross-business economies of scope.* Diversifying into related businesses offering economies of scope can drive the development of a low-cost advantage over less diversified rivals. For example, a diversified multinational company (DMNC) that uses mostly the same distributors and retail dealers worldwide can diversify into new businesses using these same worldwide distribution channels at relatively little incremental expense. The cost savings of piggybacking distribution activities can be substantial. Moreover, with more business selling more products in more countries, a DMNC acquires more bargaining leverage in its purchases from suppliers and more bargaining leverage with retailers in securing attractive display space for its products. Consider, for example, the competitive power that Sony derived from these very sorts of economies of scope when it decided to diversify into the video game business with its PlayStation product line.

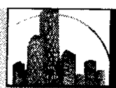


illustration capsule 9.4

The Global Scope of Four Prominent Diversified Multinational Corporations

Company	Global Scope	Businesses into Which the Company Has Diversified
Sony	Operations in more than 100 countries and sales offices in more than 200 countries	• Televisions, VCRs, DVD players, radios, CD players and home stereos, digital cameras and video equipment, PCs and Trinitron computer monitors • PlayStation game consoles and video game software • Columbia, Epic, and Sony Classical prerecorded music • Columbia TriStar motion pictures, syndicated television programs • Other businesses (insurance, financing, entertainment complexes, Internet-related businesses)
Nestlé	Operations in 70 countries and sales offices in more than 200 countries	• Beverages (Nescafé and Taster's Choice coffees, Nestea, Perrier, Arrowhead, and Calistoga mineral and bottled waters) • Milk products (Carnation, Gloria, Neslac, Coffee Mate, Nestlé ice cream and yogurt) • Pet foods (Friskies, Alpo, Fancy Feast, Mighty Dog) • Contadina, Libby's, and Stouffer's food products and prepared dishes • Chocolate and confectionery products (Nestlé Crunch, Smarties, Baby Ruth, Butterfinger, KitKat) • Pharmaceuticals (Alcon ophthalmic products, Galderma dermatological products)
Siemens	Operations in 160 countries and sales offices in more than 190 countries	• Electrical power generation, transmission, and distribution equipment and products • Manufacturing automation systems, industrial motors, industrial computers, industrial machinery, industrial tools, plant construction and maintenance • Information and communications (solutions and services needed for corporate communication networks, telephones, PCs, mainframes, computer network products, consulting services) • Mass transit and light rail systems, rail cars, locomotives • Medical equipment, health care management services • Semiconductors, memory components, microcontrollers, capacitors, resistors • Lighting (bulbs, lamps, theater and television lighting systems) • Home electronics, large home appliances, vacuum cleaners • Financial services (commercial lending, pension administration, venture capital) • Procurement and logistics services, business consulting services

illustration capsule 9.4 *(concluded)*

Company	Global Scope	Businesses into Which the Company Has Diversified
Samsung	Operations in more than 60 countries and sales in more than 200 countries	• Notebook computers, hard disk drives, DC/DVD-ROM drives, monitors, printers, and fax machines • Televisions (big screen TVs, plasma screen TVs, and LCD screen TVs), DVD and MP3 players • Cell phones and various other telecommunications products • Compressors • Home appliances (refrigerators, air conditioners, microwaves, washing machines, and vacuum cleaners) • Semiconductor products (DRAM chips, flash memory chips, graphics memory chips, and others) • Optical fibers, fiber-optic cables, and fiber-optic connectors

Source: Company annual reports and Web sites.

Sony had in-place capability to go after video game sales in all country markets where it presently did business in other product categories (TVs, computers, DVD players, VCRs, radios, CD players, and digital and video cameras). And it had the marketing clout and brand-name credibility to persuade retailers to give Sony's PlayStation products prime shelf space and visibility. These strategic-fit benefits helped Sony quickly overtake longtime industry leaders Nintendo and Sega and fortify its position against Microsoft's entry with its new Xbox offerings.

3. *Opportunities to transfer competitively valuable resources both from one business to another and from one country to another.* A company pursuing related diversification can gain a competitive edge over less diversified rivals by transferring competitively valuable resources from one business to another; a multinational company can gain competitive advantage over rivals with narrower geographic coverage by transferring competitively valuable resources from one country to another. But a strategy of multinational diversification enables simultaneous pursuit of both sources of competitive advantage.
4. *Ability to leverage use of a well-known and competitively powerful brand name.* Diversified multinational companies whose businesses have brand names that are well known and respected across the world possess a valuable strategic asset with competitive advantage potential. For example, Sony's well-established global brand-name recognition gives it an important marketing and advertising advantage over rivals with lesser-known brands. When Sony goes into a new marketplace with the stamp of the Sony brand on new businesses or product families, it can command prominent display space with retailers. It can expect to win sales and market share simply on the confidence that buyers

Transferring a powerful brand name from one product or business to another can usually be done very economically.

place in products carrying the Sony name. While Sony may spend money to make consumers aware of the availability of its new products, it does not have to spend nearly as much on achieving brand recognition and market acceptance as would a lesser-known competitor. Further, if Sony moves into a new country market for the first time and does well selling Sony PlayStations and video games, it is easier to sell consumers in that country Sony TVs, digital cameras, PCs, and so on—plus, the related advertising costs are likely to be less than they would be without having already established the Sony brand strongly in the minds of buyers.

5. *Ability to capitalize on opportunities for cross-business and cross-country collaboration and strategic coordination.*[31] A multinational diversification strategy allows competitively valuable cross-business and cross-country coordination of certain value chain activities. For instance, by channeling corporate resources directly into a combined R&D/technology effort for all related businesses, as opposed to letting each business unit fund and direct its own R&D effort however it sees fit, a DMNC can merge its expertise and efforts *worldwide* to advance core technologies, expedite cross-business and cross-country product improvements, speed the development of new products that complement existing products, and pursue promising technological avenues to create altogether new businesses—all significant contributors to competitive advantage and better corporate performance.[32] Honda has been very successful in building R&D expertise in gasoline engines and transferring the resulting technological advances to its businesses in automobiles, motorcycles, outboard engines, snow blowers, lawn mowers, garden tillers, and portable power generators. Further, a DMNC can reduce costs through cross-business and cross-country coordination of purchasing and procurement from suppliers, from collaborative introduction and shared use of e-commerce technologies and online sales efforts, and from coordinated product introductions and promotional campaigns.

6. *Opportunities to use cross-business or cross-country subsidization to outcompete rivals.* A financially successful DMNC has potentially valuable organizational resources and multiple profit sanctuaries in both certain country markets and certain businesses that it can draw on to wage a market offensive. In comparison, a one-business domestic company has only one profit sanctuary—its home market. A diversified one-country competitor may have profit sanctuaries in several businesses, but all are in the same country market. A one-business multinational company may have profit sanctuaries in several country markets, but all are in the same business. All three are vulnerable to an offensive in their more limited profit sanctuaries by an aggressive DMNC willing to lowball its prices and/or spend extravagantly on advertising to win market share at their expense. A DMNC's ability to keep hammering away at competitors with low prices year after year may reflect either a cost advantage growing out of its related diversification strategy or a willingness to accept low profits or even losses in the market being attacked because it has ample earnings from its other profit sanctuaries. For example, Sony's global-scale diversification strategy gives it unique competitive strengths in outcompeting Nintendo and Microsoft. If need be, Sony can maintain low prices on its PlayStations or fund high-profile promotions for its latest video game products, using earnings from its other business lines to fund its offensive to wrest market share away from Nintendo and Microsoft in video games. At the same time, Sony can draw on its considerable resources in R&D, its ability to transfer electronics technology from one electronics product family to another, and its expertise in product innovation to introduce better and better video game players, perhaps multifunctional players that do

more than just play video games. Such competitive actions not only enhance Sony's own brand image but also make it very tough for Nintendo and Microsoft to match Sony's prices, advertising, and product development efforts and still earn acceptable profits.

The Combined Effects of These Advantages Is Potent A strategy of diversifying into *related* industries and then competing *globally* in each of these industries thus has great potential for being a winner in the marketplace because of the long-term growth opportunities it offers and the multiple corporate-level competitive advantage opportunities it contains. Indeed, *a strategy of multinational diversification contains more competitive advantage potential than any other diversification strategy.* The strategic key to maximum competitive advantage is for a DMNC to concentrate its diversification efforts in those industries where there are resource-sharing and resource-transfer opportunities and where there are important economies of scope and brand-name benefits. These strategic-fit benefits will make the more powerful a competitor and improve its profit and growth performance.

core concept
A strategy of multinational diversification has more built-in potential for competitive advantage than any other diversification strategy.

However, it is important to recognize that cross-subsidization can only be used sparingly. It is one thing to *occasionally* divert a portion of the profits and cash flows from existing businesses to help fund entry into a new business or country market or wage a competitive offensive against select rivals. It is quite another thing to *regularly* use cross-subsidization tactics and thereby weaken overall company performance. A DMNC is under the same pressures as any other company to demonstrate consistently acceptable profitability across its whole operation.[33] At some juncture, every business and every country market needs to make a profit contribution or become a candidate for abandonment. As a general rule, *cross-subsidization tactics are justified only when there is a good prospect that the short-term impairment to corporate profitability will be offset by stronger competitiveness and better overall profitability over the long term.*

core concept
Although cross-subsidization is a potent competitive weapon, it can only be used infrequently because of its adverse impact on overall corporate profitability.

key|points

Most companies have their business roots in a single industry. Even though they may have since diversified into other industries, a substantial part of their revenues and profits still usually comes from the original or core business. Diversification becomes an attractive strategy when a company runs out of profitable growth opportunities in its original business. The purpose of diversification is to build shareholder value. Diversification builds shareholder value when a diversified group of businesses can perform better under the auspices of a single corporate parent than they would as independent, stand-alone businesses—the goal is to achieve not just a 1 + 1 = 2 result but rather to realize important 1 + 1 = 3 performance benefits. Whether getting into a new business has potential to enhance shareholder value hinges on whether a company's entry into that business can pass the attractiveness test, the cost-of-entry test, and the better-off test.

Entry into new businesses can take any of three forms: acquisition, internal start-up, or joint venture/strategic partnership. Each has its pros and cons, but acquisition is the most frequently used; internal start-up takes the longest, and joint venture/strategic partnership, though used second most frequently, is the least durable.

There are two fundamental approaches to diversification—into related businesses and into unrelated businesses. The rationale for *related* diversification is strategic: Diversify into businesses with strategic

fits along their respective value chains, capitalize on strategic-fit relationships to gain competitive advantage, and then use competitive advantage to achieve the desired 1 + 1 = 3 impact on shareholder value. Businesses have strategic fit when their value chains offer potential (1) for realizing economies of scope or cost-saving efficiencies associated with sharing technology, facilities, functional activities, distribution outlets, or brand names; (2) for competitively valuable cross-business transfers of technology, skills, know-how, or other resource capabilities; (3) for leveraging use of a well-known and trusted brand name, and (4) for competitively valuable cross-business collaboration to build new or stronger resource strengths and competitive capabilities.

The basic premise of *unrelated* diversification is that any business that has good profit prospects and can be acquired on good financial terms is a good business to diversify into. Unrelated diversification strategies surrender the competitive advantage potential of strategic fit in return for such advantages as (1) spreading business risk over a variety of industries and (2) providing opportunities for financial gain (if candidate acquisitions have undervalued assets, are bargain-priced and have good upside potential given the right management, or need the backing of a financially strong parent to capitalize on attractive opportunities). In theory, unrelated diversification also offers greater earnings stability over the business cycle (a third advantage), but this advantage is very hard to realize in practice. The greater the number of businesses a conglomerate is in and the more diverse these businesses are, the harder it is for corporate executives to select capable managers to run each business, know when the major strategic proposals of business units are sound, or decide on a wise course of recovery when a business unit stumbles. Unless corporate managers are exceptionally shrewd and talented, unrelated diversification is a dubious and unreliable approach to building shareholder value when compared to related diversification.

Analyzing a company's diversification strategy is a six-step process:

- *Step 1:* Evaluate the long-term attractiveness of the industries into which the firm has diversified.
- *Step 2:* Evaluate the relative competitive strength of each of the company's business units.
- *Step 3:* Check for cross-business strategic fits.
- *Step 4:* Check whether the firm's resource strengths fit the resource requirements of its present business lineup.
- *Step 5:* Rank the performance prospects of the businesses from best to worst and determine what the corporate parent's priority should be in allocating resources to its various businesses.
- *Step 6:* Craft new strategic moves to improve overall corporate performance.

Once a company has diversified, corporate management's task is to manage the collection of businesses for maximum long-term performance. There are four different strategic paths for improving a diversified company's performance: (1) broadening the firm's business base by diversifying into additional businesses, (2) retrenching to a narrower diversification base by divesting some of its present businesses, (3) corporate restructuring, and (4) multinational diversification.

Broadening the diversification base is attractive when growth is sluggish and the company needs the revenue and profit boost of a newly acquired business, when it has resources and capabilities that are eminently transferable to related or complementary businesses, or when the opportunity to acquire an attractive company unexpectedly lands on its doorstep. Furthermore, there are occasions when a diver-

sified company makes new acquisitions to complement and strengthen the market position and competitive capabilities of one or more of its present businesses.

Retrenching to a narrower diversification base is usually undertaken when corporate management concludes that the firm's diversification efforts have ranged too far afield and that the best avenue for improving long-term performance is to concentrate on building strong positions in a smaller number of businesses. Retrenchment is usually accomplished by divesting businesses that are no longer deemed suitable for the company to be in.

Corporate restructuring strategies involve divesting some businesses and acquiring new businesses so as to put a whole new face on the company's business lineup. Performing radical surgery on the group of businesses a company is in becomes an appealing strategy alternative when a diversified company's financial performance is being squeezed or eroded by (1) too many businesses in slow-growth or declining or low-margin or otherwise unattractive industries, (2) too many competitively weak businesses, (3) ongoing declines in the market shares of one or more major business units that are falling prey to more market-savvy competitors, (4) an excessive debt burden with interest costs that eat deeply into profitability, or (5) ill-chosen acquisitions that haven't lived up to expectations.

Multinational diversification strategies feature a diversity of businesses and a diversity of national markets. Despite the complexity of having to devise and manage so many strategies (at least one for each industry, with as many variations for country markets as may be needed), multinational diversification strategies have considerable appeal. They offer two avenues for long-term growth in revenues and profitability—one is to grow by entering additional businesses and the other is to grow by extending the operations of existing businesses into additional country markets. Moreover, multinational diversification offers six ways to build competitive advantage: (1) full capture of economies of scale and learning-curve effects, (2) opportunities to capitalize on cross-business economies of scope, (3) opportunity to transfer competitively valuable resources from one business to another and from one country to another, (4) ability to leverage use of a well-known and competitively powerful brand name, (5) ability to capitalize on opportunities for cross-business and cross-country collaboration and strategic coordination, and (6) opportunities to use cross-business or cross-country subsidization to wrest sales and market share from rivals. A strategy of multinational diversification contains more competitive advantage potential than any other diversification strategy.

exercises

1. What do you see as the strategic fits that exist among the value chains of the diversified companies listed in Illustration Capsule 9.1?
2. Consider the business lineup of the Walt Disney Company shown in Illustration Capsule 9.2. What problems do you think the top executives at Disney would encounter in trying to stay on top of all the businesses the company is in? How might they decide the merits of adding new businesses or divesting poorly performing businesses? What types of advice might they give to the general managers of each of Disney's business units?

chapter ten 10

Strategy, Ethics, and Social Responsibility

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When morality comes up against profit, it is seldom profit that loses.
—**Shirley Chisholm**
Former Congresswoman

But I'd shut my eyes in the sentry box so I didn't see nothing wrong.
—**Rudyard Kipling**
Author

The marketplace, for all its splendors, may produce value but not values.
—**E. J. Dionne**
Washington Post *columnist*

There is one and only one social responsibility of business—to use its resources and engage in activities designed to increase its profits so long as it stays within the rules of the game, which is to say engages in free and open competition, without deception or fraud.
—**Milton Friedman**
Nobel Prize–winning economist

Corporations are economic entities, to be sure, but they are also social institutions that must justify their existence by their overall contribution to society.
—**Henry Mintzberg, Robert Simons, and Kunal Basu**
Professors

Clearly, a company has a responsibility to make a profit and grow the business—in capitalistic or market economies, management's fiduciary duty to create value for shareholders is not a matter for serious debate. Clearly, a company and its personnel also have a duty to obey the law and play by the rules of fair competition. But does a company have a duty to operate according to the ethical norms of the societies in which it operates—should it be held to some standard of ethical conduct? And does it have a duty or obligation to contribute to the betterment of society independent of the needs and preferences of the customers it serves? Should a company display a social conscience and devote a portion of its resources to bettering society?

The focus of this chapter is to examine what link, if any, there should be between a company's efforts to craft and execute a winning strategy and its duties to (1) conduct its activities in an ethical manner and (2) demonstrate socially responsible behavior by being a committed corporate citizen and attending to the needs of nonowner stakeholders—employees, the communities in which it operates, the disadvantaged, and society as a whole.

STRATEGY AND ETHICS

Ethics involves concepts of right and wrong, fair and unfair, moral and immoral. Most people and most societies consider lying, cheating, stealing, and harming others to be unethical, immoral, and socially unacceptable. Honesty, integrity, keeping one's word, respecting the rights of others, and practicing the Golden Rule are generally considered ethical and virtuous—they are traits that a good person is supposed to believe in and to display. Beliefs about what is ethical serve as a *moral compass* in guiding the actions and behaviors of individuals and organizations. The issue here is how do notions of right and wrong, fair and unfair, moral and immoral, ethical and unethical translate into judging management decisions and the strategies and actions of companies in the marketplace.

What Do We Mean by Business Ethics?

Business ethics is the application of general ethical principles and standards to business behavior.[1] Business ethics does not really involve a special set of ethical standards applicable only to business situations. Ethical principles in business are not materially different from ethical principles in general. Why? Because business must draw its ideas of "the right thing to do" and "the wrong thing to do" from the same sources as anyone else. A business should not make its own rules about

core concept
By ***business ethics***, we mean the application of general ethical principles and standards to business behavior.

Business actions are judged by the general ethical standards of society, not by a special set of more permissive standards.

what is right and wrong. If dishonesty is considered to be unethical and immoral, then dishonest behavior in business—whether it relates to customers, suppliers, employees or shareholders—qualifies as equally unethical and immoral. If being ethical entails not harming others, then recalling a defective or unsafe product is ethically necessary and failing to undertake such a recall or correct the problem in future shipments of the product is likewise unethical. If society deems bribery to be unethical, then it follows that it is unethical for company personnel to make payoffs to government officials to facilitate business transactions or bestow gifts and other favors on prospective customers to win or retain their business.

The Three Categories of Management Morality

Three categories of managers stand out with regard to ethical and moral principles in business affairs:[2]

- *The moral manager*—Moral managers are dedicated to high standards of ethical behavior, both in their own actions and in their expectations of how the company's business is to be conducted. They see themselves as stewards of ethical behavior and believe it is important to exercise ethical leadership. Moral managers may well be ambitious and have a powerful urge to succeed, but they pursue success in business within the confines of both the letter and the spirit of the law—they typically regard the law as an ethical minimum and have a habit of operating well above what the law requires.
- *The immoral manager*—Immoral managers are actively opposed to ethical behavior in business and willfully ignore ethical principles in their decision making. They view legal standards as barriers that must be skirted or overcome. Prone to pursuing their own self-interest, immoral managers are living examples of capitalistic greed, caring only about their own or their organization's gains and successes. Their philosophy is that good businesspeople cannot spend time watching out for the interests of others when what really matters is the bottom line and making one's numbers. In the minds of immoral managers, nice guys come in second and the competitive nature of business requires that you either trample on others or get trampled yourself. Immoral managers are thus the bad guys and relish wearing the black hats.
- *The amoral manager*—Amoral managers appear in two forms: the intentionally amoral manager and the unintentionally amoral manager. *Intentionally amoral managers* consciously believe business and ethics are not to be mixed because different rules apply in business versus other realms of life. They think it is fine not to factor ethical considerations into their decisions and actions since business activity lies outside the sphere of moral judgment. Intentionally amoral managers view ethics as inappropriate and too Sunday-schoolish for the tough competitive world of business. Their concept of right and wrong tends to be lawyer-driven—how much can we get by with and still be in compliance? *Unintentionally amoral managers* do not pay much attention to the concept of business ethics either, but for different reasons. They are simply casual about, careless about, or inattentive to the fact that certain kinds of business decisions or company activities are unsavory or may have deleterious effects on others—in short, they are blind to the ethical dimension of decisions and business actions. Some may be so ethically unconscious that they have just never stopped to consider whether ethics applies to business decisions or company actions. Some unintentionally amoral managers may see themselves as well-intentioned and even personally ethical. *Amoral managers of both types view it*

necessary to comply with the law, but they see little reason to do more because government provides the legal framework that says what society will put up with—businesses ought to be able to do whatever the law allows them to do.

By some accounts, the population of managers is said to be distributed among all three types in a bell-shaped curve, with immoral managers and moral managers occupying the two tails of the curve, and the amoral managers (especially the intentionally amoral managers) occupying the broad middle ground.[3] Furthermore, within the population of managers, there is experiential evidence to support that while the average manager may be amoral most of the time, he or she may slip into a moral or immoral mode on occasion, based on a variety of impinging factors and circumstances.

A landscape that is apparently so cluttered with amoral and immoral managers does not bode well for the *frequency* with which company managers ground their strategies on exemplary ethical principles or for the *vigor* with which they try to ingrain ethical behavior into company personnel. And, as many business school professors have noted, there are considerable numbers of amoral business students in our classrooms. So efforts to root out business corruption and implant high ethical principles into the managerial process of crafting and executing strategy is unlikely to produce an ethically strong global business climate anytime in the near future, barring major effort to address and correct the ethical amorality and immorality of company managers.

What Are the Drivers of Unethical Strategies and Business Behavior?

The apparent pervasiveness of immoral and amoral businesspeople is one obvious reason why ethical principles are an ineffective moral compass in business dealings and why companies may resort to unethical strategic behavior. But apart from "the business of business is business, not ethics" kind of thinking, three other main drivers of unethical business behavior also stand out:

- Overzealous or obsessive pursuit of personal gain, wealth, and other selfish interests.
- Heavy pressures on company managers to meet or beat earnings targets.
- A company culture that puts the profitability and good business performance ahead of ethical behavior.

Overzealous Pursuit of Personal Gain, Wealth, and Selfish Interests People who are obsessed with wealth accumulation, greed, power, status, and other selfish interests often push ethical principles aside in their quest for self-gain. Driven by their ambitions, they exhibit few qualms in doing whatever is necessary to achieve their goals. Their first and only priority is to look out for their own best interests and if climbing the ladder of success means having few scruples and ignoring the welfare of others, so be it. A general disregard for business ethics can prompt all kinds of unethical strategic maneuvers and behaviors at companies. Top executives, directors, and majority shareholders at cable-TV company Adelphia Communications ripped off the company for amounts totaling well over $1 billion, diverting hundreds of millions of dollars to fund their Buffalo Sabres hockey team, build a private golf course, and buy timber rights—among other things—and driving the company into bankruptcy. Their actions, which represent one of the biggest instances of corporate looting and self-dealing in American business, took place despite the company's public pontifications about the principles it would observe in trying to care for customers, employees, stockholders, and the local communities where it operated. Providian Financial Corporation, despite an otherwise glowing record of social responsibility and service to many of its

stakeholders, paid $150 million in December 2001 to settle class-action lawsuits alleging that its strategy included attempts to systematically cheat credit card holders. Andrew Fastow, Enron's chief financial officer (CFO), set himself up as the manager of one of Enron's off-the-books partnerships and as the part-owner of another, allegedly earning extra compensation of $30 million for his owner-manager roles in the two partnerships; Enron's board of directors agreed to suspend the company's conflict-of-interest rules designed to protect the company from this very kind of executive self-dealing.

According to a civil complaint filed by the Securities and Exchange Commission, the chief executive officer (CEO) of Tyco International, a well-known $35.6 billion manufacturing and services company, conspired with the company's CFO to steal more than $170 million, including a company-paid $2 million birthday party for the CEO's wife held on Sardinia, an island off the coast of Italy; a $7 million Park Avenue apartment for his wife; and secret low-interest and interest-free loans to fund private businesses and investments and purchase lavish artwork, yachts, estate jewelry, and vacation homes in New Hampshire, Connecticut, Nantucket, and Park City, Utah. The CEO allegedly lived rent-free in a $31 million Fifth Avenue apartment that Tyco purchased in his name, directed millions of dollars of charitable contributions in his own name using Tyco funds, diverted company funds to finance his personal businesses and investments, and sold millions of dollars of Tyco stock back to Tyco itself through Tyco subsidiaries located in offshore bank-secrecy jurisdictions. Tyco's CEO and CFO were further charged with conspiring to reap more than $430 million from sales of stock, using questionable accounting to hide their actions, and engaging in deceptive accounting practices to distort the company's financial condition from 1995 to 2002. At the trial on the charges filed by the SEC, the prosecutor told the jury in his opening statement, "This case is about lying, cheating and stealing. These people didn't win the jackpot—they stole it." Defense lawyers countered that "every single transaction . . . was set down in detail in Tyco's books and records" and that the authorized and disclosed multimillion-dollar compensation packages were merited by the company's financial performance and stock price gains.

Heavy Pressures on Company Managers to Meet or Beat Earnings Targets When companies find themselves scrambling to achieve ambitious earnings growth and meet the quarterly and annual performance expectations of Wall Street analysts and investors, managers often feel enormous pressure *to do whatever it takes* to sustain the company's reputation for delivering good financial performance. Executives at high-performing companies know that investors will see the slightest sign of a slowdown in earnings growth as a red flag and drive down the company's stock price. The company's credit rating could be downgraded if it has used lots of debt to finance its growth. The pressure to watch the scoreboard and "never miss a quarter"—so as not to upset the expectations of Wall Street analysts and fickle stock market investors—prompts managers to cut costs wherever savings show up immediately, squeeze extra sales out of early deliveries, and engage in other short-term maneuvers to make the numbers. As the pressure builds to keep performance numbers looking good, company personnel start stretching the rules further and further, until the limits of ethical conduct are overlooked.[4] Once ethical boundaries are crossed in efforts to "meet or beat the numbers," the threshold for making more extreme ethical compromises becomes lower.

Several top executives at WorldCom, a company built with scores of acquisitions in exchange for WorldCom stock, allegedly concocted a fraudulent $11 billion accounting scheme to hide costs and inflate revenues and profit over several years; the scheme was said to have helped the company keep its

stock price propped up high enough to make additional acquisitions, support its nearly $30 billion debt load, and allow executives to cash in on their lucrative stock options. At Qwest Communications, a company created by the merger of a go-go telecom start-up and U.S. West (one of the regional Bell companies), management was charged with scheming to improperly book $2.4 billion in revenues from a variety of sources and deals, thereby inflating the company's profits and deceiving shareholders about how well the company's strategy to create a telecommunications company of the future was actually working. Scrambling to find ways to hit its earnings targets in 1999–2000, Enron entered into a partnership with Blockbuster to provide movies to homes directly over phone lines; months after the partnership was formed, Enron used "creative accounting" to book $110.9 million in profits based on the projected performance of its Blockbuster partnership (the profits were never realized because the venture was called off after a 1,000-home pilot test).

At Bristol-Myers Squibb, the world's fifth largest drug maker, management apparently engaged in a series of numbers-game maneuvers to meet earnings targets, including such actions as:

- Offering special end-of-quarter discounts to induce distributors and local pharmacies to stock up on certain prescription drugs—a practice known as "channel stuffing."
- Issuing last-minute price increase alerts to spur purchases and beef up operating profits.
- Setting up excessive reserves for restructuring charges and then reversing some of the charges as needed to bolster operating profits.
- Making repeated asset sales small enough that the gains could be reported as additions to operating profit rather than being flagged as one-time gains. (Some accountants have long used a rule of thumb that says a transaction that alters quarterly profits by less than 5 percent is "immaterial" and need not be disclosed in the company's financial reports.)

Such numbers games were said to be a common "earnings management" practice at Bristol-Myers and, according to one former executive, "sent a huge message across the organization that you make your numbers at all costs."[5]

Company executives often feel pressured to hit financial performance targets because their compensation depends heavily on the company's performance. During the late 1990s, it became fashionable for boards of directors to grant lavish bonuses, stock option awards, and other compensation benefits to executives for meeting specified performance targets. So outlandishly large were these rewards that executives had strong personal incentives to bend the rules and engage in behaviors the allowed the targets to be met. Much of the accounting hocus-pocus at the root of recent corporate scandals has entailed situations in which executives benefited enormously from misleading accounting or other shady activities that allowed them to hit the numbers and receive incentive awards ranging from $10 million to $100 million. At Bristol-Myers Squibb, for example, the pay-for-performance link spawned strong rules-bending incentives. About 94 percent of one top executive's $18.5 million in total compensation in 2001 came from stock-option grants, a bonus, and long-term incentive payments linked to corporate performance; about 92 percent of a second executive's $12.9 million of compensation was incentive-based.[6]

The fundamental problem with a "make the numbers and move on" syndrome is that a company doesn't really serve its customers or its shareholders by putting top priority on the bottom line. Shareholder interests are best served by doing a really good job of serving customers (observing the rule that

customers are "king") and by improving the company's competitiveness in the marketplace. Cutting ethical corners or stooping to downright illegal actions in the name of profits first is convoluted and misguided—when the spotlight is shined on such scurrilous behavior, the resulting fallout actually depreciates shareholder value rather than enhancing it.

Company Cultures That Put the Bottom Line Ahead of Ethical Behavior When a company's culture spawns an ethically corrupt or amoral work climate, people have a company-approved license to ignore "what's right" and engage in most any behavior or employ most any strategy they think they can get away with. In such an environment, ethically immoral or amoral people are certain to play down the relevance of ethical strategic actions and business conduct. Moreover, the pressures to conform to the norms of the corporate culture can prompt otherwise honorable people to make ethical mistakes and succumb to the many opportunities around them to engage in unethical practices.

A perfect example of a company culture gone awry on ethics is Enron.[7] Enron's leaders encouraged company personnel to focus on the current bottom line and to be innovative and aggressive in figuring out what could be done to grow current revenues and earnings. Employees were expected to pursue opportunities to the utmost in the electric utility industry that at the time was undergoing looser regulation. Enron executives viewed the company as a laboratory for innovation; the company hired the best and brightest people and pushed them to be creative, look at problems and opportunities in new ways, and exhibit a sense of urgency in making things happen. Employees were encouraged to make a difference and do their part in creating an entrepreneurial environment where creativity flourished, people could achieve their full potential, and everyone had a stake in the outcome. Enron employees got the message—pushing the limits and meeting one's numbers were viewed as survival skills. Enron's annual "rank and yank" formal evaluation process where the 15 to 20 percent lowest-ranking employees were let go or encouraged to seek other employment made it abundantly clear that bottom-line results and being the "mover-and-shaker" in the marketplace were what counted. The name of the game at Enron became devising clever ways to boost revenues and earnings, even if it sometimes meant operating outside established policies and without the knowledge of superiors. In fact, outside-the-lines behavior was celebrated if it generated profitable new business. Enron's energy contracts and its trading and hedging activities grew increasingly more complex and diverse as employees pursued first this avenue and then another to help keep Enron's financial performance looking good.

As a consequence of Enron's well-publicized successes in creating new products and businesses and leveraging the company's trading and hedging expertise into new market arenas, Enron came to be regarded as an exceptionally innovative company. It was ranked by its corporate peers as the most innovative U.S. company for three consecutive years in *Fortune* magazine's annual surveys of the most admired companies. A high-performance/high-rewards climate came to pervade the Enron culture, as the best workers (determined by who produced the best bottom-line results) received impressively large incentives and bonuses (amounting to as much as $1 million for traders and even more for senior executives). On Car Day at Enron, an array of luxury sports cars arrived for presentation to the most successful employees. Understandably, employees wanted to be seen as part of Enron's star team and partake in the benefits that being one of Enron's best and smartest employees entailed. The high monetary rewards, the ambitious and hard-driving people that the company hired and promoted, and the competitive, results-oriented culture combined to give Enron a reputation not only for trampling competitors at every opportunity but also for internal ruthlessness. The company's super-aggressiveness and

win-at-all-costs mind-set nurtured a culture that gradually and then more rapidly fostered the erosion of ethical standards, eventually making a mockery of the company's stated values of integrity and respect. When it became evident in the fall of 2001 that Enron was a house of cards propped up by deceitful accounting and a myriad of unsavory practices, the company imploded in a matter of weeks—the biggest bankruptcy of all time cost investors $64 billion in losses (between August 2000, when the stock price was at its five-year high, and November 2001), and Enron employees lost their retirement assets, which were almost totally invested in Enron stock.

Business Ethics in the Global Community

core concept
The school of *ethical universalism* holds that human nature is the same everywhere and thus that ethical rules are cross-cultural; the school of *ethical relativism* holds that different societal cultures and customs give rise to divergent values and ethical principles of right and wrong.

Notions of right and wrong, fair and unfair, moral and immoral, ethical and unethical are present in all societies, organizations, and individuals. Some concepts of what is right and what is wrong are *universal* and *transcend most all cultures*. For instance, being truthful (or not lying) strikes a chord of what's right in the peoples of all nations. Demonstrating integrity of character, not cheating, and treating people with dignity and respect are concepts that resonate with people of most religions and cultures. Most people believe that companies should not pillage or degrade the environment in the course of conducting their operations. Most people would concur that it is unethical to expose workers to toxic chemicals and hazardous materials. But the school of *ethical relativism* holds that there are important instances in which what is deemed fair or unfair, what constitutes proper regard for human rights, and what is considered ethical or unethical in business situations varies from one society or country to another. Hence, so this school of thought contends, there are occasions when cultural norms and the circumstances of the situation determine whether certain actions or behaviors are right or wrong.

Cross-Culture Variability in Ethical Standards Religious beliefs, historic traditions, social customs, and prevailing political and economic doctrines (whether a country leans more toward a capitalistic market economy or one heavily dominated by socialistic or communistic principles) all affect what is deemed ethical or unethical in a particular society or country. Moreover, there are differences in the degree to which some ethical behaviors are considered more important than others. In Japan, China, and other Asian societies, for instance, there's a strong ethic of loyalty to work groups and corporations; such fidelity stems from Confucianism and centuries-long traditions that hold that one's primary obligation is not to oneself but rather to family, clan, government, and employer.[8] In Japan, such beliefs translate into high cultural expectations that company personnel will exhibit strong loyalty to superiors and to their employer. Japanese employees, believing in the importance of loyalty to their employer, are therefore unlikely to blow the whistle when they see their company engage in wrongdoing. Moreover, some Japanese corporations will fire an employee for breach of loyalty if the employee simply interviews for a job with another firm. In Italy, people are relatively carefree; they live for the moment and are generally willing to take chances about what the future will bring. As a consequence, an Italian manager may be disinclined to keep a promise or fulfill contractual obligations; further, there are often low levels of trust between parties in business deals and honest communications are frequently lacking.[9] In China, there's greater societal toleration of child labor, dangerous working conditions, and passing off fake or inferior products than in some other parts of the world. In addition, since China's history is more

tied to the functioning of a planned or socialist economy, there is no strong concept of what constitutes moral or ethical behavior in free market transactions—some Chinese ethicists even contend that traditional concepts of morality are irrelevant insofar as behavior in a market economy is concerned because the manner in which competitive markets operate is inherently amoral.[10] One study revealed that managers in Hong Kong rank taking credit for another's work and accomplishments at the top of a list of unethical behaviors and, in contrast to managers in Western cultures, considered it more unethical than bribery or illicitly obtaining information about competitors.[11] In Mexico, nepotism (favoritism based on family or social ties) is more acceptable than in the United States or many other countries.

In the former Soviet Union, decades of authoritarian government rule and socialistic traditions created a system where Communist Party officials issued a blizzard of rules and orders about how industries were to operate in the planned economy. Bribes and favors were frequently used to get governmental officials to act favorably. Because Soviet managers found it onerous and sometimes impossible to comply with all the various dictates, many of which were conflicting or inefficient, they routinely broke rules, manipulated production data, fabricated accounts, and traded favors in the course of conducting operations. Since the collapse of communist rule and the breakup of the Soviet Union in the late 1980s, many Russian people, long accustomed to the communist idea that people are supposed to work for the collective good of society, have exhibited considerable mistrust of how business is conducted in Russia. Such views are particularly understandable given that the actions of some Russian businesspeople have proved wildly corrupt based on ethical standards in the U.S. and Western Europe, with unethical practices being more the norm than the exception.

Thus, apart from certain universal basics—honesty, trustworthiness, fairness, avoiding unnecessary harm, and respecting the environment—there are variations in what societies generally agree to be right and wrong in the conduct of business activities, and certainly there are cross-country variations in the *degree* to which certain behaviors are considered unethical.[12] As a consequence of these cross-country variations and conflicting interpretations of what exactly constitutes fairness, trustworthiness, integrity, and so on, some people argue that there are few absolutes when it comes to business ethics and thus few ethical absolutes for consistently judging a company's conduct in various countries and markets. See Illustration Capsule 10.1 for examples of business situations in which cultures and local customs have clashed on ethical standards.

The view that what constitutes ethical or unethical conduct can vary according to time, circumstance, local cultural norms, and religious convictions leads to the conclusion that there is no objective way to *prove* that some countries or cultures are correct and others are wrong about proper business ethics. *To some extent,* therefore, there is merit in the school of ethical relativism's view that what is deemed right or wrong, fair or unfair, moral or immoral, ethical or unethical in business situations has to be viewed in the context of each country's local customs, religious traditions, and societal norms. On the one hand, a company has to be very cautious about exporting its home-country values and ethics to foreign countries where it operates—"photocopying" ethics is disrespectful of other countries and neglects the important role of moral free space. On the other hand, there are occasions when the rule of "When in Rome, do as the Romans do" is ethically and morally wrong regardless of local customs, traditions, and norms.

Consider, for instance, the following example: In 1992, the owners of the SS *United States,* an aging luxury ocean liner constructed with asbestos in the 1940s, had the liner towed to Turkey, where a contractor had agreed to remove the asbestos for $2 million (versus a far higher cost in the United States, where asbestos removal safety standards were much more stringent).[13] When Turkish officials blocked

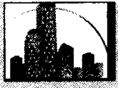

illustration capsule 10.1
When Cultures Clash on Ethical Standards: Some Examples

The following three examples illustrate the perplexing gray zone that global managers must navigate when two sets of ethical standards meet across cultures:

- You are a manager of a chain of fast-food restaurants in Russia, in partnership with a Russian company. One day you discover that a senior officer of your Russian joint venture partner has been "borrowing" equipment from the joint venture company and utilizing it in another of his business ventures. When you confront him, the Russian partner defends his actions, arguing that as an owner of both companies he is entitled to share use of the equipment.
- In preparing a bid for a multimillion-dollar contract in a foreign country, you are introduced to a "consultant" who offers to help you in submitting the bid and negotiating with the customer company. You learn in conversing with the consultant that she is well connected in local government and business circles and knows key personnel in the customer company extremely well. The consultant quotes you a six-figure fee. Later, your local coworkers tell you that the use of such consultants is normal in this country—and that a large fraction of the fee will go directly to people working for the customer company. They further inform you that bidders who reject the help of such consultants have lost contracts to competitors who employed them.
- You are the sales manager at a U.S. sleepwear manufacturing company. Company personnel discover that the chemicals used to flameproof your line of children's pajamas might cause cancer if absorbed through the skin. After these pajamas are banned from sale in the United States, you discover that the children's pajamas in inventory and the remaining flameproof material can be sold to sleepwear distributors in Asia, where there are no restrictions against the material's use. The senior executives of the company learn of this opportunity and expect you to sell the inventories of banned pajamas and flameproof materials to the foreign distributors.

Sources: Thomas Donaldson and Thomas W. Dunfee, "When Ethics Travel: The Promise and Peril of Global Business Ethics," *California Management Review* 41, no. 4 (Summer 1999), p. 45; and James E. Post, Anne T. Lawrence, and James Weber, *Business and Society: Corporate Strategy, Public Policy, Ethics,* 10th ed. (Burr Ridge, IL: McGraw-Hill/Irwin, 2002), p. 115.

the asbestos removal because of the dangers to workers of contracting cancer, the owners had the liner towed to the Black Sea port of Sevastopol, in the Crimean Republic, where the asbestos removal standards were quite lax and where a contractor had agreed to remove more than 500,000 square feet of carcinogenic asbestos for less than $2 million.

Few people would argue that exposing workers to carcinogenic asbestos is ethically correct, irrespective of what a country's law allows or the value the country places on worker safety. Likewise, many would argue that standards for judging honesty, integrity, trustworthiness, and fairness travel quite well across countries and are *universal.* According to this view, basic moral standards really do not vary *significantly* according to time, circumstance, local cultural beliefs, and religious convictions, thus making it feasible for a multinational company to have a code of ethics that can be applied more or less evenly across countries.[14]

The Payment of Bribes and Kickbacks One of the thorniest ethical problems that multinational companies face is the degree of cross-country variability in paying bribes as part of business transactions. In many countries in Eastern Europe, Africa, Latin America, and Asia, it is customary to pay bribes to government officials in order to win a government contract or to facilitate a business transaction. In some developing nations, it is difficult for any company, foreign or domestic, to move goods through customs without paying off low-level officials.[15] Likewise, in many countries it is normal to make

table 10.1 **Perceived Degree of Governmental Corruption in Selected Countries, as Measured by a Composite Corruption Perceptions Index (CPI), 2002** (A CPI Score of 10 is "highly clean" and a score of 0 is "highly corrupt.")

Country	2002 CPI Score*	90% Confidence Range	Number of Surveys Used	Country	2002 CPI Score*	90% Confidence Range	Number of Surveys Used
Finland	9.7	9.5–9.9	8	Uruguay	5.1	4.6–5.6	5
Denmark	9.5	9.3–9.7	8	Malaysia	4.9	4.6–5.2	11
New Zealand	9.5	9.3–9.6	8	South Africa	4.8	4.5–5.0	11
Sweden	9.3	9.2–9.4	10	South Korea	4.5	3.9–5.1	12
Canada	9.0	8.9–9.2	10	Brazil	4.0	3.8–4.2	10
Netherlands	9.0	8.8–9.1	9	Peru	4.0	3.7–4.4	7
Great Britain	8.7	8.4–8.9	11	Czech Republic	3.7	3.3–4.2	10
Australia	8.6	8.0–9.0	11	Mexico	3.6	3.3–3.9	10
Norway	8.5	8.0–8.9	8	China	3.5	3.1–4.1	11
Switzerland	8.5	7.9–8.9	9	Argentina	2.7	2.5–3.1	10
Hong Kong	8.2	7.8–8.6	11	India	2.7	2.5–2.9	12
United States	7.7	7.2–8.0	12	Russia	2.7	2.3–3.3	12
Chile	7.5	7.0–7.9	10	Pakistan	2.6	1.7–3.3	3
Germany	7.3	6.7–7.7	10	Philippines	2.6	2.4–2.9	11
Israel	7.3	6.7–7.7	9	Vietnam	2.4	2.0–2.9	7
Japan	7.1	6.6–7.4	12	Indonesia	1.9	1.7–2.2	12
Spain	7.1	6.5–7.6	10	Kenya	1.9	1.7–2.2	5
France	6.3	5.9–6.8	10	Paraguay	1.7	1.5–1.8	3
Italy	5.2	4.6–5.7	11	Bangladesh	1.2	0.7–1.6	5

**Note:* The CPI score ranges between 10 (highly clean) and 0 (highly corrupt); the data were collected between 2000 and 2002 and represent a composite of multiple sources, as indicated in the number of surveys used. The CPI represents the perceptions of well-informed people regarding the frequency of corrupt payments, the value of bribes paid, and the resulting obstacles to businesses.

Source: Transparency International, *2003 Global Corruption Report,* www.globalcorruptionreport.org, accessed October 1, 2003, pp. 265–66.

payments to prospective customers in order to win or retain their business. According to a 1999 *Wall Street Journal* report, 30 to 60 percent of all business transactions in Eastern Europe involved paying bribes, and the costs of bribe payments averaged 2 to 8 percent of revenues.[16] The 2003 *Global Corruption Report,* sponsored by Berlin-based Transparency International, found that corruption among public officials and in business transactions is widespread across the world. Table 10.1 shows some of the countries where corruption is believed to be lowest and highest. Table 10.2 presents data showing the perceived likelihood that companies in the 21 largest exporting countries are paying bribes to win business in the markets of 15 emerging markets. Table 10.3 indicates that bribery was perceived to occur most often in public works contracts and construction and in the arms and defense industry. On a scale of 1 to 10, where 10 indicates negligible bribery, even the "cleanest" industry sectors—agriculture, light manufacturing, and fisheries—only had "passable" scores of 5.9, indicating that bribes are quite likely a common occurrence in these sectors as well.

Companies that forbid the payment of bribes and kickbacks in their codes of ethical conduct and that are serious about enforcing this prohibition face a formidable challenge in those countries where bribery and kickback payments have been entrenched as a local custom for decades and are not

table 10.2 **The Degree to Which Companies in Major Exporting Countries Are Perceived to Be Paying Bribes in Doing Business Abroad**

Rank/ Country	Bribe Payers Index (10 = low; 0 = high)	Rank/ Country	Bribe Payers Index (10 = low; 0 = high)
1. Australia	8.5	12. France	5.5
2. Sweden	8.4	13. United States	5.3
3. Switzerland	8.4	14. Japan	5.3
4. Austria	8.2	15. Malaysia	4.3
5. Canada	8.1	16. Hong Kong	4.3
6. Netherlands	7.8	17. Italy	4.1
7. Belgium	7.8	18. South Korea	3.9
8. Britain	6.9	19. Taiwan	3.8
9. Singapore	6.3	20. China (excluding Hong Kong)	3.5
10. Germany	6.3	21. Russia	3.2
11. Spain	5.8		

Note: The Bribe Payers Index is based on a questionnaire developed by Transparency International and a survey of some 835 private sector leaders in 15 emerging countries accounting for 60 percent of all imports into non–Organization for Economic Cooperation and Development countries—actual polling was conducted by Gallup International.

Source: Transparency International, *2003 Global Corruption Report,* www.globalcorruptionreport.org, accessed October 1, 2003, p. 267.

considered unethical by many people. The same goes for multinational companies that do business in countries where bribery is illegal and also in countries where bribery and kickbacks are tolerated or customary. Some people say that bribes and kickbacks are no different from tipping for service at restaurants—whether you tip for service at dinner, make payments to government officials to get goods through customs, or give kickbacks to customers to retain their business, you pay for a service rendered.

U.S. companies are prohibited by the Foreign Corrupt Practices Act (FCPA) from paying bribes to government officials, political parties, political candidates, or others in all countries where they do business; the FCPA requires U.S. companies with foreign operations to adopt accounting practices that ensure full disclosure of a company's transactions so that illegal payments can be detected. The 35 member countries of the Organization for Economic Cooperation and Development (OECD) in 1997 adopted a convention to combat bribery in international business transactions; the Anti-Bribery Convention obligated the countries to criminalize the bribery of foreign public officials, including payments made to political parties and party officials. However, so far there has been little or no enforcement of the OECD convention and the payment of bribes in global business transactions remains a common practice in many countries.

Cross-country variability in business conduct and ethical standards makes it a formidable challenge for multinational companies to educate and motivate their employees worldwide to respect the customs and traditions of other nations and, at the same time, adhere to the company's own particular code of ethical behavior. At the level most managers confront it, bribery has no satisfactory solution.[17] Refusing to pay bribes or kickbacks is very often tantamount to losing business. Frequently, the sales and profits are lost to more unscrupulous companies, with the result that both ethical companies and ethical individuals are penalized. Sometimes subtle cross-country differences in what is deemed ethically right or wrong make it tough to draw a line in the sand between right and wrong decisions, actions, and business practices.

table 10.3 **Bribery in Different Industries**

Business Sector	Bribery Score (10 = low bribery; 0 = high bribery)
Agriculture	5.9
Light manufacturing	5.9
Fisheries	5.9
Information technology	5.1
Forestry	5.1
Civilian aerospace	4.9
Banking and finance	4.7
Heavy manufacturing	4.5
Pharmaceuticals/medical care	4.3
Transportation/storage	4.3
Mining	4.0
Power generation/transmission	3.7
Telecommunications	3.7
Real estate/property	3.5
Oil and gas	2.7
Arms and defense	1.9
Public works/construction	1.3

Note: The bribery scores for each industry are based on a questionnaire developed by Transparency International and a survey of some 835 private sector leaders in 15 emerging countries accounting for 60 percent of all imports into non–Organization for Economic Cooperation and Development countries—actual polling was conducted by Gallup International.

Source: Transparency International, *2003 Global Corruption Report*, www.globalcorruptionreport.org, accessed October 1, 2003, p. 268.

Determining What Is Ethical When Local Standards Vary But while it is indisputable that cultural differences abound in global business activities and that these cultural differences sometimes give rise to differences in ethical principles and standards, might it be the case that in many instances of cross-country differences one side is "more right" than the other? If so, then the task of the multinational manager is to discover what the right ethical standards are and act accordingly. A good example is the payment of bribes and kickbacks. Yes, bribes and kickbacks seem to be common in some countries, but does this justify paying them? Just because bribery flourishes in a country does not mean that it is an authentic or legitimate ethical norm. Virtually all of the world's major religions (Buddhism, Christianity, Confucianism, Hinduism, Islam, Judaism, Sikhism, and Taoism) and moral schools of thought condemn bribery and corruption.[18] Bribery is commonplace in India but interviews with Indian CEOs whose companies constantly engaged in payoffs indicated disgust for the practice and they expressed no illusions about its impropriety.[19] Therefore, a multinational company might reasonably conclude that the right ethical standard is one of refusing to engage in bribery and kickbacks no matter what the local custom is.

Managers in multinational enterprises have to figure out how to navigate the gray zone that arises when operating in two cultures with two sets of ethics.

A company that elects to conform to local ethical standards necessarily assumes that what prevails as local morality is an adequate guide to ethical behavior. This can be ethically dangerous—it leads to the conclusion that if a country's culture is accepting of bribery or environmental degradation or exposing workers to dangerous conditions (toxic chemicals or bodily harm), then so much the worse for honest people and protection of the environment and safe working conditions. Granting an *automatic* preference

to local country ethical norms can thus present vexing problems to company managers when the ethical standards followed in a foreign country are lower than those in its home country or in the company's code of ethics —sometimes there can be no compromise on what is ethical and what is not. Yet the notion of a self-righteous multinational company as the standard-bearer of moral truth is also scary—common sense suggests there ought to be room for *legitimate* local norms and opportunity for host country cultures to exert some influence in setting their own moral and ethical standards.

Approaches to Managing a Company's Ethical Conduct

The stance a company takes in dealing with or managing ethical conduct at any given point can take any of four basic forms:[20]

- The unconcerned or nonissue approach.
- The damage control approach.
- The compliance approach.
- The ethical culture approach.

The differences in these four approaches are discussed briefly below and summarized in Table 10.4.

The Unconcerned or Nonissue Approach The unconcerned approach is prevalent at companies whose executives are immoral and unintentionally amoral. Companies using this approach ascribe to the view that business ethics is an oxymoron in a dog-eat-dog, survival-of-the-fittest world and that under-the-table dealing can be good business. They believe the business of business is business, not ethics and that if the law permits so-called "unethical behavior" and if others are doing it too, why stand on ethical principles (when in Rome do as the Romans do). Companies in this mode are usually out to make the greatest possible profit at most any cost and the strategies they employ, while legal, may well embrace elements that are ethically shady or unsavory—for them, ethics is a nonissue.

The Damage Control Approach Damage control is favored at companies whose managers are intentionally amoral but who fear scandal and are desirous of containing any adverse fallout from claims that the company's strategy has unethical components or that company personnel engage in unethical practices. Companies using this approach, not wanting to risk tarnishing the reputations of key personnel or the company, usually make some concession to window-dressing ethics, going so far as to adopt a code of ethics—so that their executives can point to it as evidence of their ethical commitment should any ethical lapses on the company's part be exposed. Managers at these companies may opt to incorporate unethical elements into the company's strategy as long as those elements can be explained away or kept under wraps. Although unethical practices are not endorsed, executives look the other way when shady behavior occurs—management's stance is one of "See no evil, hear no evil, speak no evil" (except when there's great risk of fallout from inaction). Thus they may condone questionable actions that help the company reach earnings targets or bolster its market standing—such as pressuring customers to stock up on the company's product (channel stuffing), making under-the-table payments to win new business, stonewalling the recall of products claimed to be unsafe, bad-mouthing the products of rivals, or trying to keep prices low by sourcing goods from disreputable suppliers in low-wage countries that run sweatshop operations or use child labor.

table 10.4 **Four Approaches to Managing Business Ethics**

	Unconcerned Approach	Damage Control Approach	Compliance Approach	Ethical Culture Approach
Underlying beliefs	• The business of business is business, not ethics. • Ethics has no place in the conduct of business. • Companies should not be morally accountable for their actions.	• Need to make a token gesture in the direction of ethical standards (a code of ethics).	• Company must be committed to ethical standards and monitoring ethics performance. • Unethical behavior must be prevented and punished if discovered. • A reputation for high ethical standards is important.	• Ethics is basic to the culture. • Behaving ethically must be a deeply held corporate value and become a way of life. • Everyone is expected to walk the talk.
Means of dealing with ethics issues	• There's no need to make decisions concerning business ethics—if it's legal, it is okay. • No intervention regarding the ethical component of decisions is needed.	• Act to protect the company against the dangers of unethical strategies and behavior. • Ignore unethical behavior or allow it to go unpunished unless the situation is extreme and requires action.	• Establish a clear, comprehensive code of ethics. • Prevent unethical behavior. • Provide ethics training for all personnel. • The company has an ethics compliance office, a chief ethics officer, and formal ethics compliance procedures.	• Ethical behavior is ingrained and reinforced as part of the culture. • Rely on coworker peer pressure—"That's not how we do things here." • Everyone is an ethics watchdog—whistle-blowing is required. • Ethics heroes are celebrated; ethics stories are told.
Challenges in trying to make the approach work	• Financial consequences can become unaffordable. • Some stakeholders are alienated.	• Credibility problems with stakeholders can arise. • The company is susceptible to ethical scandal. • The company has a subpar ethical reputation—executives don't walk the talk.	• Organization members come to rely on the existing rules for moral guidance—fosters a mentality of what is not forbidden is allowed. • Rules and guidelines proliferate. • The locus of moral control resides in the code and in the ethics compliance system rather than in an individual's own moral responsibility for ethical behavior.	• New employees must receive an ethics induction. • Formal ethics management systems receive less emphasis. • Relying on peer pressures and cultural norms to enforce ethical standards can result in eliminating some or many of the compliance trappings and, over time, induce moral laxness.

Source: Adapted from Gedeon J. Rossouw and Leon J. van Vuuren, "Modes of Managing Morality: A Descriptive Model of Strategies for Managing Ethics," *Journal of Business Ethics* 46, no. 4 (September 2003), pp. 392–93. Reprinted with kind permission of Kluwer Academic Publishers.

The main objective of the damage control approach is to protect against adverse publicity brought on by angry or vocal stakeholders, outside investigation, threats of litigation, or punitive government action—hence the need to make token gestures toward rejecting unethical behavior and instituting modest corporate governance safeguards. But at companies in a damage-control mode, employees do not operate within a strong ethical context. There's a gap between talking ethics and walking ethics. The company's code of ethics, if any, exists merely as nice words on paper. Employees quickly get the message that rule-bending is tolerated, if not condoned, and that unethical behavior will go unpunished (or may even be rewarded) unless it results in egregious harm or scandal that cannot be ignored.

The Compliance Approach Anywhere from light to forceful compliance is favored at companies whose managers (1) lean toward being somewhat amoral but are highly concerned about having ethically upstanding reputations or (2) are moral and see strong compliance methods as the best way to impose and enforce ethical rules and high ethical standards. Companies that adopt a compliance mode usually do some or all of the following to display their commitment to ethical conduct: make the code of ethics a visible and regular part of communications with employees, implement ethics training programs, appoint a chief ethics officer or ethics ombudsperson, have ethics committees to give guidance on ethics matters, institute formal procedures for investigating alleged ethics violations, conduct ethics audits to measure and document compliance, give ethics awards to employees for outstanding efforts to create an ethical climate and improve ethical performance, and/or try to deter violations by setting up ethics hotlines for anonymous callers to use in reporting possible violations.

Emphasis here is usually on securing broad compliance and measuring the degree to which ethical standards are upheld and observed. However, violators are disciplined and sometimes subjected to public reprimand and punishment (including dismissal). The driving force behind the company's commitment to eradicate unethical behavior normally stems from a desire to avoid the cost and damage associated with unethical conduct or else a quest to gain favor from stakeholders (especially ethically conscious customers, employees, and investors) for having a highly regarded reputation for ethical behavior. One of the weaknesses of the compliance approach is that moral control resides in the company's code of ethics and in the ethics compliance system rather than in an individual's own moral responsibility for ethical behavior.

The Ethical Culture Approach At some companies, top executives believe that high ethical principles must be deeply ingrained in the corporate culture and function as guides for "how we do things around here." A company using the ethical culture approach seeks to gain employee buy-in to the company's ethical standards, business principles, and corporate values. The ethical principles embraced in the company's code of ethics and/or in its statement of corporate values are seen as integral to the company's identity and ways of operating—they are at the core of the company's soul and are promoted as part of "business as usual." The integrity of the ethical culture approach depends heavily on the ethical integrity of the executives who create and nurture the culture—it is incumbent on them to determine how high the bar is to be set and to exemplify ethical standards in their own decisions and behavior. Further, it is essential that the strategy be ethical in all respects and that ethical behavior be ingrained in the means that company personnel employ to execute the strategy.

Many of the trappings used in the compliance approach are also manifest in the ethical culture mode, but one other is added—strong peer pressure from coworkers to observe ethical norms. Thus, responsibility for ethics compliance is widely dispersed throughout all levels of management and the

rank-and-file. Stories of former and current moral heroes are kept in circulation, and the deeds of company personnel who display ethical values and are dedicated to walking the talk are celebrated at internal company events. The message that ethics matters—and matters a lot—resounds loudly and clearly throughout the organization and in its strategy and decisions. However, one of the challenges to overcome in the ethical culture approach is relying too heavily on peer pressures and cultural norms to enforce ethics compliance rather than on an individual's own moral responsibility for ethical behavior—absent unrelenting peer pressure or strong internal compliance systems, there is a danger that over time company personnel may become lax about its ethical standards.

Why a Company Can Change Its Ethics Management Approach Regardless of the approach they have used to managing ethical conduct, a company's executives may sense they have exhausted a particular mode's potential for managing ethics and that they need to become more forceful in their approach to ethics management. Such changes typically occur when the company's ethical failures have made the headlines and created an embarrassing situation for company officials or when the business climate changes. For example, the recent raft of corporate scandals, coupled with aggressive enforcement of anticorruption legislation such as the Sarbanes-Oxley Act of 2002 (which addresses corporate governance and accounting practices), has prompted numerous executives and boards of directors to clean up their acts in accounting and financial reporting, review their ethical standards, and tighten up ethics compliance procedures. Intentionally amoral managers using the unconcerned or nonissue approach to ethics management may see less risk in shifting to the damage control approach (or, for appearance's sake, maybe a "light" compliance mode). Senior managers who have employed the damage control mode may be motivated by bad experiences to mend their ways and shift to a compliance mode. In the wake of so many corporate scandals, companies in the compliance mode may move closer to the ethical culture approach.

Why Should Company Strategies Be Ethical?

There are two reasons why a company's strategy should be ethical: (1) because a strategy that is unethical in whole or in part is morally wrong and reflects badly on the character of the company personnel involved and (2) because an ethical strategy is good business and in the self-interest of shareholders.

Managers do not dispassionately assess what strategic course to steer. Ethical strategy making generally begins with managers who themselves have strong character (i.e., who are honest, have integrity, are ethical, and truly care about how they conduct the company's business). Managers with high ethical principles and standards are usually advocates of a corporate code of ethics and strong ethics compliance, and they are typically genuinely committed to certain corporate values and business principles. They walk the talk in displaying the company's stated values and living up to its business principles and ethical standards. They understand there's a big difference between adopting values statements and codes of ethics that serve merely as window dressing and those that truly paint the white lines for a company's actual strategy and business conduct. As a consequence, ethically strong managers consciously opt for strategic actions that can pass moral scrutiny—they display no tolerance for strategies with ethically controversial components.

But there are solid business reasons to adopt ethical strategies even if most company managers are not of strong moral character and personally committed to high ethical standards. Pursuing unethical

strategies puts a company's reputation at high risk and can do lasting damage. The experiences at Enron, WorldCom, Tyco, HealthSouth, Rite Aid, Qwest Communications, Arthur Andersen, and several other companies illustrate that when top executives devise shady strategies or wink at unethical behavior, the impact on the company can be severe and sometimes devastating. Coca-Cola was sorely embarrassed when it came to light that company personnel had rigged a marketing test of Frozen Coke at several Burger King restaurants to make it appear that consumer response was better than it really was—an outside firm was hired to spend up to $10,000 to goose demand for Frozen Coke and other frozen drinks at Burger King restaurants taking part in the test promotion. Given the results of the test, Burger King invested $65 million to make Frozen Coke and other frozen carbonated beverages a standard menu item starting in 1999. The marketing fraud came to light in February 2003 when a Coca-Cola finance manager sent a letter to Coca-Cola's CEO with detailed claims that metal shavings were getting into its Frozen Coke drinks and that there were assorted other problems with the company's marketing programs and accounting. A month later the employee was laid off, along with 1,000 other Coke employees, as part of a restructuring effort. In July 2003, four months after the marketing test fraud came to light and following several years of disappointing sales, Burger King began phasing out Frozen Coke. Coca-Cola later paid $540,000 to settle a lawsuit filed by the laid-off finance manager and offered Burger King $21 million as part of an apology.

Rehabilitating a company's shattered reputation is time-consuming and costly. Customers shun companies known for their shady behavior. Companies with reputations for unethical conduct have considerable difficulty in recruiting and retaining talented employees. Most hardworking, ethically upstanding people are repulsed by a work environment where unethical behavior is condoned; they don't want to get entrapped in a compromising situation, nor do they want their personal reputations tarnished by the actions of an unsavory employer. A 1997 survey revealed that 42 percent of the respondents took into account a company's ethics when deciding whether to accept a job.[21] Creditors are usually unnerved by the unethical actions of a borrower because of the potential business fallout and subsequent risk of default on any loans. To some significant degree, therefore, companies recognize that ethical strategies and ethical conduct are good business. Most companies have strategies that pass the test of being ethical, and most companies are aware that both their reputations and their long-term well-being are tied to conducting their business in a manner that wins the approval of suppliers, employees, investors, and society at large.

Conducting business in an ethical fashion is in a company's enlightened self-interest.

Illustration Capsule 10.2 describes elements of the strategies that three of the world's most prominent investment banking firms employed to attract new clients and reward the executives of existing clients—judge for yourself whether what they did was ethical or shady.

Linking a Company's Strategy to Its Ethical Principles and Core Values

Many companies have officially adopted a code of ethical conduct and a statement of company values. But there's a big difference between having a code of ethics and a values statement that serve merely as a public window dressing and having ethical standards and corporate values that truly paint the white lines for a company's actual strategy and business conduct. If ethical standards and statements of core values are to have more than a cosmetic role, boards of directors and top executives must work diligently

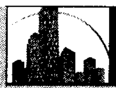

illustration capsule 10.2

Strategies to Gain New Business at Wall Street Investment Banking Firms: Ethical or Unethical?

At Salomon Smith Barney (a subsidiary of Citigroup), Credit Suisse First Boston (CSFB), and Goldman Sachs (three of the world's most prominent investment banking companies), part of the strategy for securing the investment banking business of large corporate clients (to handle the sale of new stock issues or new bond issues or advise on mergers and acquisitions) involved (1) hyping the stocks of companies that were actual or prospective customers of their investment banking services, and (2) allocating hard-to-get shares of hot new initial public offerings (IPOs) to select executives and directors of existing and potential client companies, who then made millions of dollars in profits when the stocks went up once public trading began. Former WorldCom CEO Bernie Ebbers reportedly made more than $11 million in trading profits over a four-year period on shares of IPOs received from Salomon Smith Barney; Salomon served as WorldCom's investment banker on a variety of deals during this period. Jack Grubman, Salomon's top-paid research analyst at the time, enthusiastically touted WorldCom stock and was regarded as the company's biggest cheerleader on Wall Street.

To help draw in business from new or existing corporate clients, CSFB established brokerage accounts for corporate executives who steered their company's investment banking business to CSFB. Apparently, CSFB's strategy for acquiring more business involved promising the CEO and/or CFO of companies about to go public for the first time or needing to issue new long-term bonds that if CSFB was chosen to handle their company's new initial public offering of common stock or a new bond issue, then CSFB would ensure they would be allocated shares at the initial offering price of all subsequent IPOs in which CSFB was a participant. During 1999–2000, it was common for the stock of a hot new IPO to rise 100 to 500 percent above the initial offering price in the first few days or weeks of public trading; the shares allocated to these executives were then sold for a tidy profit over the initial offering price. According to investigative sources, CSFB increased the number of companies whose executives were allowed to participate in its IPO offerings from 26 companies in January 1999 to 160 companies in early 2000; executives received anywhere from 200 to 1,000 shares each of every IPO in which CSFB was a participant in 2000. CSFB's accounts for these executives reportedly generated profits of about $80 million for the participants. Apparently, it was CSFB's practice to curtail access to IPOs for some executives if their companies didn't come through with additional securities business for CSFB or if CSFB concluded that other securities offerings by these companies would be unlikely.

Goldman Sachs also used an IPO-allocation scheme to attract investment banking business, giving shares to executives at 21 companies—among the participants were the CEOs of eBay, Yahoo, and Ford Motor Company. EBay's CEO was a participant in over 100 IPOs managed by Goldman during the 1996–2000 period and was on Goldman's board of directors part of this time; eBay paid Goldman Sachs $8 million in fees for services during the 1996–2001 period.

QUESTIONS TO CONSIDER:

1. If you were a top executive at Salomon Smith Barney, CSFB, or Goldman Sachs, would you be proud to defend your company's actions?
2. Would you want to step forward and take credit for having been a part of the group who designed or approved of the strategy for gaining new business at any of these three firms?

Sources: Charles Gasparino, "Salomon Probe Includes Senior Executives," *The Wall Street Journal*, September 3, 2002, p. C1; Randall Smith and Susan Pulliam, "How a Star Banker Pressed for IPOs," *The Wall Street Journal*, September 4, 2002, pp. C1, C14; Randall Smith and Susan Pulliam, "How a Technology-Banking Star Doled Out Shares of Hot IPOs," *The Wall Street Journal*, September 23; 2002, pp. A1, A10; and Randall Smith, "Goldman Sachs Faces Scrutiny for IPO-Allocation Practices," *The Wall Street Journal*, October 3, 2002, pp. A1, A6.

to see that they are scrupulously observed in crafting the company's strategy and conducting every facet of the company's business. In other words, living up to the ethical principles and displaying the core values in actions and decisions must become a way of life at the company.