Corporate Strategy

Corporate strategy is the selection and development of the markets (or industries)[1] in which a firm competes. Therefore, corporate strategy deals with what industries (or markets) a firm seeks to compete in. Business level strategies (low cost, diversification, and focus) that were discussed last chapter are HOW a firm competes in a single market or industry. Therefore, corporate strategy and business strategy describe very different issues -- be careful not to confuse them!

Unlike business level strategy, work on corporate strategy frameworks is not nearly as advanced or well done. Most emphasis is on *describing* corporate strategy. Describing corporate strategy involves two primary dimensions, vertical integration, where firms engage in activities that were formerly done by their buyers or suppliers and diversification where they enter additional markets. While that often gets a lot of attention, "How diversified is the firm?" is not really that important for understanding why firm performance differs. What really allows corporate strategy to result in superior firm performance are what I'll call the "building blocks of corporate strategy" - sharing resources, transferring competencies, and creating specific assets. However, before moving into them, best to go ahead and lay out how corporate strategy is described.

Describing Corporate Strategy

There are two basic descriptive dimensions of corporate strategy, how diversified and how vertically integrated an organization is. It may be helpful to think of both of these dimensions as a continuum.

Diversification occurs when a firm enters a new industry or market. Just like when we discussed Porter's Five Forces, the definition of an industry or market is critically important. There are formal classification codes, the North American Industrial Classification System (previously Standard Industrial Classification codes – see box in external analysis), for trying to classify all industries in an economy. However, for our purposes the NAICS is not very useful. However, it is critical when doing your analysis to carefully define industries in describing firm diversification. For example, was Coca-Cola's move from carbonated beverages into bottled water an instance of diversification? Depending on how you define the industry, it could be yes or no.

How diversified a firm is can be determined by what portion of its sales are derived from different markets. The larger a percentage of sales are derived from different markets/industries the more diversified the firm can be said to be. A wide range of labels can be applied to the level of a firm's diversification from single business (95% of sales from one industry), dominant business (70% from one industry) to diversified (less than 70% from any one industry).[2] While single business firms are usually found in fast moving, rapidly evolving industries where there is a need to focus, there are exceptions. William Wrigley, the chewing gum manufacturer, is

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[1] Markets and industries are used interchangeably in this section. Those with economics backgrounds refer to industries and those with marketing backgrounds favor markets.

[2] Rumelt, R. (1974). *Strategy, Structure, and Economic Performance*, Cambridge, MA: Harvard University Press.

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perhaps the most famous single business firm. However, most large firms engage in some diversification.

Related vs. Unrelated. Diversification can be either related or unrelated. The key issue here is if the operations of the firm in the new industry share some link in with the firm's existing value chain. Is there some value adding activity that can be shared? For example, is there a production facility, a distribution network, or a marketing competence that both can use? Historically it was thought that related diversification would be better than unrelated diversification. However, the coordination costs of related diversification appear to consume a lot of the expected benefits. Therefore, while most firms seem to engage in related diversification its benefits are only slightly, if at all, better than unrelated.[3]

Vertical integration occurs when a firm takes on activities that were formally done by others on its behalf. In a way, vertical integration is just a special case of diversification, a firm is diversifying into either its suppliers' or its buyers' industries. For example if a company starts to make components for its products on its own or if it starts to distribute products directly to customers it is engaged in vertical integration. Ford Motor Company under Henry Ford was extremely vertically integrated going so far at one time as to own the iron ore mines that fueled its steel mills that fed its automobile assembly operations.[4] However, recently vertical integration has fallen out of favor in preference to contract manufacturing and outsourcing. It will be interesting to see how the expansion of the internet creates opportunities for firms to vertically integrate downstream into direct distribution.

A firm's level of vertical integration can be modeled using an industry (rather than a firm) value chain. An industry value chain models all the significant value adding steps that occur in an industry from the most basic raw materials to the final consumers. The more of these activities a firm encompasses the more vertically integrated it is. A firm that enters activities to its left on the industry value chain, replacing a supplier, is said to be vertically integrating "upstream". A firm entering activities to its right, supplanting a buyer, is said to be moving "downstream". So continuing the historical Ford example, Ford buying coal mines would be upstream while him buying a dealership would be downstream vertical integration.

Vertical integration entails coordination (bureaucratic) costs just like related diversification. For example, a major issue for vertically integrated firms is transfer prices, what should one part of the firm charge another? Furthermore, a vertically integrated firm faces greater technological risk and demand uncertainty. In many ways vertical integration is a lot like financial leverage, when times are good, they are very good as the firm profits all along the value chain, but when they go bad, it's correspondingly bad all along the value chain.

However, both sets of these terms are wholly arbitrary and simply descriptive. If a firm is single business versus dominant business matters little to answering our question of why firm performance differs. Some value chain function can almost always be claimed as being shared to

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[3] Palich, L.E., L.B. Cardinal, and C.C. Miller (2000). "Curvilinearity in the diversification-performance linkage: An examination of over three decades of research." *Strategic Management Journal*, 21(2), pp. 155-174.
[4] Interestingly though, Ford did not seek to own his dealers. He actually exploited them on several occasions.

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meet the definition of "relatedness".[5] Likewise, vertical integration, upstream or downstream, which is better? Therefore, while it is important to be aware of these descriptive terms, the key issue is how well an organization is able to share resources, transfer competencies and create specific assets regardless of the description of its corporate strategy.

The Benefits of Corporate Strategy: The Building Blocks of Corporate Advantage

All (well 90%+) corporate strategy is motivated by what we'll term the three building blocks of corporate strategy: shared resources, transferred competencies, and the creation of specific assets.[6] While there are many possible reasons given for things like diversification, they can almost all be traced back to one of these three motivations.

Sharing resources is taking something an organization already has and using it in a new industry. For example, Wal-Mart plunking down one-hour photo labs in its stores is an example of sharing a resource. WMT already has stores (a resource) located all over the country. Adding this service is simply a matter of sharing its existing resource. Economies of scope, efficiencies gained due to the breath of one's goods/services, is a fundamental example of sharing resources.[7]

Transferring competencies are taking something that an organization is good at and using it in a new industry. The most famous example of this of all time was Henry Ford and his mass production/assembly line techniques. Today Ford is most famous for cars, however Ford took his ideas and applied them to farm equipment, large trucks, and even airplanes! Some of these businesses remain to this day as you can still find Ford farm equipment.

Specific Assets. Much more complex is the idea of specific assets. Specific assets are assets that have a much lower value in their next best use OR to their next best user.[8] A great example of a specific asset might be a textbook for a college course. It has great value if you are a college student in that course, but it doesn't have many alternate uses, e.g. firestarter, and few people other than a college student taking that course would pay a lot of money for it. Therefore, it is a specific asset. Common examples of specific assets are things like uniforms and pipelines. It may be helpful to think of specific assets as assets that have been customized. This is because by customizing something it frequently becomes more valuable to the person or firm who did the customizing but less valuable to everyone else.

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[5] Many scholars and experts would suggest that organizational structure should be contingent on the level of diversification and/or relatedness. This is legitimate. However, we'll suggest that the proper organizational structure should be driven by the need to facilitate the sharing of resources, transfer of competencies, and creation of specific assets rather than arbitrary descriptors of industry involvement.

[6] This position is open to debate and why I had to qualify it. Issues of why corporate strategy matter are tied to a huge body of work on why have organizations at all. Basically, this models firms using a transaction cost economics approach that focuses on the challenges of overcoming opportunism while creating specific assets. However, in looking over MANY lists of why other authors said corporate strategy was beneficial to the firm, I was hard pressed to ever find any examples whose underlying foundations couldn't fit into one of these three cases.

[7] Bailey, E E and A F. Friedlander (1982). Market structure and multiproduct industries. *Journal of Economic Literature*, 20(3): pp. 1024-1048.

[8] Williamson, O.E. (1985). *The Economic Institutions of Capitalism*. New York: Free Press.

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Specific assets are important for corporate strategy for two reasons. First, if you don't own the specific asset it probably will not get created at all. After all Ford is not likely to ever produce a car in your school's color scheme with your mascot painted on the hood. If you want one, you'll have to have it done yourself. Second, you frequently want to own specific assets so that you are not "held up" by an opportunistic partner. Hold up can occur when the provider of a specific asset decides to withhold it from you at a critical time. For example, what if you rented your textbook from me rather than owned it? I might have an incentive to increase the rental rate right before the exam when you needed the book the most. You might be able to take me to court and win for violation of contract, but by then the test is long past. You'll have to pay my higher rent. This is what economists mean when they refer to "hold up."

A great illustration of the building blocks comes from Jack Welch's managerial evaluation system at GE - probably the most diversified large company in the U.S. The central focus of the system was the divisional director's ability to recognize, develop, and SHARE the talent of their executives. If someone had someone who was really good at solving problem X that another division had, then they were expected to share that person. This further encouraged employees to devote themselves to learning about GE and doing a great job, they knew good work would be rewarded. This is a classic example of why sharing resources, transferring competencies, and getting people to invest in specific assets (especially important for organizational knowledge) is important for the management and ongoing success of diversified corporations. Managerial attention should be paid to these three factors on an ongoing basis, not just at the time a diversification or vertical integration decision is made.

Therefore, in order for a corporate strategic decision to help result in a sustained competitive advantage for a firm the benefits from the shared resources, transferred competencies, and specific assets must be greater than the integration and bureaucratic costs of performing the function internally.

However, this leads to an interesting question, what about firms that have pursued completely unrelated diversification yet have performed quite well? While these are rather rare, examples of these firms have included Hanson Trust and present day Berkshire Hathaway (BRK). What may have happened is that these firms wind up embodying a control or resource allocation function (perhaps capital) that is superior to what their component firms could do individually. For example, Warren Buffett often targets acquisitions on the foundation of taking away the current CEO's headaches of dealing with boards and regulators and letting the CEO get back to focusing on running the company that they love.[9] This of course is just a transferred competency on the part of BRK that takes over corporate governance concerns of the CEO. Warren Buffett's exceptional skill in investing could also be a transferred competency and his company's excellent credit rating a shared resource.

Warning on Matrices. Initially, consulting groups and managers attempted to deal with the complex challenges of corporate strategy through "matrices." The matrices, e.g. Boston Consulting Group (Stars, Problem Children, Cash Cows, and Dogs), you often see associated with corporate strategy can be great external analysis tools and visual aids. However, since they

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[9] Buffett's annual letters to shareholders describe his thinking in detail and are worth your time. They can be found online at: http://www.berkshirehathaway.com/letters/letters.html.

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don't tell you how to share resources, transfer competencies, or create specific assets, they are "mostly worthless" for explaining why firm performance differs. While matrices may have some value as investment guides for managers, there are superior frameworks for investing based on the work of economists and financial experts, so their value here is suspect as well.

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