CSAC15 1/13/07 9:27 Page 393

15

Diversification Strategy

Telephones, hotels, insurance – it's all the same. If you know the numbers inside out, you know the company inside out.

—HAROLD SYDNEY GENEEN, CHAIRMAN OF ITT, 1959–78, AND INSTIGATOR OF 275 COMPANY TAKEOVERS

For a company that has taken its original or main business as far as it can go, diversification as a means of channeling surplus resources should certainly be considered. For the company that has not yet developed its main business to the full potential, however, diversification is probably one of the riskiest strategic choices that can be made

—KENICHI OHMAC, STRATEGY GURU AND FORMER HEAD OF MCKINSEY & CO.'S TOKYO OFFICE

OUTLINE

- Introduction and Objectives
- Trends in Diversification over Time
  - The Era of Diversification, 1950–1980
  - Refocusing, 1980–2006
- Motives for Diversification
  - Growth
  - Risk Reduction
  - Profitability
- Competitive Advantage from Diversification
  - Economies of Scope
  - Economies from Internalizing Transactions
  - The Diversified Firm as an Internal Market
- Diversification and Performance
  - The Findings of Empirical Research
  - The Meaning of Relatedness in Diversification
- Summary
- Self-Study Questions
- Appendix: Does Diversification Confer Market Power?
- Notes

CSAC15 1/13/07 9:27 Page 394

Introduction and Objectives

Deciding "What business are we in?" is the starting point of strategy and the basis for defining the firm's identity. In their statements of vision and mission, some companies define their businesses broadly. Shell's objectives are "to engage efficiently, responsibly, and profitably in oil, oil products, gas, chemicals, and other selected businesses." Other companies define their businesses more narrowly: McDonald's vision is "to be the world's best quick-service restaurant chain": Caterpillar will "be leader in providing the best value in machines, engines, and support services for companies dedicated to building the world's infrastructure and developing and transporting its resources."

A firm's business scope may change over time. Most companies have "refocused on core businesses" during the past 25 years. RJR Nabisco sold its interests in processed foods. Delmonte fruit, pet food, chewing gum, and cosmetics before emerging as Reynolds American, a specialized tobacco company. Some conglomerates – ITT, Hanson, Gulf & Western, Cendant, and Tyco – have broken up altogether.

Some companies have moved in the opposite direction. Microsoft, once a supplier of operating systems, expanded into application and networking software, information services, entertainment systems, and video games consoles. Other companies have totally transformed their businesses. Nokia, once a supplier of paper and rubber goods, emerged as the world's biggest manufacturer of mobile phones during the mid-1990s.

Diversification is a conundrum. It represents the biggest single source of value destruction ever perpetrated by CEOs and their strategy advisers at the expense of their unwitting shareholders. Yet, specialization restricts a firm's options and condemns it to the fortunes of its industry. Thus, because of its greater diversity across different soft drinks and convenience foods, PepsiCo has survived the downturn in the soda drinks market better than Coca-Cola.

Our goal in this chapter is to establish the basis on which companies can make corporate strategy decisions that create rather than destroy value. Is it better to be specialized or diversified? Is there an optimal degree of diversification? What types of diversification are most likely to create value?

In practice, we make these types of decision every day in our personal lives. If my car doesn't start in the morning, should I try to fix it myself or have it towed directly to the garage? There are two considerations. First, is repairing a car an attractive activity to undertake? If the garage charges $85 an hour, but I can earn $600 an hour consulting, then car repair is not attractive to me. Second, am I any good at car repair? If I am likely to take twice as long as a skilled mechanic, then I possess no competitive advantage in car repair.

Diversification decisions by firms involve the same two issues:

- How attractive is the industry to be entered?
- Can the firm establish a competitive advantage within the new industry?

These are the very same factors we identified in Chapter 1 (see Figure 1.4) as determining a firm's profit potential. Hence, no new analytic framework is needed for appraising diversification decisions: diversification may be justified either by the superior profit potential of the industry to be entered, or by the ability of the firm to create competitive advantage in the new industry. The first issue draws on the industry analysis developed in Chapter 3; the second draws on the analysis of competitive advantage developed in Chapters 5 and 7.

Our primary focus is on the latter question: under what conditions does operating multiple businesses assist a firm in gaining a competitive advantage in each? This leads into exploring linkages between different businesses within the diversified firm, what has often been referred to as "synergy."

By the time you have completed this chapter, you will be able to:

- Appreciate the factors that have influenced diversification in the past and the recent trend toward "refocusing."
- Identify the conditions under which diversification creates value for shareholders and, in particular, to evaluate the potential for sharing and transferring resources and capabilities within the diversified firm.
- Determine the relative merits of diversification and strategic alliances in exploiting the linkages between different businesses.
- Recognize the organizational and managerial issues to which diversification gives rise and why diversification so often fails to realize its anticipated benefits.

Trends in Diversification over Time

As a background to our analysis of diversification decisions, let's begin by examining the factors that have influenced diversification strategies in the past.

The Era of Diversification, 1950–1980

In Chapter 13, we noted that diversification was a major aspect of the widening scope of the modern corporation during most of the 20th century. Between 1950 and 1980, diversification – the expansion of companies across different product markets – was an especially important source of corporate growth in all the advanced industrial nations.[1] The 1970s saw the height of the diversification boom, with the emergence of a new corporate form – the *conglomerate* – represented in the US by ITT, Textron, and Allied-Signal, and in the UK by Hanson, Slater-Walker, and BTR. (Table 15.1 shows how the diversification strategies of US and UK firms have changed over time.) These highly diversified enterprises were created from multiple, unrelated acquisitions. Their

CSAC15 1/13/07 9:27 Page 396

TABLE 15.1 Changes in the Diversification Strategies of US and UK Companies

	United States			United Kingdom		
	1949	1964	1974	1950	1970	1993
Single business	42%	22%	14%	24%	6%	5%
Dominant business	28%	32%	23%	50%	32%	10%
Related business	28%	37%	42%	27%	57%	62%
Unrelated business	4%	9%	21%	0%	6%	24%

SOURCES: R. P. RUMELT, "DIVERSIFICATION STRATEGY AND PROFITABILITY," *STRATEGIC MANAGEMENT JOURNAL* 3 (1982): 359–70; R. WHITTINGTON, M. MAYER, AND F. CURTO, "CHANDLERISM IN POST-WAR EUROPE: STRATEGIC AND STRUCTURAL CHANGE IN FRANCE, GERMANY AND THE UK, 1950–1993," *INDUSTRIAL AND CORPORATE CHANGE* 8 (1999): 519–50; D. CHANNON, *THE STRATEGY AND STRUCTURE OF BRITISH ENTERPRISE* (CAMBRIDGE: HARVARD UNIVERSITY PRESS, 1973).

existence reflected the naive view that senior management no longer needed industry-specific experience and, so long as managers adopted the new techniques of financial and strategic management, companies no longer needed to be constrained by industry boundaries.[2]

Refocusing, 1980–2006

After 1980, the diversification trend went into sharp reverse. Between 1980 and 1990, the average index of diversification for the Fortune 500 declined from 1.00 to 0.67.[3] Unprofitable "noncore" businesses were increasingly divested during the later 1980s, and a number of diversified companies fell prey to leveraged buyouts.[4] Although acquisition activity was extremely heavy during the 1980s – some $1.3 trillion in assets were acquired, including 113 members of the Fortune 500 – only 4.5% of acquisitions represented unrelated diversification.[5] Moreover, acquisitions by the Fortune 500 were outnumbered by dispositions. The refocusing trend was strongest in the US, but was also evident in Canada and Europe and, to a lesser extent, in Japan.[6]

This trend towards specialization was the result of three principal factors.

Emphasis on Shareholder Value The overwhelmingly important factor driving the retreat from diversification and the refocusing around core businesses was the reordering of corporate goals from growth to profitability. Economic downturns and interest-rate spikes of the early 1980s and 1989–90 revealed the inadequate profitability of many large, diversified corporations. Increased pressure on incumbent management was exerted by institutional shareholders, including pension funds such as California's Public Employees Retirement system. One outcome of shareholder activism was increased CEO turnover.[7]

The surge in leveraged buyouts put further pressure on executives to boost shareholder returns. Where an incumbent management team had destroyed shareholder value, corporate raiders saw the opportunity to use debt financing to mount a takeover bid. Kohlberg Kravis Roberts' $25 billion takeover of the tobacco and food giant RJR Nabisco in 1989 demonstrated that even the largest US companies were not safe from acquisition.[8] The result was a rush by poorly performing corporate giants to restructure before leveraged buyout specialists did it for them. The tendency for the stock market to apply a "conglomerate discount" – to value diversified companies at market valuation of the whole was less than the sum of their parts – has added a further incentive for breakups.[9]

Turbulence and Transaction Costs In Chapter 13, we observed that the relative costs of organizing transactions within firms and across markets depend on the conditions in the external environment. Administrative hierarchies are very efficient in processing routine transactions, but in turbulent conditions the pressure of decision making on top management results in stress, inefficiency, and delay. As the business environment has become more volatile, specialized companies are more agile than large diversified corporations where strategic changes and investment proposals require approval at divisional and corporate levels. At the same time, external factor markets – capital markets especially – have become increasingly efficient. The tendency for some diversified companies to spin off their growth businesses has been influenced by the belief that these businesses could better exploit their growth opportunities by drawing directly on external markets for finance, human resources, and technology.

The refocusing trend has extended to Japan and South Korea, but in the emerging countries of Asia and Latin America, large conglomerates continue to dominate their national economies: Tata Group and Reliance in India, Charoen Pokphand in Thailand, Astra in Indonesia, Sime Darby in Malaysia, Grupo Alfa and Grupo Carso in Mexico. One reason for the continued dominance of large conglomerates in emerging market countries may be higher transaction costs associated with their less sophisticated and less efficient markets for finance, information, and labor that offer diversified companies advantages over their specialized competitors.[10]

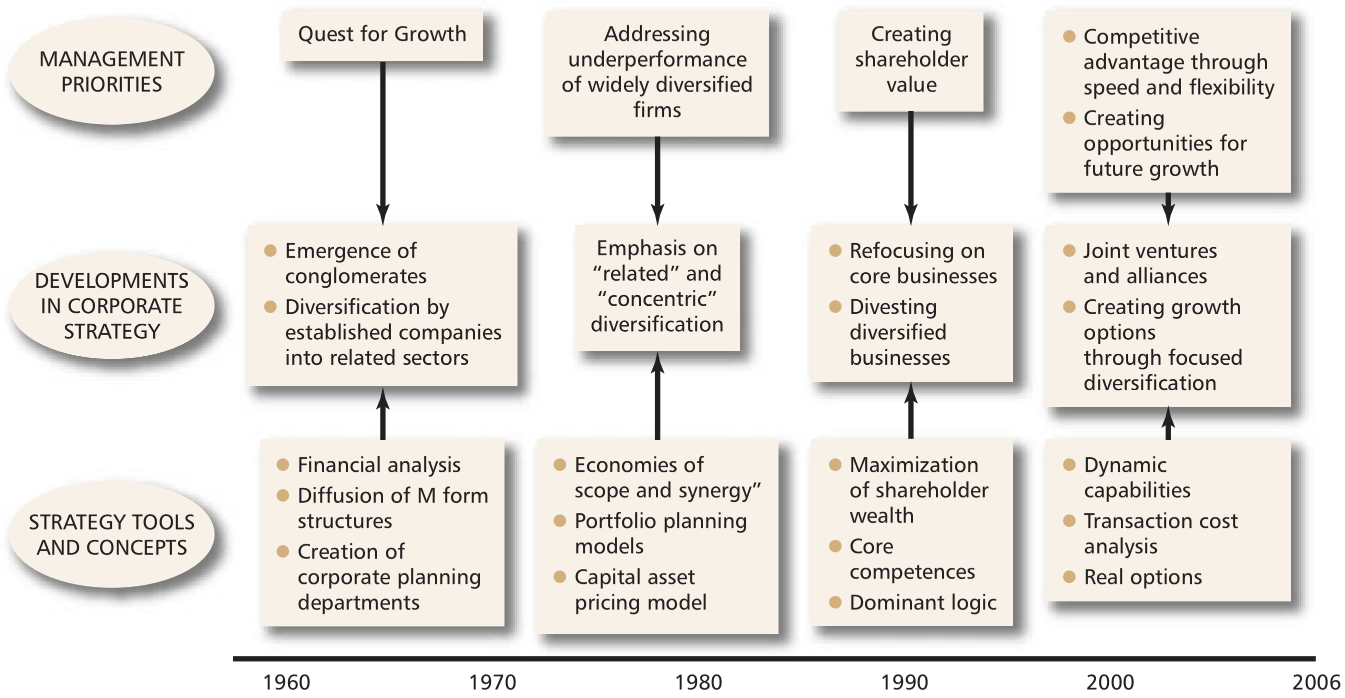
Trends in Management Thinking During the past decade there has been waring confidence in the ability of corporate headquarters to manage many different businesses, and greater emphasis on building competitive advantage by focusing on key strengths in resources and capabilities. If there are opportunities to deploy core resources and capabilities in new product markets, this is more likely to occur through collaborative arrangements with other companies rather than through diversification.

This is not to imply that ideas concerning synergies from operating in multiple product markets are dead. Indeed, recent years have seen continuing interest in economies of scope and the transferability of resources and capabilities across industry boundaries. The major change is that strategic analysis has become much more precise about the circumstances in which diversification can create value from multibusiness activity. Mere linkages between businesses are not enough: the key to creating value is the ability of the diversified firm to share resources and transfer capabilities more efficiently than alternative institutional arrangements. Moreover, it is essential that the benefits of these linkages are not outweighed by the additional management costs of exploiting them. Figure 15.1 summarizes some of the key developments in diversification strategy over the past 50 years.

Motives for Diversification

Diversification has been driven by three major goals: growth, risk reduction, and profitability. As we shall see, although growth and risk reduction have been prominent motives for diversification, they tend to be inconsistent with the creation of shareholder value.

FIGURE 15.1 Diversification: The Evolution of Strategy and Management Thinking



Growth

In the absence of diversification firms are prisoners of their industry. For firms in stagnant or declining industries this is a daunting prospect – especially if the industry faces ultimate demise. However, the critical issue for top management is whether the pursuit of growth is consistent with quest for profitability. In principle, a firm availing itself of investment opportunities outside its industry as well as within it should be entirely compatible with increasing its profit earnings. Indeed, for companies such as 3M and Canon, deploying their capabilities in new product markets is a key source of value creation. However, the overall evidence is to the contrary. As we noted in Chapter 6 when discussing the *agency problem*, managers have incentives to pursue growth rather than profitability, one of the most serious consequences of which is the propensity to undertake unprofitable diversification. Companies in low-growth, cash flow-rich industries such as tobacco and oil have been especially susceptible to the temptations of diversification. During the 1980s, Philip Morris diversified into soft drinks (7-Up), beer (Miller), chewing gum (Clark), and food (Kraft, General Foods), while Exxon diversified into copper and coal mining, electric motors, and computers and office equipment. It is notable that when public companies are under frequently resort to selling off diversified businesses.[11]

Risk Reduction

A second motive for diversification is the desire to spread risks. To isolate the effects of diversification on risk, consider the case of "pure" or "conglomerate" diversification, where separate businesses are brought under common ownership but the individual cash flows of the businesses remain unchanged. So long as the cash flows of the different businesses are imperfectly correlated, then the variance of the cash flow of the combined businesses is less than the average of that of the separate businesses. Hence, diversification reduces risk.

But does this risk reduction create value for shareholders? We must take account of the fact that investors hold diversified portfolios. If investors can hold diversified portfolios, what advantage can there be in companies diversifying for them? The only possible advantage could be if firms can diversify at lower cost than individual investors. In fact the reverse is true: the transaction costs to shareholders of diversifying their portfolios are far less than the transaction costs to firms diversifying through acquisition. Not only do acquiring firms incur the heavy costs of using investment banks and legal advisers, they must also pay an acquisition premium to gain control of an independent company.

The *capital asset pricing model* (CAPM) formalizes this argument. The theory states that the risk that is relevant to determining the price of a security is not the overall risk (variance) of the security's return, but *systematic risk*: that part of the variance of the return that is correlated with overall market returns. Systematic risk is measured by the security's *beta coefficient*. Corporate diversification does not reduce systematic risk: if three separate companies are brought under common ownership, in the absence of any other changes, the beta coefficient of the combined company is simply the weighted average of the beta coefficients of the constituent companies. Hence, the simple act of bringing different businesses under common ownership does not create shareholder value through risk reduction.[12]

Empirical studies are generally supportive of the absence of shareholder benefit from diversification that simply combines independent businesses. Studies of conglomerates in the United States have shown that their risk-adjusted returns to shareholders are typically no better than those offered by mutual funds or by matched portfolios of specialized companies.[13] Unrelated diversification may even fail to lower unsystematic risk.[14]

Hence, so long as securities markets are efficient, diversification whose sole purpose is to spread risk will not benefit shareholders. However, risk spreading through diversification may benefit other stakeholders. If cyclicality in the firm's profits is accompanied by cyclicality in employment, then so long as employees are transferable between the separate businesses of the firm, there may be benefits to employees from diversification's ability to smooth output fluctuations.

Special issues arise once we consider the risk of bankruptcy. For a marginally profitable firm, diversification can help avoid cyclical fluctuations of profits that can push it into insolvency. It has been shown, however, that diversification that reduces the risk of bankruptcy is beneficial to the holders of corporate debt rather than to equity holders. The reduction in risk that bondholders derive from diversification is the *coinsurance effect*.[15]

Are there circumstances where reductions in unsystematic risk can create shareholder value? If there are economies to the firm from financing investments internally rather than resorting to external capital markets, the stability in the firm's cash flow that results from diversification may reinforce independence from external capital markets. For Exxon Mobil, BP, and the other major oil companies one of the benefits of extending across upstream (exploration and production), downstream (refining and marketing), and chemicals is that the negative correlation of the returns from these businesses increases the overall stability of their cash flows. This in turn increases their capacity to undertake huge, risky investments in offshore oil production, transcontinental pipelines, and natural gas liquefaction. These benefits also explain why firms pursue hedging activities that only reduce unsystematic risk.[16]

Profitability

If we return to the assumption that corporate strategy should be directed toward the interests of shareholders, what are the implications for diversification strategy? We have already revisited our two sources of superior profitability: industry attractiveness and competitive advantage. For firms contemplating diversification, Michael Porter proposes three "essential tests" to be applied in deciding whether diversification will truly create shareholder value:

1. *The attractiveness test*. The industries chosen for diversification must be structurally attractive or capable of being made attractive.
2. *The cost-of-entry test*. The cost of entry must not capitalize all the future profits.
3. *The better-off test*. Either the new unit must gain competitive advantage from its link with the corporation, or vice versa.[17]

The Attractiveness and Cost-of-entry Tests A critical realization in Porter's "essential tests" is that industry attractiveness is insufficient on its own. Although diversification is a means by which the firm can access more attractive investment opportunities than are available in its own industry, it faces the problem of entering the new industry. The second test, *cost of entry*, recognizes that the attractiveness of an industry to a firm already established in an industry may be different from its attractiveness to a firm seeking to enter the industry. Pharmaceuticals, management consulting, and investment banking offer above-average profitability precisely because they are protected by barriers to entry. Firms seeking to enter these industries have a choice. They may enter by acquiring an established player, in which case not only does the market price of the target firm reflect the superior profit prospects of the industry, but the diversifying firm must also offer an acquisition premium of around 25 to 50% over the market price to gain control.[18] Alternatively, entry may occur through establishing a new corporate venture. In this case, the diversifying firm must directly confront the barriers to entry protecting that industry, which usually means low returns over a long period.[19]

The "Better-off" Test Porter's third criterion for successful diversification – *the better-off test* – addresses the basic issue of competitive advantage: if two businesses producing different products are brought together under the ownership and control of a single enterprise, is there any reason why they should become any more profitable? Combining different, but related, businesses can enhance the competitive advantages of the original business, the new business, or both. For example:

- Procter & Gamble's 2005 acquisition of Gillette was intended to boost the competitive position of both companies through combining the two companies' global marketing and distribution networks, transferring Gillette's new product development capabilities to P&G, and increasing both companies' bargaining power relative to retail giants such as Wal-Mart.
- Allianz's takeover of Dresdner Bank in 2001 to create the world's biggest bank-assurance company was to enable Allianz to sell its insurance products through Dresdner's retail bank network, to strengthen Dresdner's finance, and to allow the two companies to combine forces in creating pensions and investment products for Germany's aging baby-boomers.

Yet, although the potential for value creation from exploiting linkages between the different businesses may be considerable, the practical difficulties of exploiting such opportunities have made diversification a corporate minefield. Let us examine the issues systematically.

Competitive Advantage from Diversification

If the primary source of value creation from diversification is exploiting linkages between different businesses, what are the linkages and how are they exploited? As we shall see, the primary means by which diversification creates competitive advantage is through the sharing of resources and capabilities across different businesses. There is also the potential for diversification to enhance or exploit a firm's market power. However, since this possibility has interested antitrust authorities more than it has corporate managers, we will defer its discussion to an appendix to this chapter.

Economies of Scope

The most general argument concerning the benefits of diversification focuses on the presence of *economies of scope* in common resources:

Economies of scope exist whenever there are cost savings from using a resource in multiple activities carried out in combination rather than carrying out those activities independently.[20]

Economies of scope exist for similar reasons as *economies of scale*. The key difference is that the economies of scale relate to cost economies from increasing output for a single product; economies of scope are cost economies from increasing output across multiple products.[21] The nature of economies of scope varies between different types of resources and capabilities.

Tangible Resources Tangible resources – such as distribution networks, information technology systems, sales forces, and research laboratories – offer economies of scope by eliminating duplication between businesses through creating a single shared facility. The greater the fixed costs of these items, the greater the associated economies of scope are likely to be. Entry by cable TV companies into telephone services, and telephone companies into cable TV, are motivated by the desire to spread the costs of networks and billing systems over as great a volume of business as possible. Similar considerations have encouraged British Gas, a former state-owned monopoly supplier of gas, to diversify into supplying electricity, fixed-line telephone services, mobile telephone services, broadband internet connections, home security systems, home insurance, and home appliance repair.

Economies of scope also arise from the centralized provision of administrative and support services by the corporate center to the different businesses of the corporation. Among diversified companies, accounting, legal services, government relations, and information technology tend to be centralized – often through *shared service organizations* that supply common administrative and technical services to the operating businesses. Similar economies arise from centralizing research activities in a corporate R&D lab. In aerospace, the ability of US companies such as Boeing and United Technologies to spread research expenditures over both military and civilian products has given these companies an advantage over overseas competitors with more limited access to large defense contracts.[22]

Economies of scope can also arise in finance. By combining an industrial company with a financial services company, General Electric lowers its cost of capital to both sides of the company.

Intangible Resources Intangible resources such as brands, corporate reputation, and technology offer economies of scope from the ability to extend them to additional businesses at low marginal cost.[23] Exploiting a strong brand across additional products is called *brand extension*. Starbucks has extended its brand to ice cream, Starbucks bottled drinks, home espresso machines, and books.

Organizational Capabilities Organizational capabilities can also be transferred within the diversified company. For example:

- LVMH is the world's biggest and most diversified supplier of branded luxury goods. Its distinctive capability is the management of luxury brands. This capability comprises market analysis, advertising, promotion, retail management, and quality assurance. These capabilities are deployed across Louis Vuitton (accessories and leather goods); Hennessey (cognac); Moet et Chandon, Dom Perignon, Verve Cliquot, and Krug (champagne); Celine, Givenchy, Kenzo, Dior, Guerlain, and Donna Karan (fashion clothing and perfumes); TAG Heuler and Chaumet (watches); Sephora and La Samaritaine (retailing); and some 25 other branded businesses.

- Sharp Corporation – originally established to manufacture metal products and the Ever Sharp Pencil – developed capabilities in the miniaturization of electronic products that it has deployed to develop and introduce a stream of innovative products, beginning with the world's first transistor calculator (1964), the first LCD pocket calculator (1973), LCD color TVs, PDAs, internet viewcams, ultraportable notebook computers, and 3G mobile telephones.

Some of the most important capabilities in influencing the performance of diversified corporations are *general management capabilities*. General Electric possesses strong technological and operational capabilities at business level and it is good at sharing these capabilities between businesses (e.g. turbine know-how between jet engines and electrical generating equipment. However, its core capabilities are in general management and these reside primarily at the corporate level. These include its ability to motivate and develop its managers, its outstanding strategic and financial management that reconciles decentralized decision making with strong centralized control, and its international management capability. Similar observations could be made about 3M. While 3M's capabilities in technical know-how, new product development, and international marketing reside within the individual businesses, it is the corporate management capabilities and the systems through which they are exercised that maintain, nourish, coordinate, and upgrade these competitive advantages.[24]

Economies from Internalizing Transactions

Although economies of scope provide cost savings from sharing and transferring resources and capabilities, does a firm have to diversify across these different businesses to exploit those economies? The answer is no. Economies of scope in resources and capabilities can be exploited simply by selling or licensing the use of the resource or capability to another company. In Chapter 11, we observed that a firm can exploit proprietary technology by licensing it to other firms. In Chapter 14, we noted how technology and trademarks are licensed across national frontiers as an alternative to direct investment. The same can be done to exploit resources across different industries. Starbucks' extension of its brand to other products has been achieved primarily through licensing: Pepsi produces and distributes Starbucks Frappaccino; Breyer's produces Starbucks ice cream. Walt Disney exploits the enormous value of its trademarks, copyrights, and characters partly through diversification into theme parks, live theater, cruise ships, and hotels; and partly through licensing the use of these assets to producers of clothing, toys, music, comics, food, and drinks, as well as to the franchisees of Disney's retail stores. Disney's income from licensing fees and royalties was over $2 billion in 2005.

Even tangible resources can be shared across different businesses through market transactions. Airport and railroad station operators exploit economies of scope in their facilities not by diversifying into catering and retailing, but by leasing out space to specialist retailers and restaurants.

What determines whether economies of scope are better exploited internally within the firm through diversification, or externally through market contracts with independent companies? The key issue is relative efficiency: what are the transaction costs of market contracts, as compared with the administrative costs of a diversified enterprise? Transaction costs include the costs involved in drafting, negotiating, monitoring, and enforcing a contract. The costs of internalization consist of the management costs of establishing and coordinating the diversified business.[25]

Let's return to the Walt Disney Company. Why does Disney choose to license Donald Duck trademarks to a manufacturer of orange juice rather than set up its own orange juice company? Why does it own and operate its own Disneyland and Disney World theme parks rather than license its trademarks to independent theme park companies? And why, in the case of Tokyo Disneyland, did it choose a licensing arrangement with the Oriental Land Company, which owns and operates Tokyo Disneyland?

These issues are complex. Much depends on the characteristics of the resource or capabilities. Though the returns to patents and brand names can often be appropriated efficiently through licensing, complex general management capabilities may be near impossible to exploit through market contracts. There is little scope for 3M to deploy its new product development capabilities other than within its own business. Similarly, for Apple Computer, the only way for it to exploit its capabilities in innovation and user-friendly design outside its core computer business was for it to diversify into other areas of entertainment and consumer electronics. The more deeply embedded a firm's capabilities within the management systems and the culture of the organization, the greater the likelihood that these capabilities can only be deployed internally within the firm. In principle, Virgin could license its brand to other companies. In practice, the value of the Virgin brand depends critically on the dynamism of Virgin companies, the irreverence of the Virgin culture, and the personality of Richard Branson.

The Diversified Firm as an Internal Market

We see that economies of scope on their own do not provide an adequate rationale for diversification – they must be supported by the presence of transaction costs. However, the presence of transaction costs in any nonspecialized resource can offer efficiency gains from diversification, even where no economies of scope are present.

Internal Capital Markets Consider the case of financial capital. The diversified firm represents an internal capital market: the corporate allocating capital between the different businesses through the capital expenditure budget. Which is more efficient, the internal capital markets of diversified companies or the external capital market? Diversified companies have two key advantages:

- By maintaining a balanced portfolio of cash-generating and cash-using businesses, diversified firms can avoid the costs of using the external capital market, including the margin between borrowing and lending rates and the heavy costs of issuing new debt and equity.
- Diversified companies have better access to information on the financial prospects of their different businesses than that typically available to external financiers.[26]

Against these advantages is the critical disadvantage that investment funds within the diversified company are not allocated solely on the basis of potential returns.

Corporate management is likely to be subject to goals other than shareholder value maximization and capital allocation tends to be a politicized process. How do these conflicting factors balance out? Despite inconsistent findings, the balance of the evidence is that diversified firms exhibit key weaknesses in their internal capital markets, including a tendency to cross-subsidize their poorly performing divisions, to waste resources in internal political competition for funding, and reluctance to transfer divisional cash flows to the divisions with the best prospects.[27] However, overall averages obscure sharp differences in the efficiency of capital allocation between different diversified companies. Makron Associated identified several conglomerates with exceptional performance in terms of ten-year shareholder returns. They included GE and Berkshire Hathaway of the US, Hutchison Wampoa of Hong Kong, Bouygues and Lagardere of France, Wesfarmers of Australia, ITC of India, and Carso of Mexico. The common characteristics of these companies were: "Strict financial discipline, rigorous analysis and valuation, a refusal to overpay for acquisitions, and a willingness to close or sell existing businesses."[28]

Internal Labor Markets Efficiencies also arise from the ability of diversified companies to transfer employees – especially managers and technical specialists – between their divisions, and to rely less on hiring and firing. As companies develop and encounter new circumstances, so different management skills are required. The costs associated with hiring include advertising, the time spent in interviewing and selection, and the costs of "head-hunting" agencies. The costs of dismissing employees can be very high where severance payments must be offered. A diversified corporation has a pool of employees and can respond to the specific needs of any one business through transfer from elsewhere within the corporation.

The broader set of opportunities available in the diversified corporation as a result of internal transfer may also result in attracting a higher caliber of employee. Graduating students compete intensely for entry-level positions with diversified corporations such as Canon General Electric, Unilever, and Nestlé in the belief that these companies can offer richer career development than more specialized companies.

The informational advantages of diversified firms are especially important in relation to internal labor markets. A key problem of hiring from the external labor market is limited information. A resumé, references, and a day of interviews are a poor indicator of how an otherwise unknown person will perform in a specific job. The diversified firm that is engaged in transferring employees between business units and divisions has access to much more detailed information on the abilities, characteristics, and past performance of each of its employees. This informational advantage exists not only for individual employees but also for groups of individuals working together as teams. As a result, in diversifying into a new activity, the established firm is at an advantage over the new firm, which must assemble a team from scratch with poor information on individual capabilities and almost no information on how effective the group will be at working together.

Diversification and Performance

We have established that diversification has the potential to create value for shareholders where it exploits economies of scope and where transaction costs in the markets for resources make it inefficient to exploit these economies of scope through market contracts. Diversification that seeks to reduce risk or achieve growth is likely to destroy shareholder value. How do these predictions work in practice?

The Findings of Empirical Research

Empirical research into diversification has concentrated on two major issues: first, how do diversified firms perform relative to specialized firms and, second, does related diversification outperform unrelated diversification?

The Performance of Diversified and Specialized Firms Despite a large number of empirical studies over four decades, no consistent, systematic relationships have emerged between performance and the degree of diversification. However, there is some evidence that, beyond a certain point, high levels of diversification are associated with deteriorating profitability – possibly because of the problems of complexity that diversification creates. Among British companies, diversification was associated with increased profitability up to a point, after which further diversification was associated with declining profitability.[29] Other studies have also detected a curvilinear relationship between diversification and profitability.[30] Research by McKinsey & Company offers further evidence of the benefits of moderate diversification – "a strategic sweet spot between focus and broader diversification." Timing is the key, they note. Diversification makes sense when a company has exhausted growth opportunities in its existing markets and can match its existing capabilities to emerging external opportunities.[31] As with most studies seeking to link strategy to performance, a key problem is distinguishing *association* from *causation*. If diversified companies are generally more profitable than specialized firms, is it because diversification increases profitability or because profitable firms channel their cash flows into diversifying investments?

It is also likely that the performance effects of diversification depend on the mode of diversification. There is a mass of evidence pointing to the poor performance of mergers and acquisitions in general – for acquiring firms, the stock market returns to acquisition are unequivocally negative.[32] Among these, mergers and acquisitions involving companies in different industries appear to perform especially poorly.[33]

Some of the most powerful evidence concerning the relationship between diversification and performance relates to the refocusing initiatives by a large number of North American and European companies. The evidence, ranging from conglomerates such as ITT and Hanson, to the oil majors, tobacco companies, and engineering companies such as Daimler-Benz, is that narrowing business scope leads to increased profitability and higher stock market valuation. Markides provides systematic evidence of the performance gains to diversified companies from divesting non-core activities.[34] This may reflect a changing relationship between diversification and profitability over time: the growing turbulence of the business environment may have increased the costs of managing complex, diversified corporations. As already noted, the stock market's verdict on diversification has certainly shifted over time, with highly diversified firms having their earnings valued at a deficit rather than a premium to the overall market and takeover announcements being greeted by share price reductions for bidding firms.[35] As a result, diversified companies have fallen prey to leveraged buyout specialists seeking to add value through dismembering these companies.

Related and Unrelated Diversification Given the importance of economies of scope in shared resources and capabilities, it seems likely that diversification into *related* industries should be more profitable than diversification into *unrelated* industries. Empirical research initially supported this prediction. Rumelt discovered that companies that diversified into businesses closely related to their core activities were significantly more profitable than those that pursued unrelated diversification.[36] By 1982, Tom Peters and Robert Waterman were able to conclude: "virtually every academic study has concluded that unchanneled diversification is a losing proposition."[37] This observation provided the basis for one of Peters and Waterman's "golden rules of excellence" – *Stick to the Knitting*:

> *Our principal finding is clear and simple. Organizations that do branch out but stick very close to their knitting outperform the others. The most successful are those diversified around a single skill, the coating and bonding technology at 3M for example. The second group in descending order, comprise those companies that branch out into related fields, the leap from electric power generation turbines to jet engines from GE for example. Least successful, as a general rule, are those companies that diversify into a wide variety of fields. Acquisitions especially among this group tend to wither on the vine.*[38]

However, other evidence shattered this consistent picture. The apparent superiority of related diversifiers could be explained by the impact of risk and industry influences.[39] Some studies even found unrelated diversification to be more profitable than related.[40]

The lack of clear performance differences between related and unrelated diversification is troubling. Three factors may help explain the confused picture. First, related diversification may offer greater potential benefits, but may also pose more difficult management problems for companies such that the potential benefits are not realized. I shall address this issue in Chapter 16. Second, the tendency for related diversification to outperform unrelated diversification might be the result of poorly performing firms rushing into unrelated diversification.[41] Third, the distinction between "related" and "unrelated" diversification is not always clear. Relatedness refers to common resources and capabilities, not similarities of products and technologies. Thus, champagne and luggage are not obviously related products: however, LVMH applies similar brand management capabilities to them. Let us consider this issue further.

The Meaning of Relatedness in Diversification

If relatedness refers to the potential for sharing and transferring resources and capabilities between businesses, there are no unambiguous criteria to determine whether two industries are related – it all depends on the company undertaking the diversification. Empirical studies have defined relatedness in terms of similarities between industries in technologies and markets. These similarities emphasize relatedness at the *operational* level – in manufacturing, marketing, and distribution – typically activities where economies from resource sharing are small and achieving them is costly in management terms. Conversely, some of the most important sources of value creation within the diversified firm are the ability to apply common general management capabilities, strategic management systems, and resource allocation processes to different businesses. Such economies depend on the existence of *strategic* rather than *operational* commonalities among the different businesses within the diversified corporation.[42]

TABLE 15.2 The Determinants of Strategic Relatedness between Businesses

Corporate Management Tasks	Determinants of Strategic Similarity
Resource allocation	Similar sizes of capital investment projects Similar time spans of investment projects Similar sources of risk Similar general management skills required for business unit managers
Strategy formulation	Similar key success factors Similar stages of the industry life cycle Similar competitive positions occupied by each business within its industry
Performance management and control	Targets defined in terms of similar performance variables Similar time horizons for performance targets

SOURCE: R. M. GRANT, "ON DOMINANT LOGIC, RELATEDNESS, AND THE LINK BETWEEN DIVERSITY AND PERFORMANCE," *STRATEGIC MANAGEMENT JOURNAL*, 9 (1988): 641.

- Berkshire Hathaway is involved in insurance, candy stores, furniture, kitchen knives, jewelry, and footwear. Despite this diversity, all these businesses have been selected on the basis of their ability to benefit from the unique style of corporate management established by chairman Warren Buffett and CEO Charles Munger.
- Richard Branson's Virgin Group covers a huge array of businesses from airlines to bridal stores. Yet, they share certain strategic similarities: almost all are startup companies that benefit from Branson's entrepreneurial zeal and expertise; almost all sell to final consumers and are in sectors that offer opportunities for innovative approaches to differentiation.

The essence of such strategic-level linkages is the ability to apply similar strategies, resource allocation procedures, and control systems across the different businesses within the corporate portfolio.[43] Table 15.2 lists some of the strategic factors that determine similarities among businesses in relation to corporate management activities.

Unlike operational relatedness, where the benefits of exploiting economies of scope in joint inputs are comparatively easy to forecast, and even to quantify, relatedness at the strategic level may be much more difficult to appraise.

Diversification decisions are determined more by perceived relatedness than by actual relatedness. Prahalad and Bettis use the term *dominant logic* to refer to managers' cognition of the rationale that links their different business activities.[44] Certainly, a dominant logic in the form of a common view within the company as to its identity and rationale is a critical precondition for effective integration across different businesses. (This issue is discussed further in Chapter 16.) There is a danger, however, that dominant logic may not be underpinned by any true economic synergies. In the same way that Allegis Corporation attempted to diversify around serving the needs of the traveler, so General Mills diversified into toys, fashion clothing, specialty retailing, and restaurants on the basis of "understanding the needs and wants of the homemaker."

Summary

Diversification is like sex: its attractions are obvious, often irresistible. Yet, the experience is often disappointing. For top management it is a minefield. The diversification experiences of large corporations are littered with expensive mistakes: Exxon's attempt to build Exxon Office Systems as a rival to Xerox and IBM, Vivendi's diversification from water and environmental services into media, entertainment, and telecoms, AT&T's entry into computers with its acquisition of NCR. Despite so many costly failures, the urge to diversify continues to captivate senior managers. Part of the problem is the divergence between managerial and shareholder goals. While diversification has offered meager rewards to shareholders, it is the fastest route to building vast corporate empires. A further problem is hubris. A company's success in one line of business tends to result in the top management team becoming overconfident of its ability to achieve similar success in other businesses.

Nevertheless, if companies are to survive and prosper over the long term they must change, and this change inevitably involves redefining the businesses in which the company operates. Hewlett-Packard and IBM are among the longest-established companies in the fast-paced US electronics industry. The success and longevity of both have been based on their ability to adapt their product lines to changing market opportunities. While HP has shifted from measuring instruments to computers and printers, to cameras and other imaging products, IBM has moved from typewriters to computers to consulting services. New entrepreneurial startups will typically pioneer the development of new industries; at the same time the sophisticated organizational capabilities of large, long-established corporations offer the potential for these companies to create value in other industries when their core businesses are in decline. The histories of 3M, Canon, Samsung, and DuPont show that diversification is a central theme in the process by which large companies successfully evolve. In most examples of successful long-term evolution, diversification did not represent a discontinuity, it was typically a logical step in which existing resources and capabilities were deployed outside of the existing portfolio of businesses.

If companies are to use diversification as part of their long-term adaptation and avoid the many errors that corporate executives have made in the past, then better strategic analysis of diversification decisions is essential. The objectives of diversification need to be clear and explicit. Shareholder value creation has provided a demanding and illuminating criterion with which to appraise investment in new business opportunities. Rigorous analysis may also counter the tendency for diversification to be a diversion, a form of escapism resulting from the unwillingness of top management to come to terms with difficult competitive circumstances in the firm's core businesses.

The analytic tools at our disposal for evaluating diversification decisions have developed greatly in recent years. Twenty years ago, diversification decisions were based on vague concepts of synergy that involved the identification of linkages between different industries. More specific analysis of the nature and extent of economies of scope in resources and capabilities has given greater precision to our analysis of synergy. At the same time, we recognize that economies of scope are insufficient to ensure that diversification creates value. A critical issue is the optimal organizational form for exploiting these economies. The transaction costs of markets must

CSAC15 1/13/07 9:27 Page 410

be compared against the management costs of the diversified corporation. These management costs depend heavily on the top management capabilities and management systems of the particular company. This type of analysis has caused many companies to realize that economies of scope often can be exploited more efficiently and with less risk through collaborative relationships with other companies rather than through diversification.

Self-Study Questions

1 An ice cream manufacturer is proposing to acquire a soup manufacturer on the basis that, first, its sales and profits will be more seasonally balanced and, second, from year to year, sales and profits will be less affected by variations in weather. Will this risk spreading create value for shareholders? Under what circumstances could this acquisition create benefits for shareholders?

2 Tata Group is one of India's largest companies employing 203,000 people in many different industries, including steel, motor vehicles, watches and jewelry, telecommunications, financial services, management consulting, food products, tea, chemicals and fertilizers, satellite TV, hotels, motor vehicles, energy, IT, and construction. Such diversity far exceeds that of any North American or western European company. What are the conditions in India that might make such broad-based diversification both feasible and profitable?

3 Giorgio Armani SpA is an Italian private company owned mainly by the Armani family. Most of its clothing and accessories are produced and marketing by the company (some are manufactured by outside contractors). For other products, notably fragrances, cosmetics, and eyewear, Armani licenses its brand names to other companies. Armani is considering expanding into athletic clothing, hotels, and bridal shops. Advise Armani on whether these new businesses should be developed in-house, by joint ventures, or by licensing the Armani brands to specialist companies already within these fields.

4 General Electric, Berkshire Hathaway, and Richard Branson's Virgin Group each comprise a wide range of different businesses that appear to have few close technical or customer linkages. Are these examples of unrelated diversification and do the corporate and ownership links within each of the groups result in the creation of any value? If so, what are the sources of this value creation?

Appendix: Does Diversification Confer Market Power?

The potential for diversification to enhance profitability by increasing a firm's market power and suppressing competition has been a continuing interest for antitrust authorities in the United States and Europe – and more recently in Japan and South Korea. It has been claimed that large diversified companies can exercise market power through four mechanisms:

- *Predatory pricing*. Just as global corporations derive strength from their ability to finance competitive battles in individual markets through cross-subsidization, so multibusiness companies can use their size and diversity to discipline or even drive out specialized competitors in particular product markets through predatory pricing – cutting prices to below the level of rivals' costs. In 2003, following up complaints from AOL, the European Commission fined France Telecom 10 million euros for the predatory pricing of ISP services by its subsidiary Wanadoo.[45]
- *Bundling*. A diversified firm can extend its monopoly in one market into a related market by bundling the two products together. US Justice Department claimed Microsoft abused its monopoly power in PC operating systems by bundling its Explorer web browser with Windows, thereby squeezing Netscape from the browser market. The European Union made a similar case against Microsoft regarding its bundling of its media player with Windows.[46]
- *Reciprocal dealing*. A diversified company can leverage its market share across its businesses by reciprocal buying arrangements. These involve offers of the type: "I'll buy from you if you buy from me." A recent case involved Intel, which refused to supply microprocessors to Intergraph Corporation unless Intergraph licensed certain technology to Intel free of charge.[47] The potential for reciprocal dealing is greatest in those emerging market economies where a few large companies span many sectors.
- *Mutual forbearance*. Corwin Edwards argued that:

  > *When one large conglomerate enterprise competes with another, the two are likely to encounter each other in a considerable number of markets. The multiplicity of their contacts may blunt the edge of their competition. A prospect of advantage in one market from vigorous competition may be weighed against the danger of retaliatory forays by the competitor in other markets. Each conglomerate may adopt a live-and-let-live policy designed to stabilize the whole structure of the competitive relationship.*[48]

  Game theory shows that such *multimarket competition* is likely to inhibit aggressive action in any one market for fear of triggering more generalized warfare.[49] Empirical evidence suggest that such behavior is most likely among companies that meet in multiple geographical markets for the same product or service – the airline industry, for example.[50] Such tendencies may also exist where diversified companies meet in multiple product markets.[51]

Notes

1 A. D. Chandler Jr., *Strategy and Structure: Chapters in the History of the Industrial Enterprise* (Cambridge, MA: MIT Press, 1962); R. P. Rumelt, *Strategy, Structure and Economic Performance* (Cambridge, MA: Harvard University Press, 1974); H. Itami, T. Kagono, H. Yoshihara, and S. Sakuma, "Diversification Strategies and Economic Performance," *Japanese Economic Studies* 11, no. 1 (1982): 78–110.

2 M. Goold and K. Luchs, "Why Diversify? Four Decades of Management Thinking," *Academy of Management Executive* 7, no. 3 (August 1993): 7–25.

3 G. F. Davis, K. A. Diekman, and C. F. Tinsley, "The Decline and Fall of the Conglomerate Firm in the 1980s: A Study in the De-Institutionalization of an Organizational Form," *American Sociological Review* 49 (1994): 547–70.

4 For a discussion of restructuring of diversified companies, see R. E. Hoskisson and M. A. Hitt, *Downscoping: How to Tame the Diversified Firm* (New York: Oxford University Press, 1994).
5 A. Shleifer and R. W. Vishny, "The Takeover Wave of the 1980s," *Science* 248 (July–September 1990): 747–9.
6 L. G. Franko, "The Death of Diversification: The Focusing of the World's Industrial Firms, 1980–2000", *Business Horizons* (July–August 2004): 41–50.
7 During 2004 and 2005 CEO turnover reached an all-time high. See Booz Allen Hamilton, *CEO Succession 2005* (2006, www.boozallen.com/publications).
8 B. Burrough, *Barbarians at the Gate: The Fall of RJR Nabisco* (New York: Harper & Row, 1990).
9 L. Laeven and R. Levine, "Is there a Diversification Discount in Financial Conglomerates," *Journal of Financial Economics* 82 (2006).
10 T. Khanna and K. Palepu, "Why Focused Strategies May Be Wrong for Emerging Markets," *Harvard Business Review* (July–August 1997): 41–51; D. Kim, D. Kandemir, and S. T. Cavusgil, "The Role of Family Conglomerates in Emerging Markets," *Thunderbird International Business Review* 46 (January 2004): 7–20.
11 D. A. Ravenscraft and F. M. Scherer, "Divisional Selloff: A Hazard Analysis," in *Mergers, Selloffs and Economic Efficiency* (Washington, DC: Brookings Institute, 1987); M. E. Porter, "From Competitive Advantage to Corporate Strategy," *Harvard Business Review* (May–June 1987): 43–59.
12 These principles are outlined in any standard corporate finance text. See, for example, R. A. Brealey, S. Myers, and F. Allen, *Principles of Corporate Finance*, 8th edn (McGraw-Hill, 2006): Chapter 8.
13 See, for example, H. Levy and M. Sarnat, "Diversification, Portfolio Analysis and the Uneasy Case for Conglomerate Mergers," *Journal of Finance* 25 (1970): 795–802; R. H. Mason and M. B. Goudzwaard, "Performance of Conglomerate Firms: A Portfolio Approach," *Journal of Finance* 31 (1976): 39–48; J. F. Weston, K. V. Smith, and R. E. Shrieves, "Conglomerate Performance Using the Capital Asset Pricing Model," *Review of Economics and Statistics* 54 (1972): 357–63.
14 M. Lubatkin and S. Chetterjee, "Extending Modern Portfolio Theory into the Domain of Corporate Strategy: Does It Apply?," *Academy of Management Journal* 37 (1994): 109–36.
15 L. W. Lee, "Coinsurance and the Conglomerate Merger," *Journal of Finance* 32 (1977): 1527–37.
16 S. M. Bartram, "Corporate Risk Management as a Lever for Shareholder Value Creation," *Financial Markets, Institutions and Instruments* 9 (2000): 279–324.
17 M. E. Porter, "From Competitive Advantage to Corporate Strategy," *Harvard Business Review* (May–June 1987): 46.
18 M. Hayward and D. C. Hambrick, "Explaining the Premiums Paid for Large Acquisitions," *Administrative Science Quarterly* 42 (1997): 103–27.
19 A study of 68 diversifying ventures by established companies found that, on average, breakeven was not attained until the seventh and eighth years of operation: R. Biggadike, "The Risky Business of Diversification," *Harvard Business Review* (May–June 1979).
20 The formal definition of economies of scope is in terms of "sub-additivity." Economies of scope exist in the production of goods $x_1, x_2, \ldots, x_n$, if $C(X) < \sum_i C_i(x_i)$

where: $X = \sum_i (x_i)$
$C(X)$ is the cost of producing all n goods within a single firm
$\sum_i C_i(x_i)$ is the cost of producing the goods in n specialized firms.

See W. J. Baumol, J. C. Panzar, and R. D. Willig, *Contestable Markets and the Theory of Industry Structure* (New York: Harcourt Brace Jovanovich, 1982): 71–2.
21 Economies of scope can arise in consumption as well as in production: customers may prefer to buy different products from the same supplier. See T. Cottrell and B. R. Nault, "Product Variety and Firm Survival in Microcomputer Software," *Strategic Management Journal* 25 (2004): 1005–26.
22 More generally, research intensity is strongly associated with diversification. For the US, see C. H. Berry, *Corporate Growth and Diversification* (Princeton: Princeton University Press, 1975); for the UK, see R. M. Grant, "Determinants of the Interindustry Pattern of Diversification by U.K. Manufacturing Companies," *Bulletin of Economic Research* 29 (1977): 84–95.
23 There is some evidence to the contrary. See H. Park, T. A. Kruse, K. Suzuki, and K. Park, "Long-term Performance Following Mergers of Japanese Companies: The Effect of Diversification and Affiliation," *Pacific Basin Finance Journal* 14 (2006); P. R. Nayyar, "Performance Effects of Information Asymmetry and Economies of Scope in Diversified Service Firms," *Academy of Management Journal* 36 (1993): 28–57.
24 The role of capabilities in diversification is discussed in C. C. Markides and P. J. Williamson, "Related Diversification, Core Competencies and Corporate Performance," *Strategic Management Journal* 15 (Special Issue, 1994): 149–65.
25 This issue is examined more fully in D. J. Teece, "Towards an Economic Theory of the Multiproduct Firm," *Journal of Economic Behavior and Organization* 3 (1982): 39–63.
26 J. P. Liebeskind, "Internal Capital Markets: Benefits, Costs and Organizational Arrangements," *Organization Science* 11 (2000): 58–76.
27 D. Scharfstein and J. Stein, "The Dark Side of Internal Capital Markets: Divisional Rent Seeking and Inefficient Investment," *Journal of Finance* 55 (2000): 2537–64; V. Maksimovic and G. Phillips, "Do Conglomerate Firms Allocate Resources Inefficiently Across Industries?" *Journal of Finance* 57 (2002): 721–67; R. Rajan,

H. Servaes, and L. Zingales, "The Cost of Diversity: The Diversification Discount and Inefficient Investment," *Journal of Finance* 55 (2000): 35–84.
28 C. Kaye and J. Yuwono, "Conglomerate Discount or Premium? How Some Diversified Companies Create Exceptional Value," Marakon Associates (2003).
29 R. M. Grant, A. P. Jammine, and H. Thomas, "Diversity, Diversification and Performance in British Manufacturing Industry," *Academy of Management Journal* 31 (1988): 771–801.
30 L. E. Palich, L. B. Cardinal, and C. C. Miller, "Curvilinearity in the Diversification-Performance Linkage: An Examination of over Three Decades of Research," *Strategic Management Journal* 22 (2000): 155–74.
31 N. Harper and S. P. Viguerie, "Are You Too Focused?" *McKinsey Quarterly* (2002 Special Edition): 29–37.
32 G. Andrade, M. Mitchell, and Erik Stafford, "New Evidence and Perspectives on Mergers," *Journal of Economic Perspectives* 5, no. 3 (2001): 103–120.
33 J. D. Martin and A. Sayrak, "Corporate, Diversification and Shareholder Value: A Survey of Recent Literature," *Journal of Corporate Finance* 9 (2003): 37–57.
34 C. C. Markides, "Consequences of Corporate Refocusing: Ex Ante Evidence," *Academy of Management Journal* 35 (1992): 398–412; C. C. Markides, "Diversification, Restructuring and Economic Performance," *Strategic Management Journal* 16 (1995): 101–18.
35 G. A. Jarrell, J. A. Brickly, and J. M. Netter, "The Market for Corporate Control: Empirical Evidence Since 1980," *Journal of Economic Perspectives* 2, no. 1 (Winter 1988): 49–68.
36 R. P. Rumelt, *Strategy, Structure and Economic Performance* (Cambridge, MA: Harvard University Press, 1974).
37 Tom Peters and Robert Waterman, *In Search of Excellence* (New York: Harper & Row, 1982): 294.
38 Ibid.
39 H. K. Christensen and C. A. Montgomery, "Corporate Economic Performance: Diversification Strategy versus Market Structure," *Strategic Management Journal* 2 (1981): 327–43; R. A. Bettis, "Performance Differences in Related and Unrelated Diversified Firms," *Strategic Management Journal* 2 (1981): 379–83.
40 See, for example, A. Michel and I. Shaked, "Does Business Diversification Affect Performance?," *Financial Management* 13, no. 4 (1984): 18–24; G. A. Luffman and R. Reed, *The Strategy and Performance of British Industry, 1970–80* (London: Macmillan, 1984).
41 C. Park, "The Effects of Prior Performance on the Choice between Related and Unrelated Acquisitions," *Journal of Management Studies* 39 (2002): 1003–19.
42 For a discussion of relatedness in diversification, see J. Robins and M. F. Wiersema, "A Resource-Based Approach to the Multibusiness Firm: Empirical Analysis of Portfolio Interrelationships and Corporate Financial Performance," *Strategic Management Journal* 16 (1995): 277–300; J. Robins and M. F. Wiersema, "The Measurement of Corporate Portfolio Strategy: Analysis of the Content Validity of Related Diversification Indexes," *Strategic Management Journal* 24 (2002): 39–59.
43 R. M. Grant, "On Dominant Logic, Relatedness, and the Link Between Diversity and Performance," *Strategic Management Journal* 9 (1988): 639–42.
44 C. K. Prahalad and R. A. Bettis, "The Dominant Logic: A New Linkage Between Diversity and Performance," *Strategic Management Journal* 7 (1986): 485–502.
45 "Wanadoo Fined €10m for Predatory Pricing," *Financial Times* (July 17, 2003).
46 "Microsoft on Trial," *Economist* (April 28, 2006) (www.economist.com).
47 E. D. Cavanagh, "Reciprocal Dealing: A Rebirth?" *St. Johns Law Review* 75 (2001): 633–47.
48 US Senate, Subcommittee on Antitrust and Monopoly Hearings, *Economic Concentration*, Part 1, Congress, 1st session (1965): 45.
49 B. D. Bernheim and M. D. Whinston, "Multimarket Contact and Collusive Behavior," *Rand Journal of Economics* 2 (1990): 1–26.
50 In the US airline industry, extensive multimarket contact resulted in a reluctance to compete on routes dominated by one or other of the airlines. See J. A. C. Baum and H. J. Korn, "Competitive Dynamics of Interfirm Rivalry," *Academy of Management Review* 39 (1996): 255–91.
51 S. Jayachandran, J. Gimeno, and P. R. Varadarajan, "The Theory of Multimarket Competition: A Synthesis and Implications for Marketing Strategy," *Journal of Marketing* 63 (July 1999): 49–66.