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Competitive Advantage of an Unrelated Diversified Company

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Abstract

A company is diversified when it is in two or more lines of business. Companies pursue unrelated diversification strategy when they enter into a new activity that has no obvious similarities with any of the company's existing activities. This is often risky for a company with strengths in one industry or product to tackle a completely unrelated industry, but the potential benefits are also significant for businesses that succeed with this growth strategy. This paper reviews the competitive advantage of unrelated diversification and concludes that the critical factor in determining success is the level of management expertise in formulating and implementing the unrelated diversification strategy.

Key words: Diversification; Unrelated diversification; Competitive advantage

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INTRODUCTION

The corporate strategy of a company should address the question: "What is the appropriate scale and scope of the enterprise?" It should influence how large and how diversified firms will be. Successful corporate strategies are not only the product of successful definition but also the result of organizational capabilities or competencies that allow firms to exploit potential economies/synergies that large size or diversity can offer (Berger, 2005).

Companies diversify: (1) To grow, (2) To more fully utilize existing resources and capabilities, (3) To escape from undesirable or unattractive industry environments, and (4) To make use of surplus cash flows. Unrelated diversification refers to diversification into a new activity that has no obvious similarities with any of the company's existing activities. Companies may pursue unrelated diversification for several reasons: (1) continue to grow after a core business has matured or started to decline, (2) to reduce cyclical fluctuations in sales revenues and cash flows. The main problem with conglomerate or unrelated diversification is that managers often lack expertise or knowledge about their companies' businesses (Berger, 2005).

The objectives of this paper are:

- To give an overview of the concept of diversification.
- To examine the competitive advantage of unrelated diversification strategy and its implication to management of business.

1. THEORETICAL FRAMEWORK

Diversification is a strategy that takes a company into new markets with new products or services. Companies may choose a diversification strategy for different reasons (Wernerfelt & Montgomery, 1988). *Firstly*, companies might wish to create and exploit economies of scope, in which the company tries to utilize its exciting resources and capabilities in other markets. This can oftentimes be the case if companies have under-utilized resources or capabilities that cannot be easily disposed or closed. Using a diversification strategy, companies may therefore be able to utilize all its capabilities or resources, and be able to attract new business from market segments not catered to earlier. *Secondly*, managerial skills found within the company may be successfully used in other markets, where the dominant logic and managerial procedures

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of management can be successfully transferred to other markets. *Thirdly*, companies pursuing a diversification strategy may be able to cross-subsidize one product with the surplus of another. This way, companies with a very diverse portfolio of products catering to different markets may potentially grow in power, and be able to withstand a prolonged period of price competition etc. When having subsidized one product for a substantial period of time, the company might possibly be able to win a monopoly, making it the only supplier in the respective market. *Fourthly*, companies may also want to use a diversification strategy to spread financial risk over different markets and products, so that the entire success of the company is not reliant on one market or product only (Wernerfelt & Montgomery, 1988).

There may however be other reasons for companies to use a diversification strategy than the four listed above, and companies may very well benefit from a diversification strategy for other reasons. However, it is important for companies to realize the possible danger of diversifying its scope of operations too much. Companies might risk neglecting its core capabilities and become too diversified, where too many different products supplied to different markets might have negative effects on products and services, where e.g. product quality or uniqueness might suffer due to the shift in focus on different products and markets. The diversification strategy can be split into two different types (Papelu, 1985): (1) Related diversification; (2) Unrelated diversification.

According to Papelu (1985), related diversification is one of the two variants of diversification strategy. When making related diversification, companies expand their operations beyond current markets and products, but are still operating within existing capabilities or within the existing value network. When expanding into different products or markets using existing capabilities, companies can create related diversification by using its capabilities and resources in other settings. A car manufacturer might for instance expand its operations into manufacturing of motorcycles or trucks, and use its capabilities and resources to become successful in these markets.

Likewise, a company might create related diversification by integrating into the existing value network. For instance, companies producing steel might go into the mining business, where it might control the supplies etc. for its main operations. Likewise, clothes manufacturers might create their own brand shops, in which they sell their clothes. On the other hand, unrelated differentiation is a diversification strategy where companies expand their operation into markets or products beyond current resources and capabilities. This strategy is also sometimes referred to as the conglomerate strategy. The unrelated diversification seems to be applicable and meaningful in at least two cases (Chang, 2006):

Firstly, if the parent company is able to provide different businesses with managerial knowledge and expertise that strengthens the individual business, it will be very feasible to diverse into different markets that will potentially increase parent company profits. Secondly, unrelated diversification might give a company the opportunity of increasing the strength of the economy of different markets, and to develop competencies that can be shared between different markets and products. According to Parich *et al.* (2000), unrelated diversification decisions involve two basic issues: (1) is the industry to be entered more attractive than the company's existing business? and (2) can the company establish a competitive advantage within the industry to be entered? (i.e. what synergies exist between the core business and the new business? The potential advantages include: (1) business risk scattered over different industries, (2) financial resources can be directed to those industries offering best profit prospects, (3) stability of profits – hard times in one industry may be offset by good times in another industry, and (4) if bargain-priced companies with big profit potential are bought, shareholder wealth can be enhanced.

2. IMPLICATIONS TO MANAGEMENT

According to Schoar (2002), successful unrelated diversification strategies result from the ability of managers to develop skill and competency at managing diversification. Managers must develop three important types of mental models:

First, they must have well-developed understandings of their company's diversity and relatedness that define their companies. Second, managers should understand how their company's businesses are related. Third, they should also have well-developed beliefs about how unrelated diversification should be managed in order to achieve competitive advantage. These would enable them to:

- Coordinate the activities of businesses in order to achieve synergies.
- Allocate resources to the various businesses in a diversified firm.
- Decide whether various functional activities such as engineering, finance and accounting, marketing and sales, production, and research and development should be centralized at the corporate headquarters or to decentralized and operated by Strategic Business Unit managers.
- How to compensate and reward business unit managers so that their goals and objectives are best aligned with those of the organization (Schoar, 2002).

Managers learn from trial and error. They should evaluate success of past strategic decisions. These acquired beliefs should become embedded in an organization's routine operating procedures. By engaging in a number of acquisitions over time, managers can come to develop an expertise about how the acquisition process should be managed. All these activities should enable the diversified company to gain competitive advantage.

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CONCLUSION

Despite the substantial number of empirical studies in both finance and strategic management, research on the relationship between diversification and competitive advantage has not yet reached a definitive consensus on whether companies are better off remaining focused or diversified in different businesses (Martin and Sayrak, 2003). The size of a company alone does not guarantee the firm an advantage. Coordination required to exploit economies of scale and scope is not without cost. Size creates additional challenges and difficulties, including problems of communication and coordination. Though unrelated diversification has been disastrous for many companies, diversified companies can also be successful. Critical factor in determining success is the level of management expertise in formulating and implementing the unrelated diversification strategy.

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