Diversification: best practices of the leading companies

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1. A bad reputation

Everyone knows how huge General Electric, or GE, is but may not realize how highly diversified it is as well, with operation in many areas. These include jet engines and replacement parts; rail system products and maintenance services; power plant products and services; gas, steam and aero turbines; advanced turbine machinery; major appliances such as refrigerators, freezers, ranges, cook tops, dishwashers; lighting products; electrical control equipment; plastics; commercial finance; magnetic resonance and CT scanners; US network television services – and this is merely a sample.

With customers in over 160 countries and more than 300,000 employees worldwide, GE is also one of the world's most esteemed companies, being regularly named among *Fortune* magazine's ''Most Admired Companies'' and ranked highly in Barron's annual survey of the world's most respected companies. GE is rated well on corporate governance, too. In terms of financial strength, the company has been given the highest AAA rating by Innovest and regularly outperforms most other large companies on the most fundamental measure of all: return on shareholders' funds, also known as return on equity.

Yet GE's highly diversified business model is shunned by many CEOs, senior executive teams and boards. The reason? The message has gone out that diversification is bad and focus is good. (No one seems to pause and ask: If focus is so good, why do the most focused firms of all, small businesses, fail at such alarming rates?)

This article takes a fresh look at diversification to find out why so many managers and boards are fearful of it. And, by showing how to make diversification a success, we encourage companies to get over the barrier that prevents them from benefiting from a range of potential business opportunities. (See Box 1, ''The diversification project.'')

2. Sloppy analysis

Sloppy analysis is one major contributor to diversification's bad reputation. It's all too easy to write off the failure of a diversified business as ''too diversified''. Here is a case in point. By 2006, Burns Philp had become Australia's 95th largest company by market capitalization. In December of that year it was delisted, having been taken over by the Rank Group. But it was an earlier period that ultimately led to the company's near collapse and salvage acquisition.

In many of its moves, Burns Philp failed to understand the industries it was getting into. In one case this involved the US spices market and the intensity of the competition it would face, especially from a major player, McCormick & Co. In the US spices market McCormick held a 30 percent share and fought Burns Philp's entry into the market by escalating payments to retailers to get the best positions on supermarket shelves. Burns Philp's

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Box 1. The diversification project

The purpose of my research was to understand the features of successful diversifiers; what causes diversified firms to fail; what successful diversifiers and successful focused firms have in common (Kenny, 2009).

The initial identification of the pool of successful diversifiers came from a study by Marakon Associates. They identified 88 successful diversified companies from around the world with market values over $500m (Kaye and Yuwono, 2003). Along with other firms from other sources I chose four of the top 22 of these to study in depth. These were GE (US), Wesfarmers (Australia), Bidvest (South Africa) and ITC (India). Being geographically spread was one of the criteria. Others diversifiers studied in depth were Burns Philp (an Australian diversified failure) and the Australian department store chain David Jones (failed in its attempt to diversify). Two focused successes also came under the microscope – McDonald's and Westfield.

The major selection criterion employed to be classed as a success, for both diversified and focused firms, was the achievement of an ROE of at least 14 percent for the ten previous consecutive years. This benchmark was derived from *Standard & Poor's Quality Rankings* and placed the companies in at least the A minus category of firm performance (Standard & Poor's, 2005).

management misread the situation and the consequent bidding war that would take place. McCormick was prepared to ''fight to the death,'' to quote Burns Philp's CEO at the time.

The press and pundits leapt on Burns Philp's case. ''Too diversified!'' they bellowed. Indeed, this is the argument in many analyses of failures of this type. But it is simplistic. Rather than ''diversification'' being the culprit, we have identified at least eight drivers of Burns Philp's failure:

1. lack of effective management at the division level, cited by the CEO at the time;
2. expansion overseas, with the cultural and regulatory differences and complexities this implies, e.g. Italy, US, Germany;
3. expansion via acquisition, with all the consequent integration requirements;
4. overpayment for acquisitions, with the resulting expense burden;
5. failure to exercise effective due diligence in acquisitions, e.g. checking for hidden liabilities;
6. lack of understanding of the industries it was getting into, e.g. the US spices market;
7. rash expansion, resulting in head office staff being stretched and unable to react to crises effectively; and
8. lack of management discipline, i.e. inability to put in place essential measures, systems and processes.

None of these are inherent in diversified companies. A focused firm on an expansion route could just as easily stumble over the same obstacles.

3. Onion analogy

A second driver of diversification's bad reputation is the way we look at it. This gives rise to what we call the onion analogy. Onion is good for you, but too much can actually kill you. So there must be some optimal level.

The onion analogy is based on the corporate perspective on diversification. This involves viewing the various activities and businesses of a diversified firm, such as GE, from the head office, looking down. It leads CEOs to consider whether the head office adds value by providing needed services and capabilities to the various businesses. And this is fine. But this same perspective also induces CEOs and boards to over-emphasize the relatedness among their businesses, even if they are unrelated. Followers of the onion analogy, including some academics, posit that moderately diversified companies outperform focused companies on the one hand and highly diversified companies on the other. This produces an inverted U-shaped curve with performance on the ''Y'' axis – too little diversification, no good; too much diversification, also no good (Palich *et al.*, 2000).

The concern about becoming too diversified is that there can be an ever-increasing strain on top management to manage an increasingly unconnected (and therefore less familiar) portfolio of businesses. Were senior management to be responsible for developing the competitive strategies and detailed operational plans across business units as diverse as home improvement, energy, industrial and safety products, insurance, and chemicals and fertilizers, to take one diversifier's situation, they would certainly experience ''strain.'' But successful diversifiers do not do this. CEOs and senior management at companies such as General Electric, Wesfarmers, Bidvest and ITC act as support staff to their divisions. As Warren Buffett, CEO of Berkshire Hathaway, understands, the ''heavy lifting,'' the development of business unit strategies and operational plans, is delegated to division management. So the ''strain'' on head office is kept to a manageable level by being continually parcelled out.

But let us look at the optimum-level hypothesis a different way through a business-unit perspective rather than a corporate one. This requires us to restate the optimum-level case thus: firms whose business units are highly related to each other, such as in a focused company, are outperformed by those whose business units are moderately unrelated to each other. The latter also outperform firms whose business units are highly unrelated to each other. Since business units are the drivers of corporate performance, this argument says that business units perform better when being somewhat unrelated to other business units rather than highly related or highly unrelated. From a business-unit perspective there seems no sense to this argument.

We look next at the particular practices that successful diversifiers follow to achieve success.

4. Selecting capable division managers

Michael Porter made the point many years ago that ''competition occurs at the business unit level. Diversified companies do not compete; only their businesses do''. (Porter, 1987) Successful diversifiers never forget this axiom. Divisions are the cutting edges of diversified firms and their leaders make all the difference. Business unit managers have to be capable. Without high performing individuals in place, diversification will struggle because the managerial load will get shifted back to the company's corporate center. If this leads to the head office developing the strategies and operational plans for the company's diverse businesses, then the writing is on the wall for the company as a whole.

The previous CEO of GE, Jack Welch, lauded by many as the US's most effective CEO in recent decades, had this to say regarding his role and the importance of effective division managers: ''[My job] is to put the best people on the biggest opportunities . . . and [make] the best allocation of dollars,'' not to decide how to ''produce a good [television] program.. [or] build an engine'' (Slater, 1999a). The latter is the role of the divisions.

Wesfarmers, like GE, is highly diversified and very successful. It has 200,000 employees, making it Australia's biggest private sector employer. It is a top-ten company with a market capitalization of about $38 billion, with businesses in retailing (Coles, Kmart, Target), home and office supplies (Bunnings, Officeworks), insurance, resources (coal mines), chemicals, energy and fertilizers (includes plastics), industrial safety, and more.

Michael Chaney, who until a few years ago was the CEO of Wesfarmers, is unequivocal about the importance of having effective business-unit managers to make a diversified company work. As individual divisions are run autonomously at Wesfarmers, business-unit managers need, of course, to know their industry and be able to focus on key financials, such as return on capital employed. But additionally, he says, these ''above-the-waterline characteristics'' need to be supplemented by ''below-the-waterline characteristics,'' including emotional intelligence, i.e. interpersonal sensitivity; broad-scanning interests;

and reflection on how big issues might affect a business. Commercial nous, Chaney says, is another component, as are integrity and the ability to communicate. This latter skill is essential if a business-unit manager is going to motivate others. Chaney has also pointed out the need for Wesfarmers managers to have conceptual thinking skills so that they do not become tunnel-vision managers, but instead can think outside of the box.

5. Securing competitive advantage

Jack Welch sought to secure competitive advantage for GE via its business units by establishing a system in which division managers acted like small business owners. That way, he felt, they would know their customers and their needs, respond to them promptly and produce a real competitive edge. ''We [have] to find a way to combine the power, resources, and reach of a big company with the hunger, the agility, the spirit, and the fire of a small one,'' he said (Slater, 1999b).

To achieve this, GE stripped away layers of management that clogged the organization and laid bare the divisions and business units, directly exposing them to competitive pressures. Talking about transforming GE into a successful diversifier, Welch has said: ''We found ourselves in the early 1980s with corporate and business staffs that were viewed – and viewed themselves – as monitors, checkers, kibitzers, and approvers. We changed that view and that mission to the point where staff now sees itself as facilitator, adviser, and partner of operations, with a growing sense of satisfaction and cooperation on both sides. Territoriality has given way to a growing sense of unity and common purpose'' (Slater, 1999b).

Wesfarmers has a similar story. A former outsider, who was subject to a takeover by Wesfarmers, comments on how autonomy operates within the company to secure competitive advantage: ''Wesfarmers' philosophy of autonomy and financial rigor has been clearly apparent since the takeover. This is in contrast to previous experience with high degrees of operational scrutiny and financial hurdles which were sometimes unclear, or known to just a few. The approval process underpinning capital investments, divestments or acquisitions has been supportive of the ROC [return on capital] ethic'' (Chaney, 2004).

6. Establishing a supportive corporate center

A division within a diversifier succeeds if the business unit itself delivers competitive advantage and it is given appropriate support by the corporate center. A key characteristic of the center in successful diversifiers is that it provides clear guidelines and it can handle diversity, i.e. it refrains from meddling with the way the various divisions achieve their competitiveness. A hands-off yet supportive policy is not easy to achieve, as interfering can become the norm.

There are three main reasons why meddling occurs. One is the lack of competent managers at business unit levels. The second is the lack of clear lines of authority and responsibility between head office and divisions. I addressed both of these previously. The third is that head office has not clearly defined its role. This includes:

- keeping external stakeholders adequately informed;
- developing innovative financial approaches;

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- ensuring that the company is seen as a reputable, responsible corporate citizen;
- ensuring the company is equipped to respond to unforeseen crises; and
- ensuring that the corporate culture is communicated throughout the company.

This list comes from Wesfarmers, with 130 staff located at its corporate center. Numbered in the center's total is the CEO, the Chief Financial Officer (CFO), group accounting, corporate human resources, head office corporate affairs, business development, group legal, group risk management, corporate tax and corporate treasury. Group accounting is the largest of these, but business development contains 20 analysts.

Wesfarmers headquarters is always careful not to tell its divisions how to run their businesses. Its aim is to ''add value'' by assisting, not interfering unless results require drastic action. The latter rarely occurs. This hands-off yet supportive approach has the effect of producing a highly competent group of division managers.

7. Installing appropriate performance measures

We have seen that having skilled managers in place is a precursor to employing diversification successfully. But good managers can go bad in poor systems. Recognizing this, successful diversifiers ensure that their performance measures are sound and that they encourage the right behavior.

Bidvest has its headquarters in South Africa but runs significant operations in the UK, Central and Eastern Europe, Singapore, Hong Kong and greater China, New Zealand, and Australia. With 107,000 employees, its foundation business is food service, which means providing supplies to hotels, restaurants, clubs and canteens. Bidvest is also in freight handling, contract cleaning and security, financial services, office and industrial products, and motor vehicle sales. The company is renowned for its ability to correct under performing acquisitions. Every business that has been acquired by Bidvest has proved more profitable after takeover than before. How do they do it?

Bidvest's model, like GE's and Wesfarmers', encourages managers to run their businesses as independent, decentralized units, but at the same time they are subjected to what Bidvest calls ''the discipline of constant measurement.'' This balance between entrepreneurial freedom and accountability through measurement rigor appears to be the real alchemy of Bidvest's success as a diversifier.

Bidvest uses profit and return on funds employed (ROFE) as the key performance measures for its divisions. It defines ROFE as trading income divided by net operating assets, and it fills the equivalent role of GE's ROTC (return on total capital) and Wesfarmers' ROCE (return on capital employed). Yet unlike GE and Wesfarmers, Bidvest doesn't enforce a standard percentage for ROFE across all business units. For some, it could be quite high, for others relatively low. An individual target depends on prior history. Improving profit and ROFE is what's important at Bidvest.

GE, Wesfarmers and Bidvest each see return-on-capital performance measures, such as ROCE, as discouraging division managers from pursuing growth for growth's sake or to satisfy ego. Return-on-capital performance measures are far removed from revenue-building, market share or customer base as the ultimate measures of success or the justification for business expansion. Performance measures such as ROCE also hold managers back from taking a devil-may-care attitude to expenditure. In addition, such measures are congruent with the ultimate performance measure employed by successful diversifiers for the corporation as a whole: return on equity.

8. Setting effective incentives

ITC, one of India's foremost companies, has a market capitalization of over $22 billion and a turnover of $6 billion. It employs over 26,000 people at more than 80 locations across India.

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Rated among the World’s Best Big Companies and Asia’s ‘‘Fabulous 50’’ by *Forbes* magazine, ITC has also been named among ‘‘India’s most respected companies’’ by *Business World* and among ‘‘India’s most valuable companies’’ by *Business Today*. ITC also ranks among Asia’s 50 best performing companies, compiled by *Business Week*.

ITC’s diversified presence extends to cigarettes, hotels, paperboards and specialty papers, packaging, agri-business, branded packaged foods, information technology, lifestyle retailing, and gifts and stationery. While it is a market leader in its traditional businesses, it is rapidly gaining market share even in its nascent businesses of branded packaged foods, branded apparel, personal care and stationery. ITC’s diversification is aimed to create multiple drivers of growth.

The compensation policy of ITC includes a significant variable pay component comprising performance-linked bonus payments and an Employee Stock Option Scheme structured towards aligning individual performance with the company’s strategic goals.

Like ITC, Bidvest is enthusiastic about using ‘‘incentivization’’ to attract and retain motivated people and, when applied to its decentralized management system, encourages managers ‘‘to seek returns in open competition with their peers.’’ It also produces an ‘‘owner-manager mind-set’’ that, they say, ‘‘drives us forward.’’ Division managers send financial reports to Bidvest’s CEO monthly and are rewarded via a base salary, an annual short-term incentive and a long-term incentive. The base salary is set at the market rate or lower, while the short-term incentive is based on a percentage of division profit and on achieving a benchmark for return on funds employed (ROFE). Only after a division manager reaches the division’s threshold ROFE does the percentage profit calculation kick in.

GE rewards its division managers via fixed salaries and bonuses. Depending on the staff member’s organization level, the bonus can come in the form of cash or shares or a combination of both. The practice of providing incentives beyond a fixed salary is widespread in GE.

In the case of successful diversifiers, their CEOs and division managers are subject to systems that are heavily weighted towards their achieving a high return on investment for the entity they manage – and ultimately for the company as a whole and its shareholders. Through these systems, CEO, division and business-unit performance is aligned with an increase in the value of the company, a prime indicator of which is return on equity for the company as a whole.

9. Aligning the corporate culture

Divisions in diversified companies will by definition be very different in their operations, the industries they work in, their customer bases and the like. Successful diversifiers are very tolerant of these differences. But they use culture to unify the organization.

GE has one culture across all of its varied divisions. Describing itself as ‘‘imagination at work,’’ GE’s culture is a major driver of how the company operates, its policies and procedures, and what it will and won’t take on. It has been distilled to four values that read as actions: imagine, solve, build, and lead. Each of these is defined in detail. Here’s part of how it describes ‘‘imagine’’: ‘‘Imagine is a sense of possibility that allows for a freedom beyond mere invention. Imagine dares to be something greater. At GE, Imagine is an invitation to dream and do things that you did not know you could do.''

ITC enshrines its culture in a number of ways. One is its mission statement: ''To enhance the wealth-generating capability of the enterprise in a globalizing environment, delivering superior and sustainable stakeholder value.'' It then backs this up with six ''core values'': trusteeship; customer focus; respect for people; excellence; innovation; and nation orientation. These are aimed ''at developing a customer-focused, high-performance organization which creates value for all its stakeholders.''

Wesfarmers summarizes its culture as four ingredients: shareholder focus; growth philosophy; structure; and climate. As with GE, these are defined in detail. For instance in the case of ''growth philosophy,'' it says: ''It is impossible to predict the future with any reliability so we grow our business by taking incremental steps, learning as we grow.''

While there are individual corporate differences, five fundamental and distinctive themes run through the cultures of successful diversifiers:

1. *Growth*. Business growth is important to all of them.
2. *Autonomy*. Division managers need to run their businesses as if they were their own – like a McDonald's franchise.
3. *Return on investment*. They're not in the business of growing for growth's sake, nor just for profit; they need to produce an economic return that can be justified *objectively*.
4. *Stakeholder focus*. They recognize clearly whom they depend on for success, i.e. customers, suppliers, employees, etc.
5. *Integrity*. First-class corporate governance and proper dealings are important to all of them.

10. Paying the right price

One of the routes to business growth that successful diversifiers employ is acquisition. It would seem axiomatic that you should not pay too much when acquiring a business. But what is ''too much''?

A problem arises regarding the computed value of an acquisition because accountants cannot agree on how to value a firm – not the value of *a* particular firm, but how to value a firm. There are at least six methods for conducting an evaluation so the negotiations for the purchase of a company can start with a very broad range. We see this played out every day with public companies in the press. But it happens on many more occasions with private companies. It is critical to know how to play the valuation game – as successful diversifiers do.

Successful diversifiers also try to avoid the danger of getting caught up in a deal's own momentum, the weight of effort that goes into the transaction process. This is geared to overcoming problems and achieving a positive outcome. But ''deal fever'' leads to the feeling among the acquiring team that it's ''too-late-to-pull-out.'' Hence, deals get done under the weight of their own momentum even if they are not, in the final analysis, good ones.

CEO hubris, i.e. insolence or excessive self-confidence, can derail a deal. Boards and CEOs need to be cautious here. Hubris often explains the large size of premiums paid for some

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acquisitions. Mathew Hayward and Donald Hambrick reviewed a range of acquisitions over $100 million and researched 106 transactions. In their *Administrative Science Quarterly* article, they conclude that CEO hubris is highly associated with premiums paid for acquisitions (Hayward and Hambrick, 1997). They also find that the greater the CEO hubris and acquisition premiums, the greater the shareholder losses.

Executive teams can guard against getting caught up in a deal's own momentum and CEO hubris by remaining objective and focusing on the numbers.

11. Integrating acquisitions

Successful diversifiers are great integrators. Diversification won't work well unless acquisitions are integrated successfully. Bringing the acquired firm ''into the fold'' effectively means not alienating its employees. To put this more positively, a smooth integration process has employees in the acquired business feeling accepted. It also includes getting the systems of the two organizations working well together – computer systems, measurement systems and a range of human resources systems. Some studies blame poor integration for up to 70 percent of all failed acquisitions.

To avoid an integration mess, effective up-front planning and extensive follow-through is needed. Brian Joffe, the CEO of Bidvest, maintains that a key to a successful acquisition is communication in the initial stages, post acquisition. Areas covered by his company are future direction; corporate objectives; performance measures and everything that can help people make sense of how they are going to be working under the new arrangement. If all this is clear, Joffe says, a company will achieve a successful result nine times out of ten. When Bidvest buys a business, it gets the key people together, explains its philosophies, describes its objectives, details its performance measures, and then empowers staff to get on with the job.

Wesfarmers has developed its own ''integration framework,'' a ''how to'' for handling the acquisition process. The company follows it in every merger, even though it requires the allocation of a considerable amount of resources. For example, in the case of its acquisition of the company, Howard Smith, Wesfarmers assigned a senior manager and around 60 staff to the job of successfully integrating the new purchase. It took about six months and progress was measured against a timeline that showed the tangible benefits for Wesfarmers.

12. Diversification and business growth

In approaching the issue of diversification, managers need to keep an open mind. In evaluating alternatives in growing a business, such as being a focused firm or a diversified one, senior executive teams and boards need to avoid getting caught up in the prevailing orthodoxy, share market hype or press hysteria. These are often uninformed by fact and fuelled by prejudice, special interests and rumor.

To beat the current downturn and to come out of it stronger than the competition, managers have to be prepared to entertain fresh ideas and different opportunities. Rather than seeing diversification as the leper of management, something organizations do not want to touch, it should be on their agenda for growth. If not, CEOs and boards may be incurring a serious opportunity cost. They should *not* be frightened to stray from what they see as ''core business.''

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