UNIVERSITY OF LIVERPOOL

MKIB 351: Global Strategic Management

Lecture 5 - Corporate-level strategies – Part 1

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Attendance code: 980422

Agenda

- Corporate-level strategy (corporate strategy)
  - Expansion strategies: Integration, Diversification
- Integration
  - Vertical Integration
    - Benefits/Drivers of vertical integration
    - Risks of vertical integration
    - Alternatives to vertical integration
  - Horizontal integration
- Diversification
  - Product diversification
    - Motives for diversification
  - Geographic Diversification
  - Combining Product and Geographic Diversification

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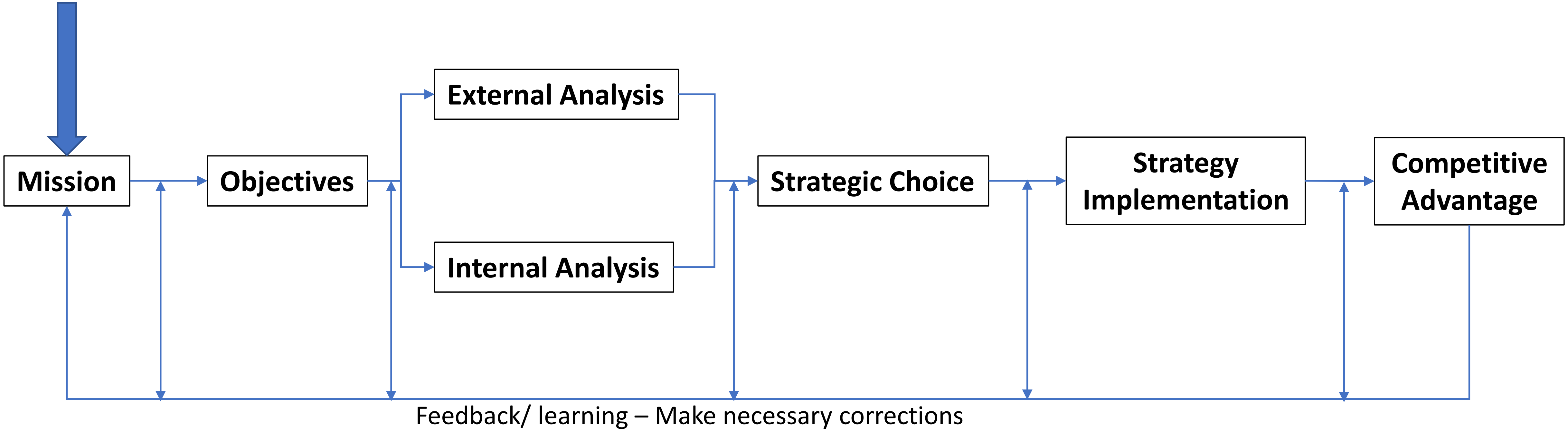
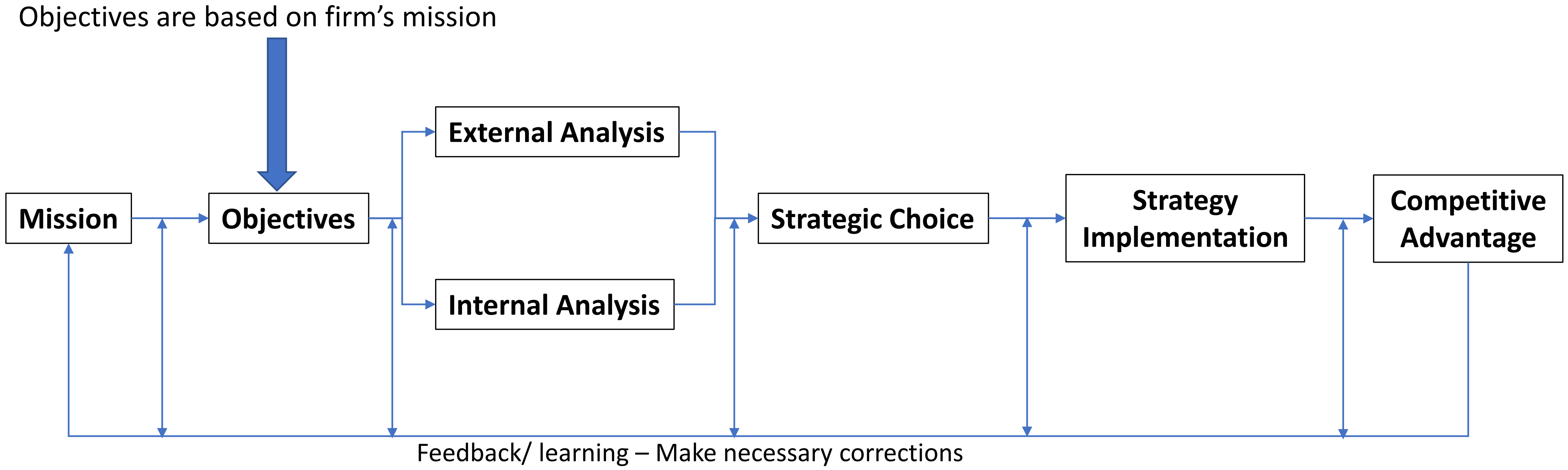
Strategic management process

The strategic management process begins when a firm defines its mission.



From Barney and Hesterly (2006)

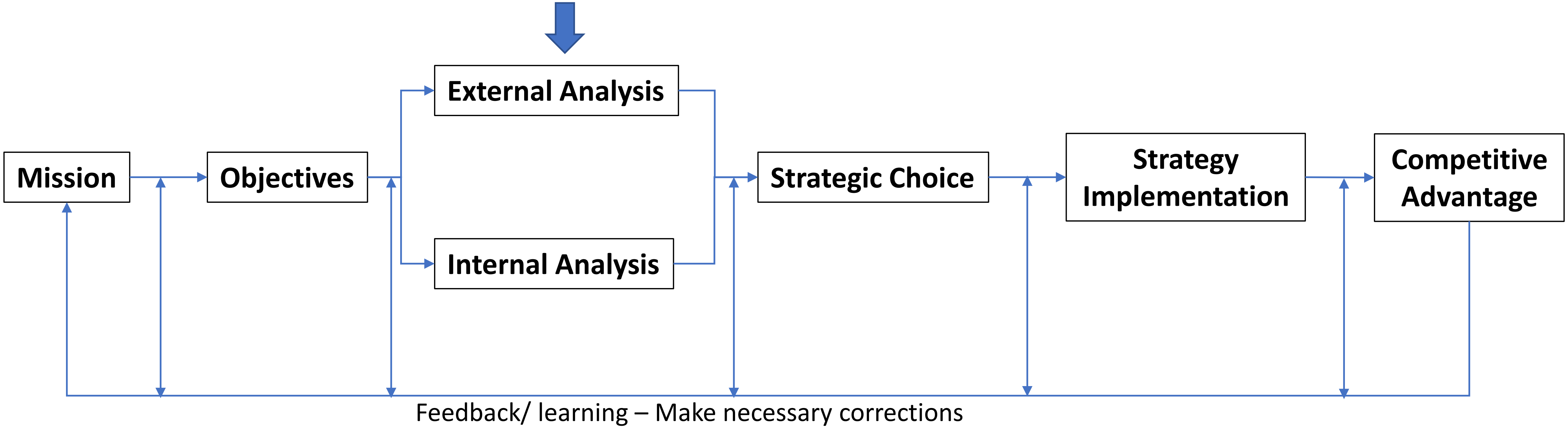
Strategic management process



From Barney and Hesterly (2006)

Strategic management process

Identify the critical threats and opportunities in firm's competitive environment.
Identify its organizational strengths and weaknesses.



From Barney and Hesterly (2006)

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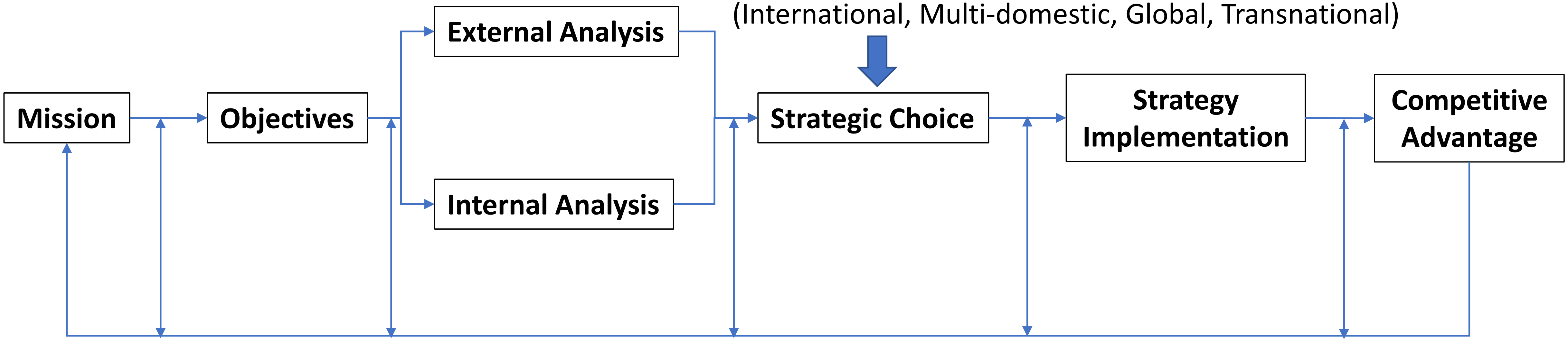
Strategic management process

Given that a firm is equipped with a mission, objectives, and completed external and internal analyses, a firm is ready to formulate strategy for gaining competitive advantage.

What global strategy (AAA framework)
How (method) of going global (Internationalization theories: e.g. Uppsala, Network, Born Global)
Resulting firm types depending on International Strategies (International, Multi-domestic, Global, Transnational)



Feedback/ learning – Make necessary corrections

From Barney and Hesterly (2006)

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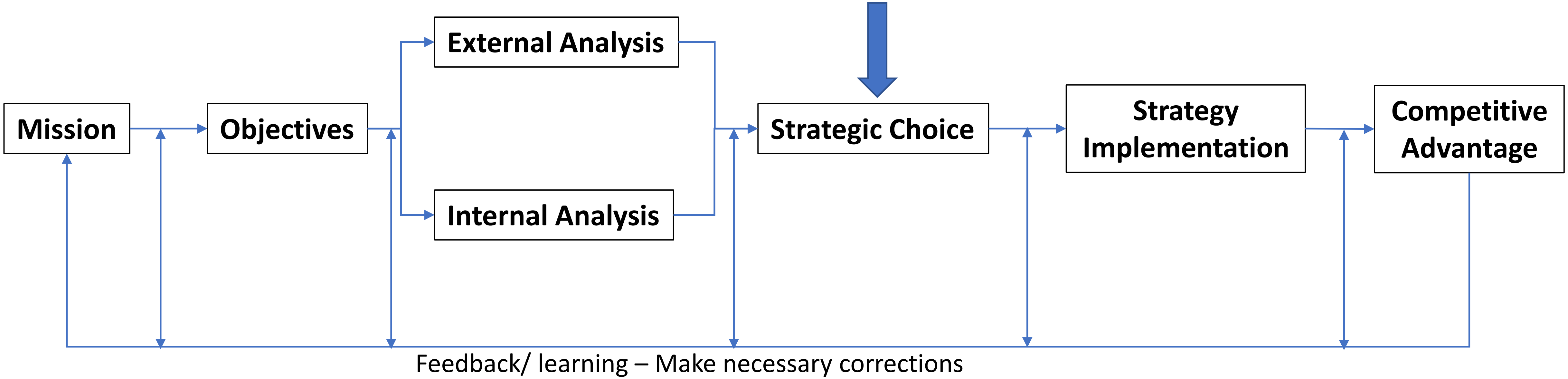
Strategic management process

Corporate-level strategy (corporate strategy)
How a firm creates value through the configuration and coordination of its multimarket (global and local) activities.
Expansion strategies: Integration, Diversification, Cooperation



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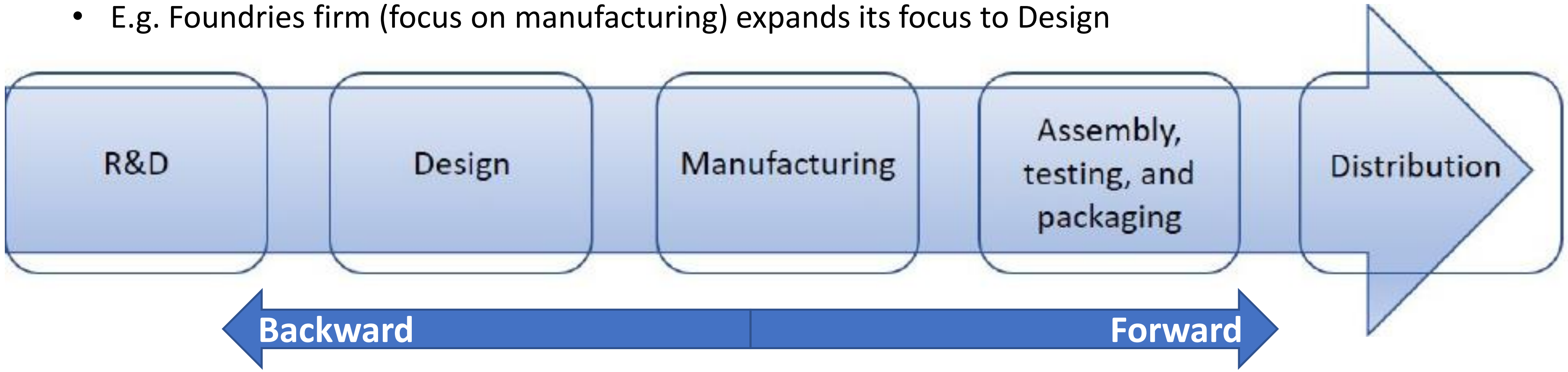
Integration

- Value chain: that set of activities that must be accomplished to bring a product or service from raw materials to the point that it can be sold to a final customer.
- Integration is a growth strategy in which firm is expanding its operation within the industry value chain.
- Types of Integration:
    - Horizontal
        - is the process of expanding by over another company that operates at the same level of the value chain.
    - Vertical
        - is the expansion of a firm up or down the vertical industry value chain
            - E.g., Fabless firm (Focus on Design) expands its focus to manufacturing

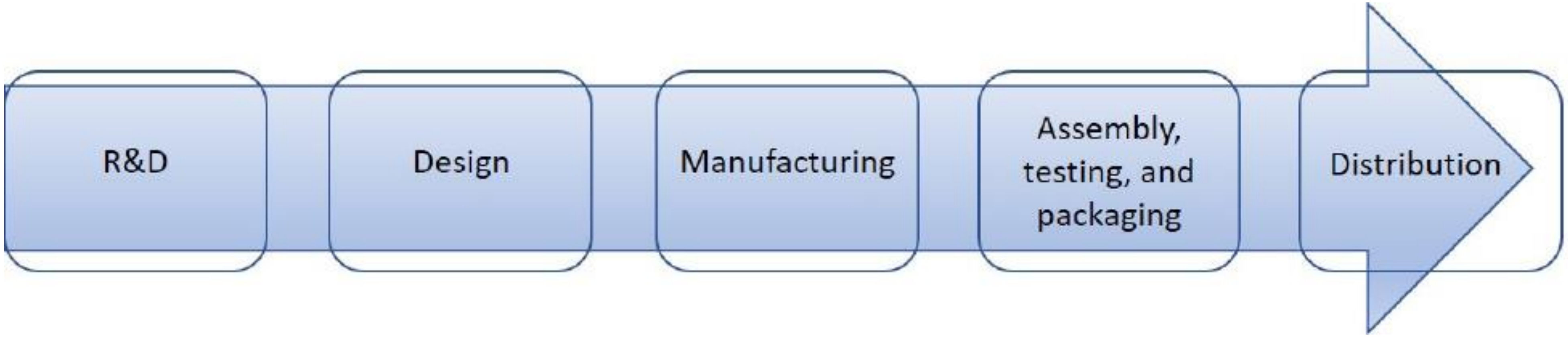
Vertical Integration

- A firm's level of **vertical integration** is simply the number of steps in this value chain that a firm accomplishes within its boundaries.
- Types of vertical integration:
  - **Forward** vertical integration
    - Moving ownership of activities closer to the end customer
    - E.g., Fabless firm (Focus on Design) expands its focus to manufacturing
  - **Backward** vertical integration
    - Moving ownership of activities upstream to the originating inputs of the value chain
    - E.g. Foundries firm (focus on manufacturing) expands its focus to Design



Levels of vertical Integration

- Fully vertically integrated
  - All activities are conducted within the boundaries of the firm.
    - E.g., Integrated Device Manufacturers (E.g., Intel)
  - Faces different competitors in each stage of the industry value chain.
- Low degree of vertical integration
  - firm focus on only one or a few stages of the industry value chain.
    - E.g., fabless firms (focus on design) – E.g. Apple
    - E.g., foundries firms (focus on manufacturing) – E.g. TSMC



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Benefits/Drivers of vertical integration

- Generally, an enhanced market orientation, resulting from vertical integration, has been widely shown to enhance firm performance (Shoham, Rose, & Kropp, 2005)
- Lowering costs
  - Avoid significant costs related to the expenses of monitoring, negotiations (e.g., enforcing contracts with supply chains and other partners), distribution, and etc.
  - Cost reduction through:
    - Economies of scales
      - Manage the entire production process are able to increase the overall size of their operations to better meet important business needs.
      - E.g., a company that purchases its distribution centres may be able to establish more efficient processes for delivering goods to customers.
    - Decreased labour cost due to learning curve
    - Lower material procurement costs
      - In some industries where there are raw material or input disruptions, inconsistencies, or price fluctuations, supply assurance via backward vertical integration is advantageous.

Benefits/Drivers of vertical integration

- Improving quality
  - Enhanced innovation
    - Broadens a firm's perspective of the value chain, giving rise to novel ideas for strategy execution and ultimately innovation.
  - Get customer feedback
    - Companies get information about marketing and competition, which is valuable for developing new products and providing superior offers.
  - Improve reliability
    - E.g., companies ensure products arrive at customers in order and on time by increasing synergy and coordination between supply, production, and distribution.
- Increase Market Power
  - Firms can monopolize the market throughout the chain and provide competitors with less access.
  - Rise industry barriers to entry

Benefits/Drivers of vertical integration

- Facilitating investments in specialized assets
  - Specialized assets have a high opportunity cost:
  - They have significantly more value in their intended use than in their next-best use.
  - They can come in three types:
    - Site specificity
      - Assets required to be co-located, such as the equipment necessary for mining bauxite and aluminium smelting (i.e. the process of extracting aluminium from bauxite).
    - Physical-asset specificity
      - Assets whose physical and engineering properties are designed to satisfy a particular customer, such as bottling machinery for Coca-Cola.
    - Human-asset specificity
      - Investments made in human capital to acquire unique knowledge and skills, such as mastering the routines and procedures of a specific organization, which are not transferable to a different employer.
  - Investments in specialized assets tend to incur high opportunity costs because making the specialized investment opens up the threat of opportunism by one of the partners.
  - Backward vertical integration is often undertaken to overcome the threat of opportunism and to secure key raw materials.

Risks of vertical integration

- Often requires large upfront capital requirements to implement
  - heavy upfront capital expenditure requirements to acquire the proper company, integrate new and existing systems, and ensure staff are trained across the entire manufacturing process.
- A higher degree of vertical integration can lead to:
  - Increasing costs:
    - High market share can lead to reduce incentives to lower costs
    - The increased organizational complexity results in increasing administrative costs.
  - Reducing quality
    - High market share can lead to reduce incentives to innovate or to increase quality
    - Given the greater exposure to more customers, external suppliers may gain higher learning and experience effects and so develop unique capabilities or quality improvements
  - Reducing flexibility
    - When faced with changes in the external environment such as fluctuations in demand and technological change
      - E.g., Nokia

Alternatives to vertical integration - Taper integration

- A way of arranging value activities in which a firm is backwardly integrated but also relies on outside-market firms for some of its supplies and/or is forwardly integrated but also relies on outside market firms for some of its distribution.
  - Both Apple and Nike, for example, use taper integration: They own retail outlets but also use other retailers.
- Benefits of taper integration:
  - It exposes in-house suppliers and distributors to market competition so that performance comparisons are possible.
    - Rather than reducing its competencies by relying too much on outsourcing, taper integration allows a firm to retain and fine-tune its competencies in upstream and downstream value chain activities
  - Enhances a firm’s flexibility.
    - E.g., when adjusting to fluctuations in demand, a firm could cut back on the finished goods it delivers to external retailers while continuing to stock its own stores.
  - Firms can combine internal and external knowledge, possibly paving the path for innovation.
- Firms that pursued taper integration achieved superior performance in both innovation and financial performance when compared with firms that relied more on vertical integration or strategic outsourcing (Rothaermel, Hitt, & Jobe, 2006).

Horizontal integration

- Horizontal integration is a type of corporate strategy that can improve a firm's strategic position in a single industry.
- A firm should go ahead with horizontal integration if the target firm is more valuable inside the acquiring firm than as a continued standalone company.
- An industry-wide trend toward horizontal integration leads to industry consolidation.
  - Competitors in the same industry such as airlines, banking, telecommunications, pharmaceuticals, or health insurance frequently merge to respond to changes in their external environment (i.e. respond to Covid-19 pandemic, Financial crises, and etc.)
- Benefits:
  - Reduction in competitive intensity
    - Industry competition tends to decreased.
    - Firms find themselves in an oligopolistic industry structure and maintain a focus on non-price competition (i.e., focus on R&D spending, customer service, or advertising).
    - Because of the potential to reduce competitive intensity in an industry, government authorities must approve any large horizontal integration activity

Horizontal integration

- Benefits:
  - Lower costs
    - Through economies of scale or cost synergies in marketing; research and development (R&D); production; and distribution.
  - Increased differentiation
    - can help firms strengthen their competitive positions by increasing the differentiation of their product and service offerings.
      - Horizontal integration can do this by filling gaps in a firm's product offering, allowing the combined entity to offer a complete suite of products and services.
- Drawbacks:
  - Creation of a monopoly
  - Higher prices / Less options for consumers
    - Larger company may take advantage of consumers by raising prices and narrowing product options
  - Reduced flexibility for the new, larger company
    - Increased bureaucracy, and a greater need for transparency

Diversification

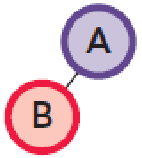
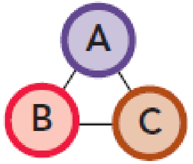
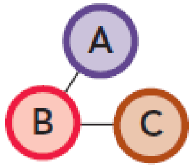
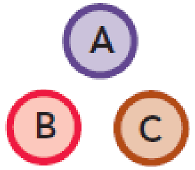
- Adding new businesses to the firm that are distinct from its existing operations.
- The goals of diversification strategy are:
  - To promote growth
  - To create additional stakeholder and shareholder value
    - Value is created when the strategy allows a company's businesses to increase revenues or reduce costs while implementing their global-level strategies
  - To mitigate risk

- Dimensions of Diversification:
  - Product diversification
    - Through entries into different industries
  - Geographic diversification
    - Through entries into different countries
  - Both product and geographic diversification

Product diversification

- Types of Product Diversification:
  - Related
    - Refers to entries into new product market or activities that are *related* to a firm's existing markets or activities
    - Emphasis on economies of scope at different location in the value chain.
      - Economies of scope exists among a firm's businesses
  - Unrelated
    - Refers to entries into industries that have no obvious product-related connections to the firm's current lines of business
    - Focus on financial synergy
    - Product-unrelated diversifiers (such as Samsung) are called conglomerates, and their strategy is known as conglomeration.

Levels of Product Diversification

Low Levels of Diversification		
Single business:	95% or more of revenue comes from a single business.	
Dominant business:	Between 70% and 95% of revenue comes from a single business.	
Moderate to High Levels of Diversification		
Related constrained:	Less than 70% of revenue comes from the dominant business, and all businesses share product, technological, and distribution linkages.	
Related linked (mixed related and unrelated):	Less than 70% of revenue comes from the dominant business, and there are only limited links between businesses.	
Very High Levels of Diversification		
Unrelated:	Less than 70% of revenue comes from the dominant business, and there are no common links between businesses.	

From Hitt et al. (2017)

Motives for diversification

- While the main motivation for diversification is value creation, adopting a diversification strategy may be motivated by other factors that may be value-neutral or even value-reducing.
- Motives that may result in value-creating diversification:
  - Economies of scope (related diversification)
    - Shared activities
    - Core competencies
      - Shared business level competencies
      - Corporate competencies
  - Anticompetitive
    - Multipoint competition
    - Exploiting market power
  - Financial economies (unrelated diversification)
    - Efficient internal capital allocation
    - Business restructuring

Motives for diversification

- Motives that may result in value-neutral diversification:
  - Tax laws
  - Low performance
  - Uncertain future cash flows
  - Risk reduction for firm
  - Tangible resources
  - Intangible resources

- Motives that may result in value-reducing diversification:
  - Diversifying managerial employment risk
  - Increasing managerial compensation

Motives for diversification - Value-creating

- Shared activities as an economy of scope
  - Examples:

Value Chain Activity	Shared Activities
Input activities	Common purchasing Common warehousing facilities Common suppliers
Production activities	Common product components (manufacturing) Common maintenance operation
Warehousing and distribution	Common product delivery system Common warehouse facilities
Sales and marketing	Common advertising efforts Common marketing departments Cross-selling of products
Dealer support and service	Common service network Common guarantees and warranties

Motives for diversification - Value-creating

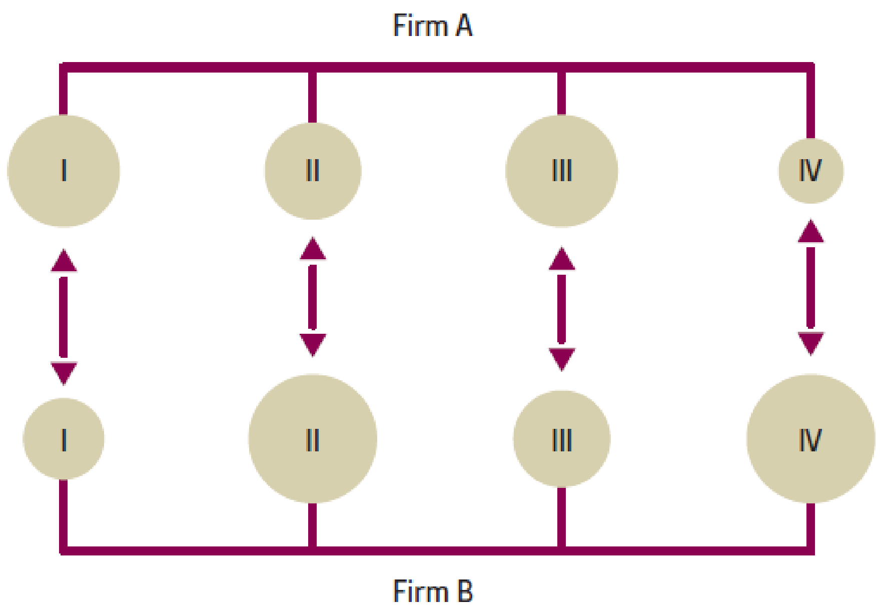
- Shared activities as an economy of scope
  - Failure to exploit shared activities across businesses can lead to out-of-control costs.
    - E.g., Levi Strauss's unwillingness to centralize and coordinate order processing led to a situation where six separate order-processing computer systems operated simultaneously. This costly redundancy was ultimately replaced by a single, integrated ordering system shared across the entire corporation.
  - Can increase the revenues in diversified firms' businesses.
    - "product bundles"
    - exploiting the strong, positive reputations of some of a firm's businesses in other of its businesses
  - May limit the ability of a business to meet its specific customers' needs
    - E.g., Businesses that share sales activities may have lower overall sales costs but be unable to provide the specialized selling required in each business.
  - If one business in a diversified firm has a poor reputation, sharing activities with that business can reduce the quality of the reputation of other businesses in the firm.
  - To the extent that a diversified firm can exploit shared activities while avoiding above problems, shared activities can add value to a firm.

Motives for diversification - Value-creating

- Core Competencies
  - Are complex sets of resources and capabilities that link different businesses in a diversified firm through managerial and technical know-how, experience, and wisdom.
  - Types:
    - Shared business level competence
      - When the business within a diversified firm that develops and then shares this core competence with other businesses in the firm in a non-domestic market
    - Corporate Competencies
      - A firm develops managerial skills, technical knowhow, experience, and wisdom in managing a diversified corporation.
      - This type of competence usually exists at a firm’s corporate headquarters, and may or may not be associated with shared activities.
  - Can be explored simultaneously with shared activities
  - However, core competencies is a result of the intangible nature of these economies of scope.
    - May cause invented competencies
      - i.e. illusory inventions by creative managers to justify poor diversification moves by linking intangible core competencies to completely unrelated businesses.

Motives for diversification - Value-creating

- Anticompetitive
  - Motivations for diversification is based on the relationship between diversification strategies and various anticompetitive activities by firms
  - Multipoint competition
    - Firms may tacitly agree to not compete in one industry in order to avoid competition in a second industry
    - The potential loss that each firms may experience in some of its businesses must be compared with the potential gain that each might obtain if it exploits competitive advantages in other of its businesses.
    - If the present value of gains does not outweigh the present value of losses from retaliation, then both firms will avoid competitive activity
    - To pursue such strategy:
      - The payoff must be substantial to all firms
      - Firms must have strong strategic linkages among their diversified businesses



From Barney and Hesterly (2006)

Motives for diversification - Value-creating

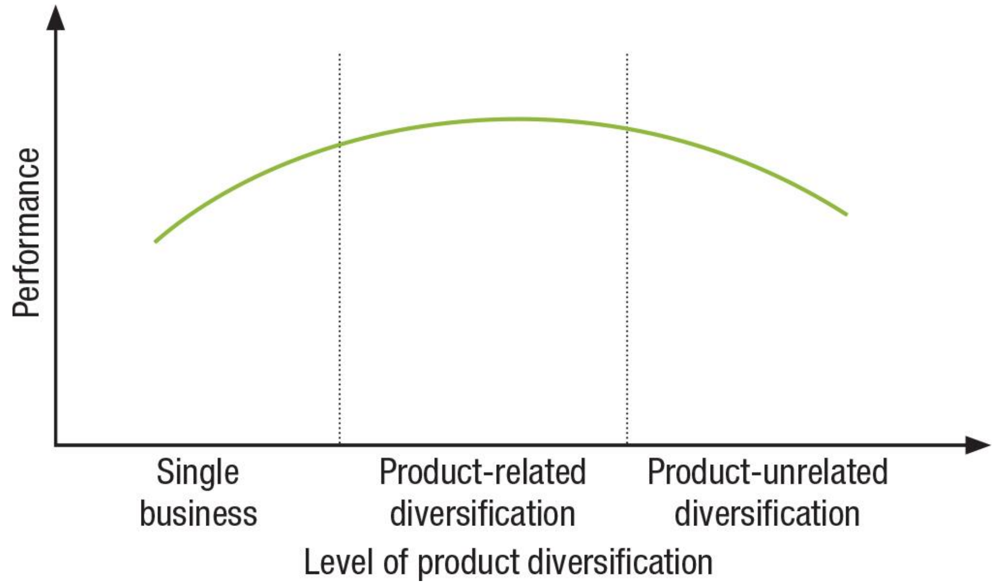
- Anticompetitive
  - Market Power
    - Exist when a firm is able:
      - To sell its products above the existing competitive level
      - To reduce the costs of its primary and support activities below the competitive level
      - Or both
    - Firms can use excessive profit from one business to subsidize the operations of another of its businesses.
      - Setting prices so that they are less than a business's costs
      - May be to drive competitors out of the subsidized business and then to obtain monopoly profits in that subsidized business.

Motives for diversification - Value-creating

- Financial economies (unrelated diversification)
    - Financial economies are cost savings realized through improved allocations of financial resources based on investments inside or outside the firm
    - An unrelated diversification strategy can create value through two types of financial economies:
        - Efficient Internal Capital Market Allocation
            - Diversification creates an internal capital market
            - Offers some efficiency advantages over an external capital market:
                - Inside information is available to the managers
                - No information leak to competitors
            - Over time, there should be fewer errors in funding businesses through internal capital markets, compared with funding businesses through external capital markets.
            - However, it greatly depends on managerial ability and incentives.
    - Restructuring of Assets
        - The diversified firm buys another company, restructures that company's assets in ways that allow it to operate more profitably, and then sells the company for a profit in the external market.
            - It is difficult to restructure intangible assets such as human capital and effective relationships that have evolved over time between buyers (customers) and sellers (firm personnel).

Motives for diversification -Value-neutral

- Tax Advantages
  - A diversified firm can use losses in some of its businesses to offset profits in others, thereby reducing its overall tax liability.
  - Empirical research suggests that the tax savings of these activities are usually small.
- Low Performance
  - Research shows that low returns are related to greater levels of diversification (Matvos, Seru, & Silva, 2018)
  - However, overall, the relationship of diversification and firm performance is curvilinear (Inverted-U shaped relationship)
    - Performance may increase as firms shift from single business strategies to product-related diversification, but performance may
    - Although low performance can be an incentive to diversify, firms that are more broadly diversified compared to their competitors may have overall lower performance.
    - Note that not all related diversifiers outperform unrelated diversifiers



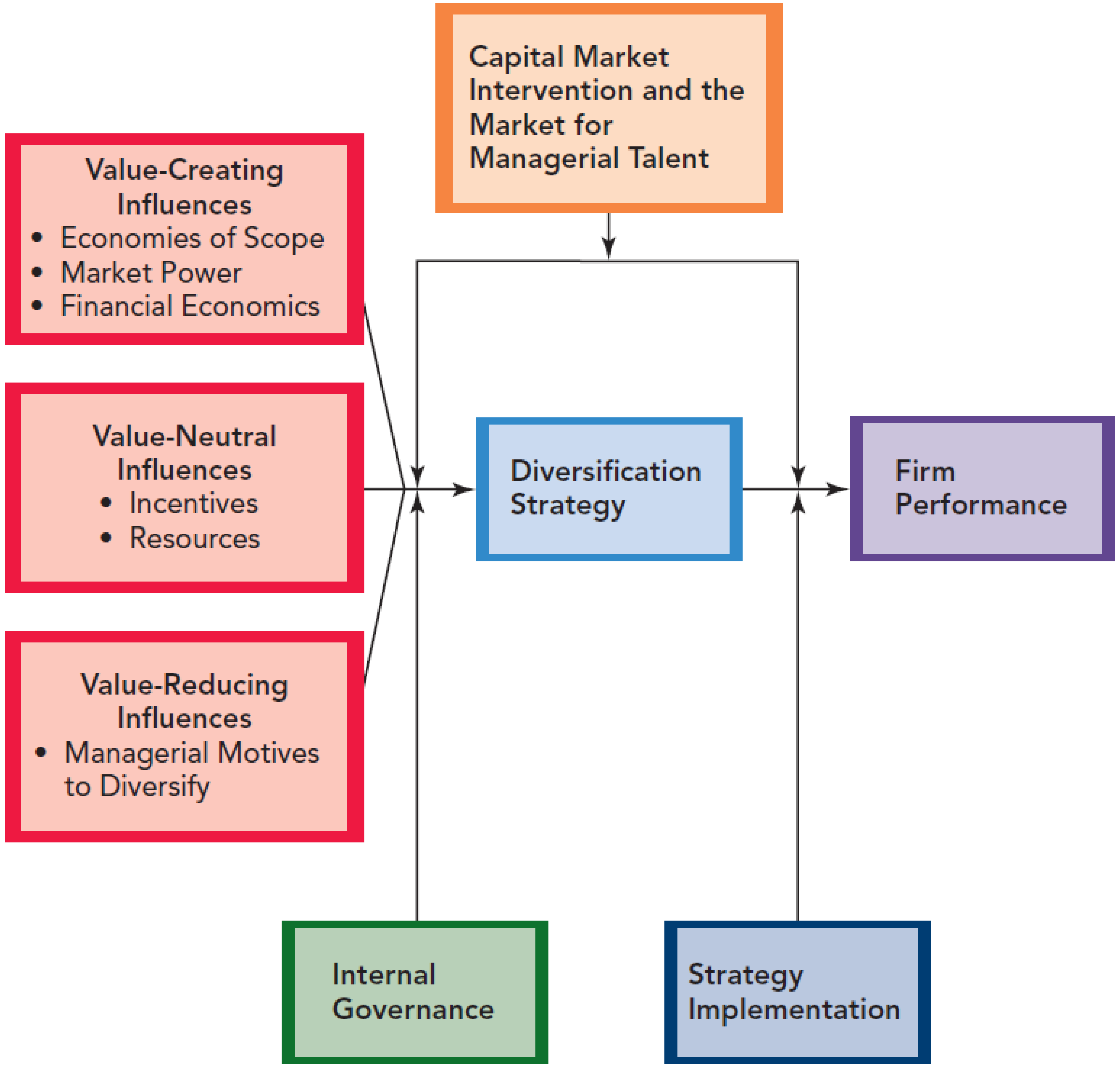
From Peng (2014)

Motives for diversification -Value-neutral

- Risk Reduction
  - If Business unit 1 is having a bad year, Business unit 2 might be having a good year, and a firm that operates in both of these business units simultaneously can have moderate levels of performance.
  - Firms that diversify to reduce risk will have relatively stable returns over time, especially as they diversify into many different businesses with cash flows that are not highly correlated over time.
- Tangible resources
  - Excess tangible resources (e.g., free cash flow, sales force) can induce mostly related diversification.
  - However, diversification based on financial resources only is more visible to competitors and thus more imitable and less likely to create value on a long-term basis.
- Intangible resources
  - Intangible resources such as tacit knowledge could encourage diversification

Motives for diversification - Value-reducing

- Managerial Motives to Diversify
  - Diversification provides additional benefits to top-level managers that shareholders do not enjoy.
    - Increased compensation and social status
  - A strong external market for managerial talent may deter managers from pursuing diversification



From Hitt et al. (2017)

Product Relatedness versus Other Forms of Relatedness

- Product relatedness has attracted three significant points of debate:
  - Can product relatedness be measured?
    - Consider Alphabet's (Google) products:
      - Search engines online advertising (original product), autonomous (self-driving) vehicles, connected home devices, delivery drones, Internet balloons, robotic arms, smartphones, and etc.
    - How do we characterize Alphabet's product relatedness?
      - An Internet-related products and services company ?
        - But in today's economy, what products and services are *not* related to the Internet?
        - Thus, such "relatedness" may not be very meaningful.
      - Can also argue that Alphabet is a conglomerate, with little product relatedness among its diverse businesses
      - Given that most of Google's "other bets" have tiny revenues and major losses and that its search engines generate the lion's share of revenues and profits.

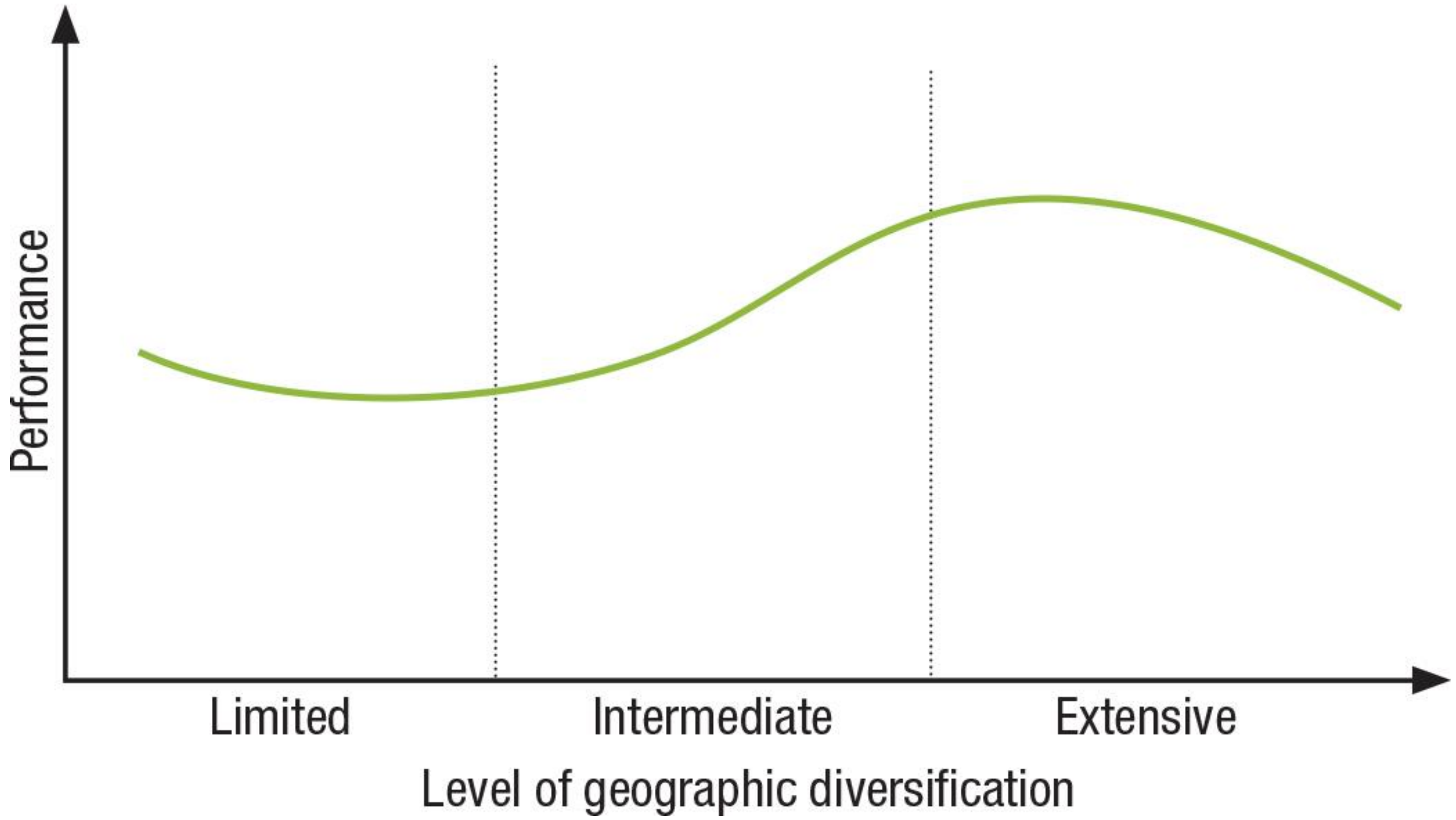
Product Relatedness versus Other Forms of Relatedness

- Product relatedness has attracted three significant points of debate:
  - The dominant logic school argues that it is not only the visible product linkages that count as product relatedness
    - Dominant logic:
      - A common underlying theme that connects various businesses in a diversified firm.
    - Instead of treating easyGroup as s a product-unrelated conglomerate, perhaps we can label it a related yield management firm?
  - “Product-unrelated” conglomerates may be linked by institutional relatedness
    - Institutional relatedness
      - A firm’s informal linkages with dominant institutions in the environment that confer resources and legitimacy.
    - E.g., sound informal relationships with government agencies—in countries (usually emerging economies) where such agencies control crucial resources such as licensing and financing—would encourage firms to leverage such relationships by entering multiple industries.
      - Samsung, Tata, and Wanda, which are often classified as product-unrelated conglomerates, may actually enjoy a great deal of institutional relatedness with the Korean, Indian, and Chinese governments, respectively.

Geographic Diversification

- Geographic diversification can be done domestically as well as internationally.
  - International diversification is defined as the number and diversity of countries in which a firm competes
- Categories of international diversification:
  - Limited
    - Geographically and culturally adjacent countries
  - Extensive
    - Scope extends beyond geographically and culturally neighboring countries
- Geographic diversification and firm performance
  - Call to “go global”
    - Effect of international expansion on low-level entry is initially negative
    - Moderate to high level of expansion shows positive relationship between geographic scope and firm performance, to an extent

Geographic Diversification



From Peng (2014)

Combining Product and Geographic Diversification

- Most firms have to accommodate both dimensions of diversification simultaneously
- Anchored replicators (Cell 3)
  - Focus on product-related diversification and a limited geographic scope
  - seek to replicate a set of activities in related industries in a small number of countries anchored by the home country.
  - E.g., Walgreens, until its recent merger with Alliance Boots, only operated drug stores in the United States, Puerto Rico, and the US Virgin Islands.
- Classic conglomerates (Cell 4)
  - Focus on product-unrelated diversification within a small set of countries cantered on the home country
  - E.g., Turkey’s Koc Group and China’s Wanda Group.

		Product Scope	
		Related	Unrelated
Geographic Scope	Extensive	(Cell 1) *Multinational replicator*	(Cell 2) *Far-flung conglomerate*
	Limited	(Cell 3) *Anchored replicator*	(Cell 4) *Classic conglomerate*

From Peng (2014)

Combining Product and Geographic Diversification

- Multinational replicators (Cell 1)
  - Focus on product-related diversification on the one hand and extensive multinational expansion on the other hand
  - E.g., Walgreens recently acquired the UK- and Switzerland-based Alliance Boots and formed a new combined company called Walgreens Boots Alliance, which operates drug stores in 25 countries.
- Far-flung conglomerates (Cell 2)
  - Focus on both product-unrelated diversification and extensive geographic diversification
  - E.g. Alphabet, Amazon, easyGroup, GE, Mitsui, Samsung, Siemens.

		Product Scope	
		Related	Unrelated
Geographic Scope	Extensive	(Cell 1) *Multinational replicator*	(Cell 2) *Far-flung conglomerate*
	Limited	(Cell 3) *Anchored replicator*	(Cell 4) *Classic conglomerate*

From Peng (2014)

Combining Product and Geographic Diversification

- Migrating from one cell to another, although difficult, is possible
  - Anchored replicators (Cell 3) strategically migrating to Multinational replicators (Cell 1)
    - When
      - Trade and investment barriers are lowered
      - The costs of doing business abroad are reduced
  - Classic conglomerates (Cell 4) strategically migrating to Multinational replicators (Cell 1)
    - Reduced their product scope but significantly expanded their geographic scope (Meyer, 2006).
    - Of course, in theory, they could also have migrated to Cell 2 or Cell 3. In practice, they mostly moved to Cell 1 (Peng, Kathuria, Viana, & Lima, 2021)

Geographic Scope \ *Product Scope*	Related	Unrelated
Extensive	(Cell 1) *Multinational replicator*	(Cell 2) *Far-flung conglomerate*
Limited	(Cell 3) *Anchored replicator*	(Cell 4) *Classic conglomerate*

From Peng (2014)

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