Strategic Management for Competitive Advantage
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Lecture 15
Diversification-1

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Welcome to the course strategic management for competitive advantage. Today, we will be talking about one of the grand strategies, which is diversification. We will discuss this elaborately.

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So, the concepts that we will be covering in today's lecture are diversification- there are many types of diversification, one is called concentric diversification, and another is conglomerate diversification.

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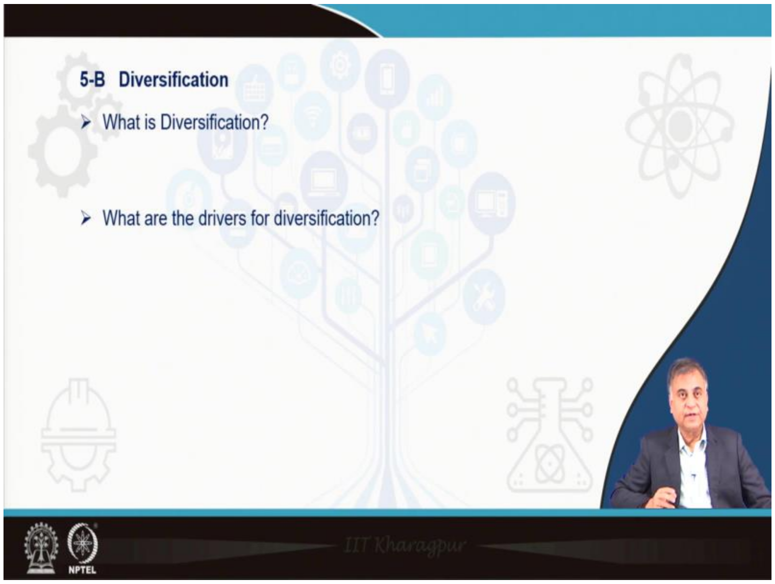

So, what is diversification, and what are the drivers for diversification? Diversification, as you have already seen, is one of the grand strategies, and particularly falls under a growth strategy.

So, what are the motives and drivers of diversification? Growth is one of the motives, other one for the reduction of risk, another motive is the value creation for the shareholders.

Now, what is diversification? Diversification is essentially a way a company wants to have opportunities for growth and reduction of risk, and utilization of its resources, facilities, equipment, and capabilities in the most efficient and effective manner.

Now, one of the main reasons for diversification is economies of scope. If I want to explain it another way, suppose an individual is having some surplus investable capital or cash.

So, what will an investor do with that (surplus cash)? If you have some surplus cash, first, you want to put it in a fixed deposit, or real estate. You may want to invest in a fixed bond - government bond while looking for stability, and low risk. And if after investing there, you still have some funds, you will go for mutual fund, then even after that, you have the money, you go for stock or equity.

So, you see, as you go down, your risk may increase, but the gain also increases as you take more and more risk. Generally, no one invests all their money in one or two shares, they broaden their scope of the risk and spread their risk by investing in a number of shares.

Similarly, what happens in the corporate world? In the corporate world, if you have surplus fund, what do you do? You diversify in related or unrelated products or businesses. So, you may acquire some company for diversifying.

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Now, what are the drivers for diversification? Drivers are firstly economies of scope, what are economies of scope? All of you must have heard of the economies of scale, we have discussed in previous lectures. But again, what are economies of scope?

Economies of scope are the use of common resources for more than one business or more than one product so that you get the cost advantage, instead. Suppose (say) two separate products or two or three separate businesses, if you use your resources independently and separately, you will consume more resources, but if you share those resources, you get economies of scope. As the output increases, you get the cost advantage.

So, by diversifying, you are achieving economies of scope, and also one of the aims of diversification is to have a greater market share. You want to have supremacy over the market, that is another driver for diversification.

And another important aspect of diversification is risk reduction. Like I told you, you diversify in different products or businesses because all businesses have a cycle of growth, cycle of maturity, and decline. You spread your risk or hedge your risk so that you reduce your risk vulnerability, that is why no individual invests in one stock they invest in many stocks. That is how you are spreading or reducing the risk.

Then another reason for diversification is utilizing existing managerial and operational talent. Many good companies have good talents of managers and operational people. If they have limited businesses or limited products, these people will be stagnated. For the growth of the company, you diversify, and your talented managerial and operational people can have their career advancement.

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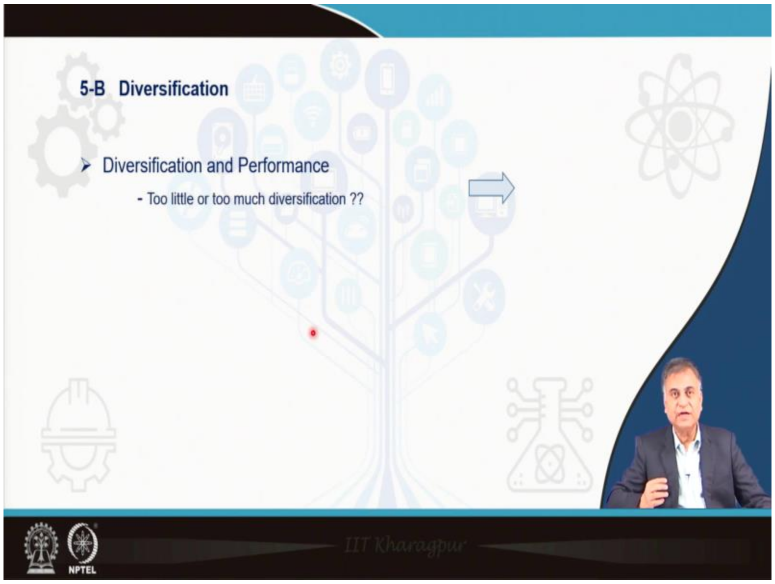

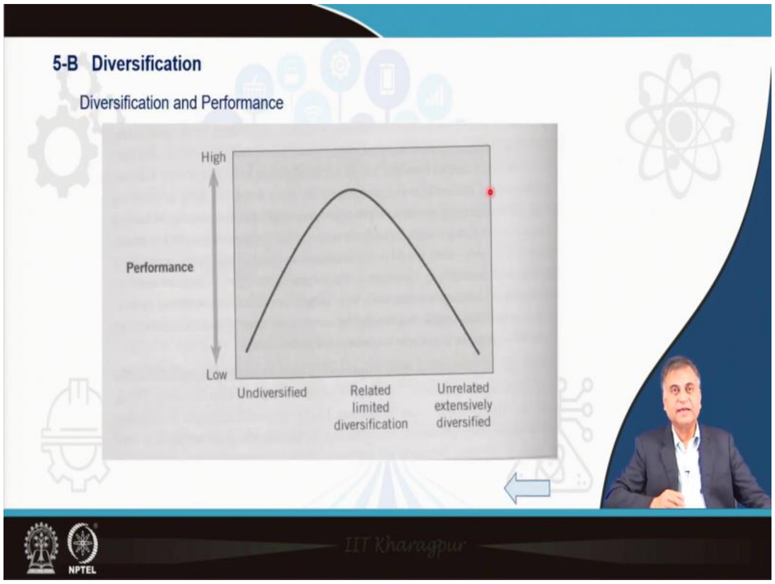

Now diversifications and performance, how does it relate or correlate? Is too little or too much diversification good or bad? In fact, too little or too many diversifications are not advisable.

So, if you see, this is the graph of diversifications and performance, if you see here, these are the performance high and low, and this is an empirical study. So, these are undiversified portfolios. These are related and limited diversification, and this is unrelated and extensive diversification.

So, you can see the performance is highest when you have limited and related that is concentric diversification - concentric. Limited diversification will give you the highest performance, and if you do not diversify in unrelated areas, these your performances are not that good. This answers whether too little or too much diversification is good or not. So, you have seen the empirical relationships between diversifications and performance.

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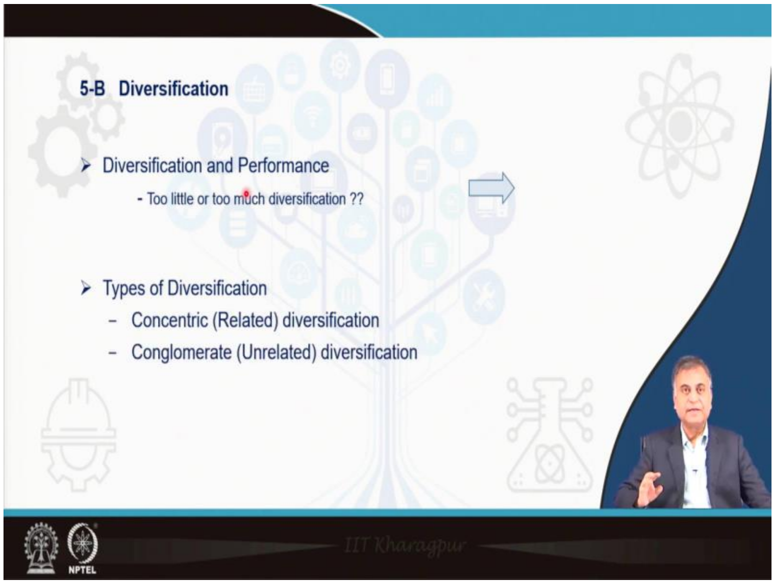

Next, we will talk about types of diversification. What are the different types of diversification? One is called concentric diversification another is conglomerate diversification. What is concentric diversification? Those are actually related diversification like when two or more products or businesses use the same available manufacturing facilities and processes, R&D efforts, human resources, distribution channel or sales and administrative works etc., then it is called concentric or related diversifications.

Like take the case of Apple, starting with the PC desktop, then it diversified to mp3 players, then notebook, smartphones, iPad, and other gadgets. But these are all related to their core competence, and these are called concentric diversification.

Similarly, if you see Google, Android operating system- they have developed, also the Chrome operating system using their own software developer, using their IT specialist, and using hardware specialist. So, these are related concentric diversification.

Another diversification is called conglomerate diversification. These are basically done for investment purposes. Here these products or the businesses are not related to each other, or they are not related to the existing business or the existing products. Again, those are not related to a common technology or by a common market. So, these are called conglomerate or unrelated diversification.

Take the case of ITC. ITC is in tobacco company, hotel or hospitality industry, paper and pulp industry, and food and consumer products. So, these are the conglomerate diversification.

Similarly, if you look at that Reliance, also to some extent, Reliance is in telecommunication (Reliance Jio), Reliance Infrastructure, Reliance oil and gas is in the oil sector, and under that also there are upstream,and downstream diversification. So those are conglomerate diversification, Reliance also has concentric diversification. So, these are called types of diversification.

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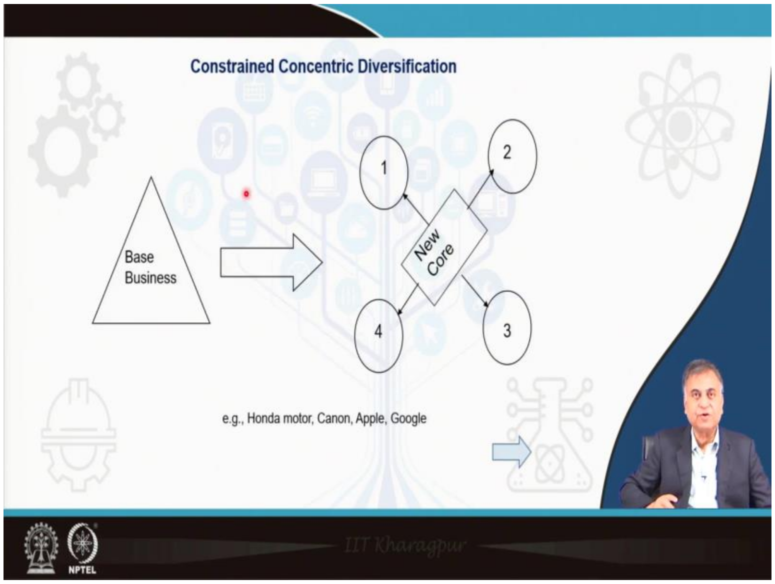

Now, we will talk about concentric diversification. Concentric diversification is also of two types, one is called controlled or constrained diversification here, new products or new businesses coming from a new core business are related to the new core businesses, and this new core is related to the base business. Take the case of Apple, and Google there, you have seen that they are in the constraint concentric diversification.

Similarly, Honda Motor, Honda motors is the world's largest motorcycle producer. They are also the suppliers of automobile engines and many related products. They have been doing it for the last 7 decades, and have distinct competence. So, they have gone through those constrained concentric diversification.

Similarly, Canon, Canon started with cameras, and then they diversified to Xerox machines, video, and the manufacturing of semiconductor equipment. But their core competence is in the basic 3 segments i.e., microelectronics, precision mechanics and fine optics. So, these are the concentric diversifications.

So, Nylon started with polyester filament yarns from their textile grade, then they diversified to the industrial grade and from those industrial polyester filament yarn, they have gone for the conveyor belt, V belt, and tires these are also the concentric diversification.

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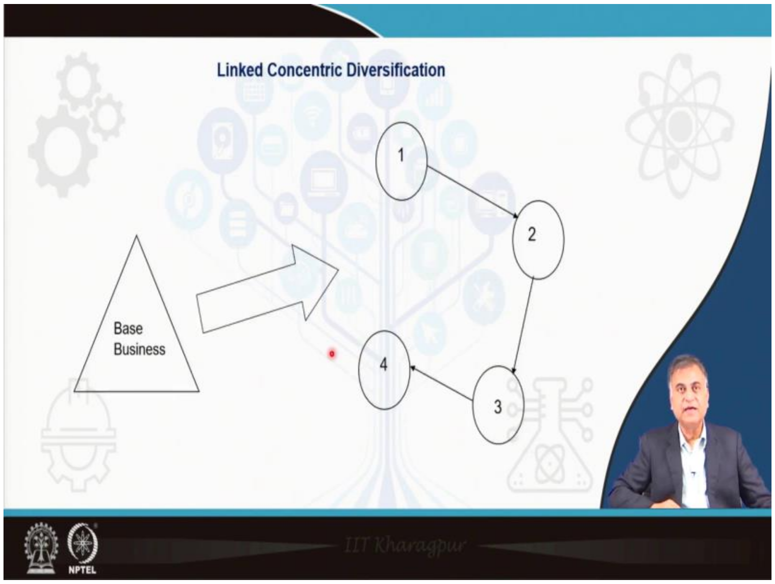

Another is called linked concentric diversification. What are these linked concentric diversification? The new products or businesses are linked to each other, but these are not linked to their core or the base businesses, these are different from the base businesses. But these links to each other are rather very weak, it is not a very strong link, and it is just a business relationship link. So, such linked concentric diversification is applicable when you have foreign collaborators, and they are supplying you the know-how or with the capital or with their own products. All it is applicable (there), where the margin is high.

Why will you go from a business which does not have any correlations with your base business if the margin is high? Take the case of Indian shaving products limited, they produce shaving blades, and now Gillette company have some considerable equity in this company.

So, what does Gillette do as an original parental company? They have diversified from blade to toiletry products, and also writing pads. So, they have provided the know-how to this company. The lucrative thing is that, in the blade industry, the margin is very low i.e., 8 to 10 per cent. But the other product i.e., writing products, pads and toiletries, their margin is more than 30 per cent.

So, it is a good proposition that is why they have got a product which has a business link but this chain is very weak and is called linked concentric diversification.

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Now, integration, there may be vertical integration. Vertical integration is of two types backward integration and forward integration. Then there may be horizontal integration, we will talk all about these - vertical integrations, horizontal integration. Then we will talk about the advantages and disadvantages of all these in the next few slides.

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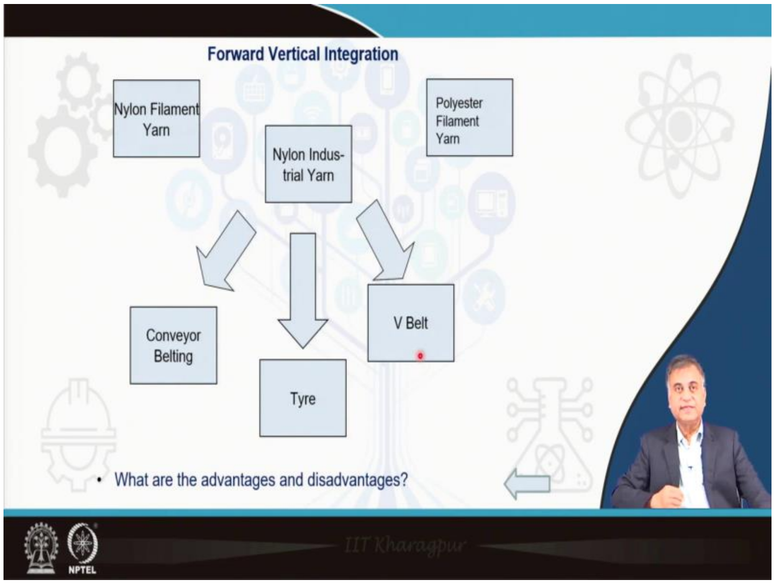

So, this is a forward vertical integration like you can see here Nylon filament yarn, polyester filament yarn from there, you come to the Nylon industrial yarn. After the Nylon industrial yarn, you go for the conveyor belting, tire, and V belt.

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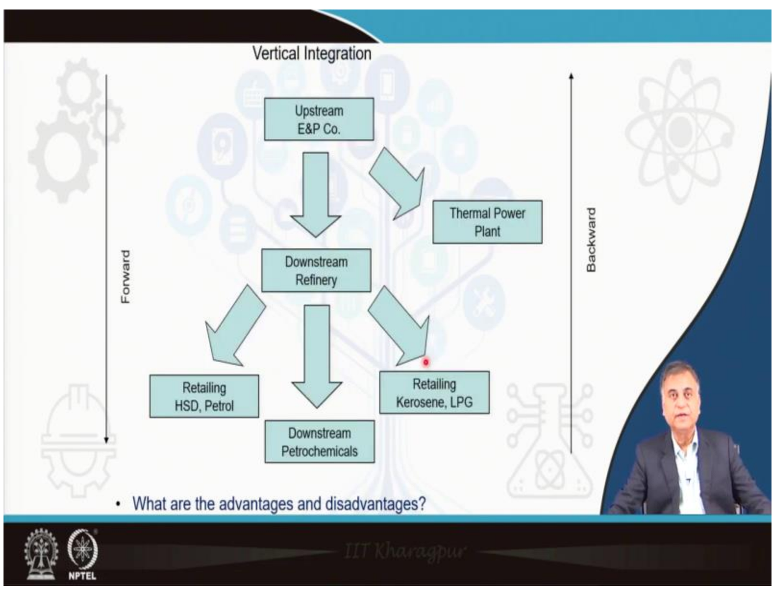

Now, if we see this vertical integration, say upstream Exploration and Production Company (E&P) say ONGC. So, ONGC was basically an E&P upstream company. Then they acquired the

Mangalore refinery, which is a downstream business and products, and the inputs come from oil and gas - comes from the upstream companies.

So, then ONGC, after this refinery had gone for retailing - HSD, petrol, and retailing kerosene, LPG. Then they have gone further downstream in the petrochemicals C2 and C3 plants in Dahej. They also have unutilized gas in the northeastern region, say in Tripura.

So, they have those unutilized gas there (Tripura). In northeastern states, there is not much industry, so, they have gone and built a gas-based power plant for electricity. So, these are all forward integration, they have gone forward integration.

Now, see the Reliance, Reliance has gone for the backward integrations like Reliance first had those petrochemicals - the Patalganga petrochemical (plant) then they have acquired IPCL Indian petrochemicals in Vadodara, then after that they have established Jamnagar refinery, and this is further downstream. From there, they have gone for the oil and gas exploration and production on the eastern coast i.e., the D6 structures. So, they have gone backward integration. So, ONGC has gone for forward integration, while Reliance has gone for backward integration.

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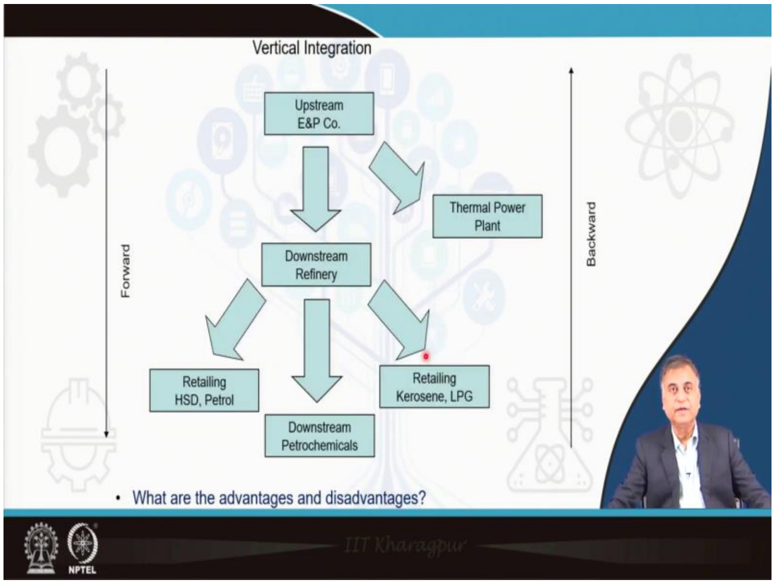

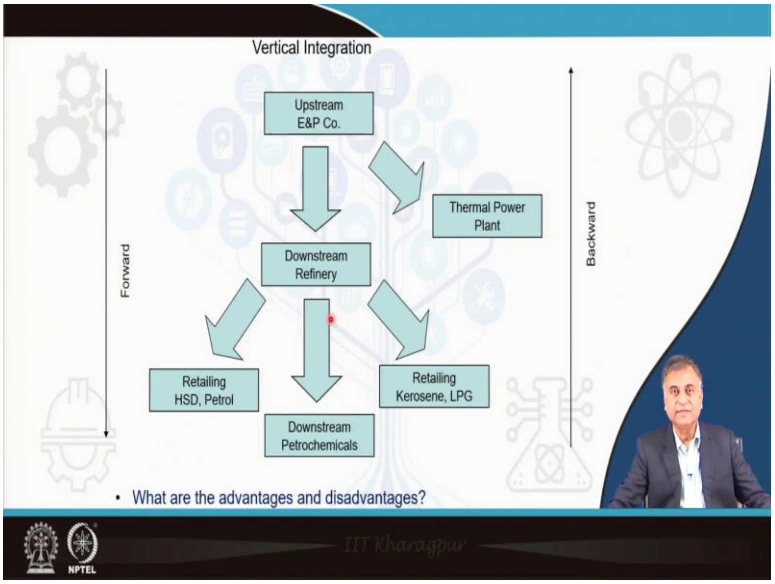

Similarly, if you see further this is Reliance, Reliance started in the 1970s with fabric there was only Vimal, then they went further backwards, that is, how those fabrics are produced from polyester filament yarn and polyester staple fiber.

So, they built those plants for making the fabric ingredients. Then this polyester filament yarn and polyester staple fiber are produced from what, what are the ingredients? Ingredients are Purified Tetra Phthalic Acid (PTA) and Mono Ethylene Glycol (MEG).

So, they have constructed and developed those PTA and MEG plants. Then they went further, what are the inputs of this PTA and MEG? So, these Para-Xylene comes from Naphtha, and Naphtha comes from those petrochemical plants and refineries. So, Reliance has gone complete backward integration. Now, what are the advantages and disadvantages of these forward integration and backward integration? I will just discuss it.

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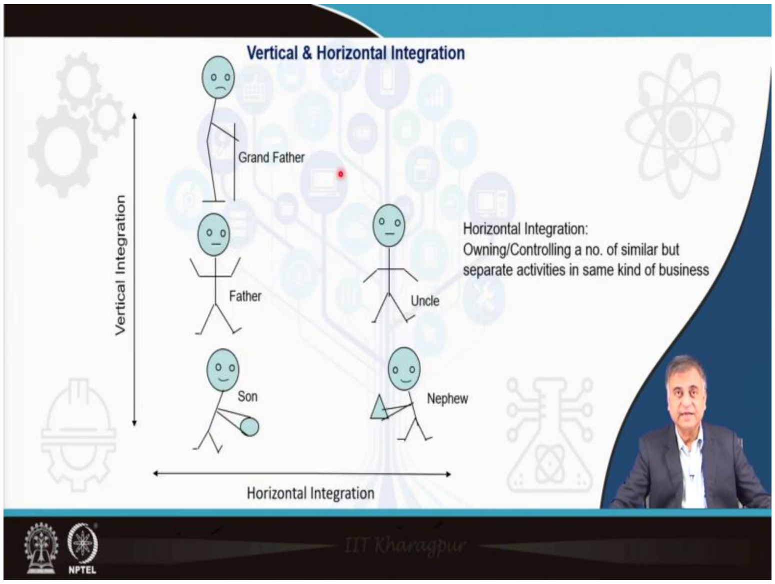

Let us first see this one. This is the vertical integration, grandfather, father, son. These are the horizontal integration we will talk about horizontal integration, what is horizontal integration? It is owning or controlling a number of similar but separate activities in the same kind of business.

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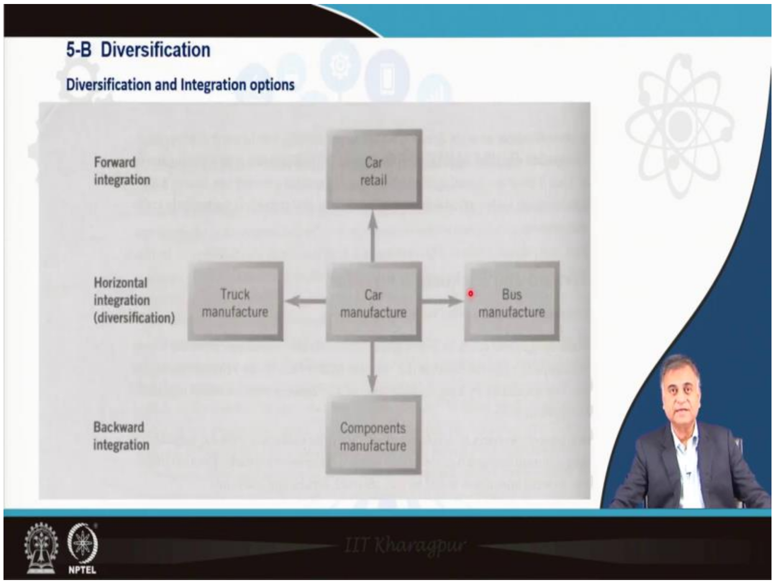

This graph will be useful for you. Suppose car manufacturer Maruti Suzuki, they are producing car now, if they want to diversify to bus manufacturing or track manufacturing, this is called horizontal diversification or horizontal integrations.

Now, if the Maruti Suzuki goes for car retailing, means they are going forward integration. If you are going closer to your customer, you are going nearer to your clients or the end users.

And what is backward integration? Now, if Suzuki wants to develop the components of the car, i.e., the engine or the tire or the radiator, if they want it to produce themselves, that is the backward integration i.e., you go towards the supplier's end.

Say Tata Motors, first, they were in truck and bus manufacturing, then they went for light commercial vehicle (LCVs) i.e., car manufacturing these are called horizontal integrations. Again, these are the concepts of forward and backward integration.

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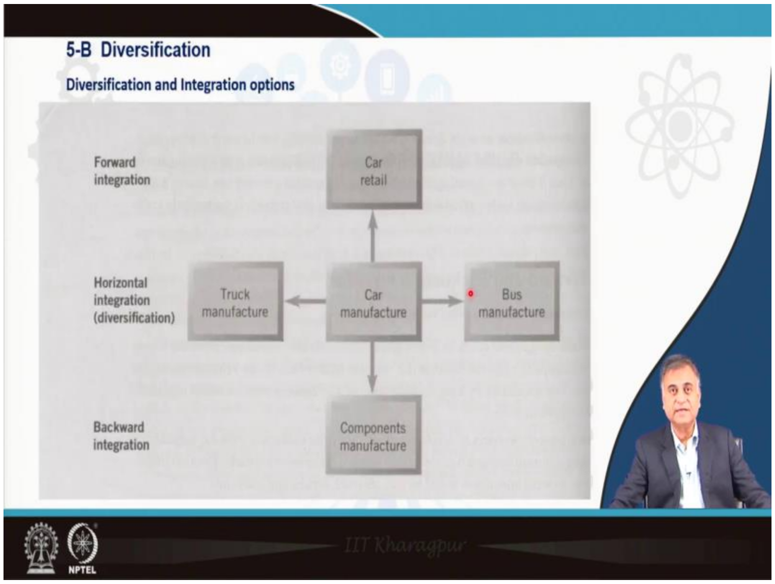

Now, coming to the point, what is the advantages of backward and forward integration?

The advantages are (say) first we take the case of backward integration, then we will go for the forward. Backward integrations, the advantages are that you have the overall control of the supplies of your inputs, and as a result, your quality check and control are at your hand.

So, your finished products, will have better quality, and when do you go for it? You go for it when your supplier margin is very high, or else you go for strategic reason, suppose those inputs are very strategic in nature, outsourcing sometimes may be threatening for your positions. So, you go for then backward integration.

If you see the Steel Authority of India, Tata iron and steel (Tisco), they have their own captive iron ore mines, they have their own coal mines, those are the very important strategic inputs for their (iron-making) steel plant. While having their own (iron ore), they also get it through outsourcing from others for strategic reasons. These are the advantages of backward integrations.

Then forward integrations, what are the advantages? The advantages of forward integrations are that you are closer to your customer. So, you have control over your distribution channel, you have control of your logistics, and then you have the inventory build-up for the dealer. And also, when do you go for it? When the dealer's margin is lucrative, then only you go for that.

So, when the markup is very high for the dealers, you go for this forward integration, but what are the disadvantages of this (forward and backward integration)? Disadvantages for both forward and backward integrations are similar. Your capital is locked up, and you lose your flexibility, because outsourcing- if you go for outsourcing, it is cheaper, also, if you outsource, you are free, your resources are free, and will give you more time to concentrate - more on the core businesses. So, these are the main disadvantages of backward and forward integration.

But nevertheless, when it is very strategic in nature, then you go for these backward and forward integrations. Another point, important point is that you have control over the warranty management, and after-sales services because you are not dependent on the dealer. These are the advantages.

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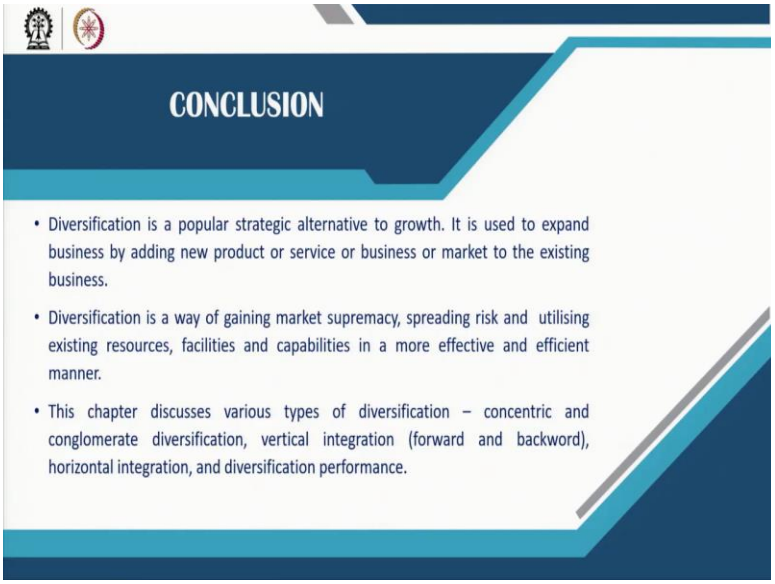

To summarize today's lecture, we will see what we have done so far. We have come to know that diversification is a popular strategic alternative to growth, it is used to expand business by adding new products or services or business or markets to the existing business. We have also discussed that diversification is a way of gaining market supremacy, spreading risk and utilizing existing resources, facilities and capabilities in a more effective and efficient manner.

We have also discussed various types of diversification, such as concentric diversification, conglomerate diversification, then vertical integrations, forward integration, backward integration, and horizontal integrations. We have also discussed the performance of diversification i.e., too many diversifications are good or too little diversifications are good? We have seen both are bad, and in fact, limited related diversification is good for the performance of an organization. So, this is in a nutshell, we summarize today's lecture.

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Then there are some reference books available, which you can refer to and enrich your knowledge. Thank you very much for attending.