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Corporate Strategy, Relatedness and Diversification

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Dr. Gert Bruche is Professor of International Management lecturing at the Berlin School of Economics. This paper surveys the discussion of the last decades on corporate strategy and horizontal diversification among strategy researchers and consultants. An earlier draft of the paper was presented at a workshop of Chinese and German experts on "Restructuring of State Owned Enterprises in China" on 6 May 2000 in Berlin. In the process of restructuring and privatising the State Owned Enterprises, China faces the choice of appropriate corporate models in terms of diversity and governance. The paper was meant as a basis for discussion of these issues, and for a number of propositions on the particular considerations of diversification strategies in emerging economies (like mainland China) which are not necessarily the same as in developed economies. The author is grateful to Gerald Lamusse for his helpful hints and suggestions to improve the text of this paper.

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Content

0. Introduction

1. Empirical – statistical research on diversification

- 1.1 Actual diversification development over the last decades
- 1.2 Diversification and company performance: results of empirical studies

2. The rationale of the related-diversified company

- 2.1 Relatedness based on tangible operational and market linkages
- 2.2 Relatedness and the cross-business transfer of competences and knowledge
- 2.3 Relatedness as the basis for market power based rents
- 2.4 Why does the exploitation of relatedness often fail?

3. The rationale of the unrelated-diversified company (conglomerate)

- 3.1 "Cognitive relatedness" based on a 'dominant logic'
- 3.2 Conglomerates as 'cluster managers'
- 3.3 Conglomerates as efficient governance structures
- 3.4 Superior use of talent and management resources

4. Diversification and refocusing in an evolutionary perspective

- 4.1 Diversification and the industry life-cycle
- 4.2 Dynamic value migration
- 4.3 Corporate strategy as evolutionary search for winner strategies

5. Organising, managing and controlling diversified corporations

- 5.1 The M-form corporation and two types of governance systems
- 5.2 Corporate styles and parenting advantage
- 5.3 Value based management of diversified corporations

6. Summary and Conclusions

Exhibits

Notes

References

0. Introduction

The Corporate strategy of diversified companies (as different from business level strategy) has two major tasks: (i) the selection of the mix of businesses (i.e. the decision on the 'diversification strategy') and (ii) the value enhancing management of this mix of businesses based on appropriate organisational structures, systems and resource policies. Although these tasks seem to be rather straightforward there are few topics in the strategic management literature that have been discussed as controversially as the issue of corporate diversification and the roles of corporate management. In fact, the influx of new concepts and terminology has up to now made (and still makes) it difficult to determine whether we are making progress in developing theoretical and prescriptive knowledge, or we are degenerating into a Tower of Babel. Given this situation the following survey takes stock of many contributions from different sources and perspectives, and attempts, by bringing them together in one integrated paper, to provide a balanced overview and facilitate an unbiased discussion.¹

The paper limits itself mainly to corporate strategy of 'horizontally' and "laterally" diversified companies. 'Vertical diversification', the operation of the diversified firm in markets that have buyer-supplier relationships with each other is not part of this survey (see on this topic for instance Antlitz 1999). The issue of "geographic diversification", i.e. internationalisation or globalisation of firms, has also not been taken up as the author believes that this is foremost a topic of business strategy; the term 'diversification' for this activity may even be misleading. It has been claimed that the boundaries of the modern corporation themselves are becoming more and more blurred as co-operative arrangements, 'strategic networks', and the 'virtual' or 'hollow' corporation, evolve into substitutes for the traditional integrated corporation (see for example Sydow 1992). Although this is certainly an important extension of the diversification discussion, again these issues will not be included in the survey, which has more modest ambitions.

The survey is structured into five major chapters. In the first chapter, after a short presentation of the findings on the observable degree of diversification in the overall economy, one of the key questions of research in this field is taken up, namely: is there a relationship between the degree and type of diversification of companies and

their economic performance? Chapter 2 explores the mechanisms, merits and pitfalls of “related diversification”, followed by chapter 3 which deals with contributions on “unrelated or conglomerate diversification”². Since most of the literature covered hitherto looks at the topic implicitly or explicitly from a static, cross-sectional perspective chapter 4 reviews some considerations from a longitudinal and more dynamic perspective. In chapter 5 attention then turns to the second task of corporate strategy mentioned above, namely the value enhancing organization and management of the diversified company, which is covered in a very selective fashion. In the last chapter the survey is summarized, some conclusions are drawn and some research desiderata are identified.

1. Empirical – statistical research on diversification

1.1 Actual diversification development over the last decades

In order to trace changes in the 'diversity' of companies over longer periods we need a descriptive typology that reflects different levels of diversification. One widely used typology allocates companies into groups according to a "specialisation ratio" (the firm's sales within its major activity as a proportion of its total sales) and a "related ratio" (the proportion of the firm's total sales that are related to each other) (see exhibit 1).³ Several studies that use this typology show a clear trend in the period from the 1950s until the 1970s: the number of single business companies fell steadily whereas the number of diversified firms increased; diversification became the preferred form of growth in this period (see exhibits 2-4).

Contrary to the impression one might get from reading the popular business press, that ‘diversification is out’ and refocusing is the dominant trend in the period from 1980 to the present, a closer look reveals that the reality is not that simple. Indeed, several studies and the observation of the business press seem to indicate a return to a more focused corporate model, which started in the US and the UK and spread later to continental Europe and Japan. Between 1980 and 1990 the average index of diversification for the Fortune 500 companies declined from 1,00 to 0,67 (Grant 1998, 366). In the U.S. unprofitable diversified businesses were increasingly attacked by leveraged buyouts often leading to the establishment of more focused companies. One study shows a trend in the US of divestiture of unrelated businesses, and

restructuring around fewer more closely related businesses (Grant 1998, 367). On the other hand, another study shows, for the Fortune 500 companies in the 1980s, that although many firms refocused, a large number of firms continued to diversify. The firms that refocused tended to those that had been "overdiversified", while the firms that diversified were the "underdiversified" firms (Markides 1996, 8). As a result there was only a small change in overall diversification levels of all Fortune 500 companies (Markides 1996, 8). Whilst these findings apply mainly to the US, another long-term study of the top 100 domestically owned industrial companies in France, Germany and the UK shows a long-term trend (from 1950 until the end of the observation period in 1993) of a rising share of conglomerates in the sample (Whittington 1999, 4) (see exhibit 5). The more recent restructuring and acquisition activity in Europe's telecoms, utility and banking sectors, seems to point again in the direction of refocusing whilst refocused companies at the same time try to establish pan-European operations or even to become "global players", i.e. in this context refocusing is the natural complement of a resource mobilization process for an internationalization strategy. All of this taken together, it becomes clear that the information on diversification development for the last two decades is rather inconclusive and more solid empirical-statistical research would be needed to categorize and describe the complex changes in corporate diversification.

1.2 Diversification and company performance: results of empirical studies

The relationship between the degree of diversification of a company and performance is one of the most researched questions in the academic strategic management literature of the last decades. A large number of empirical studies from the perspectives of a number business disciplines such as industrial economics, strategic management and finance tried to hypothesize and test empirically the question, which type of company or diversification strategy has led to better performance. In their survey of 82 studies on the diversification-performance linkage performed during the last three decades, Palich et al. (2000) selected 55 studies that could be included into a rigorous "statistical meta-analysis". They found three basic hypotheses in this literature (see exhibit 6) and then "tested" the hypothesis that companies with a low to moderate level of diversification display a better performance⁴ than either single business companies or conglomerates ('curvilinearity' hypothesis)⁵. As a result of their analyses a very large body of empirical research seems to confirm that diversification

tends to be beneficial up to a certain point beyond which it causes performance problems. This result has been shown to hold for studies over the past three decades.

Although it principally confirms the "curvilinearity hypothesis", the study makes the important reservation that "diversification may not be quite as strong a player as some have imagined, at least not when accounting-based measures are the focus" (Palich et al. 2000, 167).⁶ There are a number of shortcomings of the studies that are mentioned by Palich et al. themselves: the majority of diversification-performance studies failed to control for industry effects⁷, for firm size, firm leverage, advertising, capital, R&D intensities, and degree of internationalisation, each of which have been shown to have significant effects on performance. Apart from that, most of the 55 studies reviewed concern companies from the Anglo-Saxon world, which has a system of corporate governance and of financial market institutions quite different from those of European, Asian or Latin American countries. Besides this "cultural" or "institutional" bias a principal shortcoming of many studies conducted seems to be the static, cross-sectional approach thereby neglecting the aspect that diversification may often be a necessary stage in the "migration" of companies into areas with more attractive market opportunities (see part 5).

In addition to the more academic research, a few studies have been conducted in a more practice-oriented style. In one such study Boston Consulting Group analysed the total return to shareholders (TSR) for Germany's largest companies for the years 1991 until 1995. The study came to the conclusion that there is no clear relationship between type and level of diversification and TSR; there are "good" conglomerates and "bad" conglomerates as well as "good" and "bad" focused firms in the sample (BCG 1996, 150) (see exhibit 7). The investment bank Goldman Sachs comes to similar conclusions in a survey of the TSR of very large companies in the US and Europe (BCG 1996, 148).

In conclusion, it can be said that although three decades of empirical research may have provided some support for the "curvilinearity" hypothesis, an unbalanced 'glorification' of focus strategies or a generalizing criticism of diversification as put forward by many financial analysts⁸ and some researchers⁹ may be too simplistic. In the following, some of the reasons that may provide a potential for competitive

advantages of the diversified company compared to single business companies are reviewed. As the exploitation of these potentials may be dependent on additional factors such as the form of organization, the competencies of the management etc. the preceding inconclusive findings on diversification and performance do not necessarily imply that there are no potentials, but only that their exploitation probably needs additional conditions.

2. The rationale of the related-diversified company

The major rationale for the existence of related diversified companies and for the pursuit of related diversification by the management is based on the concept of "relatedness" between the different businesses of a diversified corporation (the author prefers this straight term to the commonly used term 'synergy'¹⁰). Certain types of relatedness can be exploited to achieve a competitive advantage of the "diversified related business company" over single business competitors (be they independent single business companies or the individual businesses operating as part of - unrelated - conglomerates). The multitude of competing, overlapping or simply unrelated concepts of relatedness and competitive advantage in the literature can be assigned to four different lines of thought: the "traditional" approach to tangible operational relatedness as proposed by industrial economists; the competence and knowledge based approach to relatedness emphasized in resource based management theory; the market power version of relatedness (again investigated by industrial economists and more recently by game theorists). The fourth approach is an attempt to define a form of "strategic relatedness" based on the strategic similarity of businesses; since it does not require any 'tangible links' between the businesses this concept will not be discussed here, but later as one of the possible 'rationales' for the process of value creation in conglomerates (see part 3.1). After having discussed the potential advantages of the related multi-business corporation, a final chapter investigates some reasons why these potentials can often not be exploited to the full or may be outweighed by disadvantages.

2.1 Relatedness based on tangible operational and market linkages

The most widely accepted rationale and perceived competitive advantage for a 'related diversified multi-business firm' is usually found in a number of tangible relationships among its business units. "Tangible relationships arise from opportunities

to *share activities* in the value chain among related business units due to the presence of common buyers, channels, technologies and other factors" (Porter 1985, 323-324; *emph. added by G.B.*). Such tangible relationships in activities, for instance in procurement, production, marketing and sales, may lead to competitive advantage if sharing leads to lower unit cost or enhances differentiation of the businesses' products (see for an illustration exhibit 8). Economists and strategists have dealt with the issue of tangible relationships under the term "economies of scope" (e.g. Baumol/ Panzar/ Willig 1982)¹¹, a term that should be reserved exclusively for the lowering of units costs due to activity or resource sharing.¹²

One important type of market relatedness is that of complementary products. Products from nearly every industry are used by the buyer in conjunction with other complementary products. Computers are, for example, used with software and printers, cars are often bought with loans, and need servicing and repair, TV sets are combined with video recorders, plants for electroplating processes are used with the chemicals to perform the processes. Three strategic practices regarding complements can be distinguished (Porter 1985, 417): (i) Controlling complements which concerns simply the primary question, whether the firm wants to offer complementary products itself or leave this to other firms. (ii) Bundling, indicating that the firm sells separable products or services to buyers only as a package, a bundle. Similar concepts are: providing 'system solutions' or total solutions to the customer (IBM was famous in the 70s and 80s for this approach), or, the development of 'category management' capacities by producers (such an approach is for instance pursued by the German office supplies company Herlitz AG) in the market for fast moving consumer goods. (iii) The strategic idea behind cross- subsidization is for firms to deliberately sell one good at low profit or even at a loss in order to sell more profitable items. A typical example of these practices is for instance the pricing used by many jet engine makers, who sell their engines at cost or below because the real business comes from selling spare parts and maintenance over the long lifetime of the engine. The selling of complements and bundling (or offering total customer solutions) is one important rationale for diversification and has many important strategic implications regarding cost and differentiation position (see Porter 1985, chapter 12).

2.2 Relatedness and the cross-business transfer of competences and knowledge

Whereas strategic management research in the tradition of industrial economics focuses more (although not exclusively) on tangible interrelationships, researchers in the tradition of the resource-based view of the firm see mainly the intangible resources, such as know-how and particular capabilities or competences as the basis for decisions on corporate portfolio building, diversification and divestment decisions (the classic work is Penrose 1959/1995; for a good overview see the book by Campbell/Luchs 1997 with many important contributions)¹³. Expertise in a certain (platform-) technology is an example of a 'core competence' that could be shared among several businesses. As the cost of developing such a competence has already been incurred, and because competencies based on intangible resources are less visible and more difficult to understand and imitate, transferring these competencies from one business unit to another one or using the competency to enter a new business field may save costs and enhance competitiveness. An often cited example would be the entry of Honda from motorcycles into many related fields based on its engine technology. Based on examples such as Honda, Prahalad and Hamel (1990) advocate in an influential article that the diversified corporation should not be seen as a portfolio of discrete businesses, but as a collection of competitively important competencies that could be used in different products and markets.

The research in this field is vast and has led to numerous frameworks and attempts to develop analytical and prescriptive tools. It is mainly concerned with question of how those competencies that can provide the basis of diversification can be identified in practice, how competences can be built, acquired or lost, and how a transfer of competences across businesses can be achieved (see Markides/Williamson 1994, Snyder/Ebeling 1992 or Collis/Montgomery 1998 as examples for this literature). An interesting competence-based perspective on the issue of relatedness and corporate strategy has been developed by Goold, Campbell and Alexander (1995), who argue that even if there are (intangible) interrelationships between businesses there is no logic for a competence-based corporate portfolio strategy if the parent company (or the 'headquarter') does not have the required 'parenting skills'. Parenting skills are capabilities that do not reside in the business units, but are required core skills of the parent company without which relatedness between the businesses in the portfolio cannot be exploited.

The existence of the related diversified multi-business corporation has also been explained in a transaction cost theory perspective. Transaction cost theory asks whether the exploitation of relationships such as know-how or physical plants that can be applied in several businesses, necessitates hierarchical governance, i.e. is better achieved within a diversified business rather than through leasing or selling the underused assets to other firms via the market. From this perspective, in all situations where there are prohibitive transaction costs (due to risk of opportunism, information asymmetries and measurement problems) hierarchical governance, i.e. the diversified firm, is the more efficient solution (Teece 1980, 1982, Hill 1994). The main criticism has been that transaction cost theory cannot really explain the multiproduct firm as it focuses on transaction cost only and does not (cannot) include production cost and overhead cost, which are affected in the case of resource and know-how sharing across businesses of one firm (see for instance Antlitz 1999, 31; Sydow 1992, 150; Kay 1992, 326).

2.3 Relatedness as the basis for market power based rents

Diversification may not only enhance profitability by increasing efficiency or differentiation, but also by creating market power and/or limiting the intensity of the forces of competition. The large diversified corporation may have an advantage over the specialised firm in several respects: (i) Comparable to global firms that can finance competitive battles in individual countries through cross-subsidisation (Yip 1992, chapter 7) diversified firms may use size and diversity to drive out more specialised competitors from particular product markets through cross-subsidisation and predatory pricing¹⁴ (Grant 1998, 373). Moreover, the firm that has developed a reputation for toughness through carrying out predatory acts once may deter the entry of other competitors to the particular product market. (ii) Reciprocal buying arrangements may allow a diversified company to use its buying power across its many businesses to give preference to suppliers, who become loyal customers for another of the company's businesses (Grant 1998, 373). (iii) Again comparable to global firms large diversified companies may have more options for action and thus more power vis-a-vis societal stakeholder groups (Ringelstetter 1995, 94). (iv) The provision of complementary products by a diversified company (see above) may not only differentiate it in the sense of meeting customer preferences, but also give it a position

of power due to significant switching cost for the customers who have become dependent on the "total solution" provided. (v) Finally, the research on multimarket competition has shown that multimarket competitors, due to their multiple response and sanctioning options, have a tendency to refrain from aggressive action as 'focal points' or natural equilibrium points for competition may be more prevalent. The generally more collusive behaviour among diversified multimarket competitors can thus improve profitability for diversified firms (Bernheim / Whinston 1990; Neubauer 1999).

2.4 Why does the exploitation of relatedness often fail?

Although the sharing of activities and resources can lead to unit cost savings and enhanced differentiation, the exploitation of interrelationships through horizontal strategy may also bring with it several categories of additional costs. The cost of coordination that will be influenced by the potentially greater complexity of a shared activity, the cost of compromise meaning that businesses may have to perform an activity in a suboptimal due to the necessity of sharing it with other units, and the cost of inflexibility (Porter 1985). Another frequently quoted argument is that of the limited information-processing capability of corporate headquarters (bounded rationality) and the enormously complex information needs for strategically managing a large range of businesses (Hill 1994). A further reason is that as the related diversified company becomes very complex, the likelihood of political manoeuvring and tactical self-interested behaviour of business management teams will inevitably increase (for this and the following arguments see Campbell/Sadtler 1998). Generally, it can also be said that corporate staff are often very far away from the real business and do not have direct exposure to customers and the market. This makes the service they provide unresponsive or uncompetitive, or both (a good example are internal IT departments, which often reduce the competitiveness of the businesses they are supposed to serve, which is why so many of them are being farmed-out in outsourcing deals). As a final reason, the acquisition premiums that are often paid in related diversifications prove to be a bonus only for the seller, often being simply much too high for the buyer to recoup through the exploitation of relatedness.

3. The rationale of the unrelated-diversified company (conglomerate)

The reasons for the possible existence of competitive advantages of 'unrelated diversified companies' or conglomerates as well as more generally their 'raison d'être', are less clear as compared to those for the related diversified corporation. Four issues have been selected from the inconclusive and often contradictory discussion. Firstly, the reason for the success of a number of conglomerates may be found in a 'cognitive relatedness' of their businesses, although these may seem to be unrelated at first sight. Secondly, many so-called conglomerates (e.g. GE or Siemens) are in fact groups of unrelated clusters of related businesses. Thirdly, many defenders of the conglomerate argue from a corporate governance perspective, i.e. that conglomerates may be efficient capital allocation mechanisms. Fourthly, conglomerates may be particularly good breeding grounds for managerial talent and provide a basis for attracting and rewarding good managers.

3.1 'Cognitive relatedness' based on a 'dominant logic'

Starting from an analysis of the various sources of relatedness investigated by management researchers and theorists, Prahalad and Bettis (1986) propose another "elusive" linkage between businesses, which they find in "strategic similarity". They argue that strategically similar businesses can be managed using a single "dominant management logic", which they define as "the way in which managers conceptualize the business and make critical resource allocation decisions" (p. 490). This type of relatedness is different from the more tangible forms mentioned above in that it is a cognitive concept - it is "stored process knowledge", a "mind set" of the management, a conceptualization of the business (p. 490, 491). Strategic similarity of seemingly unrelated businesses arises from many different aspects of business (see exhibit 9). The importance of Prahalads and Bettis argument is that strategic similarities can be found between businesses with the more tangible forms of relatedness as well as between seemingly 'unrelated' businesses. This would explain some of the confusion about conglomerates. As Grant put it in an note on Prahalad and Bettis' article, "observation of any consistently successful conglomerate reveals well-developed and highly effective corporate management systems applied to business units which share key strategic similarities" (Grant 1988, 641). This type of relatedness, which has also

been termed "corporate relatedness" (to distinguish it from business level relatedness) can exist in both related diversified companies and conglomerates.

3.2 Conglomerates as 'cluster managers'

Some confusion also arises because the businesses of many of the big so-called conglomerates (e.g. Siemens, GE, Preussag etc.) are 'related' and 'unrelated' at the same time. They own 'divisions' or 'groups' which are in fact engaged in different unrelated 'sectors' of the economy. Within these groups, however, they often own a cluster of related businesses. As they manage clusters of businesses they may well have competitive advantages at the level of 'divisions' or 'groups' due to relatedness, although this may not be the case at corporate level. The definitional problem of what constitutes 'business level' and therefore also in which cases we can start considering 'cross-business' relationships, runs through the whole discussion of diversification (economists tending to consider markets or businesses in much broader terms than would be justifiable upon closer inspection).

3.3 Conglomerates as efficient governance structures (internal capital market)

One argument in favour of the conglomerate has been that compared to the allocation of financial resources by owners through the buying and selling of shares, diversified firms and particularly conglomerates facilitate the mobilization of "slack resources" (Ringlstetter 1995, 101). This can for instance be funds accumulated from depreciation of assets which in single business companies may not find attractive investment opportunities, as they may be considered by the management of these companies as belonging to the firm and therefore not used productively enough. The holding of a diversified company on the other hand can divert these "slack resources" from cash cow businesses into more attractive uses (Funk 1999, 763).

A second line of arguments is based on principal-agent considerations. According to Williamson (1970, 1975, 1985) the capital market suffers from information and control disadvantages in its relationship with freestanding firms. The management of diversified companies can be considered as a 'qualified fund manager' who holds valuable know-how about markets and businesses as well as about the quality of businesses' management. Cash-flow projections can therefore be analyzed and

evaluated much better by the holding of a diversified company than by the shareholder or the "normal" fund manager (Funk 1999, 763). Corporate management teams of diversified firms are therefore able to establish internal capital markets that overcome the information and control disadvantages of the external market (see also the summary of the discussion by Hill, 301-305). This argument in favour of conglomerates has also been put forward in particular in defence of the conglomerates of emerging economies like such as South Korea, India and Indonesia, where this form of corporation acts as a "substitute" for a range of institutional voids - inter alia the lack of an efficient capital market (Khanna/Palepu 1997, Achi et al 1998).

Another line of argument in favor of conglomerates, has been that they allow a balancing of risk and return among a number of independent businesses and thus provide stability and the chance to pursue more long-term strategies (see the short overview of the debate in Oster 1999, 190-192). The conglomerate may also, on average, obtain cheaper financing for its overall business compared to single business companies, especially if these are active in more risky business environments or of relatively small size. The standard argument against this line of thought has been that a proper diversification of an investor's portfolio can be achieved by simply diversifying his investments into shares of different firms, and that there is no need for this to be undertaken by the diversified firm. An argument related to risk-return considerations is that only large cash rich companies can enter into new uncertain businesses with long investment pay-back periods and with the commitment of significant management resources, and more often than not it is mainly diversified companies which are in a position to do so (e.g. the original build-up of the mobile phone business by Mannesmann in Germany). In this way the conglomerate is, in some cases, the most effective way to execute change/transition processes between industries.

3.4 Superior use of talent and management resources

A third argument bears some relationship to resource-based theory, already mentioned above as well as to the concept of dominant management logic (see Funk 1999, p.763-764). Broadly diversified conglomerates may have some advantage in developing human resources, particularly in the field of management resources. Since they offer a broad range of managerial tasks in many businesses, they are often able to attract the best managerial talent. At the same time and for the same reason, they

also have an advantage in developing managers into, and preparing them for, top positions. Another related argument has been that as diversified corporations reduce managerial risk, managers of diversified firms have stronger incentives to invest in company specific know-how acquisition (Oster 1999, 192-194). In this sense diversification is one of the instruments managers have to protect their investment in the organization. This, in turn, can increase the value-creation of the conglomerate firm as compared to single business or even related-diversified corporations.

4. Diversification and refocusing in an evolutionary perspective

The mainly static views presented so far neglect the fact that the phases of diversification and refocusing can be also seen as transitory stages in the evolution and self-transformation of companies. One longstanding, and two more recent contributions from this perspective are reviewed below: the idea that diversification is a reaction to the life-cycles of industries; the concept of 'business or value migration' in based on the process of 'defragmentation' of the vertical value chain; the idea of strategy as an evolutionary search for business opportunities.

4.1 Diversification and the industry life-cycle

In many industries we find that firms push to find new areas in which to reinvest their assets as the industry and the firm ages (see for this proposition Levitt 1984, Chenhall 1984). This is in line with the usual life-cycle of most products. In the early phases of the life cycle investment costs are typically high: research and development, high advertising spend to build up the market, building of new capacity, and strong demand on managerial resources to keep up with activities in the core market. In a later stage of the market evolution, industry supply increases, competition shifts to a price base and cost management skills may become more important. This implies that as the organization ages it may develop excess capacity in particular functional areas. Diversification is a way to use that excess capacity. The alternative of shutting down excess capacity is often not an option due to the high transaction costs of changing the infrastructure of an organization or the difficulties of exiting an industry (Harrigan 1981). The view of diversification as putting excess capacity to new uses is actually one of key arguments for the growth of the firm proposed by one of the pioneers of

resource-based theory, who put particular emphasis on the use of excess capacity in managerial resources (Penrose 1959/1995).

4.2 Dynamic value migration

It has been proposed that certain conglomerates that have performed well over long periods of time¹⁵ have undergone a permanent process of business migration, i.e. of restructuring their portfolios in order to divest underperformers and to strengthen value creators or enter into new promising businesses (Heuskel 1999). According to this view success is not in the first instance the result of either a particular degree of diversification or focus, nor of the ability to exploit relatedness or other factors, it is rather the ability to permanently renew the portfolio of businesses with sufficient speed in order to respond to new challenges in a world that is fundamentally uncertain and unpredictable. Heuskel characterizes these conglomerates with the term "breathing enterprises" (Heuskel 1999).

In the last five years or so, the logic of this migration process has come under the influence of yet another development. In order to understand the 'path' of business migration (i.e. the direction of many diversification and 'refocusing' movements) it is necessary to look at the implications of the on-going revolutionary changes in the economics of information for the traditional vertically integrated firm. The proposition is that the new economics of information renders the need of close vertical integration of value creating steps in one firm partially obsolete and thus facilitates and drives the deconstruction of the traditionally vertically integrated value chains of large companies (Stern 1998). The different stages of the value chain develop into independent markets and the old product centered companies migrate horizontally or vertically and develop into different types like layer players, orchestrators, market makers etc. (Heuskel et al, 2000). Traditional industry boundaries become more and more blurred (see exhibit 10). Examples for this development are the deconstruction and reconfiguration of the PC industry, the migration of oil companies into food retailing (gas convenience shops), of the car companies into finance and banking, and of the electricity suppliers into multi-utility and telecoms.

4.3 Corporate strategy as evolutionary search

Another stream of thought starts from the idea that strategies are based on narrow predictions about an inherently uncertain world. Based on our understanding of biological evolution and on the way robust complex adaptive systems survive Beinhocker (1999) suggests that companies should not have singular focused strategies but instead "cultivate and manage *populations of multiple strategies* that evolve over time" (p. 97, *emph. added by G.B.*). He uses the metaphor of a company trying to find the high points (profit opportunities) in a landscape by deploying platoons of hikers who are permanently on the move in a parallel search process and who mix short and long jumps (short incremental and major long-term decisions). There are many further useful analogies with nature and biology that are drawn by Beinhocker and proposals how the evolutionary search process can be organized more effectively. General Electric and Microsoft are portrayed as companies in which many of the features for "evolutionary search" have been realised (p.104). Although the article is not explicitly meant as a contribution to the diversification / focus controversy, it clearly suggests that the diversified company, and particularly also the well-managed conglomerate, may be understood as an organisation for the management of populations of multiple strategies and thus provides a very robust adaptive organisational set-up that may, under certain circumstances, have better survival chances than the single-business firm.

5. Organising, managing and controlling diversified corporations

The preceding chapters were concerned mainly with the questions related to the first task of corporate strategy, namely, on which basis or with which rationale to select the businesses the company should compete in. The second task of corporate strategy concerns the issue of how the given diversified corporations can be managed profitably. As this again opens a very broad field, only a few important contributions have been selected for inclusion in this survey. First, a broader perspective from the view of institutional economics and organization theory outlines two different forms of governance of diversified corporations. Secondly, we review some of the literature that tries to develop typologies of organisational or management 'styles' of diversified corporations, usually based on a limited number of in-depth case studies, and then tries to identify the special roles of the headquarters. Thirdly, the issue of the

shareholder value movement and the implication for the management of diversified corporations is raised.

5.1 The M-form corporation and two types of governance systems

It has been argued that the multidivisional structure (M-form) is the appropriate organisational form for diversified firms (Chandler 1962). However, as has been found in many studies, superficially similar M-form firms may have substantial differences in internal arrangements with regard to centralization, integration, and internal control. Hill (1994) points out that diversified firms can create value in two different forms. One involves the realization of economies of scope¹⁶, as would be the case in related diversified firms. This requires organizational arrangements that stress co-operation between related divisions. In contrast, the other involves establishing an efficient governance of the internal capital market variety, and therefore requires organizational arrangements that emphasize competition between the divisions (Hill 1994, 308). According to Hill these two approaches require fundamentally different organizational philosophies and may well be incompatible (see exhibit 11 for the basic features of these two forms).

As early as 1937 Coase suggested that the limits to the size of the firm come from increasing bureaucratic and complexity cost that create diminishing returns to management. Since the competitive M-form corporation can be run using a more decentralized approach with less information-processing needs by the corporate center as compared to the co-operative, form the latter reaches the limits of profitable growth earlier (Hill 1994, 314).¹⁷

5.2 Corporate styles and parenting advantage

Whilst the work of Hill is more influenced by transaction cost and principal agent theories, another stream of literature has tried to generalize from case studies and identify stylized roles of corporate headquarters in managing the multi-business corporation. Porter (1987) for instance investigated 33 leading diversified US companies and identified four different roles of the corporate headquarter: portfolio manager, restructurer, skill transferer and activity sharer (p. 53). Whilst the last two

roles obviously fit with the model of the related diversified corporation, each approach has certain strategic and organizational prerequisites to be effective (Porter 1987,53).

Regarding the related diversified corporation that must manage linkages across business units, Michael Porter (1985, 393-415) investigated four broad categories of what he called "horizontal organization": 'Horizontal structures' are organizational structures cutting across business lines (e.g. group and sector structures in large corporations, interdivisional task forces), 'horizontal systems' in such areas as planning, control, incentives and capital budgeting, 'horizontal human resource practices' and 'horizontal conflict resolution processes' (conflicts among business units). Thus the simple concept of the divisionalised form (M-form) as a decentralized way of managing the large corporation has to give way to a more complex model in which interrelationships can be leveraged for competitive advantage.

In a widely read book, Goold and Campbell (1987) investigated the management process in 16 large diversified companies, and identified three basic management styles that were always pursued by a few of the companies in the sample: strategic planning style, strategic control style, financial control style (see exhibit 12). Campbell and others later developed the idea of "parenting advantage", i.e. the idea that multi-business companies create value by influencing - or parenting - the businesses they own. The parenting framework focuses on the competencies of the parent organization and on the value created from the relationship between the parent and its businesses. Subsequently Campbell et al tried to develop a number of analytical or prescriptive tools and methods which are designed to support corporate strategy decision making, inter alia the Ashridge portfolio matrix (Campbell/Goold/Alexander 1995, Goold/Campbell/Alexander 1994). This discussion on the research on corporate organisation and the role of the headquarter in diversified companies will be limited for the purpose of this paper to these examples. There is, of course, a broad stream of research on these issues from the perspective of resource-based theory as well as from the view of contract theory and institutional economics, which conceptualize these issues under a 'governance' perspective (see for instance chapters 8 –12 in Campbell/Luchs (1997) for the former, and Bühner (2000) and Ringlstetter (1995) for the latter).

5.3 Value-based management of diversified corporations

A strong influence on the strategic management of large diversified corporations comes from the value-based management approach (or shareholder value approach) which was popularized through the book of Rappaport 1986 and spread by consulting firms and business schools that use various versions of this concept (see for instance: Steward 1991, Röttger 1994 or Lewis 1994). There are a number of implications and consequences for the management of large diversified corporations resulting from following this approach (for a description of the implementation of value-based management in some German corporations see Ballwieser 2000, Börsig 2000, Esser 2000 and Neubürger 2000). With the emphasis on concepts like Discounted Cash Flow, EVA, Added Value or CFROI, (i) more emphasis is placed on future profits as well as on the effective use of capital of the firm; (ii) a stricter unitary perspective across all units in the diversified firm is introduced; (iii) more transparency and stricter financial goals underpin the active nature of managing an evolution and that of a business migration, by providing the rationales for major decisions (divestment and acquisitions); (iv) the company is seen less as an unchangeable entity, and more as a portfolio of businesses that have to be rapidly divested in case of underperformance. On the whole, the value-oriented management tends to energize structural decision making in large diversified companies, and it leads to much more frequent and fast changes in the business-mix of the diversified corporation. Of course, in general, the application of value-based measurements to individual businesses works best if there are no strong interrelationships which may blur the clear relationship between business unit action and performance.

6. Summary and Conclusions

The academic as well as the practice-oriented discussion of corporate strategy for the multi-business corporation has been on-going for more than three decades. Although a considerable amount of empirical work and a large body of theoretical and prescriptive literature exists, no integrated theory is in sight. This is partly due to the fact that very different streams of thought and theory have been applied to the topic, but may also be due to the impossibility of generalizing on such a complex topic with the aim of identifying only a few causal relationships.

It is an empirical fact that the diversified multi-business company is the prevailing model of the firm of the contemporary capitalist economy. Even if the proclaimed trend towards the 'focused firm' has any substance it does not imply a development towards the single business firm; it simply means that 'overdiversified' firms reduce their level of diversification to some extent. It may also well be that there is no "equilibrium point" in the sense of an optimal level of diversification and size. Rather, we may well be in a permanent movement of up- and downsizing driven by environmental changes.

A second finding of empirical research is that there seems to be some support for a "curvilinear hypothesis", i.e. performance is on average lower for single business firms, increases for related diversified firms and decreases again for unrelated diversified firms. These results, which have been 'distilled' out of a large number of empirical studies of the last decades, are, however, not generally accepted since the empirical studies show a number of shortcomings, and more practice-orientated studies have shown no clear relationship between the level of diversification of firms and their performance. Therefore, it may well be that the degree of diversification bears less relationship with company performance than other factors such as the organization, the human resources and the management systems of the company.

The key conceptual construct in the discussion of the diversified corporation has been the "relatedness" of the various businesses. Relatedness has been used as the basis for similar, but not identical arguments of different authors from an industrial economics perspective (sharing of activities across businesses, market power advantages) as well as from the perspective of resource-based theory of the firm (transferring of knowledge and best practices across businesses). The advantages of the exploitation of these relationships have to be seen against the disadvantages of increased costs due to higher complexity, compromises and internal politicking of related diversified corporations. Transaction cost theory, as another line of research has been less successful in modeling and explaining the multi-business corporation, mainly because it neglects the important issue of operations' costs. Following from the discussion, it can be concluded that the exploitation of relatedness is either implicitly or explicitly considered by the overwhelming majority of researchers and consultants as the key mechanism to achieving corporate competitive advantage, and

that the large related diversified company is seen as the 'normal form' of the modern corporation.

Although the unrelated diversified company, i.e. the conglomerate, is seen by many researchers more critically, a number of arguments have been put in its favor, inter alia, information advantages of the holding of the conglomerate compared to the capital market, risk considerations, and superior use of management resources. Another line of thought maintains that in many conglomerates it is merely another form of "relatedness", i.e. the different businesses of the conglomerate are actually not really unrelated. For instance a kind of "cognitive relatedness" for strategically similar businesses has been proposed, and some conglomerates may be seen as managers of clusters of related businesses.

Whereas the literature and research reviewed implicitly assumes some kind of (static) equilibrium thinking, one can also see the diversified firm in a more dynamic, longitudinal perspective as a transformation mechanism to continuously adjust the organization to the changing environment. In this perspective, diversification has been shown to be just a way to use excess capacities of mature businesses, as a form that allows "business migration", or as a form to search for organizational opportunities in an uncertain world through deploying 'populations' of strategies. Diversification in this sense secures the survival of the corporation as different from the single business firm, which grows and dies along with the industry in which it is positioned.

After exploring in various ways the first question of corporate strategy, namely which businesses the company should compete in (and the rationales for selecting businesses) a final chapter of this survey dealt in an, admittedly, very cursory fashion with some selected literature on the management of specific diversified corporations. The first contribution made the simple but useful point that related diversified companies should be run stressing co-operation between divisions (if exploiting relationships is a key issue), whereas the unrelated diversified company should stress competition between divisions. Various empirical case-based studies have found different 'styles' in which diversified corporations can be managed, each style having its own internal consistency and logic. Another important contribution develops the ideas of "parenting skills", i.e. particular capabilities which headquarters of diversified

corporations must possess (in addition to capabilities that may reside in the businesses) in creating value for its range of businesses. Finally, it can be observed that the shareholder value movement and the related value-based management approaches have greatly influenced the way in which large diversified corporations are managed. A stricter unitary perspective across businesses, a certain renaissance of the portfolio approach and a greater emphasis on the "transformational role" of corporate centers, are just some of the implications.

Where does all this leave us? Although this survey revealed a very broad and partly diffuse discussion of corporate strategy and diversification, the author believes that some conclusions can still be drawn. First, we need more empirical research on the real evolution of diversification in the last 20 years; this research should include large corporations from all major world regions (avoiding a bias towards anglo-saxon corporations). Secondly, the research on the relationship between diversification and performance probably works under too many simplifying assumptions; it is doubtful whether generalizations at such a level are meaningful at all; a more qualitative, longitudinal approach (which includes the performance dimension) might lead to more rigorous results. Thirdly, the key construct for understanding the modern diversified corporation is "relatedness"; what we need, however, is a broader concept of relatedness and the integration of several approaches into one integrated concept probably best fitted under the umbrella of the resource-based theory of the firm. Fourthly, the idea to viewing the diversified corporation as a transformation mechanism could be explored further. Finally, the various approaches on the organization and management of diversified corporations should be integrated into an overall framework for corporate organization and strategy that includes all the building blocks mentioned above as well.

Exhibits

Exhibit 1: Classification of Diversification Strategies

	Type of company	Specialisation Ratio (Share of major business in total revenue)	Relatedness & Sub - Types
Low ↑ Level of Diversifi- cation ↓ High	(1) Single Business Companies	SR > 95%	
	(2) Vertically Integrated Companies	Vertically-related sales > 70%	
	(3) Dominant Business Companies	95% < SR < 70%	(3.1) „Dominant-constrained“ Majority of other businesses share linkages (3.2) „Dominant-linked“ Majority of other businesses related to at least one other business (3.3) „Dominant-unrelated“ Majority of other businesses unrelated
	(4) Related-Business Companies	SR < 70%	(4.1) „Related-constrained“ Majority of businesses share linkages (4.1) „Related-linked“ Majority businesses linked to at least one other business
	(5) Unrelated-Business Companies	SR < 70%	

Source: Adapted from Rumelt 1974

Exhibit 2: Changes in the Diversity of Fortune 500 Companies, 1949-1974

	1949 %	1954 %	1959 %	1964 %	1969 %	1974 %
Single Business Companies	42,0	34,1	22,8	21,5	14,8	14,4
Vertically Integrated Companies	12,8	12,2	12,5	14,0	12,3	12,4
Dominant Business companies	15,4	17,4	18,4	18,4	12,8	10,2
Related-Business Companies	25,7	31,6	38,6	37,3	44,4	42,3
Unrelated-Business Companies	4,1	4,7	7,3	8,7	18,7	20,7
	100,0	100,0	100,0	100,0	100,0	100,0

Source: Rumelt (1982), pp. 359-370

Exhibit 3: Changes in the Diversity of Fortune 500 Companies, 1949-1974

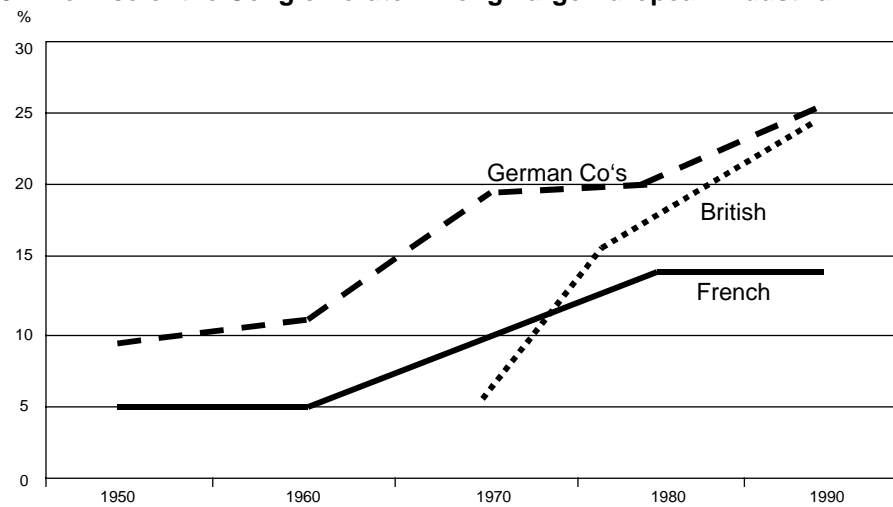
	1958 %	1963 %	1963 %	1973 %
Single Business Companies	26,3	24,6	19,5	16,9
Vertically Integrated Companies	13,2	15,3	18,6	18,6
Dominant Business companies	21,0	16,9	18,7	17,8
Related- Business Companies	30,7	35,6	36,4	39,8
Unrelated- Business Companies	8,8	7,6	6,8	6,8
	100,0	100,0	100,0	100,0

Source: Itami et al (1982), p. 78-110

Exhibit 4: Changes in the Diversity of the 305 Largest British Manufacturing Companies, 1960-1980

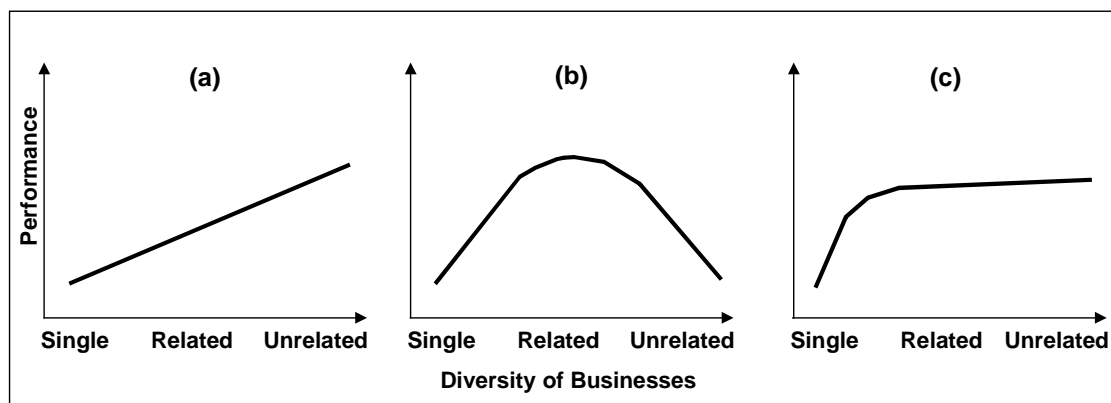
	1960 %	1970 %	1975 %	1980 %
Single Business Companies	34,2	14,5	12,5	9,5
Vertically Integrated Companies	2,0	3,3	3,4	3,0
Dominant Business companies	23,5	26,0	21,6	24,7
Related- Business Companies	32,0	44,4	49,0	49,7
Unrelated- Business Companies	7,4	11,8	13,5	13,2
	100,0	100,0	100,0	100,0

Source: Jammine (1984), p. 215

Exhibit 5: The Rise of the Conglomerate Among Large European Industrial Firms

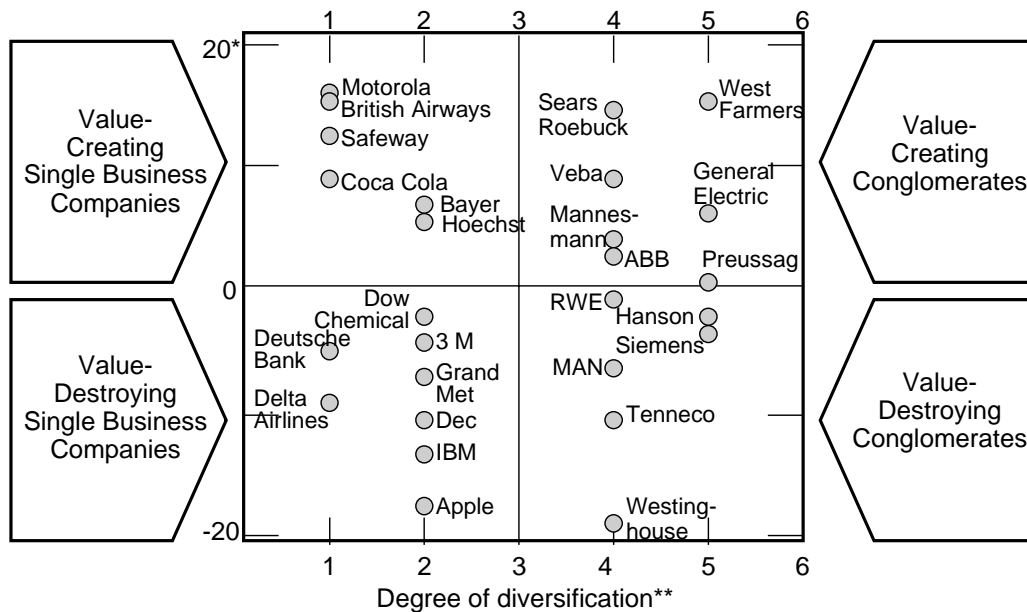
The percentages refer to the share in the top 100 domestically-owned industrial companies

Source: Whittington (1999), p.6

Exhibit 6: Three Models of the Diversification-Performance Relationship

Explanation: (a) The Linear Model; (b) The Inverted-U (Curvilinear) Model; (c) The Intermediate Mode

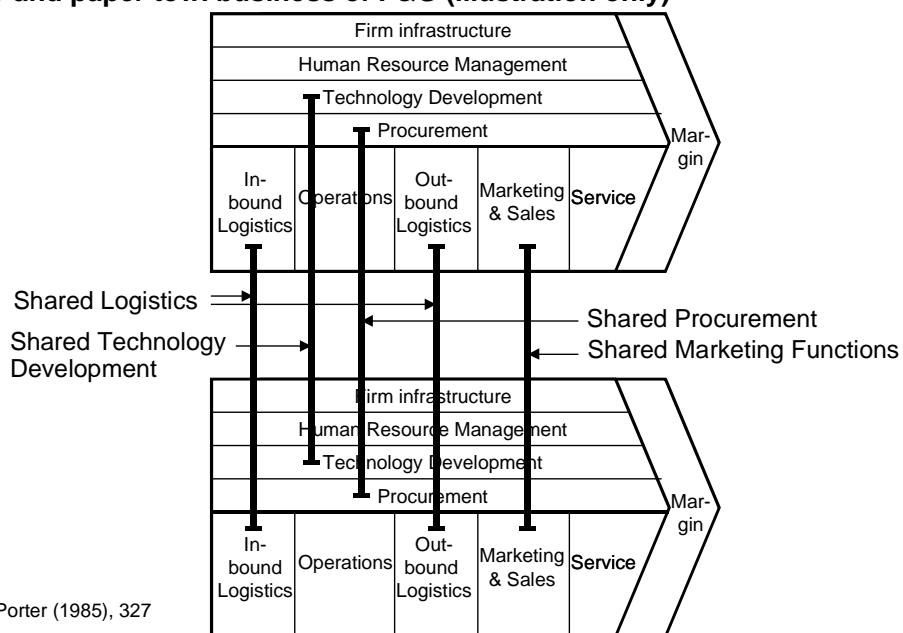
Source: Palich et al (2000), 157

Exhibit 7: Shareholder Value Created by Focused and Diversified Companies

* Relative Shareholder Return 1991 until 1995 in %

* Number of different businesses

Source: BCG 1996, 150

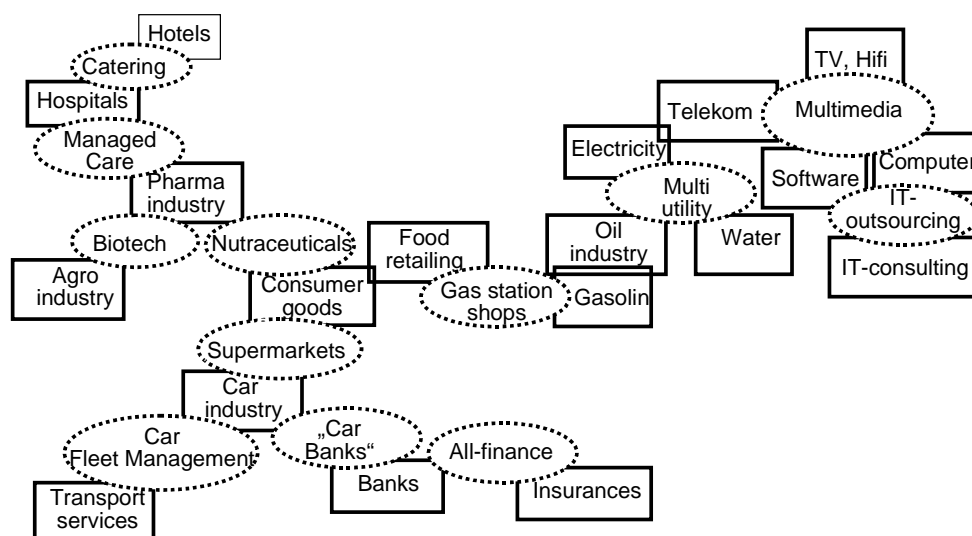
Exhibit 8: Interrelationships between value chains of the disposable diaper and paper towel business of P&G (illustration only)

Source: Porter (1985), 327

Exhibit 9: Possible determinants of „cognitive relatedness“ based on strategic similarity

<i>Corporate management function</i>	<i>Determinants of strategic similarity</i>
Resource allocation	Similar sizes of capital investment projects Similar time spans of investment projects Similar sources of risk Similar general management skills required for senior managers
Strategy formulation	Similar key success factors Similar stages of the industry life cycles Similar competitive positions occupied by each business within its industry
Targeting, monitoring and controlling of business unit performance	Goals defined in terms of similar performance variables Similar time horizons for performance targets

Source: Grant (1988), 641

Exhibit 10: New markets beyond traditional industry boundaries

Source: Adapted from Heuskel (1999), p. 35

Exhibit 11: Two structural variants of M-form corporations

	<i>Source of Economic Benefit</i>	
	<i>Exploiting relationships</i>	<i>Governance</i>
Basic structure	Multidivisional	Multidivisional
Operating- and Business-Level Strategic Decisions	Some Centralisation of Critical Functions	Complete Decentralisation
Interdivisional Integrating Mechanisms	Moderate to Extensive	Nonexistent
Divisional Performance Appraisal	Mix of Subjective and Objective Criteria	Primary Reliance on Objective Financial Criteria (ROI)
Incentive Schemes	Linked to Corporate Performance	Linked to Divisional Performance

Source: adapted from Hill 1994, p. 312

Exhibit 12: Centre-division relationships acc. to Goold and Campbell

	<i>„Strategic Planning“</i>	<i>„Strategic Control“</i>	<i>„Financial Control“</i>
Key features	„Masterplanner“ Top-down Highly prescribed Detailed controls	„Strategic shaper“ Strategic & financial targets Bottom-up Less detailed controls	„Shareholder/banker“ Financial targets Control of investment Bottom-up
Advantages	Co-ordination	Centre-divisions complementary Ability to coordinate Motivation	Responsiveness
Dangers	Centre out of touch Divisions tactical	Too much bargaining Culture change needed New bureaucracies	Loss of direction Centre does not add value
Company examples	BOC, Cadbury, Lex, STC, Public sector pre 1990s	ICI, Courtaulds, Public Sector post 1990s	BTR, Hanson plc, Tarmac

Source: Johnson / Scholes (1999), 426 (based on Goold/Campbell (1987))

Notes

¹ Whilst the author tries to do justice to the many different views, he does not want to deny that his choice and perspective are influenced by his broad experience as a manager, and his current work as a lecturer and consultant in strategic management.

² The author chooses to use the terms ‘unrelated diversification’ and ‘conglomerate diversification’ interchangeably here. Other authors use the term ‘conglomerate diversification’ as the more general term under which they distinguish further between related and unrelated diversification moves. Rumelt 1974; Oster 1999, 184-185;

³ It further distinguishes "constrained" (the firm's activities are linked to one another) from "linked" (each activity is related to at least one other activity, but not to all other activities) diversification. Vertically integrated firms are classified into a separate "vertical-related" category. By applying these criteria we arrive at eight different types of types of companies (see exhibit 1).

⁴ The various research studies rely on accounting-based as well as on (capital) market- based performance measures. The authors included in their meta-analysis only studies with at least one of the following performance constructs: growth (sales growth or earning growth), profitability (return on assets, return on equity, return on sales, return on total invested capital), risk adjusted returns (Jensen, Treynor, Sharpe measures), and unadjusted market value (market-to-book value, Tobin's q). (Palich et al. 2000, 162)

⁵ Model b, in figure 2, is sometimes called the 'curvilinearity hypothesis', i.e 'diversification exhibits an inverted-U relationship with firm performance.

⁶ Whilst capital market-based performance indicators are considered by Palich et al. as a better measure since they capture expected future returns (as opposed to past outcomes reflected in accounting-based measures) and are less easily influenced by management, the number of studies using them is just too small to allow meaningful conclusions (Palich et al. 2000, 168)

⁷ That means the studies failed to take into account the fact that average industry profitabilities are very different, and companies may therefore display either a better or not as good performance depending on the industry they are part of, or depending on the distribution of industries in their portfolio of businesses.

⁸ It is understandable that financial analysts prefer to be able to analyse and understand the performance of companies, and that this usually easier to do for single business companies than for diverse and less transparent multi-business companies.

⁹ See for instance Campbell/Sattler 1998: "...value destruction is endemic to the multi-business company"

¹⁰ One could say that synergies are the availability of opportunities based on the union of two related businesses that would not be available to either if operating separately.

¹¹ According to Baumol et al. economies of scope exist in the production of goods x_1, x_2, \dots, x_n , if: $C(X) < C(x_i)$ where $X = \sum x_i$, $C(X)$ is the cost of producing all n goods within a single firm, and $\sum C(x_i)$ is the cost of producing the goods in n specialised firms. See Baumol/Panzar/Willig (1982), pp. 71-72

¹² As mentioned above the concept of relatedness is not confined to cost savings only, but may, for instance, also entail the possibility of achieving higher prices due to activity sharing. E.g. if BMW and Roll Royce cars were displayed in the same show rooms this may help BMW to obtain better prices for BMWs than a completely separated sales organisation for both brands; in marketing this would be categorised under the term 'image transfer'.

¹³ The idea that corporate strategy decisions could be based on an analysis of the firm's 'distinctive competences' is not a particularly recent one, and can already be found in the contributions of Ansoff (1965) and Andrews (1980) for example.

¹⁴ Predatory pricing refers to the practice of setting a price in order to drive other firms out of business. It includes the idea that the predatory firm sets its price below cost, with the expectation that it will recover whatever losses it incurs after competitors have been driven out of the market, allowing it to exercise market power.

¹⁵ Conglomerates such as GE, Vivendi or Mannesmann (meanwhile acquired since by Vodafone).

¹⁶ I use the term economies of scope here because it is the term used by Hill.

¹⁷ It may well be that the finding of chapter 2, namely that there are efficient and inefficient related diversified companies and conglomerates, has something to do with the mentioned incompatibilities and different limits of size.

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