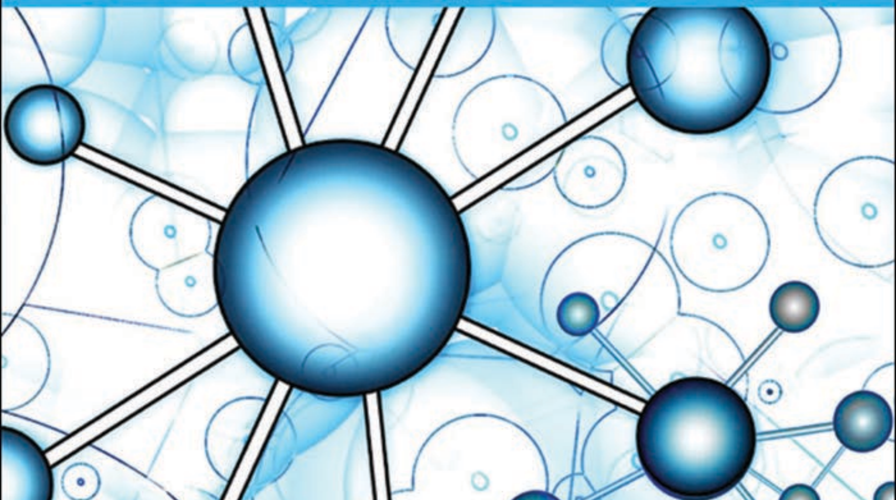
"Will challenge and educate every manager considering whether, and how, to diversify."
Professor Constantinos Markides, London Business School

DIVERSIFICATION STRATEGY

How to grow a business by diversifying successfully



Graham Kenny

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London and Philadelphia

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To my wife, Margaret, who has wholeheartedly supported my various pursuits and collaborated with me over many years.

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Books by Graham Kenny

- *Strategic Factors: Develop and Measure Winning Strategy*, published in Australia and New Zealand in 2001 by President Press and re-published in 2005 in the rest of the world by Elsevier Butterworth-Heinemann as *Strategic Planning and Performance Management.*

- *Sure-Fire Steps to Small Business Success*, President Press, 2007.

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PREFACE

I wrote this book because basically I got tired of people dismissing companies and writing off corporate failures simply because they were diversified. It smacked of ill-informed opinion, bordering on prejudice.

The genesis of this book was a conversation I had with my brother-in-law, John, a couple of years ago. Our families were on holidays together and we were both walking to the beach from the apartments in which we were staying. He made a remark that he wouldn't buy some company's shares because the firm was diversified. This was "conglomerate discount" in action. Although John was, before retirement, the Chief General Manager of a large corporation and is now a regular share trader, I didn't buy his conventional argument.

I also put against his view my experience as a consultant of 17 years' standing, my prior years as an academic, my own executive experience and a study that I had undertaken on the collapse of an Australian conglomerate. This diversifier and public company, Burns Philp, which features in Chapter 12, was written off as a "diversification failure." Yet when I studied its case, I found there were many drivers of its demise – and diversification in itself didn't seem to be one of them.

Other things troubled me about diversification. One was that the term itself is used broadly and is poorly defined. So you can make your case against diversification in any way you like. Another was that discussions of diversification inevitably get caught up with whether a particular example is related to "core business" or not. I've found that it's often hard to define exactly what the "core" of a business is and this, too, troubled me. Moreover, in most cases I looked at, the difference between "related" and "unrelated" seemed quite arbitrary.

I put all this together with studies on diversification.

While academia wrings its hands over the issue, managers have to get on and do the best they can from what they know. And what they *do* know is this: some diversified firms succeed, while others fail; some focused firms prosper and some collapse. Their question, then, is twofold: (1) *should* I diversify? and if I do, (2) *how* do I become a successful diversifier?

This is what this book is all about – providing some signposts along the road to successful diversification. It extends the work of my previous books on strategy.[1]

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1 Kenny, G. 2001. *Strategic factors: Develop and measure winning strategy.* Sydney: President Press; republished in 2005 as *Strategic planning and performance management.* Oxford: Elsevier Butterworth-Heinemann; Kenny, G. 2007. *Sure-fire steps to small business success.* Sydney: President Press.

ACKNOWLEDGMENTS

First and foremost, I'd like to thank my business partner, fellow company director and wife, Margaret Kenny. Highly qualified, holding a Bachelor of Business and Master of Commerce, she is co-author of the Strategic Factor System and has worked with me over many years to develop it. She brings to our company extensive experience in business and technology as an analyst, manager and lecturer. We work together constantly, travel overseas to conferences together and discuss our business and business methods regularly. We also collaborate on client projects, especially those concerned with performance measurement. Margaret's support and encouragement have enabled me to press on not only with this book, but with all my endeavors.

My second debt of gratitude is owed to Constantinos, or Costas, Markides, Robert P Bauman Professor of Strategic Leadership at the London Business School. He took time out from his very busy schedule in August/September 2007 to read a previous draft of this book. His seven points, tendered to me in an email dated September 15, proved crucial in lifting the book to a new and better level. Without his input, given at a vital stage in the manuscript's development, this book would not exist – certainly not in its current form. It would definitely not have been as good. To Costas, for his generosity, I'd like to say a very heartfelt "thank you."

I'd also like to express my appreciation to the employees of the various companies mentioned in the book. Several gave their time to provide information, to check facts, to review detail and to read drafts concerned with their organizations. I will not mention any by name as many wished to remain anonymous and I don't wish to disclose any individual by mistake. But to all of you collectively, may I say "thanks."

Catherine Hammond has been my editor now for seven years. She helped me on my previous books and has edited many of my articles. Hopefully she will edit my other books that are in the pipeline. I say "helped," but as any writer knows, a good editor does much more than this. She's my quality controller, my gatekeeper and my teacher. I've learnt much from Catherine about writing and expressing myself.

Penny McCann typed and re-typed this manuscript on numerous occasions – never showing impatience and always with loving care and great accuracy. But this is only part of Penny's role in this book and our business. She's been my Personal Assistant and the business' Administration Manager for 16 years. Without her assistance over this period, much of what I have achieved, with what looked like apparent ease, would not have been possible.

Thank you also to Jo Rudd for compiling an excellent index and to Simon Leong for type and cover design.

My thanks are also due to those who gave so generously of their time in reading an early draft of this book and in providing valuable comments: John Forbes, Jim Carroll, Keith Kessell, Chris Ryan and Richard Goyder. Their input gave me reassurance that I was on the right path and that I had something of value to say.

ABOUT THE AUTHOR

Graham Kenny heads the company, Strategic Factors, which specializes in strategic planning and performance measurement.

His firm assists organizations to undertake strategic analysis, write strategic plans and measure performance. It does this, in part, through a facilitation process designed to ensure that clients retain ownership of whatever is produced. Strategic Factors has also been responsible for developing innovative software for planning, producing key performance indicators and monitoring performance. Its products are all based on the company's Strategic Factor System.

For more than 15 years, Graham has conducted public seminars on strategic planning and performance measurement. He has met a vast array of organizational situations and problems. Coming to grips with each of them has broadened his knowledge.

In the private sector he has consulted to clients in hotels, shipping, transport, property management, legal services, building and construction, mineral processing, software development, electrical equipment, importing, battery production, mineral refining, food processing and packaging, banking, communications, dairy products, pharmaceuticals, information services, concrete, mining equipment, paper products, health services, manufacturing, civil-engineering consulting, property development and hospitality industries. In the public sector, again in strategic planning and performance measurement, Graham has assisted clients in hospitals and human services, sustainability, treasury and finance, local government, funds management, electricity transmission, sport promotion, government infrastructure, energy and resources, port facilities, main roads and highways, information services, trustee services, lotteries, horse racing, tax, railways, higher education, the armed forces, government research, health, forensic medicine, technical repairs, rural finance, agriculture, electricity supply and water resources. In the not-for-profit sector, again in strategic planning and performance measurement, Graham has consulted to organizations in caring for the mentally disabled and autism and for university-college accommodation.

Graham's executive experience has also been extensive. As General Manager, he has been responsible for turning a loss-making manufacturer of timber building products into a profitable operation. He has been Plant Manager in a concrete company, a Market Development Manager at an electricity generator and distributor, and a Design Engineer and Construction Supervisor in a city council.

Graham writes extensively in publications aimed at on-the-job managers. His articles have appeared in *Company Director*, *Leadership Excellence, Management*, *Marketing*, *Commodities & Trade to Asia*, *HR Monthly* and *Charter*.

He has also published numerous articles in academic management journals throughout the world, some of which have been reproduced in U.S. management textbooks and translated into other languages. Journals have included *Journal of Management Studies, Human Relations, Canadian Journal of Administrative Sciences, Journal of General Management, Asia Pacific Journal of Management, Evaluation Review* and *IEEE Transactions on Engineering Management*.

Graham's academic qualifications include a Doctor of Philosophy in Management from the University of New South Wales, Australia, as well as a Master's Degree in Management from Durham University in the United Kingdom, and a Bachelor of Engineering from the Queensland University of Technology, Australia. He has been Professor of Management at San Diego State University, U.S.A., the University of Alberta and the University of New Brunswick, Canada; Visiting Research Fellow at the University of Bradford Management Centre in the United Kingdom; Visiting Scholar at the University of North Florida, U.S.A.; Adjunct Professor of Management at Bond University, Australia; and Senior Lecturer in Management at the University of Technology, Sydney.

Graham is a Foundation Fellow of the Australian Institute of Company Directors, a Fellow of the Australian Institute of Management, and a Member of the U.S. Academy of Management.

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PART ONE

SETTING THE DIVERSIFICATION SCENE

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CHAPTER 1

Management's Leper

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Diversification has become the leper of management: something you certainly don't touch. As a result, stock markets have become great punishers of diversifiers, hitting them with a "conglomerate discount" in share trading. The message has gone out: diversification is bad, focus is good. The former has even been lampooned as "di-worsification."[1] So, managers and boards are frightened to stray from "core business," even though this concept proves illusive in practice. Books and articles have been written about how businesses should "stick to their knitting" and profit from their core[2] – a tradition that goes back at least to 1982, with Tom Peters' and Robert Waterman's book, *In Search of Excellence*.[3]

As a consequence, managers and their boards are basically faced with two prospects:

1. Stay focused, don't risk reprimand from colleagues, peers or the market; stick with the prevailing view against diversification,

or:

2. Be game and diversify, risking derision if something goes wrong.

It's a no-brainer. Best to avoid diversification altogether.

But organizations should be concerned about the cost of avoiding diversification, as the pendulum has swung too far to the focused side in organizational thinking. This swing leads to:

- a turning off of minds to diversification possibilities,
- a lack of awareness of methods to manage diversification,
- poor management of diversified organizations in all sectors, not just business, and,
- missed opportunities to grow a company and shareholder value.

This book is about how to diversify *and* succeed. It's addressed to three groups of managers:

1. Those who are afraid to diversify because of the critics and nay-sayers, and the reputation diversification has acquired,

2. Those who, in spite of the controversy, choose to run diversified organizations anyhow, but could run them better, and

3. Those who have no choice, e.g., they operate in the public-sector setting where diversification is mandated, but they could do a better job.

To all of you I say, "read on." There's much to be learnt in these pages from the workings of both diversified and focused successes – as well as diversified failures.

A DISCOVERY

From the research I've conducted for this book, I've come to appreciate that diversification *is*, in actual fact, widespread, even though the message against it has gone out, and some have heeded the call. It seems that diversification is almost the inevitable consequence of doing business – of running organizations.

Take, for example, your local real estate agent. That office is involved in two businesses: property sales and property management. The customers, employees, competitors, required skills and even technology in sales are quite different from those in rentals. Yet the business may only have two staff, the owner and one employee. The owner looks after sales, because large amounts of money ride on each transaction, while the employee manages the rentals, the more routine side. This is diversification *and* divisionalization in action. And with a staff of only two!

Take as another example our own small company – again diversified. We operate three businesses under one structure: one in management consulting, one in management education, through which we conduct public seminars, and a third in the development of software for performance measurement. They each have separate brands, but are within the one company.

As yet a further example, take a building client of ours. With 250 staff, this company has diversified beyond construction to office and shop fitouts, to facilities management and maintenance, and, more recently, to property development. And so the list may go on until we get to General Electric, with over 300,000 employees spread around the world in a wide range of businesses.

Diversification in *business* appears to be more far-reaching than its critics appreciate.

But that's only the private sector. How about a not-for-profit organization that cares for adults with mental disabilities? Its clients live in suburban homes under the 24-hour supervision of a carer. It also operates a sheltered workshop, winning relatively simple packing contracts so that its clients can be usefully employed. But its diversification goes further: respite services are provided to family members who have someone with mental disabilities living at home.

In the public sector, diversification examples are also numerous. Look at any local government organization – a city, shire or municipal council – and note its diversity. One city council that my company has worked with has revenue of many millions and over 7,000 employees. It has so-called "business-units" in works, transport, water, city business development, parking, venue hire, waste services – the list goes on. As does the diversification and the complexity.

A FIELD IN LIMBO

In spite of all the discussion on the topic, managers are cut adrift in this diversification sea.

In 1993, Michael Goold and Kathleen Luchs reviewed four decades of management-thinking on the question of diversification. As they put it: "In the 1960s, the spectacular performance of a few successful conglomerates seemed to prove that any degree of diversification was possible … In the 1970s, many diversified companies turned to portfolio planning, aiming to achieve an appropriate mix … In the 1980s, many corporations restructured and rationalized, basing their strategies on 'sticking to the knitting' and eschewing broad diversification."[4] Their question was the old chestnut: how should managers approach diversification?

The authors' conclusion, based on the research to that time, was that "evidence on the performance of companies pursuing more or less related diversification strategies is ambiguous and contradictory … no firm relationship between diversification strategies and performance has been discovered."[5].

In 2000, another two researchers, Aswin van Oijen and Sytse Douma, expressed a similar view when they wrote: "In spite of many years of experience and research, the jury is still out on the merits of product diversification. The notion that firms should limit themselves to a few core businesses has gained wide acceptance. However, … highly diversified firms can still be very successful. The strategic management literature does not offer much support here. It is quite a challenge to find a subject that has been studied more often than the link between diversification and performance. Nevertheless, the findings of these studies remain inconclusive."[6]

From 1993 to 2000 to the present day, the field remains in limbo. So what do managers and academics do?

The latter generally continue to seek to identify those special conditions under which diversification succeeds or fails. This search becomes increasingly refined and narrow – even focusing on and comparing different ways of measuring relatedness and their "construct validity." Nothing wrong with all of this except that it starts to move away from the big question.

Posed by practitioners, this big question, like most, is simple: should I diversify or not? Well …, says the academic with considerable hesitation – and the manager's attention is lost. While the academic world is the world of the average score, gleaned from research and multiple cases, the practitioner universe is that of the singular: *my organization, here and now.*

Michael Chaney, the previous CEO of one of the successful diversifiers, Wesfarmers, has thrown us a challenge:

"When I did an MBA in the late 70s there was a debate about whether you should be a conglomerate or a focused company and I have never paid much attention to the debate because it misses the point. If you look at the ASX [Australian Securities Exchange] over the past 20 years, the two companies that have done the best in terms of shareholder returns are Wesfarmers and Westfield. You couldn't get two more different companies, with diametrically opposed strategies. Westfield is the focused property company that ran out of opportunities in Australia and went international, while Wesfarmers was the diversified company that stayed at home by diversifying more. Anyone who says a diversified company is worse than a focused company has to explain these two companies."[7]

I agree. As Richard Rumelt observed in one of the field's seminal works, *Strategy, Structure and Economic Performance*, "The heterogeneity of the major categories [of diversification] indicates that performance differences are not really related to diversity per se, but are more a function of the firm's strategy for dealing with growth and diversity."[8]

UNROLLING THE STRATEGY

In this book I take a fresh look at diversification and hope to renew your perspective by reviewing the management practices of several firms that have made it a winner for them over at least a decade. I've selected General Electric, Wesfarmers, Bidvest and ITC to show the way when it comes to diversification success. But, as a comparison, I've also looked at why focused companies succeed, firms like McDonald's, David Jones and Westfield. Moreover, I have thrown into the mix a diversification failure: Burns Philp; a high-profile diversifier that didn't make the grade: Berkshire Hathaway; as well as academic research and various consultants' reports that tell us why diversification has succeeded or why it hasn't and shouldn't. In choosing my sample of firms, I've also been careful to have a variety of countries in which the companies are headquartered. Thus Australia, India, South Africa as well as the United States are represented.

Managers have every right to be confused by "diversification." So Chapter 2, "What is Diversification?," examines the dilemma that managers face in dealing with the term. The chapter provides a working definition and illustrates diversification's many and varied dimensions.

Chapter 3, "Identifying Successful Diversifiers," lays out the criteria that I employed to select the diversified firms presented in Chapter 4. The chapter discusses investor-versus-economic performance in making assessments and stresses the importance of the measure, "return on equity." The chapter also explains why a firm needed to exceed a return on equity benchmark of 14 per cent every year for at least the last 10 years to be selected.

"The Diversified Exemplars" is Chapter 4. This outlines the functioning of the chosen successful diversifiers: General Electric, Wesfarmers, Bidvest and ITC, each of which is headquartered on a different continent and conducts different businesses. In addition to describing each firm in detail, the chapter presents their 10-year revenue, profit and return-on-equity performances.

Chapters 5 to 11 move to prescription and tender seven levers that you can pull to get diversification to work. These are: establish a supportive corporate center; select capable division managers; install appropriate performance measures; set effective incentives; align the corporate culture; secure competitive advantage; buy well and integrate. Each chapter reviews how the successful diversifiers manipulate each lever, looks at other corporate examples beyond the four exemplars and considers other publications on each topic.

We can also learn much about being successful from observing failure – what not to do. So Chapter 12, "Diversification Goes Pear-Shaped," reviews the unsuccessful attempts of Burns Philp to diversify. This company went from highly diversified to more focused, but still faced ruin. The chapter identifies several drivers of its demise, but none of them, in the final analysis, was specifically product diversification. The chapter concludes that we may hasten to judgment in cases such as this, wrongly accusing diversification for firm failure.

Chapter 13, "Dabbling in Diversification," examines a further unsuccessful attempt to diversify. While the department-store chain, David Jones, has gone on to great success, it had to overcome the repercussions of its diversification dalliance. This took the form of Foodchain, which not only cost the company millions, but led to significant management and board changes. The case leads to a re-examination of the very basics of competitive advantage.

Chapter 14 takes a good look at a corporate icon – Berkshire Hathaway. "Diversification Genius?" analyzes the performance of the company over a 10-year period to try and discover how, in spite of not meeting the ROE benchmark of 14 per cent once in the last decade, it has made its founder, Warren Buffett, a very wealthy man. The answer lies in great self-promotion and in not paying dividends!

Chapter 15, "The Focused Message for Diversifiers," reviews the history and performance of two focused successes – McDonald's and Westfield. It addresses the question: What is it that successful focused companies do that divisions and business units within diversifiers can learn from? "Much," is the answer. The chapter reveals how focusing on an organization's key stakeholders and the strategic factors relevant to each is critical.

How we regard something affects how we react to it. Chapter 16, "Adopting a Different View," challenges you to think differently about diversification, not simply adopting a head-office perspective. Such a corporate view involves the search for relatedness among the divisions of a diversified organization. As the chapter demonstrates, this turns out to be a hollow quest. The alternative is a business-unit perspective, which brings into focus corporate support and business-unit competitive advantage.

Writing this book has been a wonderful learning experience for me and I hope, through your reading it, a useful one for you too. The last chapter, "Diversification Lessons," lays out nine broad lessons that this book and its accompanying research have produced.

---

1 Lynch, P. & Rothchild, J. 1989. *One up on Wall Street*. Philadelphia: Running Press. Also Franco, L.G. 2004. The death of diversification? The focusing of the world's industrial firms, 1980-2000. *Business Horizons*, July-August, 41-50.

2 Zook, C. & Allen, J. 2001. *Profit from the core*. Boston: Harvard Business School Press. Zook, C. 2004. *Beyond the core*. Boston: Harvard Business School Press.

3 "Sticking to the knitting" is a reference to the phrase used originally by Peters, T.J. & Waterman, R.H. 1982. *In search of excellence*. New York: Harper & Row. They suggested that successful corporations did not diversify widely but stayed with what they knew, their industry.

4 Goold, M. & Luchs, K. 1993. Why diversify? Four decades of management thinking. *Academy of Management Executive*, 7(3): 7-25, p.7.

5 Ibid, p.15.

6 Van Oijen, A. & Douma, S. 2000. Diversification strategy and the roles of the center. *Long Range Planning*, 33: 560-578.

7 Quoted in Arbouw, J. 2004. The NAB's strategic acquisition. *Company Director*, July: 8-13.

8 Rumelt, R.P. 1974 (1986). *Strategy, structure and economic performance*. Boston: Harvard Business School Press.

CHAPTER 2

What is Diversification?

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What is diversification? It turns out that this isn't an easy question to answer – not for academics, nor for managers. In their conclusion to a review of many diversification studies, academics James Robins and Margarethe Wiersema came to a conclusion in 2003 that is both stark and startling for researchers *and* managers:

"One of the most striking problems introduced by the ambiguity of these [diversification/relatedness] indexes is the fact that findings which previously appeared to support the same position may actually contradict each other … The fact that the most widely used indicators of related diversification cannot be treated as reliable measures of 'relatedness' within corporate portfolios creates a real dilemma for researchers."[1]

It creates a real dilemma for managers too! It also does little to give managers confidence in the results of diversification research.

I've observed that one of the problems managers face in dealing with diversification is its definition. What stands as diversification for one manager within an organization may not for another. This leads to confusion on what action to take. Because of diversification's complexity, its definition proves in practice to be very subjective.[2]

When McDonald's introduces salads into its product range, is this diversification? The accepted answer is "no," since it has stayed within its original fast food industry and has only extended its product line. If the same company went into clothing retailing, would this be a diversification? The accepted answer is "yes," since it has moved into a different industry, but here managers hedge their bets. One may say, "Yes, but it's related to what it currently does. It's in retailing." Another may reply, "Yes, it's diversification, but it's unrelated. It's not in food." So the diversification waters get muddied and managers are left not sure what a diversification really is.

Fortunately, a study has been undertaken to help us identify the dimensions of relatedness/diversification. In 1997, J. L. Stimpert and Irene Duhaime identified 25 dimensions of relatedness.[3] These were derived from the literature and from interviews with managers. They are shown in Figure 2.1, which provides a broad range of items on which any two businesses in a diversified company may differ. The greater the number of dimensions on which there is variation, the greater the diversity.

Figure 2.1 **Dimensions of Relatedness/Diversification**

Businesses –

are cost leaders
produce commodity products
emphasize new product development
are market share leaders
have strong brand names
produce high value-added products
serve niche markets
share customers
emphasize advertising
emphasize customer service
emphasize product design
emphasize R&D
require same raw materials
are vertically linked
share manufacturing process
share distribution network
share quality emphasis
share investment requirements
are about the same size
similarly impacted by economy
in same stage of life cycle
share cash flow characteristics
share management skills
are required to meet financial targets
share accounting system

My definition of diversification is the variation between businesses within a company. This variation can be by products or services, e.g., food vs. clothing, in the McDonald's example above; customer type, e.g., domestic versus industrial customers in washing machines; manufacturing processes, e.g. tailor-made clothing versus factory-made clothing, and so the variations go on.

The degree of diversity is determined by two factors. The first is the degree of difference in one dimension, such as products produced. The second is the number of dimensions in variation – products produced, customer type, technology employed, delivery mechanism, and so on. Mining iron ore and running a general hospital are highly diverse because differences exist in a number of dimensions, e.g., skills, clients, processes, risk to life, etc., and because these differences are, in most cases, extreme, e.g., client needs.

It's the definition above that I'll have in my mind as we proceed.

---

1 Robins, J.A. & Wiersema, M.F. 2003. The measurement of corporate portfolio strategy: Analysis of the content validity of related diversification indexes. *Strategic Management Journal*, 24: 39-59.

2 Stimpert, J.L. & Duhaime, I.M. 1997. The eyes of the beholder. Conceptualizations of relatedness held by the managers of large diversified firms. *Strategic Management Journal*, 18(2): 111-125.

3 Ibid.

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CHAPTER 3

Identifying Successful Diversifiers

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The *initial* identification of my sample of successful diversifiers came from a study published by consultants Marakon Associates, which resulted in a report called "Conglomerate Discount or Premium? How Some Diversified Companies Create Exceptional Value." The authors, Chris Kaye and Jeffrey Yuwono, analyzed the performance of 88 diversified companies from around the world, each with market values of over $US500 million.[1] They reviewed each firm's total shareholder return over a 10-year period – total shareholder return (TSR) being the sum of share price appreciation plus dividends. The TSR figure that became the focus in analyzing company performance was the average of three 10-year TSRs ending in June of 2000, 2001 and 2002. This "rolling" approach was designed by the authors to achieve a more accurate picture of each company's long-term performance.

They then listed the 88 companies from highest to lowest performer and divided the group into four sub-groups. The four firms that I have studied in depth, and which are described in Chapter 4, come from the top quartile of 22. This group had TSRs of 16 per cent or more over the period. I chose the ones I did because, of the top 22, they were among the larger companies judged by market capitalization, because their 10-year TSRs exceeded their country's relevant benchmark significantly and because of their geographic spread.

The 22 are listed in Figure 3.1, with the relevant data from Marakon Associates' analysis. But my choice of successful diversifiers also depended on an additional current criterion: *economic performance*.

ECONOMIC PERFORMANCE

Why the criterion *economic performance*?

Total shareholder return is made up of the increase in share price plus dividends *if they were reinvested*. TSR is therefore a measure of performance from an *investor's perspective*. It's also a *hypothetical* figure since most investors don't reinvest their dividends. Moreover, TSR is affected by share market ups and

Figure 3.1 **Successful Diversifiers Studied**

Company	10-Yr TSR[1]	Country Delta[2]	Regional Delta	World Delta	2001/2 Avg.Mkt.Cap ($US million)	Country
Bidvest	36%	20%	24%	26%	1,402	South Africa
Onex	30%	15%	14%	20%	2,193	Canada
ITC	29%	17%	23%	18%	3,489	India
Fimalac	26%	11%	14%	16%	1,205	France
Spotless Group	25%	11%	15%	15%	590	Australia
General Electric	24%	8%	9%	14%	374,736	US
Wesfarmers	23%	10%	13%	13%	5,659	Australia
Berkshire Hathaway 'A'	23%	7%	7%	12%	94,838	US
Hutchison Whamp.	22%	7%	17%	12%	37,245	Hong Kong
Champion Ents.	22%	6%	6%	12%	460	US
Futuris Corp.	22%	8%	12%	12%	585	Australia
Leucadia Nat.	21%	6%	6%	11%	1,768	US
Bouygues	21%	6%	10%	11%	10,465	France
Gcarso 'A1'	21%	-2%	6%	11%	2,780	Mexico
China Res. Entrep.	19%	4%	13%	9%	2,227	Hong Kong
Industrivarden A	18%	0%	6%	8%	1,865	Sweden
Lagardere	17%	2%	5%	7%	5,921	France
Viad	17%	1%	1%	7%	2,210	US
Orkla	17%	6%	5%	6%	3,887	Norway
Dover	16%	1%	1%	6%	7,382	US
Wendel Investissement	16%	1%	5%	6%	962	France
Textron	16%	0%	0%	6%	6,471	US

(1) TSRs were calculated from an average of three 10-year TSRs ending in June of 2000, 2001 and 2002.

(2) Delta refers to the difference between the company's 10-year TSR and that of the relevant benchmark.

downs. For instance, most share markets around the world have been subject to a bull run over several years. This has pushed the TSRs up, in many cases independent of their fundamental economic performance. The driver has been the expectation of future share price increases – so-called "irrational exuberance."[2] Technology stocks are a good example. They can be "in" or "out," as can commodity shares.[3]

So in selecting my sample, I wanted to go beyond Marakon Associates' TSR grid and view *economic performance*. The fundamental figure here is *return on equity* (ROE), described by expert business analyst, Ciaran Walsh, as "possibly the single most important business ratio there is."[4] This ratio is net profit after tax and abnormal items (NPAT, also known as net income) divided by equity, which is also known as shareholders' equity, shareholders' funds, net assets and net worth – highly confusing! But these terms have various historical and national origins and are used in a variety of contexts.

Shareholders' equity is derived from the funds contributed by shareholders in the initial purchase of shares plus any funds retained by a firm from profits that are not paid to shareholders as dividends – called retained earnings. So an ROE number provides us with an assessment of how well a firm uses shareholders' money. This can then be compared to alternative investment opportunities. Moreover, ROE is a number that is devoid of share market hype.

INVESTOR VERSUS ECONOMIC PERFORMANCE

How is it that from time to time companies that do so well on investor criteria, such as total shareholder return, can be so ordinary on fundamentals? The answer lies in part in timing and hype.

Timing. Over the past several years, share markets globally have had a great run. Index records have been broken. Being in these markets and publicly traded has helped a company's share price to rise. In numerous cases, total shareholder returns have risen independently of the rate of return on equity. Western markets are awash with retirement/superannuation/mutual funds,[5] and they often look for larger companies with capital gain prospects. Hence capital gains do not necessarily reflect ROE changes. As a case in point, General Electric bemoaned its current share price in its *2005 Annual Report*: "Our performance is strong. We earn significantly more income and generate substantially more cash than we did when the stock traded at an all-time high."[6] The company registers a similar complaint in its *2006 Annual Report*. One outcome of all of this has been the growth of an investment community focused on "value-based investing." This means valuing a company based upon fundamentals such as ROE.

Hype. Some shares are also carried along by fashion and hype, which raise expectations of future capital gain. Tech and biotechnology stocks are just two examples. But often these expectations are dashed when the investment bubble bursts. Why? Because the fundamentals, profit and ROE, just didn't stack up. The hype, intentional or not, can also come from the larger-than-life CEOs – Warren Buffett at Berkshire Hathaway, for example. But there's also a huge industry out there that is only too glad to talk stocks up – brokers, advisers, financial planners, analysts, the stock exchanges themselves, now increasingly privatized. In short, anyone whose interests are served by an ever-increasing stock market. And that equates to many organizations and people. Remember the hype surrounding the introduction of the Internet?

As a case in point, take the US broking firm Merrill Lynch. It was prosecuted in 2002, following the dot com bust, for misleading investors. New York State's Attorney General, Eliot Spitzer, took the company on and was successful in having it pay a $US100 million fine. Spitzer got hold of internal email messages and documents which showed that analysts were privately saying one thing, and recommending to investors something entirely different. Its star analyst, Henry Bloget, described one stock as a "piece of shit" just before Merrill Lynch called it an "attractive investment." The firm was caught recommending stocks to small investors while warning its big clients against them.[7]

Brokers and analysts can always explain why stocks will continue to appreciate and a week later explain why a "correction" was long overdue. Proper analysis requires seeing through the hype and examining fundamentals, of which return on equity is central.

MEASURING ROE

There are several formulae used to calculate return on equity, but there is *no* standard accounting method. The formula I employ might affect sample selection.

One of these formulae takes net income for a year and divides it by equity for that same year. This is the easiest method to apply since it can be calculated for a firm on a single year's figures. But it has a basic flaw, which is that equity for a year incorporates retained earnings for that same year. This latter figure is a function of net income for that same year. Thus, the denominator and numerator in the formula are not independent. For example, if a company with $10 million in equity produces a net income of $2 million, and half of that becomes retained earnings, then the ROE for that year, using this formula, is $2 million divided by $10 million plus the $1 million of retained earnings or 2 divided by 11: 18.2 per cent.

An alternative approach is to use the equity figure at the beginning of the year as the denominator in the formula. So a firm's 2007 ROE equals its 2007 net income divided by its 2006 equity – which is the equity at the beginning of 2007. In the example above, using this formula, ROE becomes 20 per cent: beginning year equity is $10 million and the company makes $2 million in net income, so its ROE is $2 million divided by $10 million or 20 per cent. This seems a more logical approach and is the method adopted here. It's also the one employed by Standard & Poor's in its analyses.[8] I haven't adopted other variations that readers might encounter or be familiar with. For example, the Wesfarmers company averages the beginning and end equity for a year to produce the denominator in the formula, and General Electric averages the previous five years' equity figures to produce its ROE denominator.

BENCHMARKING ROE

Having decided on a *method* to measure ROE, the next task was to set a *benchmark*, which would become the cut-off point in choosing my sample of successful diversifiers. To arrive at this number, I turned to *Standard & Poor's Quality Rankings*.[9] This study divides stocks into categories, as shown in Figure 3.2. These categories are based on per-share earnings and dividend records. Standard & Poor's has been amassing this data on earnings and dividend rankings, also known as Quality Rankings, since 1956.

Figure 3.2 **Quality Rankings Qualification**

Letter	Description
A+	Highest
A	High
A-	Above Average
B+	Average
B	Below Average
B-	Lower
C	Lowest
D	In Reorganization
LIQ	Liquidation

My major interest was in the return-on-equity performance of these stocks. This, together with size and leverage statistics, is shown in Figure 3.3. The average ROE figures in the far right column of the table are for all 20 years, not just for the four shown – 1985, 1993, 2001 and 2004.

There are several noteworthy features of the numbers in Figure 3.3. Firstly, there is a correlation between return on equity and size, as measured by sales: the larger the sales, the better the ROE. Secondly, there is an inverse relationship

Figure 3.3 **Size, Leverage and Profitability of Quality Rankings Portfolios at Different Points in Time**

Quality Ranking	Sales ($ Millions)				Long-Term Debt/Total Assets (1)				Return on Equity				ROE
	1985	1993	2001	2004	1985	1993	2001	2004	1985	1993	2001	2004	Average (2)
A+	3,837	6,529	13,434	19,270	14.3%	14.6%	16.3%	15.9%	16.0%	20.5%	20.8%	18.3%	20.1%
A	2,659	2,877	5,829	4,095	14.4%	14.7%	23.4%	17.8%	12.8%	12.8%	14.7%	17.1%	15.2%
A-	1,910	2,995	5,782	4,975	19.8%	19.1%	20.2%	17.4%	11.0%	12.1%	15.0%	16.3%	14.0%
B+	840	1,867	3,399	3,811	17.5%	18.2%	24.1%	19.7%	8.3%	11.7%	10.2%	15.2%	12.1%
B	969	1,508	3,196	3,687	12.3%	18.7%	28.4%	29.0%	5.8%	6.5%	2.1%	11.7%	9.6%
B-	364	1,057	897	1,264	21.1%	18.1%	25.4%	25.2%	5.9%	9.9%	-2.9%	6.2%	5.9%
C	285	406	256	568	30.8%	25.5%	34.5%	31.7%	-24.0%	-4.5%	-145.0%	-5.1%	-27.0%

(1) Excludes Financials and General Electric due to its large financial business.

(2) This is the average across all 20 years, not simply the four numbers to the left.

between the ratio of long-term debt to total assets and return on equity: the lower debt is to total assets, the higher the ROE. This challenges the idea that high ROEs mean high debt/equity ratios. The third feature is the ROE itself. If we focus on the far right column and on the A- category ("above average") and higher rankings (A and A+), the figure of 14 per cent for return on equity suggests itself. This is the number for the A-, the "above average" group. I've used this as the benchmark measure for successful diversifiers, *applied to at least 10-years of ROE history in each case*.[10]

IN SUMMARY

Several firms from Marakon Associates' top 22 that one might have thought would make the cut, didn't, because they didn't consistently meet the 14 per cent ROE criterion over a ten-year period. Among these was Onex in Canada, whose ROE numbers fluctuated wildly; in several years Onex has returned losses. Orkla in Norway and Berkshire Hathaway in the US also did not make the cut because their ROE results didn't consistently hurdle the 14 per cent benchmark. (Berkshire Hathaway is examined in detail in Chapter 14.)

To sum up, I chose the diversified exemplars in Chapter 4 because:

- they appeared among the top 22 successful diversifiers on total shareholder return (TSR) in Marakon Associates' list,
- their 10-year TSRs exceeded their country's benchmark on TSR significantly,
- they exceeded my return on equity benchmark of 14 per cent every year for at least the last 10 years,
- they were among the larger companies in the top 22 judged by market capitalization,

- they were highly diversified, and
- they were widespread geographically, with one located in the US, another in Australia, another in South Africa and the fourth in India.

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1 Kaye, C. & Yuwono, J. 2003. Conglomerate discount or premium? How some diversified companies create exceptional value. *Marakon Associates*, August, 25.

2 See Schiller, R.J. 2005. *Irrational exuberance* (second edition). New York: Currency Doubleday.

3 As an illustration of this, BHP Billiton, the world's largest mining company, lost $AU27 billion or 14 per cent in market value in two weeks in 2006. Its CEO exclaimed that the "fundamentals" had not changed, only fears of an economic downturn. Source: *The Age* newspaper, May 24, 2006.

4 Walsh, C. 2006. *Key management ratios.* Harlow: Prentice Hall. Also employed, among other ratios, by stock pickers who concentrate on fundamentals. See, for example, *Stingy Investor* at www.ndir.com.

5 Kohler, A. 2006. Fear not, even as we enter third leg. *The Sydney Morning Herald*, March, 29. Kohler points out that "the world is awash with money" and because of the cost of capital "takeovers can now be self-funding" (p.21).

6 General Electric's *2005 Annual Report*, p.12.

7 Coultan, M. 2006. Street fighter takes on the state. *The Sydney Morning Herald*, November 4-5: 41 & 44.

8 See Standard & Poor's, 2005. *Stock appreciation ranking system (STARS): Methodology, analysis, & performance attribution*, June.

9 Standard & Poor's, 2005. *Standard & Poor's quality rankings: Portfolio performance, risk, and fundamental analysis*, October.

10 A rule-of-thumb figure of 15 per cent for ROE is also considered a desirable target. See McClure, B. 2003. Keep your eyes on the ROE. *Investopedia.com*, October 1.

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CHAPTER 4

The Diversified Exemplars

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What makes a successful diversifier?

To answer this question, I've chosen four *exemplars*: General Electric, Wesfarmers, Bidvest and ITC. Let's now look at what each company does and the details of its return on equity performance.

GENERAL ELECTRIC

General Electric, or GE, is huge. It's also highly diversified, and it is one of the world's most esteemed companies.[1] In 2006, GE was named *Fortune* magazine's "Most Admired Company" for the second straight year and was ranked second in *Barron's* annual survey of the world's most respected companies. In November 2005, GE was rated number one in corporate governance for the third straight year.[2] In terms of financial strength, in 2006 the company remained one of only six "Triple-A"-rated US industrial companies. Its key financial results, 1997-2006, are set out in Figure 4.1.

The company can trace its beginnings to Thomas A. Edison, who established the Edison Electric Light Company in 1878. In 1892, a merger of Edison General Electric Company and Thomson-Houston Electric Company created General Electric Company. GE is the only company listed in the Dow Jones Industrial Index today that was also included in the original index in 1896.

GE describes itself as "Imagination at Work." It's a diversified technology, media and financial services company focused, as it says, "on solving some of the world's toughest problems." It has products and services ranging from aircraft engines, power generation, water processing and security technology to medical imaging, business and consumer financing, media content and advanced materials. GE serves customers in 160 countries and employs more than 300,000 people worldwide. Truly massive.

In 2005, under its new CEO, Jeffrey Immelt, who followed Jack Welch in 2001, GE was restructured. It's now set up as

Figure 4.1 **GE, Key Financial Results, 1997-2006**

	2006	2005	2004	2003	2002	2001[2]	2000	1999	1998	1997
Revenue [1]	$163,391	149,702	134,481	112,886	113,856	107,558	129,853	111,630	110,469	90,840
Net income (net profit after tax)	$20,829	16,353	16,819	15,236	14,167	13,791	12,735	10,717	9,296	8,203
Shareholders' equity	$112,314	109,354	110,821	79,631	64,079	55,000	50,492	42,557	38,880	34,438
Return on equity (%) [3]	19.0	14.8	21.1	23.8	25.8	27.3	29.9	27.6	27.0	26.4

(1) Dollars in US millions.

(2) GE's revenue figures were restated from 2001 onwards by the company; hence the dip. For example, prior to rework, 2004 revenue was $152,866. However, net income remained unchanged for those years.

(3) Calculated by dividing end-year net income by beginning-year shareholders' equity. The 1997 figure is calculated by using beginning-year shareholders' equity of $31,125 million – equity at the end of 1996 (not listed above).

six major divisions focused on the broad markets that GE serves. Here's a brief description of each.

GE Infrastructure: With $US47,429 million in 2006 sales, Infrastructure is GE's largest business. It provides jet engines and replacement parts and repair and maintenance services for all categories of commercial, military, executive and regional aircraft. These products and services are sold worldwide to airframe manufacturers, airlines and government agencies. Rail systems products and maintenance services are provided, as well as financial products to airlines, aircraft operators, owners, lenders and investors; power plant products and services; gas, steam and aero derivative turbines, generators, combined cycle systems, controls and related services; renewable energy solutions; advanced turbo machinery products and related services for the oil and gas market; substation automation, network solutions and power equipment sold to power transmission and distribution customers; chemical water treatment program services and equipment; and financial products to the global energy industry.

GE Industrial: This business generated $US33,494 million in revenue in 2006 and is GE's second largest business. It provides major appliances and related services: refrigerators, freezers, electric and gas ranges, cooktops, dishwashers, clothes washers and dryers, microwave ovens, room air conditioners and residential water system products. It also produces lighting products, electrical distribution and control equipment, high-performance-engineered plastics used in a variety of applications, telecommunications equipment and construction materials, structured products, silicones and high-purity quartzware. Rentals, leases, sales and asset management services of commercial and transportation equipment are part of this business, as is measurement and sensing equipment, security equipment and systems and a broad range of automation hardware and software.

GE Commercial Finance: This business, GE's third largest, generated $US23,792 million in 2006. It provides loans, leases and other financial services to customers, including manufacturers, distributors and end-users for a variety of equipment and major capital assets. These assets include industrial-related facilities and equipment; commercial and residential real estate; vehicles; corporate aircraft; and equipment used in many industries, including construction, manufacturing, telecommunications and healthcare.

GE Money: Weighing in at number four on revenue, with sales of $US21,759 million in 2006, this business provides private-label credit cards; bank cards; corporate travel and purchasing cards; personal loans; auto loans; leases and inventory financing; residential mortgages; home equity loans; debt consolidation loans; current and savings accounts and insurance products for consumers.

GE Healthcare: With 2006 revenue of $US16,562 million, this business slots in at number five in size. It provides medical imaging systems such as magnetic resonance (MR) and computer tomography (CT) scanners, x-ray, nuclear imaging and ultrasound, as well as diagnostic cardiology and patient monitoring devices; related services, including equipment monitoring and repair, computerized data management and customer productivity services. Diagnostic imaging agents used in medical scanning procedures are produced, as well as protein separations products, including chromotography purification systems used in the manufacture of biopharmaceuticals, and high-throughput systems for applications in genomics, proteomics and bioassays.

NBC Universal: Coming in at number six by revenue, with sales of $US16,188 million in 2006, NBC Universal's principal businesses are the furnishing of US network television services to 230 affiliated stations, the production of television programs, the production and distribution of motion pictures, the operation of 30 VHF and UHF television broadcasting stations, of cable/satellite networks around the world and of theme parks, and investment and programming activities in multimedia and the Internet.

The revenue from these businesses is truly global, with some of the greatest rates of growth occurring in developing countries such as China, Korea, India and Turkey. Take Infrastructure, for example, GE's largest business group: 60 per cent of its orders came from outside the US. In GE Money, this figure for earnings was 70 per cent. The global break-up of GE's revenue was: Americas, 14 per cent; Europe, 51 per cent; Pacific Basin, 25 per cent; and Other Global, 10 per cent. GE aims to have "leadership businesses," that is, firms that either dominate their respective markets or are seen as innovators.

WESFARMERS

Wesfarmers, like GE, is highly diversified. Although about a tenth of GE's size, with 30,000 employees, it's also very successful. It appears at number seven in Figure 3.1 and, as Figure 4.2 shows, it passes the return on equity test for the last 10 years. It was regarded by *Forbes.com* in 2003 as one of the world's top-performing diversified companies[3] and still achieves rave reviews.

Wesfarmers is a top-20 Australian company, with a market capitalization of around $AU17 billion. It stands in sharp contrast to GE in many ways. Whereas GE's growth has been via global expansion, Wesfarmers' has been largely within Australia, with only 10 per cent of its employees located outside that country, in nearby New Zealand. GE is high-tech, Wesfarmers is low-tech. GE places great emphasis on "imagination," "innovation," and "change"; Wesfarmers projects a steadier profile.

The conglomerate began life in 1914 as a farmers' cooperative in the State of Western Australia. Its focus at that time was on the provision of services and merchandise to the rural community. Since its public listing in 1984, Wesfarmers has diversified, growing rapidly by greatly broadening its business and geographic base outside its home State. Over a 13-year period to 2005, with Michael Chaney as CEO, Wesfarmers' share price rose from $AU6 to nearly $AU40. The company's market capitalization climbed from $AU1 billion to $AU14 billion. It would be fair to say that although the investment community eschewed conglomerates over that period, Wesfarmers remained and is a share market "darling."

Figure 4.2 **Wesfarmers, Key Financial Results, 1997-2006**

	2006 (1)	2005	2004	2003	2002	2001	2000	1999	1998	1997
Revenue (2)	$8,858	8,190	8,407(3)	7,753	7,386	4,389	3,495	3,119	2,823	2,710
Net income (net profit after tax)	$ 869	618	873	538	414	251	207	179	166	140
Shareholders' equity	$3,166	3,083	3,332	3,758	3,400	1,594	1,226	1,206	1,168	1,011
Return on equity (%) (4)	28.2	18.5	23.2	15.8	26.0	20.5	17.2	15.3	16.4	15.7

(1) *For the 2006 Annual Report, Wesfarmers moved to AIFRS – the Australian version of International Financial Reporting Standards (IFRS).*

(2) *Dollars in Australian millions.*

(3) *Included the sale of a subsidiary called Landmark.*

(4) *Calculated by dividing end-year income by beginning-year shareholders' equity. The 1997 figure is calculated by using beginning-year shareholders' equity of $893 million – equity at the end of 1996 (not listed above).*

Wesfarmers is set up as five business divisions, as shown in Figure 4.3. The company has retained its favored status through year-on-year results in these divisions. The size of each division is listed in the *2006 Annual Report*: Home Improvement, $AU4.28 billion; Energy, $AU1.68 billion; Industrial and Safety, $AU1.18 billion; Insurance, $AU1.12 billion; Chemicals and Fertilizers, $AU595 million. Other Activities, though not formally a division, amounts to $AU18 million. (This structure may change with Wesfarmers' acquisition of the giant food retailer, Coles, in November 2007.)

BIDVEST

The firm rated number one in Figure 3.1 is Bidvest. With its headquarters in South Africa, Bidvest passes the ROE test. Its results for the last 10 years are shown in Figure 4.4. It has achieved an annual compound growth rate in headline earnings per share of 26.5 per cent over the last 14 years.

The company began in 1988 with its first acquisition and has continued on this acquisitive and internal expansion trail to achieve 17 years of growth. It was founded by the current CEO, Brian Joffe. For his achievements he was one of the *Sunday Times*' top five businessmen in 1992 and was voted South Africa's Top Manager of the Year in 2002 in the Corporate Research Foundation's publication *South Africa's Leading Managers*.

Though South African based, the company has significant operations also in the United Kingdom, Europe, New Zealand, Ireland and Australia. Its foundation business was in food service in 1988, providing supplies to hotels, restaurants, clubs and canteens. Its operating divisions now are Services, Food-service Products, Commercial Products, Automotive Products and Corporate Services – the last being a bit of a catchall. Bidvest has activities in freight handling, contract cleaning and security, financial services, food distribution to restaurants, office and industrial products, and motor vehicle sales. These activities are covered by 90,000 employees worldwide.

Figure 4.3 **Wesfarmers' Diversity**

WESFARMERS LIMITED

Home Improvement	Energy	Industrial and Safety	Insurance	Chemicals and Fertilizers	Other Activities
• retail building materials • home & garden products • bargain hardware & variety	• coal mining • coking coal to export • thermal coal • liquid petroleum gas • industrial gasses & equipment • power generation	• maintenance & repair products • industrial safety products & services	• general & specialist insurance • general insurance software	• manufacture & marketing of chemicals for industry, mining & mineral processing • fertilizers • soil & plant testing • agronomy advisory services	• rail freight business • investment banking • softwood milling

ITC

ITC Limited appears at number three in Figure 3.1 and passes the ROE test handsomely. Since 1997 its lowest ROE figure has been 29.7. (See Figure 4.5.)

ITC was incorporated on August 24, 1910 under the name "Imperial Tobacco Company of India Limited." Its beginnings were humble. A leased office on Radha Bazaar Lane, Kolkata, was the center of the company's existence. ITC celebrated its 16th birthday on August 24, 1926, by purchasing a plot of land situated at 37, Chowringhee (now renamed J.L. Nehru Road), Kolkata, for the sum of Rs 310,000. This decision of the company was historic in more ways than one. It was to mark the beginning of a long and eventful journey into India's future.

The headquarters building, "Virginia House," which was built on that plot of land two years later, would go on to become one of Kolkata's most venerated landmarks. The company's ownership progressively Indianized, and its name was changed to I.T.C. Limited in 1974. In recognition of its multi-business portfolio, encompassing a wide range of businesses, the periods in the name were removed, effective September 18, 2001. The company now stands rechristened as "ITC Limited."

ITC is one of India's foremost private sector companies, with a market capitalization of around $US16 billion and a turnover of $US3.5 billion in 2006. Rated among the World's Best Big Companies and Asia's "Fabulous 50" by *Forbes* magazine, ITC has also been named among "India's Most Respected Companies" by *Business World* and "India's Most Valuable Companies" by *Business Today*. The company ranked third in pre-tax profit among India's private sector corporations in 2006.

ITC's diversified presence extends to cigarettes, hotels, paperboards and specialty papers, packaging, agri-business, branded packaged foods, information technology, lifestyle retailing, and gifts and stationery. While it is a market leader in its traditional businesses, it is rapidly gaining market share

Figure 4.4 **Bidvest, Key Financial Results, 1996-2005**

	2006	2005	2004	2003	2002	2001	2000	1999	1998	1997
Revenue [1]	R77,276	62,811	51,262	47,073	41,950	29,415	26,427	14,646	7,432	5,069
Net income (net profit after tax)	R 2,388	1,961	1,531	1,334	1,231	1,035	884	659	400	214
Shareholders' equity	R 8,928	7,469	5,998	5,353	5,563	3,860	3,028	2,985	2,803	1,758
Return on equity (%) [2]	32.0	32.7	28.6	24.0	31.9	34.2	29.6	23.5	22.8	26.7

(1) *South African Rand in millions*

(2) *Calculated by dividing end-year net income by beginning-year shareholders' equity. The 1997 figure is calculated by using beginning-year shareholders' equity of R802 – equity at the end of 1996 (not listed above).*

Figure 4.5 **ITC, Key Financial Results, 1997-2006**

	2006	**2005**	**2004**	**2003**	**2002**	**2001**	**2000**	**1999**	**1998**	**1997**
Revenue (1)	16,510	13,585	12,039	11,194	9,982	8,827	8,069	7,700	6,923	5,990
Net income (net profit after tax)	2,235	2,191	1,592	1,371	1,189	1,006	792	623	526	346
Shareholders' equity	9,061	7,895	6,410	5,365	4,413	3,534	2,799	2,234	1,762	1,359
Return on equity (%) (2)	28.3	34.2	29.7	31.1	33.6	35.9	35.5	35.4	38.7	30.9

(1) *Rupees in crores. One crore equals ten million rupees.*

(2) *Calculated by dividing end-year net income by beginning-year shareholders' equity. The 1997 figure is calculated by using beginning-year shareholders' equity of 1,121 crores – equity at the end of 1996 (not listed above).*

even in its nascent businesses of branded packaged foods, branded apparel and stationery.

ITC is also dedicatedly nation-oriented. Yogesh Chander Deveshwar, chairman since 1996, cites "a commitment beyond the market." In his own words: "ITC believes that its aspiration to create enduring value for the nation provides the motive force to sustain growing shareholder value. ITC practises this philosophy by not only driving each of its businesses towards international competitiveness but by also consciously contributing to enhancing the competitiveness of the larger value chain of which it is a part."

ITC's diversification is aimed to create multiple drivers of growth anchored on its time-tested core competencies: unmatched distribution reach, superior brand-building capabilities, effective supply chain management and acknowledged service edge in hoteliering. Over time, the strategic forays into new businesses are expected to garner a significant share of their emerging high-growth markets in India.

Through its Agri-Business, ITC is also one of India's largest exporters of agricultural products and one of the country's biggest foreign exchange earners ($US2.8 billion in the last decade). The company's "e-Choupal" initiative enables Indian agriculture to significantly enhance its competitiveness by empowering Indian farmers through the use of the Internet. On the sourcing side, this network makes an invaluable contribution to strengthen the Company's branded packaged foods business through access to high quality, identity-preserved agri produce at competitive prices.

This transformational strategy, which has already become the subject matter of a case study at the Harvard Business School and finds prominent mention in C K Prahalad's book, *The Fortune at the Bottom of the Pyramid*, is expected to progressively create for ITC a huge rural distribution infrastructure, significantly enhancing the Company's marketing reach.[4] The impact of this pioneering initiative continues to earn global and domestic accolades, the most recent of which is the Stockholm Challenge Award 2006. The e-Choupal won the Development Gateway Award in 2005 and the World

Business Award in 2004.

ITC's wholly owned information technology subsidiary, ITC Infotech India Limited, is pursuing emerging opportunities in providing end-to-end IT solutions, including e-enabled services and business process outsourcing.

ITC's production facilities and hotels have won numerous national and international awards for quality, productivity, safety and environment management systems. ITC was the first company in India to voluntarily seek a corporate governance rating. ICRA, an associate of Moody's Investors Service, accorded it the second highest rating, signifying "a high level of assurance on the quality of corporate governance."

ITC employs over 20,000 people at more than 60 locations across India. Ranked among India's most valuable companies by *Business Today* magazine, it has an over-arching vision captured in its corporate positioning statement: "Enduring value. For the nation. For the shareholder."

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1 Ranked first in the *Financial Times'* 2004 "World's Most Respected Companies Survey" for the seventh consecutive year since the Survey's inception in 1998.

2 *Financial Times*' annual survey of CEOs in 2005 (November).

3 Kirkman, A. 2003. A good mix. *Forbes.com*, April.

4 Prahalad, C.K. 2004. *The fortune at the bottom of the pyramid*. Upper Saddle River: Wharton School Publishing.

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PART TWO

DETAILING THE STRATEGY

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CHAPTER 5

Establish a Supportive Corporate Center

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To be effective, any organization needs a value-adding corporate center. But a key characteristic of the center in successful diversifiers is that it not only provides clear guidelines but is supportive and diverse-tolerant. The last means that the center is able to handle diversity in the sense of not meddling with how the various divisions achieve their competitiveness. A hands-off, yet supportive policy is *not* easy to achieve and requires setting up a framework within which a diversifier's divisions can get on with their job without unnecessary interference.

Successful diversifiers accomplish this by a number of mechanisms: clearly defining the role of head office; getting the decentralization balance right; and having an effective CEO as well as a strong CEO-CFO relationship.

THE ROLE OF THE CORPORATE CENTER

In 2002 Michael Goold and Andrew Campbell reported a study that looked at the roles and minimum sizes of corporate (head office) staff.[1] This research was based on survey data gathered on the size, cost, roles and functional composition of headquarters staff in more than 600 companies drawn from a range of industries in the US, the UK, France, Germany, the Netherlands, Japan and Chile.[2] It also collected data on overall company sizes, organization structure, the type of businesses in each company (e.g. how related, their geographic spread) and the policies of the corporate center (e.g. levels of influence, linkages between businesses). These firms were *not* necessarily diversified.

Via statistical analysis, the study's authors were able to produce an estimate of the number of staff required at a corporate center to undertake a *minimum* corporate-center role. This involves fulfilling legal and regulatory requirements, instituting basic corporate governance, producing annual reports, submitting tax returns, and undertaking compliance matters such as occupational health and safety. Also included here are appointing senior management, establishing the structure of the company, raising capital, handling shareholder relations and managing major corporate risks. These activities were reported to be present in the corporate centers of more than 90 per cent of all companies studied.

From the study, the authors proposed the numbers in Figure 5.1 as benchmarks for *European* companies undertaking the minimum roles of the corporate center. *US* benchmarks, they suggested, were 25 per cent higher.

Figure 5.1 **Sizes of Corporate Centers**

Company Size (number of employees)	Staff Required for Minimum Corporate Center Role	Minimum Corporate Center Staff per Thousand Employees
2,000	5	2.5
5,000	9	1.8
10,000	15	1.5
20,000	23	1.1
50,000	43	0.9
100,000	65	0.6

Source: Goold, M. & Campbell, A. 2002. Parenting in complex structures. *Long Range Planning*, 35: 219-243.

If the corporate center goes beyond the minimum activities that I've outlined to include further value-adding functions, then the numbers, the authors suggest, go up by about five people for a company with 10,000 employees and around 15 for a company with 50,000 employees. These additional activities include corporate planning, government and public relations, internal audit and corporate human resources.

Goold and Campbell report that Dow, in placing emphasis on manufacturing excellence, has developed a strong *corporate* manufacturing function to influence its businesses and to co-ordinate manufacturing across various sites. Rio Tinto uses the expertise of its *corporate* technical staff to improve the planning of its mining operations. BP has ushered in a high performance culture throughout the company by establishing performance contracts between business unit heads and the CEO. This requires *corporate* support. Virgin leverages its brand into a variety of businesses, from airlines through financial services to internet access. The *corporate* center plays a significant role here too.

I observe, however, that the numbers in Figure 5.1 are *not* those in my successful diversifiers. I'd like to look at two of the latter cases here, in some detail.

Wesfarmers, with 32,000 employees, has 130 staff at its corporate center. If they used the scale in Figure 5.1 they would have between 23 and 43 staff to cover a *minimum* corporate center role. Let's say 35. So clearly Wesfarmers' corporate center does much more than the minimum. Numbered in its total is the CEO, the Chief Financial Officer (CFO), group accounting, corporate human resources, head office corporate affairs, business development, group legal, group risk management, corporate tax and corporate treasury. Group accounting is the largest of these, but business development contains 20 analysts.

In spite of this relatively large corporate center, Wesfarmers headquarters is always careful not to tell its divisions how to run their businesses. Its aim is to "add value" across the range of divisions and business units, but not to interfere unless requested or unless results require drastic action. The latter rarely occurs.

ITC in India also has a relatively large head office: 250 people for a total employee strength of 21,000. Again, according to Figure 5.1, it would be around 25! – a ten-fold difference. However, the figure of 25 is to undertake a *minimum* role at the corporate center and not necessarily for a diversified firm. So ITC's center must be doing more. When I queried the 250 figure, the company replied that it is the result of greater strategic management at head office and an elaborate corporate governance structure, wherein the Board of Directors and numerous corporate functions operate out of the corporate center. These functions include: Planning and Treasury, Accounting, Legal, Secretarial, Environment, Health and Occupational Safety, Human Resources, Communications, Internal Audit and Information Technology. Of the 250 head office people, about one-third are "managers."

The rest are support staff.

ITC's figure is partly explained by the fact that the company is a pioneer in India in setting corporate governance benchmarks and the first firm in that country to voluntarily seek a corporate governance rating. It also has a *three-tier* governance structure that has been designed to address the special needs of each of its businesses as well as meeting the requirements of the company as a whole. The governance structure adopted by the company looks like this:

- The first tier is concerned with the strategic supervision of the group and focuses attention on the accountability of management. It is conducted by the Chairman, Y.C. Deveshwar, and his Board of Directors and is free from involvement in the *task* of strategic management of the company as a whole. Hence this review can be conducted with objectivity.

- The second tier does involve strategic management of the company. It is carried out by the Corporate Management Committee and is uncluttered by the day-to-day *tasks* of executive management. It thus remains focused and energized.

- The third tier focuses on the effective management of ITC's individual businesses by each Division CEO. Each is assisted by a Division Management Committee and is concerned with the performance of the division and the businesses within.

As we have said, one outstanding feature of successful diversifiers is that head office plays a supportive role. The death knell for diversifiers is when the tail wags the dog – when the corporate center becomes the focus of attention and, as a consequence, it mushrooms. Then head-office red tape begins to hold back the performance of the divisions, and their ability to deliver a competitive advantage in their local industries suffers.

There's little point hiring skilled and highly motivated managers in the divisions and then weighing them down with a non-supportive head office. That would only add to the various units' costs: *directly* by increasing overheads, and *indirectly*, through increased paperwork, periodic reports and just plain head-office bureaucracy. It's confidence in division managers, because of their basic competence and the system in which they operate, that allows head office to work in the background.

GETTING THE DECENTRALIZATION RIGHT

In his insightful book, *Who Says Elephants Can't Dance?*, Louis Gerstner reflects on his experience as CEO in turning IBM around.[3] He makes the point that every CEO has to decide what is to be decentralized, and thus local, and what is to be "common" across the whole of a company. Not "centralized," he insists, but *common* across all of an enterprise's entities. Great institutions, he believes, get this balance right. Let's look at this issue for successful diversifiers.

Gerstner proposes that shared activities fall into three categories.

The first group of these involves leveraging the size of the enterprise, which is clearly *common*, and includes what he calls "unifying functions" such as data processing, data and voice networks, purchasing and basic human resources systems, and real estate management. These also have the potential to yield economies of scale and are no-brainers, he says, when it comes to their being handled at the corporate center. We see this in the successful diversifiers.

The second group of shared activities is more subtle, involving business processes that are more closely linked to customers and to the marketplaces of the divisions. The common systems here are not simply centered at corporate HQ but require linkages *among* the divisions of a company. As possible candidates, Gerstner proposes common databases, common fulfillment systems, common parts numbering systems and common customer relationship management systems. He points out that sharing in these areas isn't easy as it does require that profit-center managers yield some of their control over the running of their businesses.

It's interesting to reflect on this second group of activities as far as diversified firms are concerned. In these companies there may not exist the opportunities that Gerstner suggests for IBM. For instance, in Wesfarmers, in the Home Improvement Division and with its Bunnings brand, there may be zero opportunity to share the "common" activities with the Energy Division and its coal customers, or with the customers of the Insurance Division. This is not to say that the possibilities shouldn't be looked at.

The third category that Gerstner describes poses something of a problem. It involves a shared approach to winning a *marketplace*, often a new or redefined marketplace. He gives an example from his days at American Express:

"During my time at American Express I was running the so-called Travel Related Services business, which included the American Express Card division. It was the largest and most profitable segment of American Express. American Express bought a brokerage company as a step to create a one-stop financial supermarket. In the course of enticing the brokerage company to join American Express, the deal makers promised the brokerage that they would have access to the American Express cardmember list. In other words, they would be allowed to make cold calls to cardmembers to try to sign them for brokerage accounts. When this became known to the card division, there was an open revolt. Those of us who had build the card division believed it was assembled on a basis of trust, privacy, and personalized service. Cold calls from securities brokers did not fit into our definition of customer service.

The war went on for years, and the integration or synergy that the CEO had hoped to achieve not only never happened, but it led to the departure of many senior executives and ill will that contributed to the eventual disposition of the brokerage business."[4]

We can see from this example how the growth of one business could lead to the erosion of another. Gerstner describes this as going "a step too far" and, as a result, these types of efforts inevitably fail. The reason: they ask people to undertake activities that are in conflict. *Between* divisions of successful diversifiers, the kind of conflicts that Gerstner describes don't generally arise, because their divisions are so diverse.

THE TOP TEAM

I'd now like to consider the roles of some key players in a successful diversifier's corporate center. I will particularly focus on the CEO in this section, and the CEO-Chief Financial Officer (CFO) relationship in the next.

Diversification success begins with a company's board, and the most important decision the board can make is the appointment of the CEO. This wielder of power not only affects everyone in lower positions in the organization, but significantly influences board operations, because it is the CEO who supplies information to the board.

The Blue Ribbon Commission on CEO Succession met over the course of a six-month period in Washington, D.C. and, in 1998, produced a report that outlined, among other topics, the characteristics of a successful CEO.[5] The importance of this study was highlighted by numerous cases of CEO failure, embarrassing newspaper reports and CEO churn, with newly appointed CEOs being fired and longer-term CEOs being asked to leave. In the five-year period from 1992 to 1997, 100 of the Fortune 500 CEOs were replaced by their own board.

The Commission found that there were certain characteristics exhibited by successful CEOs in all types of situations and corporate cultures. These are shown in Figure 5.2.

The concept of the "right" CEO, however, suggests not only these general characteristics but others required by an organization's specific situation: its strategic direction, competitive position, performance, corporate culture and so on.

Figure 5.2 **Characteristics of a Successful CEO**

Traits	Indicators
Problem-Solving Capability	• Intellectually resourceful • Possesses sound judgment and keen discernment • Strategically focused
Temperament and Motivational Factors	• Emotionally robust • Strongly committed to personal and business values • Mature use of power
Interpersonal Relations and Communication	• Communicates effectively • Able to manage a variety of constituencies, both internal and external • Consistently articulates and adheres to company vision
Insight into Self and Others	• Understands own strengths and weaknesses • Grasps the needs of the organization and of others
Leadership Characteristics	• Paints exciting picture of change • Sets the pace of change and orchestrates it well • Demonstrates recognition and concern for others • Clearly defines expectations • Serves as a trusted example • Determines company's values agenda • Develops and enables a talented team

Source: *Report of the Blue Ribbon Commission on CEO Succession*, 1998.

In response to this, management consulting firm RHR International developed an *additional* set of "key leadership factors," the relevance of which depends on a firm's situation. They painted four scenarios:

- Rapid Growth: marked by a dramatic increase in revenue and market share, often accompanied by new products and/or markets.

- Turnaround: when a company is in significant trouble and needs major financial and operational restructuring.

- Merger Integration: when two companies are faced with the challenge of combining resources to function as a single entity.

- Industry Undergoing Structural Shift: when an industry undergoes major changes that require the company to change its culture.[6]

The key leadership factors pertinent to each of these scenarios are listed in Figure 5.3.

Diversifiers face three of these corporate situations in particular: Rapid Growth, Turnaround and Merger Integration. Bidvest, for example, is always on the growth trail and much of this is through acquisition; hence the need for turnaround of the acquired firms, and for merger integration. If we look at the key leadership factors in Figure 5.3 for Rapid Growth, Turnaround and Merger Integration, we see that someone like Brian Joffe, CEO of Bidvest, is in possession of most of them. In the Rapid Growth category, in the case of diversifiers, I would add "thrives on diversity."

As another example, take Jack Welch, General Electric's CEO for two decades until 2001. He also flourished in his position. In 1981, at 45, he became the eighth and youngest CEO in GE's history, and he transformed the organization. His goal was to make GE "the world's most competitive enterprise."[7] Embarking on a revolution, he achieved the largest corporate makeover in history. Described as having an "unremitting zest for business," Welch was the right leader at exactly the right time.[8] He has spread his views widely, always communicating his love for his role.[9]

Perhaps another indicator of how the CEOs of our successful diversifiers thrive in their jobs is their longevity in their positions. Jack Welch had been CEO of General Electric for 20 years when he retired; Michael Chaney of Wesfarmers was CEO for 13 years until he stepped down in 2005; Brian Joffe has been CEO since Bidvest's foundation in 1988; Yogesh Deveshwar has been CEO of ITC from 1996 to the present.

Further evidence for the importance of a CEO to a diversi-

Figure 5.3 **Key Leadership Factors in Various Situations**

Corporate Situation	Key Leadership Factors
Rapid Growth	• Sees alternatives beyond traditions and habits • Embraces change easily • Effectively communicates clear vision of the future • Willing to surround self with needed talent • Delegates authority; trusts others to get the job done
Turnaround	• Near-term focus with long-term awareness • Stands ground in face of resistance • Clear and concise communicator • Motivates people to think about where the company is going – not where it is coming from • Generates solid team around new agenda
Merger Integration	• Able to visualize picture of future organization • Understands the cultures of the two organizations and potential implications of their differences • Recognizes that cultures are more powerful than individuals; willing to work with cultural dynamics • Consensus-building management style
Industry Undergoing Structural Shift	• Excellent industry knowledge • Able to think out-of-the-box • Comfortable with ambiguity • Passion for change • Creates a sense of urgency • Motivates others to change their mind-sets as well as their management practices

Source: RHR International website, 2006.

fier's success comes from Marakon Associates' 2003 study entitled "Conglomerate Discount or Premium? How Some Diversified Companies Create Exceptional Value."[10] It cites as a "striking finding" that "each successful conglomerate had a clear-sighted, financially oriented leader." Each fosters "an entrepreneurial, incentive-based culture, assembles capable management teams, sets them targets, monitors their performance and concentrates on resource allocation and portfolio management." The CEOs of the ten top-performing diversifiers examined by their study all exhibited these characteristics. But achievements will only eventuate if CEOs thrive in their role.

Further specific evidence for the importance of CEO selection comes from *turnaround situations*. Poor selection is, as Stuart Slatter has pointed out, "the single most important factor leading to decline and stagnation."[11] Grinyer and Spender have identified the characteristics required of a CEO in the turnaround of a *diversified firm*: a broad field of vision; a questioning attitude towards the recipes adopted; a wide exposure to senior managers in industries with different recipes; and breadth of experience working with key executives.[12]

Some years ago as CEO, I was responsible – with a management team – for turning around a company called White River Timber. This company made trusses and frames for houses and supplied these and other related building products to large commercial builders. What the management team and the wider organization needed, fundamentally, was leadership in finding an answer to the questions: What business are we in? and How do we make it succeed? We found the answers, and success, by narrowing the product range, ceasing to engage in unprofitable activities, and improving product quality and customer service.

On another scale Andrew Mohl, CEO of AMP, provides some lessons regarding a CEO's role in leading a business through a successful turnaround. AMP is involved in insurance – life, risk and general; retirement savings and income management; funds management; and financial planning. Headquartered in Australia, it has today $AU122 billion assets under management, over 3.4 million customers and more than 3,500 employees. But in late 2002, when Mohl took over as CEO, the company was in dire straits. Five years later on the eve of his voluntary departure at age 51, and somewhat battle-scarred, he reflected on his demanding years at the helm by providing these six pointers for CEOs in leadership roles in business turnarounds. These are also relevant to the CEOs of diversifiers:

> *Brutal honesty* – on both sides of the conversation. Managers and staff can then agree on where improvements need to be made.
>
> *Communicate*. You can't spend too much time on this. And when things go wrong, get the bad news out fast.
>
> *Listen*. If you're constantly telling people things, you're not going to learn very much.
>
> *Tight/loose*. Keep it tight in terms of core values and broad objectives, but give people freedom to execute in terms of how they get there.
>
> *Be the coach*. Coaching is the most effective way to lift performance at all levels of the organization.
>
> *Get the right people* in the right jobs, performing to their potential on the things that matter.[13]

The CEO role of providing leadership and direction is also emphasized by Allan Loren who, until 2005, was D&B's (formerly Dun & Bradstreet) CEO and Chairman. He arrived at D&B in May 2000 and, in his role of CEO, set about transforming a disjointed organization. As he says, "my sense was that the company had no direction, no strategy, and lacked the ability to focus."[14] His role as CEO was to provide these ingredients and concentrate "on changing the behavior of our team members to help them grow as leaders … it was leadership, created through cultural change, what we call 'winning culture.'"[15]

Richard Goyder, the present CEO of Wesfarmers, appointed in July 2005, cites "*resisting the temptation to micro-manage divisions*" as a prerequisite for a successful CEO of a diversified company. Not every CEO can resist that temptation. And for those who don't, diversification becomes a disaster.

Goyder, who had been Wesfarmers' Chief Financial Officer for several years before, also admits that the sheer scale of his new role caught him off guard: "The difference between CEO and CFO is the absolute constancy of work – you are never away from what's going on. The CEO's role is very demanding, and I think it's a lonelier role. There are less people you can confide in."[16] He focuses on medium-to-long-term planning and on defining a clear direction for his leadership team and for his management teams to follow. "Getting the settings right," he calls it.

THE CEO-CFO RELATIONSHIP

Because the discussions at senior levels in diversified firms often center around *finance*, a CFO has a very important role. He or she gets to act as advisor and confidant to the CEO and, on other occasions, may act as liaison officer, controller and even CEO stand-in. Hiring an effective CFO is *very* important.

It's even been suggested that the relationship between a CEO and his or her Chief Financial Officer (CFO) is as close as one gets to a corporate marriage. As Catherine Stenzel and Joe Stenzel have noted rather exuberantly: "A chief financial officer working seamlessly with a chief executive officer is a thing of beauty to behold."[17] The business news periodically profiles a number of star CEO-CFO combinations, which often follow a characteristic pattern: when the CEO moves up or out, the CFO soon follows.

A rare insight into one such CEO/CFO relationship has been recently documented. The company is Leighton Holdings, the CEO is Wal King and the CFO is Dieter Adamsas. They've spent almost 30 years working together.

Leighton Holdings is Australia's fiftieth largest company by market capitalization, has over 15,700 employees and is the parent company of Australia's largest project development and contracting group. Founded in the State of Victoria in 1949, the organization has grown from a small, privately owned civil engineering firm into a group that includes Thiess, John Holland, Leighton Contractors, Leighton Asia (Northern), Leighton Asia (Southern) and Leighton Properties. Operations are spread all around the Asia-Pacific region on projects in Australia, Hong Kong, Indonesia, Malaysia, Singapore, Philippines, Thailand, Vietnam, China, Taiwan, Sri Lanka, the near Pacific and New Zealand.

The Group's companies offer a broad range of project development and contracting services. Project development and project management of construction and property developments complement the Group's contracting activities, which include engineering and building construction, contract mining, environmental services, operations and maintenance, and facilities management. Key resources are an experienced, long-serving management team, a strong balance sheet and the largest fleet of mobile plant and equipment in Australia. In 2007 Leighton Holdings achieved a revenue of $AU10 billion, net income of $AU455 million and a return on equity of 41.2 per cent.

It was when King and Adamsas were interviewed in 2005 that they gave some rare insights into the effective CEO/CFO pairing.[18] King says: "Our relationship has always been very solid but it's changed as all of us have changed. It's a relationship built on trust and mutual understanding of where we are going with various things. … Anything he needs to say he says to me and anything I need to say I say to him. There's always a constant stream of dialogue, which is informal and formal depending on the circumstances. … There will be a fair debate on the differences." Adamsas agrees and adds: "I'm obviously the CFO and the modern CFO has a broader-based responsibility but one of the fundamental platforms is financial control. I'm getting feedback on how the company is tracking and talk to Wal about that all the time. It's a natural thing and I continually informally and formally talk to Wal. The individuals around the place know if I'm in the loop, then Wal is too. … Having said that, at the end of the day he's the CEO and he has the final say."

Stenzel and Stenzel have reflected more broadly on the role relationship and power between a CEO and CFO. They cite as "leadership competencies" three that are especially relevant here: transparency, optimism and teamwork. Their comments on the first two are reflected in the King-Adamsas relationship. On *transparency*, they point out that the CEO-CFO relationship is the right place to begin in working towards organization-wide transparency. "Between a CEO and CFO there is absolutely no room for mistrust. From a governance point of view, if the CEO and CFO cannot be candid and transparent with each other, how can they hope to lead the workplace in such an attribute?"[19] They go on to say that the CEO-CFO team should lead openly by discussing what they believe and value, why they do what they do and how they feel. Olli-Pekka Kallasvuo, CEO of mobile phones at Nokia, adds: "I would also claim that the role of the CFO must be aligned to the approach of the CEO. Without alignment, success is difficult."[20]

What's noticeable – and it comes with the territory – is that the CEO and CFO surround themselves with a group of highly skilled supporters – the topic of our next chapter.

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CHAPTER 6

Select Capable Division Managers

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Crucial to diversifiers' success is the CEO's and corporate center's selection of capable division managers. Without these individuals in place, diversified companies will struggle as the managerial load gets shifted back to the corporate center. If this turns into the center having to develop the *competitive strategies* for the company's diverse divisions, then the writing is on the wall for the company as a whole.

What do successful diversifiers say about what makes division managers capable?

JACK WELCH'S VIEW

The CEO of General Electric, Jack Welch, lauded by many as the US's most effective CEO in recent decades, had this to say regarding his role and the importance of effective division managers: "[My job] is to put the best people on the biggest opportunities … and [make] the best allocation of dollars," not to decide how to "produce a good [television] program .. [or] build an engine."[1] The latter is the role of the divisions.

Welch has had quite a lot to say on the issue of hiring capable managers. In his book *Winning*, he describes the task of hiring as "what winners are made of."[2] He lays down three "acid tests" for effective recruits: integrity, intelligence and maturity. Beyond these fundamental three, he gives five further characteristics: an individual's positive energy, the ability to energize others, the courage to make tough yes-or-no decisions, the ability to get the job done and passion.

While effective division managers need all of these, they need still more – a further four qualities which Welch has especially highlighted for "someone who is going to run a major division." These four are 1) authenticity, 2) ability to see around corners, 3) ability to surround themselves with people who are better and smarter than they are, and 4) heavy-duty resilience. Let's now look at each of the four in detail.

Authenticity. Welch describes this as self-confidence and conviction. These traits, he says, make a leader bold and decisive which, he points out, is absolutely critical when a division must act quickly. But authenticity also makes leaders likable. This comes across in the way they communicate and reach people on an emotional level, he says. “Their words move them: their message touches something inside.”

He relates how when he was at GE, he would occasionally encounter a very successful executive who just could not be promoted to the next level. In the early days, he struggled to work out why. “These executives demonstrated the right values and made the numbers, but usually their people did not connect with them. What was wrong? Finally, we figured out that these executives always had a certain phoniness to them. They pretended to be something they were not – more in control, more upbeat, more savvy than they really were. They didn’t sweat. They didn’t cry. They squirmed in their own skin, playing a role of their own inventing.” In Jack Welch’s view, capable division managers can’t be fake. “They have to know themselves – so that they can be straight with the world, energize followers, and lead with the authority born of authenticity.”

Ability to See around Corners. Welch describes this quality as the ability to “anticipate the radically unexpected” or “the ability to imagine the unimaginable.” It is tied up with having a vision for the future and the ability to predict it. The best division managers, he points out, have a special sense for changes in the marketplace, including the prediction of competitors’ next moves and the emergence of new competitors.

Ability to Surround Themselves With People Better and Smarter Than They Are. Whenever GE had a crisis, Welch would quickly assemble the smartest people he could find and put them to solving the problem. As he points out, a capable division manager should do likewise and needs to have “the courage to put together a team of people who sometimes make him look like the dumbest person in the room! I know that sounds counterintuitive. You want your leader to be the smartest person in the room – but if he acts as if he is, he won’t get half the pushback he must get to make the best decisions.”

Heavy-duty Resilience. "Every leader makes mistakes," says Welch. "Every leader stumbles and falls. The question with a senior-level leader is, does she learn from her mistakes, regroup, and then get going again with renewed speed, conviction, and confidence?" Every division manager needs this trait when going into the job, because when a crisis occurs, it is too late then to learn it. Welch says that when he placed people in new leadership situations, he always looked for candidates who had had one or two very tough experiences. He particularly liked, as he put it, "the people who had had the wind knocked clear out of them but proved they could run even harder in the next race."

OTHER CEOS' VIEWS

Michael Chaney, the previous CEO of Wesfarmers, is also unequivocal about the importance of having effective division managers to make the company work. As individual divisions are run autonomously, their managers need to know their industry and be able to focus on key financials, such as return on capital employed. But additionally, he says, these "above-the-waterline characteristics" need to be supplemented by "below-the-waterline characteristics."

Here we're talking about what is sometimes called emotional intelligence – interpersonal sensitivity, broad-scanning interests, reflection on how big issues might affect a business – not just focusing on the business only. Commercial nous, Chaney says, is another component, as is integrity and the ability to communicate. This latter skill is essential if a division manager is going to motivate others. Chaney has also pointed out the need for division managers to possess conceptual thinking skills, so that they don't become tunnel-vision managers, but instead can think outside of the box.[3]

Wesfarmers' current CEO, Richard Goyder, adds his own twist to the importance of having capable division managers. "Our divisional managers communicate well with me, so I'm able to assess what's going on and keep an eye on things without having to run the business myself," he explains.

"This frees me up to concentrate on looking forward, and to consider things such as areas for growth in our existing businesses and potential mergers and acquisitions."[4]

At Bidvest, they aim to get their division managers to think as "owner-managers" of the businesses they run. And many of them were – prior to being acquired by Bidvest. Interestingly, though, they stay on to enjoy the benefits of being part of this successful diversifier.[5] The former CEO of D&B, Allan Loren, has said that a key to that company's turnaround was producing leaders: "To make better leaders, we have to modify their behavior, not their personality. We spend a lot of energy helping team members become better leaders."[6]

In contrast to our successful diversifiers, Burns Philp (discussed in detail in Chapter 12) failed because it couldn't get the appropriate division managers in place in time to cope with its diversity. As the CEO of the time had to admit: "We did the best job we could with the management we had, but we didn't bring in enough new management to do the job ….. management was not able to deliver at the rate we expected."[7]

LEADERSHIP AND LEARNING

Wesfarmers nurtures not only its current division managers, but the next generation of them as well. It aims to retain and develop people who are capable of taking on leadership and management responsibilities in each of the company's six divisions. To this end, Richard Goyder, its CEO, and senior executives meet twice-yearly to discuss succession planning and evaluate the merits of up to 120 employees who have demonstrated leadership potential: "We assess their readiness for new roles, discuss what development requirements they might have and what opportunities might be opening up for them across the group."[8] In addition Wesfarmers also runs an established Executive Development Program, during which "high-potential individuals" (usually around 10-20 per year) are put through a series of leadership and management courses designed to assist them in realizing their potential and ambitions. Goyder himself is heavily involved in this program.

ITC too places emphasis on management development, focusing particularly on its diverse business portfolio. As it says: "A key focus of ITC's management development efforts is the development of business leadership across businesses in support of ITC's belief that an organization with a diversified business portfolio can be managed effectively only when competent and effective leadership is distributed across the organization."[9] In addition to formal training and development programs, these management development initiatives include a host of interventions such as cross-functional and multi-business exposure, developmental assignments/secondments, membership of task forces, and special assignments in systems and processes such as the organization's performance appraisal system and the strategy of organization itself. ITC recognizes that comprehensive management development focused on division managers is the key to enhancing effective building of strategic capabilities and processes for organizational vitality and renewal.

Along similar lines, Bidvest has developed its Bidvest Academy, for its current and future division managers. Launched in May 2003, the Academy has grown beyond the company's initial expectations. Delegates, who come from all of Bidvest's businesses throughout South Africa, are nominated by the respective division chief executives as recommended by the head of each business. Every delegate is assessed, not only by management, but by members of his or her peer group and subordinates. Packed into three four-day and one two-day workshops spread over six months, delegates are grouped into division teams and present a project to Bidvest's CEO, Brian Joffe, and division heads.

The program covers leadership (including how to generate higher levels of energy and performance), business strategy, services (customer service, customer orientation and marketing) and finance. The leadership program is built around a model which identifies leadership energy as the driver of all system performance. Bidvest believes that leadership energy drives employee energy which, in turn, generates customer satisfaction and profitability.

General Electric has had a very long tradition in leadership and learning. Its center, now called the John F. Welch Leadership Center, was the world's first major corporate business school and celebrated its 50th anniversary in 2006. At GE, learning is a cultural force and the Center is its epicenter, at the forefront of real-world application for cutting-edge thinking in organizational development, leadership, innovation and change.

The 53-acre corporate learning campus, located in Crotonville, north of New York, attracts the world's brightest and most influential minds in academia and business. Every year, for thousands of GE's people from entry-level employees to its highest-performing executives, a journey to Crotonville is something of a pilgrimage. As GE says, it is potentially a transformative learning experience that, for many, becomes a defining career event. The facility's meandering outdoor walkways and recreation areas are designed to encourage exploration and spontaneous connection with other learners. Its very structure is a reinforcement of what GE says is best about its approach to learning: authentic human connection coupled with the invigorating pursuit of ideas. Today, says General Electric, the Welch Leadership Center continues the company's legacy, issuing each of its employees an important reminder: "to never stop learning."

However, a diversifier can throw all the money it likes at training, but it will only bear fruit if *performance* is measured with measures that are appropriate. This *is* what successful diversifiers do and it is the subject of our next chapter.

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1 Slater, R. 1999. *The GE way fieldbook: Jack Welch's battle plan for corporate revolution*. New York: McGraw Hill.

2 Welch, J. 2005. *Winning*. London: Harper Collins, p.81.

3 Treadgold, T. 2004. One out of the box. *BRW*, August, 19-24: 40.

4 Morgan, S. 2006. Blueprint for success. *Management Today*, October, 7-11.

5 *Engineering News*, 2005, August, 21.

6 Hanessian, B. & Sierra, C. 2005. Leading a turnaround: An interview with the chairman of D&B. *The McKinsey Quarterly*, 2.

7 *The Sydney Morning Herald*, 1997, May, 24.

8 Ibid., 8.

9 ITC website, 2007.

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CHAPTER 7

Install Appropriate Performance Measures

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Having skilled and motivated division managers in place is one thing. Getting them to operate effectively is another. Good managers can go bad in poor systems. Recognizing this, successful diversifiers ensure that their systems are sound. Here we take a look at the system of measures that successful diversifiers employ.

I'll review the methods of each of the four exemplars in turn.

GENERAL ELECTRIC

Performance measurement is evidently very important to GE; its *2005* and *2006 Annual Reports* are dotted with measures and targets. Growth is a key performance indicator. In its *2005 Annual Report*, one of what GE calls its "strategic imperatives" is to "sustain a strong portfolio of leadership businesses that fit together to grow consistently through the cycles." Its second strategic imperative also emphasizes growth: "Drive common initiatives across the company that accelerate growth, satisfy customers and expand margins." Its third and last imperative is also growth-oriented: "Develop people to grow a common culture that is adaptive, ethical and drives execution."

These "strategic imperatives" have undergone a transformation from 2005 to 2006 to emerge as "strategic principles." There are now four: "build leadership businesses," "focus on reliable execution and financial discipline," "drive growth as a process" and "spread ideas across great people and teams that share common values" (*2006 Annual Report*). While growth is still center stage, the introduction of "focus on reliable execution and financial discipline" only goes to emphasize the importance of this chapter.

While the company is particularly focused on raising its level of organic growth – this being internally generated growth in revenue as against growth through acquisition – all growth has to be profitable. (Incidentally, the historical level for GE's organic growth has been five per cent, but GE set itself a target of eight per cent in 2004, reaching it in 2005.

This, it says, is twice the rate of its industrial and financial peers.[1]) To track growth's profitability the measures of net income and return on investment become paramount. Hence return on equity (ROE) and return on total capital (ROTC) are key ratios for GE as a whole. You might recall that ROE is net profit after tax divided by shareholders' equity. ROTC is profit *before* tax and interest divided by shareholders' equity *plus* long-term borrowings.[2]

GE also sets targets on financial measures for its individual businesses. They're required to achieve more than 10 per cent growth in annual earnings *and* a 20 per cent return on total capital. ROE is also measured for some businesses. For instance, in the *2005 Annual Report*, ROEs of 24 per cent for Commercial Finance and 29 per cent for Consumer Finance were reported.

Cashflow and its maximization are key foci, too. It's through high levels of cashflow that GE is able to pay dividends and fund its expansions. In 2007, GE forecast it would generate $US40 billion from earnings, working capital reductions and divestitures. It is committed to return 50 per cent of its earnings back as dividends.

With 316,000 employees, six major divisions and many more businesses spread around the world, it would be easy to lose track. GE needs effective measurement. The profitability of each division and each business within each division is a central concern. Return on equity and return on total capital matter a great deal. Those businesses that make it get to stay, those that don't are at least queried and may be ejected. This can be seen in GE's 2005 exit from insurance, in which it had invested one-third of the company's equity for little return. The change in this industry's security requirements following 9/11 made it uncertain and no longer attractive to GE.

Since 2002 it has exited from businesses worth $US30 billion and acquired businesses worth $US65 billion.

GE *is* a great measurer of all of its staff, from top to bottom, and not just division managers. Individual performance appraisals are used to provide feedback to *all* employees.

These are placed on a bell-shaped curve and those that consistently rate in the top 20 per cent are encouraged and nurtured. Those in the bottom ten per cent are counseled and assisted. The story that persists in doing the rounds, that the bottom ten per cent are fired, is not true. But many in this bottom tier choose to leave – "self-select," as it's called.

WESFARMERS

Wesfarmers' performance measurement system requires each of its divisions to report on "key performance indicators." Three of these are "operating revenue," "earnings before interest, tax and goodwill amortization," and "return on capital employed." One division can thus be compared to another.

Wesfarmers stresses its "primary objective," which it describes as "to provide a satisfactory return to shareholders." "Satisfactory" for Wesfarmers equates to being in the top quartile for Australian public companies.

For Michael Chaney, who retired as CEO in 2005, the organization needs to be "performance-oriented." Chaney stressed this through all his pronouncements, linking all performance to providing a satisfactory return to shareholders. This translates into the "return on capital employed" (ROCE) measure at the division and business-unit levels.[3] (The major difference between return on capital employed (ROCE), for example, and return on equity is that the former number incorporates debt as well as equity. In a firm with debt, the result on ROCE is lower than the ROE number.)

There are approximately 70 business units within the five divisions, which means that each division and each business unit can be compared to each other. (When I say "five" divisions, I'm excluding "Other Activities" in Figure 4.3.) Each is expected to achieve an ROCE of at least 20 per cent. Anyone with more than this is expected to find new growth opportunities and, if the figures add up, capital will be provided. Divisions or business units with ROCEs in the 10 to 20 per cent range are told to produce five-year plans that show how they will achieve 20 per cent. Those with ROCEs less than 10 per cent need to show cause for why they shouldn't face the "ultimate capital reduction" by being sold.[4] This bottom-line focus steers managers away from growth per se – away from building revenue, market share or customer base as ultimate measures of success or the merit of a decision to expand. "I know management's not going to be focused on empire-building, but on return on capital," Michael Chaney has said.[5]

While a performance-oriented culture and bottom-line-based performance measurement are two of the positive aspects that come from being part of Wesfarmers, so too is access to capital. In fact, lack of capital is no longer a problem for the businesses at Wesfarmers.

BIDVEST

Bidvest describes itself as "an acquisitive and opportunistic company," but will only make an acquisition if the price is right. If not, it walks away – and has done so on numerous occasions. The reason the company doesn't have a division in the US is that it hasn't been able to locate any acquisitions at prices it thought reasonable.

Its acquisitions are usually low-tech and are often under-performing companies, started and managed by people in whom the CEO, Brian Joffe, identifies potential. Many of these managers have remained with the company for several years after acquisition.

Bidvest is renowned for its ability to correct underperformers. Every business that has been acquired by the company has proved more profitable after takeover. This is achieved, in part, through performance measurement. While the Bidvest model encourages its business managers to run their businesses as independent, decentralized units, developing a niche of activity and a clear competitive advantage, this is subject to what it calls "the discipline of constant measurement." The balance between entrepreneurial freedom and accountability through measurement rigor appears to be the true alchemy of Bidvest's success.

Bidvest maintains control through this discipline of constant measurement. It uses profit and return on funds employed (ROFE), the latter being trading income divided by net operating assets. These are the key metrics in the performance assessment of its businesses. This ROFE fills the equivalent role of GE's ROTC and Wesfarmers' ROCE.

Yet unlike GE and Wesfarmers, it doesn't enforce a standard percentage for ROFE across all divisions and business units. For some, it could be quite high, for others relatively low. An individual target depends on prior history. *Improving* profit and ROFE is what's important at Bidvest. What *is* centrally designed is capital allocation. A division such as Foodservice Products, Australasia, is limited in its capital expenditure. Even within this limit, it couldn't purchase a business without head-office-board approval in South Africa, but it could buy new equipment.

ITC

At the enterprise level ITC's goals include:

- Sustaining ITC's market standing as one of India's most valuable corporations
- Achieving a leadership position in each of the business segments within a reasonable time frame
- Achieving a return on capital employed (ROCE) in excess of the company's cost of capital, at all times.

Amongst listed companies in the private sector, ITC was ranked fourth in terms of gross turnover and third in terms of pre-tax profits for the financial year that ended 31st March 2006. The company was ranked sixth by market capitalization amongst listed private sector companies in the country, also at that date. ITC has consistently achieved an ROCE well in excess of its cost of capital.

ITC is organized into four major divisions: fast-moving consumer goods (FMCG); hotels; paperboards, paper and packaging; and agribusiness. Each has a chief executive who reports to ITC's board. Each CEO works to achieve agreed division ROCE targets. Within each division there are numerous business units. For example, within foods there are separate units for ready-to-eat confectionery, staple foods, and snack foods.

The company's commitment in the area of economic *performance* is encapsulated in its vision statement, which is "to sustain ITC's position as one of India's most valuable corporations through world class performance, creating growing value for the Indian economy and the company's stakeholders." ITC's performance management is a combination of processes and policies:

- A robust and comprehensive framework focused on effective strategy implementation. This comprises a sophisticated business planning process that enables the annual formulation of a five-year rolling business plan, with clearly identified objectives, strategies, action plans and performance milestones; a multi-layered monthly/quarterly performance review process that enables close monitoring of business performance against the Plan at the Divisional, Corporate and Board levels.

- A strong internal control environment across all the businesses through a combination of Divisional Accounting Systems and Policies (DASP) and Standard Operating Procedures (SOPs) within the overall policy framework set out by the Corporate Accounting Systems and Policies (CASP).

- Apart from CASP, centrally issued policies include those relating to corporate governance, project management, centralized treasury management, enterprise-wide risk management and information technology.

- A strong internal audit function that carries out risk-focused audits across business units, the key findings of which are reviewed by the Audit Committee of the company. The Audit Compliance and Review Committee, headed by a Director and consisting of senior managers, systematically reviews Internal Audit findings, the degree of underlying risks and the status of implementation of internal audit recommendations.

- The company's financial statements, which are duly audited by Statutory Auditors as required under the Companys Act, 1956 and conform to the requirements of the Accounting Standards issued by the Institute of Chartered Accountants of India.

EASY MONEY

Successful diversifiers clearly require their divisions to stand on their own two feet. However, one of the practices that diversified companies are criticized for is *easy money*. It is said that in some companies, funds are allocated between divisions at below-market rates of return. This leads to slack decision-making in divisions and eventually, if not corrected, may bring about corporate collapse.

Wesfarmers avoids this laxity by having the appropriate performance measures in place and by insisting that any capital accessed internally be at market rates. To quote the *2004 Annual Report* under "strategic developments": "Contrary to the conventional wisdom that capital is a limited resource, the modern corporation finds identifying good investment opportunities to be a more relevant constraining factor … if no attractive investments emerge within a reasonable time frame, it is better to return money to shareholders." In 2005 the company did just that, with a capital return to shareholders of a dollar per ordinary share, amounting to $AU378 million.

Other successful diversifiers such as Bidvest, General Electric, and ITC operate with a similar market-based outlook.

The picture that emerges from these companies is of a head office, small of course, raking in hordes of cash for later allocation. As Wesfarmers' former CEO, Michael Chaney, has pointed out about his company, its diversified activities and diverse industry involvement have been the keys to its success – not an impediment. Being diversified has facilitated dispassionate and clinical examination of investment decisions and the allocation of funds at market rates. Easier to do, he says, when not locked into a single industry.

The Boston Consulting Group, in their 1999 study, found that a *disciplined approach to performance measurement* was a cornerstone of successful diversifiers.[6] They saw that in *premium* diversifiers, if the numbers couldn't be achieved, their managers were required to change their businesses – and quickly. Companies like ConAgra, Textron and Allied Signal demanded performance, and the necessary measures were put in place to achieve it. Contrast this with Burns Philp and its failure (Chapter 12), where the necessary disciplines couldn't be established in time.

IN SUMMARY

Successful diversifiers show tremendous discipline – in their performance measurement, and, as a consequence, in their capital allocation.

But successful diversifiers are also very growth-oriented. So they measure *revenue* at division and corporate levels. Growth must be *profitable*, yet the measure here isn't profit per se, but *return on investment* – profit related to a base. This fundamental metric in successful diversifiers at the division level is labeled ROTC (return on total capital) at General Electric, ROCE (return on capital employed) at Wesfarmers and ITC, and ROFE (return on funds employed) at Bidvest.

Targets are set for this return-on-investment measure at the division level as well as the corporate level. In addition, return on equity (ROE) is monitored closely.

There's a saying in management that goes, "what gets measured, gets done." And that's true up to a point. But I've seen many measures totally ignored in organizations. What's closer to the mark is: what gets noticed, gets done. And things that are measured are easier to notice. However, what's undoubtedly true in organizations is: what gets rewarded, gets done. How successful diversifiers reward their managers is covered in the next chapter.

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1 See also an interview of the CEO of General Electric, Jeffrey Immelt, in the *Harvard Business Review*, June, 2006, entitled "Growth as a Process."

2 ROTC for GE is earnings plus after-tax interest (also known as EBIT, earnings before interest and tax) divided by an average over five years of shareholders' equity plus borrowings. Source, *GE 2005 Annual Report,* p. 109. In other organizations this ratio is also called return on capital employed or ROCE.

3 Wesfarmers defines ROCE as earnings before interest, tax and amortization divided by total assets less creditors and provisions.

4 Source, Wesfarmers' corporate office.

5 Kirkman, A. 2003. A good mix. *Forbes.com*, April.

6 Shulman, L. 1999. *Management lessons of premium conglomerates*. The Boston Consulting Group, December.

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CHAPTER 8

Set Effective Incentives

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Successful diversifiers design incentive systems that motivate and focus their division managers. Incentives reinforce the basic discipline embedded in these organizations by attaching rewards to the achievement of financial and other targets. These incentives, paid via salary and bonuses, are generally high when compared with the normal packages afforded other employees. The bonuses may actually dwarf the salary component.

In this chapter, we examine the practices of our four exemplars, particularly noting the details of Wesfarmers system – which we look at in depth.

THREE OF THE CASES

Bidvest is big on what it calls "incentivization." This is used to "attract and retain motivated people" and, when applied to its decentralized management system, encourages managers "to seek returns in open competition with their peers." It also produces an "owner-manager mind-set" which, as they say, "drives us forward."[1]

Division managers send financial reports to Bidvest's CEO monthly, and are rewarded via a base salary, an annual short-term incentive and a long-term incentive. The base salary is set at the market rate or lower, while the short-term incentive is based on a percentage of division profit and on achieving a benchmark for return on funds employed (ROFE). Only after a division manager reaches the division's threshold ROFE does the percentage profit calculation kick in.

Each division and each business within a division has complete autonomy as to how incentives are designed *within* them. There's no single Bidvest system.

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

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

WESFARMERS

My study has also afforded a rare insight into how these incentive systems work. Wesfarmers' CEO and division managers are subject to a system that is heavily weighted towards return on investment. This links to the company's overarching corporate objective: to provide a satisfactory return to shareholders. Remuneration to these managers is based on a fixed annual salary (pitched in line with the market for these positions), an annual incentive and a long-term incentive.

Here is the system in more detail.

Wesfarmers' return on capital employed (ROCE) for *divisions* carries over to the reward system for individual managers. The focus of its incentive system is particularly on its five division heads, excluding "Other Activities" as in Figure 4.3. They have the greatest authority in setting strategic direction and achieving it, as well as creating shareholder value and market competitiveness. But about 300 managers are involved in the system overall. Approximately 70 of these head up business units immediately *below* the division head level, while the remainder answer to these business-unit managers. So the structure is: 5 division heads, 70 business-unit managers immediately below them, or who head support functions, and 235 managers below these business-unit managers, all of whom are involved in the scheme.

The remuneration that applies to the division heads, known as *division managing directors*, is made up of three components: fixed annual remuneration, which is in line with the market for these positions; annual incentive; and long-term incentive. A retention incentive may also be provided, payable only on termination of employment.

The *annual incentive*, which is paid in cash, is linked to overall company performance, as well as to individual division performance on financial and non-financial measures. The measures include annual group net profit after tax, division profit (earnings), return on capital and safety for business operations where this is appropriate. (See Figure 8.1.) Wesfarmers chooses these measures because of their impact on *corporate* return on equity (ROE), "a key group measure of annual achievement of satisfactory return to shareholders."[2] The specific weightings vary for particular divisions within the ranges shown in Figure 8.1.

Figure 8.1 **Wesfarmers' Division Incentive Measures and Weightings**

Measures	Weighting
Financial • Group net profit after tax • Division earnings before interest, tax and goodwill amortization • Division return on capital before goodwill amortization	50% to 70%
Non-Financial • Safety measures • Discretionary	30% to 50%
Total	100%

Subject to reaching targets on these measures, an annual cash incentive payment totaling between zero and 60 per cent of the division manager's *fixed* annual remuneration (FAR) is made. The maximum payment cannot exceed 60 per cent of FAR. These targets are determined after the preparation of the financial statements each year and after a review of performance on non-financial measures by Wesfarmer's CEO. (The annual division and corporate budgets are also subject to Board approval.)

Division targets are set so that a division manager receives zero per cent of FAR for achieving 92.5 per cent of his or her targeted performance. This incentive percentage increases on a pro rata basis to reach two-thirds of the maximum payment for achieving 100 per cent of budget. A full 60 per cent of FAR is made for achieving 110 per cent or more of budget. As noted above, the maximum payment cannot exceed 60 per cent of FAR no matter how high the performance is.

Long-term incentives come in the form of the Wesfarmers Long-Term Incentive Plan (WLTIP), which awards fully paid shares, not stock options, with a three-year trading lock on each award. This is designed to foster long-term alignment of performance with the corporate objective of providing a satisfactory return to shareholders. WLTIP awards may be made annually, depending on results. The WLTIP provides for up to an *additional* 50 per cent of FAR to be awarded to division managing directors if Wesfarmers' corporate ROE hurdle is achieved. This hurdle is reviewed annually by the Board and currently requires that Wesfarmers' five-year, average ROE is above the 50th percentile ROE of a comparative group of companies in the previous financial year. In 2006 the hurdle for the incentive was achieved, and rewards were provided as Wesfarmers' shares.

The comparative companies used in the calculation of the long-term incentive are the 50 largest by market capitalization in the Standard & Poor's Australian Stock Exchange 100 index, as at 30 June for the relevant year. Awards are made once the financial performance has been verified by the company's external auditor and approved by the Board.

To sum up, *division managing directors* – those executives who head up Wesfarmers' five divisions – may receive as a *maximum* payment: their fixed annual remuneration (FAR), plus 60 per cent of FAR if their *division* achieves 110 per cent or more of its budget, plus an additional 50 per cent of FAR if the *company* achieves its targeted ROE. In total this amounts to FAR plus 110 per cent of FAR.

The system for *business-unit managers*, those 70 managers immediately below the division managing directors, is similar to that in Figure 8.1, except that in addition to *division* earnings and return on capital, it can include business-unit measures. The amount payable under the annual incentive and the Wesfarmers Long-Term Incentive Plan, in which these managers also participate, is less than that of the division managing directors.

The remuneration of *Wesfarmers CEO*, Richard Goyder, is made up of fixed annual remuneration (FAR) and *long-term* incentives based on a combination of performance measures linked to improving shareholder value. The major one of these is ROE for Wesfarmers as a whole. This is tempered by a maximum gearing ratio target set by Wesfarmers' board; gearing ratio is the ratio of debt to equity, and it's an indicator of financial risk. The CEO's long-term incentive comes in the form of Wesfarmers shares – as is the case with the division managing directors.

In systems such as Wesfarmers', successful diversifiers align CEO, division and business-unit performance with an increase in the value of the company, a prime indicator of which is return on equity. But there is more to success than incentivized managers. The corporate culture has to be aligned. Otherwise managers are on their own, lacking support. Aligning the corporate culture is examined in the next chapter.

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1 All quotes from Bidvest's *2004 Annual Report*.

2 Wesfarmers' *2005 Annual Report*.

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CHAPTER 9

Align the Corporate Culture

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The divisions of a diversifier are by definition very different in their operations, the industries in which they work, their customer bases and the like. Successful diversifiers are very tolerant of these differences. But they use culture to unify the organization. GE has *one* culture across *all* of its six and varied divisions. Bidvest, ITC and Wesfarmers likewise have *one* homogenizing culture. Each operates through a vast range of divisions that serve a broad scope of industries.

An organization's culture may be described as "how we do business around here." Successful diversifiers put much effort into coming up with an answer that drives the organization's performance in an effective direction. They see culture as what Richard Goyder, CEO of Wesfarmers, has called a "setting." And getting the settings right is very important to gaining advantage.

Let's look at the cultures of our four successful diversifiers and list a few of the elements common to all four.

GENERAL ELECTRIC

GE draws together this behemoth of six businesses and over 300,000 employees via a set of values: *imagine*, *solve*, *build* and *lead*. The values are noteworthy for their action orientation, for the passionate way GE expresses them and for the way they bring together its diverse divisions. Here's the description that GE offers of each.

Imagine. "From the very beginnings of our company, when Thomas Edison was changing the world with the power of ideas, GE has always stood for one capability above all others – the ability to imagine. Imagine is a sense of possibility that allows for a freedom beyond mere invention. Imagine dares to be something greater. At GE, Imagine is an invitation to dream and do things that you didn't know you could do. Because at GE the act of imagining is fused with empowerment – the confidence that what we imagine, we can make happen."

Solve. "Every business has to have a reason to exist – a reason that answers the fundamental question of 'why are we here?' For GE, the big question has a simple answer: We exist to solve problems – for our customers, our communities and societies, and for ourselves."

Build. "From 0 to 60 in six seconds? Try zero to $5 billion in five years. It's not so much a vision for our future – where we're headed is in many ways a reflection of where we've already been. It's not a destination. It's a quest. A quest for growth. And when we look to the future, we know that for us, there's only one way to get there. Build."

Lead. "Imagine. Solve. Build. Each of these is merely a word without one vital element. Lead. GE is already synonymous with leadership. But with this mantle comes responsibility. And it's not just a responsibility to maintain the status quo or manage what worked yesterday. It's the bigger responsibility to change. Because change is the essence of what it means to lead. It's a call to action that engages our unceasing curiosity, our passion, and our drive to be first in everything that we do."[1]

WESFARMERS

Wesfarmers pulls its diversity together via a clear shareholder focus. It trumpets its objective, "to provide a satisfactory return to shareholders," one of its stakeholders, and sets out to achieve this by means of four "strategies":

- Strengthen existing businesses through operating excellence and satisfying customer needs,
- Secure growth opportunities through entrepreneurial initiative,
- Renew the portfolio through value-adding transactions,
- Ensure sustainability through responsible long-term management.[2]

Wesfarmers states that it will only achieve its central objective by meeting the needs of other stakeholders:

- satisfying the needs of customers through the provision of goods and services on a competitive and professional basis;
- providing a safe and fulfilling work environment for employees, rewarding good performance and providing opportunities for advancement;
- contributing to the growth and prosperity of the countries in which it operates by conducting existing operations in an efficient manner and by seeking out opportunities for expansion;
- responding to the attitudes and expectations of the communities in which the company operates;
- placing a strong emphasis on protection of the environment; and
- acting with integrity and honesty in dealings both inside and outside the company.[3]

Wesfarmers' culture is further reinforced by a set of values that are noteworthy because of how they differ from those of GE:

Shareholder Focus. "Our management systems are aligned to support our corporate objective, which is to provide a satisfactory return to shareholders. We don't just talk about our objective – we make sure that it is happening in practice."

Growth Philosophy. "It is impossible to predict the future with any reliability so we grow our business by taking incremental steps, learning as we grow."

Structure. "Our business units operate autonomously, which means they are able to make their own decisions about how their business is run within performance and growth philosophy parameters. This recognizes that divisional managers know more about running their business than anyone in corporate office."

Climate. "It is the climate within Wesfarmers that allows our financial focus to be translated into results. Our reputation is important so it is vital that we always act ethically and with integrity – this also makes people feel good about themselves and their working environment. We have mutual respect for each other, are open and without politics. We need to be able to take calculated risks and innovate to grow."[4]

This focus on return on investment and competitive advantage based on stakeholders – customers, employees and communities – not only drives the decision-making of managers and the resource allocation between divisions, but it also aids learning. The CEO, the corporate office and division managing directors as a group get to understand what produces results and how to go about achieving them. To aid in this process, and since its early days, Wesfarmers has maintained a business development unit of about 20 analysts whose role it is to evaluate new opportunities. This unit provides a training ground for future business managers, many of whom go out to the divisions for further development. Half of the divisions are now run by people who have come in through that stream.

BIDVEST

Bidvest prides itself on operating in a big business environment, yet conducts its operations with "a small business heart." It believes, it says, in empowering people, building relationships and improving lives and that "incentivization" and "decentralized management" are the keys to its success. It subscribes to a philosophy of transparency, accountability, integrity, excellence and innovation in all its business dealings, and it strives to deliver strong and consistent shareholder returns. "Most importantly," it says, it understands "that people create wealth, and that companies only report it."[5]

Bidvest describes decentralized management thus: "The successful Bidvest management model encourages owner-managers to seek returns in open competition with their peers. Each business runs as an independent, decentralized unit, focusing on its specific area of activity as a niche part of a bigger picture. Each business has access to substantial resources and strategic input."[6]

The owner-manager mind-set also leads to leanness. Offices are deliberately sparse, and status symbols and lavish surroundings are actively discouraged.

ITC

ITC enshrines its purpose in a mission statement: "To enhance the wealth generating capability of the enterprise in a globalizing environment, delivering superior and sustainable stakeholder value." It then backs this up with six "core values" that are aimed "at developing a customer-focused, high-performance organization which creates value for all its stakeholders." Here is how it expresses its values:

Trusteeship. "As professional managers, we are conscious that ITC has been given to us in 'trust' by all our stakeholders. We will actualize stakeholder value and interest on a long term sustainable basis."

Customer Focus. "We are always customer focused and will deliver what the customer needs in terms of value, quality and satisfaction."

Respect for People. "We are result oriented, setting high performance standards for ourselves as individuals and teams. We will simultaneously respect and value people and uphold humanness and human dignity. We acknowledge that every individual brings different perspectives and capabilities to the team and that a strong team is founded on a variety of perspectives. We want individuals to dream, value differences, create and experiment in pursuit of opportunities and achieve leadership through teamwork."

Excellence. "We do what is right, do it well and win. We will strive for excellence in whatever we do."

Innovation. "We will constantly pursue newer and better processes, products, services and management practices."

Nation Orientation. "We are aware of our responsibility to generate economic value for the Nation. In pursuit of our goals, we will make no compromise in complying with applicable laws and regulations at all levels."

COMMON ELEMENTS

Successful diversifiers see culture as a major ingredient of their success. Often this is enshrined in their *corporate values*. General Electric's culture and the part it plays in unifying this diversifier is particularly noteworthy. Describing itself as "imagination at work," GE's culture is a major driver of how the company operates, its policies and procedures, and what it will and won't take on. GE has distilled its culture into four action words – imagine, solve, build and lead, each of which is defined in detail.

But successful diversifiers don't have the same culture *in total*, although there are common elements.

Wesfarmers' culture is much more nuts-and-bolts. Its values – shareholder focus, growth philosophy, structure and climate – don't have the same zing as those of GE. Nor do ITC's six values: trusteeship, customer focus, respect for people, excellence, innovation and nation orientation. Bidvest doesn't itemize its values, but suggests that they and its culture are already enshrined in all of its other material.[7]

In spite of these differences, fundamental and distinctive underlying themes run through the cultures of successful diversifiers:

Growth. Business growth is important to all of them.

Autonomy. Division managers need to run their businesses as if they were their own – like a McDonald's franchise.

Return on Investment. They're not in the business of growing for growth's sake, nor just for profit; they need to produce an economic return that can be justified *objectively*.

Stakeholder Focus. They recognize on whom they depend for success, i.e. customers, suppliers, employees, etc.

Integrity. First-class corporate governance and proper dealings are important to all of them.

Some of these common elements have already been discussed in detail in previous chapters, e.g. growth and return on investment, so I won't cover them here. But there are a couple that deserve special attention because of the emphasis placed on them by successful diversifiers.

On the issue of *autonomy* Bidvest talks in terms of a "decentralized, entrepreneurial business model" and a "decentralized culture." "Business success across so many geographies and commercial sectors demonstrates the broad relevance of Bidvest's entrepreneurial culture and highlights the benefit of our policy of making each independent business unit accountable for performance."[8] This "entrepreneurial culture" permeates the whole company, which means, says Cyril Ramaphosa, Bidvest's Chairman, that "managers and workers … think like and behave like entrepreneurs."[9] Brian Joffe, the CEO of Bidvest, is quoted as saying: "Bidvest is made up of seven divisions … [and] seven executive chairmen as such. I'm not the chairman of every single business activity … Those divisions are absolutely independent."[10] As one research analyst described it, Joffe has adopted an "entrepreneurial approach which says, 'we are going to empower people to make decisions to derive value out of the business,' rather than have a very structured hierarchical system for managing that business."[11] Bidvest has now established its Bidvest Academy for management development to sustain its culture and produce future leaders for its businesses.

All successful diversifiers stress the importance of integrity and corporate governance. Some, like General Electric, have received awards for their corporate-governance standards. Wesfarmers has a particular take on *integrity*.

Wesfarmers' current CEO, Richard Goyder, sees integrity as an important part of the company's culture *and* a key ingredient of the success of the business going forward. He articulates it at every turn. "Of course we want to make a dollar," he says. "But we want to do that in a way that is ethical and responsible. That means making sure that our employees have a safe place to work and opportunities to develop. It means treating the environment with respect. It means dealing appropriately with our customers and suppliers. And it means supporting and benefiting the communities in which we operate." Integrity, he says, is everything: "Without integrity it would be impossible to remain competitive over the medium-to-long term. Customers and suppliers won't deal with you if you don't have the values they think you should have. Our view is that if you compromise on your ethics, then you've got nothing. Once you've lost trust, the game's over."[12]

Proving that it works in business terms, Goyder points out that several of Wesfarmers' acquisitions, including the high-profile takeover of hardware business Bunnings, finalized in 1994, were initiated by direct approaches from the existing business owners or companies' management. "The ultimate acquisition of Bunnings came about because the Bunning family came and knocked on our door," he reveals. "They said, 'We think you're a good company and we'd like to talk to you about an opportunity.' People don't do that if your reputation is poor."[13]

ON CULTURE

For Wesfarmers' former CEO, Michael Chaney, his organization's culture is all-important to its success. Wesfarmers has found that their return-on-capital culture drives not only the decision-making of division managers, but also their learning process. The CEO, corporate office and division managers get to understand, as a group, what produces results and how to go about achieving them. For instance, the division heads and the CEO meet annually for a strategy retreat, as well as meeting regularly to discuss business outcomes. A "college" of managers thus becomes established, through which Home Improvement, for example, gets to learn from Insurance, Energy picks up some ideas from Chemicals and Fertilizers, and so on. This can be seen also in ITC, Bidvest and General Electric.

Chaney has described their culture this way: "Culture is what it's all about. I define performance culture as employees right down through the group saying: 'I know what the objective of this company is, I know what part I play in it, I need to make every post a winner if we're going to succeed.'"[14]

We can look outside our successful diversifiers for lessons about the impact that an organization's culture has on its performance.

Rod Vawdrey, the CEO of Fujitsu Australia, believes that culture is like the personality of the organization. And if there are many people all going in different directions, the personality of the company becomes confused.[15] In transforming the performance of D&B, Allan Loren recognized that its culture was key. Like Vawdrey, he saw that dysfunctional decision-making and inertia can occur in an organization that operates with multiple cultures – or with split "personalities." So in the company's turnaround, he set about establishing well-defined values and guiding principles for *all* staff to follow. This required that they be owned by the CEO first, acted on by senior management and reinforced at every opportunity. Only then would guiding principles, corporate values and other behavioral precepts take hold. Only then can culture change and, with it, performance.

While installing the appropriate performance measures is required to get division managers to focus on key results, the performance orientation mustn't stop there. It must be enshrined in people's attitudes and their approaches to decisions, ideas and waste, among other behaviors. A clearly articulated culture is essential to achieving a top-to-bottom focus on excellent corporate performance.

There's a subtlety at play here that requires emphasis. It's the difference between the consistent application of corporate values and the production of homogeneity between divisions. Take Wesfarmers as an example. It has a set of values that it applies to *all* its divisions. But it also recognizes that *within* these guidelines are sub-cultures that pertain to each division and are driven by the nature of each division's industry. Its Home Improvement Division, for instance, being in the retailing of hardware products, has quite a different sub-culture from the Insurance Division and the Energy Division. To be successful, Wesfarmers has had to recognize and appreciate these subtleties and not insist on homogenous divisional *sub-cultures*. To do so would have stifled the divisions. As current CEO, Richard Goyder, says, "Culture is very hard to build and easy to destroy."

Just how divisions operate in a successful diversifier is the focus of the next chapter.

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1 General Electric's *2005 Annual Report.*

2 Wesfarmers' *2006 Annual Report*.

3 Wesfarmers' *2005 Annual Report*.

4 Wesfarmers' website, 2007.

5 Bidvest's *2004 Annual Report*, p.1.

6 Ibid, p.14.

7 The author's personal communication with Bidvest.

8 Bidvest's *2005 Annual Report*.

9 Bidvest's *2004 Annual Report*.

10 "Bidvest swims against tide," 2002. *All Africa*, September 11.

11 "Springbucks," 1998. *The Sydney Morning Herald*, March 21.

12 Morgan, S. 2006. Blueprint for success. *Management Today*, October, p.8.

13 Ibid., pp.10-11.

14 Kirkman, A. 2003. A good mix. *Forbes.com*, April, 14, p.1.

15 Jones, R. 2006. Creating an industrial strength company. *Management Today*, 28: 12-15.

CHAPTER 10

Secure Competitive Advantage

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Michael Porter made the point many years ago that "competition occurs at the business unit level. Diversified companies do not compete; only their businesses do."[1] To put this in other terms, I'd say that it's the divisions that are the cutting edges of diversified firms. *Successful* diversifiers never forget this axiom.

SUPPORT FROM THE CORPORATE CENTER

A division within a diversifier succeeds if:

- it's given appropriate support by the corporate center, and
- the division itself delivers competitive advantage.

Jack Welch at GE sought to produce divisions that acted like small businesses. That way, they'd know their customers and their needs, respond to them promptly, produce competitive advantage and succeed. "We [have] to find a way to combine the power, resources, and reach of a big company with the hunger, the agility, the spirit, and the fire of a small one," Welch has said.[2]

To achieve that, GE stripped away layers of management that clogged the system. This laid bare the divisions and business units and exposed them to competitive pressures – directly. In transforming GE into a successful diversifier, Welch has said: "We found ourselves in the early 1980s with corporate and business staffs that were viewed – and viewed themselves – as monitors, checkers, kibitzers, and approvers. We changed that view and that mission to the point where staff now sees itself as facilitator, adviser, and partner of operations, with a growing sense of satisfaction and cooperation on both sides. Territoriality has given way to a growing sense of unity and common purpose."[3]

Robert Nardelli, head of Power Systems at GE, was reported in 1999 as having organized his business into a number of profit-and-loss centers, "to get people focused on managing markets and customer relationships. We try not to burden people with the bureaucracy commonly associated with a $US7.5 billion behemoth. Rather, we develop centers of excellence focused on meeting customer needs within specific markets. In that way, we have clear ownership and quick, innovative responses to marketplace needs."[4]

This is also appreciated at Wesfarmers. It believes strongly that its divisions and business units should operate autonomously – within the parameters of performance and the company's growth philosophy. This quote from a former outsider, who was subject to a takeover by Wesfarmers, illustrates the point:

"Wesfarmers' philosophy of operational autonomy and financial rigor has been clearly apparent since the takeover. This is in contrast to previous experience with high degrees of operational scrutiny and financial hurdles which were sometimes unclear, or known to just a few. The approval process underpinning capital investments, divestments or acquisitions has been supportive of the ROC [return on capital] ethic."[5]

Wesfarmers appreciates that enhancing the performance of existing businesses includes:

- setting appropriate targets;
- monitoring through accurate and timely information;
- encouraging best practice initiatives;
- encouraging innovation;
- establishing effective human resource planning systems;
- providing specialist resources (project development, legal, accounting/taxation, treasury, information technology etc.);
- driving continuous improvement in safety, health and environmental performance;

- reinforcing divisional autonomy in operational matters;
- ensuring that all the above systems are integrated and have a shareholder-return focus;
- providing strategic guidance;
- providing specialist commercial resources;
- providing finance; and
- applying strict concepts of value.[6]

The hands-off approach to divisions by Wesfarmers' corporate center produced a highly competent group of managers. To ensure head office remains hands-off, it has clearly defined its own role:

- keeping external stakeholders adequately informed;
- developing innovative financial approaches;
- ensuring that the company is seen as a reputable, responsible corporate citizen;
- ensuring the company is equipped to respond to unforeseen crises; and
- ensuring that the corporate culture is communicated throughout the company.[7]

COMPETITIVE ADVANTAGE AT THE DIVISION LEVEL

To address this issue effectively, I have to make a fundamental distinction between "critical success factors" and "strategic factors," since the former pervades the management lexicon.

Campbell and his co-authors define critical success factors as "certain activities or issues [that] are critical to performance and to the creation of competitive advantage".[8] In discussing the value that a corporate center provides its divisions, they list 14 critical success factors relevant to the six businesses of a diversified food company. Their list, typical of other listings of critical success factors, is:

- product branding
- selling
- product mix management
- scale and capacity utilization
- business development skills
- formula branding
- positioning to match locality
- site selection
- property development costs
- value engineering
- detailed operating controls
- management selection and training
- supply chain logistics
- low overheads.

I'd here like to point up the difference between critical success factors and what we call *strategic factors* and the latter's impact on division competitive advantage – and success.[9]

The first thing to note is that the critical success factors are very *broad*, e.g., "value engineering" above. As we just saw, Campbell's definition of critical success factors is "certain activities or issues" – which itself is very broad. The second comment is that the factors do *not* relate to a particular stakeholder, to customers, suppliers or employees, for example. Both these facts mean that it's difficult to see the link between the critical success factors themselves and "the creation of competitive advantage," for a division within a diversifier.

To look outside diversified companies for examples, we *can* see this link in the case of a non-diversified business like Toyota. And Toyota, in being focused, is like a division within a diversified firm. Its focus is on strategic factors – those relevant to its customers and to each of its other key stakeholders. In the case of Toyota's *customers*, the strategic factors are:

- product quality
- customer service
- retail store presentation
- product availability
- range of products
- product features
- image and brand
- price.

The differences between these and the 14 critical success factors listed earlier are fundamentally important to achieving competitive advantage at division and business-unit levels.

Firstly, strategic factors *do* relate to a *specific key stakeholder*, as we have just seen, whereas critical success factors do not. Critical success factors pertain to the organization or division as a whole – one set only – whereas strategic factors address each key stakeholder's choice to support one business over its competitors. In Toyota's case they are what makes customers buy a Toyota car rather than one of the many alternatives. These criteria are basic to how Toyota builds its competitive advantage. And basic too for how divisions within a diversifier should build theirs.

There are, of course, another set of strategic factors for Toyota's employees, such as remuneration, job security, equity, job requirements, etc.; another set is for its suppliers, and so on for each of its key stakeholders. Each of these sets becomes the basis of attracting Toyota's key stakeholders' support.

A second important difference between strategic factors and critical success factors is their *validation*. Because critical success factors are developed by management, they can only be validated by management itself. Power politics and influence play a huge part in what gets recognised as a "critical success factor." This inevitably produces distortions of priorities. Strategic factors, by contrast, are validated by the key stakeholders themselves. Toyota's customers, for instance, are continually surveyed on this score. This *external* validation leads to a more incisive view of what's important for success, of how to achieve competitive advantage.

A third important departure lies in the *content* of the lists themselves. Refer to the list for Toyota's customers. Here are the decision criteria that, as a potential customer, I use to decide whether I buy a Toyota or not. The perspective is that of a key stakeholder – in this case, customers. This approach forces a management team to take an external view of what it does, an *outside-in* view. Competitive strategy is built on these factors with the aim of achieving competitive advantage: better customer service than the competition, better store location, and so on.

Looking back at the previous list of 14 critical success factors, and comparing the two lists again, you'll notice that the 14 critical success factors seem to be an *inside-out* view of the world. These are items that a business, through its management and employees, handles. They're *activities*. As a customer, for example, I don't decide to buy from one vendor or another based on "selling." What's the *outcome* for me? I'd ask. It turns out that if you look through the whole list, all have an inside-out view and are *not* the basis for designing effective *competitive* strategy.

Wesfarmers, General Electric and the other successful diversifiers are very stakeholder-focused. Shareholders, sure, but also customers, employees and suppliers, among others. In Wesfarmers' case, for instance, stakeholders are enshrined in the firm's basic purpose. Stakeholders then get translated into each company's divisions. General Electric, Bidvest and ITC all seek to create a small business mentality within a big business structure. Their divisions and business units must deliver competitive advantage for *their* key stakeholders. I've suggested a pathway here – focusing on strategic factors.

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1 Porter, M. 1987. From competitive advantage to corporate strategy. *Harvard Business Review*, May-June, 43-59.

2 Slater, R. 1999. *Jack Welch and the GE way*. New York: McGraw-Hill.

3 Ibid.

4 Ibid.

5 Chaney, M. 2004. *The Wesfarmers' culture*. A presentation at Wesfarmers' Best Practice Conference 2004.

6 Ibid.

7 Ibid.

8 Campbell, A., Goold, M. & Alexander, M. 1995. Corporate strategy: The quest for parenting advantage. *Harvard Business Review*, March-April, 120-132.

9 For more on strategic factors, see Kenny, G. 2001. *Strategic factors: Develop and measure winning strategy.* Sydney: President Press; republished in 2005 as *Strategic planning and performance management*. Oxford: Elsevier Butterworth-Heinemann.

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CHAPTER 11

Buy Well and Integrate

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There are many euphemisms in management and finance circles for what the person in the street might describe as "don't pay too much." But I rather like "the cost of entry must not capitalize all the future profits."[1] Successful diversifiers are good shoppers. They don't pay a premium now and spend the next decade clawing it back.

They're also very keen integrators. But what does this mean in a *diversified* company? In a focused construction company, integration might mean that the acquired company is absorbed into the acquirer's organization in such a way that the construction *procedures* of the acquired entity follow those of the acquirer. But in a diversified company things are different. There isn't the same single-industry concentration. So what is integration in successful diversifiers?

First, however, let's look at why diversifiers buy.

REASONS FOR BUYING

What I've found interesting about the successful diversifiers I've reviewed is that they don't diversify to avoid risk. Yet this is the way many people think of "diversification": spreading risk.

Take the area of personal investment as an illustration. Here financial planners often advocate "a third, a third, a third." An individual, they say, should hold a third of his or her assets in cash, a third in shares and a third in property. This way, goes the reasoning, if something goes wrong in one category, the other two should be okay. For instance, if the share market takes a dive, there's always cash and, hopefully, property to bolster the portfolio. This clearly is a risk-avoidance approach to wealth creation and is likely to show an overall low return on capital.

One alternative is to switch categories as fortunes change. Hold cash when the share market and property are poor and interest rates are high. Hold shares when interest rates are low, and get into property after an extended period of low asset prices. But it can be tricky to pick these cycles *and* there are significant costs associated with switching. A second alternative is to pick winners in *one* category and sit. For instance if the investor knows property well, that person buys an effective investment or investments and lets inflation and its compounding effect do the rest. Or in shares, the individual chooses a couple of "winners" and stays for the long haul, letting dividends and capital growth look after things.

Successful diversifiers do *not* diversify to avoid risk, nor do they *sit*. Instead, they diversify because they see opportunities that they can capitalize on, literally, and they actively manage situations, i.e. divisions, that aren't performing well. They're also prepared to exit an industry if it's not working for them. To put this in a more proactive way, this means that if a division can't deliver results in that industry, the diversifier gets out. Which means that if the diversifier cannot put in place a divisional management team that can achieve a competitive advantage in that industry, it recognizes this fact and sells up.

On the *opportunistic side*, take the September 2006 pronouncement by Wesfarmers' Richard Goyder when the company launched its first takeover bid since its $AU320 million purchase of Lumley Insurance in 2003. It was a $AU700 million friendly offer for insurance broker and underwriter, OAMPS. "The combination of OAMPS and the Wesfarmers insurance division will create a substantial business which will be a strong competitor in the insurance sector in Australia," Goyder said. "It will also provide Wesfarmers with a more diversified business base, from which we can explore additional opportunities in the financial services sector."[2] Note, "additional opportunities," not "spread our risk."

On the *exiting side*, take GE and Wesfarmers. GE exited insurance and Wesfarmers got out of the metropolitan-based Charlie Carters supermarket chain. Successful diversifiers are by no means passive investors. They insist that each acquisition stand on its own two feet, and they measure performance objectively – as we've seen in previous chapters. Their portfolios are based on each business aggressively seeking profit and a high return on investment. While being diversified may have, at times, the effect of smoothing out the peaks and troughs that arise from individual businesses' revenue and returns, this isn't the primary motive for diversifying.

PAYING THE RIGHT PRICE

It would seem axiomatic that an acquirer – in our case, a diversified one – shouldn't pay too much. But what is "too much?" There are two angles to this question.

The first is that accountants can't agree on how to value a firm – not the value of *a* firm, but *how to* value a firm. There are at least six methods of which I'm aware for doing this. Of course, the second issue follows: what's the value of a firm? So the negotiations for the sale and purchase of a company can start with a very broad range. We see this played out every day with public companies in the press. But it happens on many more occasions with numerous private companies that we're not aware of. I've been personally involved in some of them. Now, I don't want to get into the ins and outs of the valuation methods that can be applied to companies. I simply want to point out at this juncture that successful diversifiers know how to play the valuation game.

They also know how to avoid the second angle to this question, which has been variously described as management getting caught up in a deal's own momentum [3] and CEO hubris, i.e. insolence or excessive self-confidence. The former refers particularly to the weight of effort that gets built up and put into the transaction process. This momentum is geared to overcoming problems and achieving a positive outcome. A phenomenon can even develop that has been labeled "deal fever" by the US company Pitney Bowes.[4] It often develops into a "too-late-to-pull-out" stage. Hence, deals get done under the weight of their own momentum even if they're not, in the final analysis, good ones.

Regarding CEO hubris, an interesting and important study was conducted by Mathew Hayward and Donald Hambrick that assessed the role of a CEO's hubris in explaining the large size of some premiums paid for acquisitions.[5] Acquisition premiums were defined by the authors as the ratio of the ultimate price paid for a target firm's shares, divided by the share price prior to news of a takeover. CEO hubris was measured by three observable sources: recent organizational success, recent media praise for the CEO, and the CEO's self-importance. After reviewing acquisitions over $US100 million and researching 106 transactions, the authors concluded:

"We found that four indicators of CEO hubris are highly associated with the size of premiums paid: the acquiring company's recent performance, recent media praise for the CEO, a measure of the CEO's self-importance, and a composite factor of these three variables. The relationship between CEO hubris and premiums is further strengthened when board vigilance is lacking – when the board has a high proportion of inside directors and when the CEO is also the board chair. On average, we found losses in acquiring firms' shareholder wealth following an acquisition, and the greater the CEO hubris and acquisition premiums, the greater the shareholder losses. Thus, CEO hubris has substantial practical consequences, in addition to having potentially great theoretical significance to observers of strategic behavior."

Successful diversifiers guard against getting caught up in a deal's own momentum and CEO hubris by remaining *objective* and *focusing on the numbers*.

An illustration of this objectivity comes from outside our four successful diversifiers – from the US-headquartered firm Pitney Bowes. The company, which describes itself as "the world's leading provider of mailstream solutions," supplies a complete range of hardware, software and outsourcing options for mail and document management, i.e. the flow of information, mail, documents, and packages into and out of an organization. While US-based, Pitney Bowes has offices in 27 countries, revenue of $US5.7 billion and over 34,000 employees.[6] It has gathered considerable experience in what it calls a "disciplined approach" to acquisition assessment, through the process of acquiring 70 companies in six years. In a 2007 *Harvard Business Review* article entitled "Rules to

Acquire By,"[7] its Chief Financial Officer, Bruce Nolop, shared what the company had learnt. While he says that "every acquirer needs its own checklist," he provides Pitney Bowes' homegrown checklist which, he says, ensures the company collects the needed information. The list has these 13 areas:

- Financial Information
- Corporate Data
- Products, R&D, and Manufacturing
- IT Infrastructure
- Distribution and Marketing
- Customers, Competition, and Markets
- Strategy
- Legal Information
- Environmental Matters
- Acquisition/Disposition
- Tax Matters
- Governmental Regulations and Certain Filings
- Other Information

Successful diversifiers have their own "disciplined approach" and checklists – with one important difference, which leads to even further detachment: unlike Pitney Bowes, they are *diversified,* not married to a single industry. Wesfarmers' just retired CEO, Michael Chaney, has summed this up succinctly: "If you're a single-focused company, you tend to be distracted by an operational vision like being the world's biggest something – you're driven towards it by paying too much because you think every opportunity may be your last."[8] He has also pointed out: "It is easy to get distracted by the notion that being important in a market is what it is all about. It's not. It's about being profitable."[9] The diversified structure, he maintains, reinforces this objectivity. Rather than hobbling performance, being diversified, he says, has been the key to Wesfarmers' success. It has allowed dispassionate and clinical investment decisions which are easier to achieve when you are not locked into a single sector.

INTEGRATION

Integration refers to the way an acquiring company brings the acquired firm "into the fold." Effective integration avoids alienating employees in the acquired company. Putting this more positively, effective integration has employees in the acquired business feeling accepted. Integration also includes the way in which the systems of the two organizations work together; this can involve computer systems, measurement systems and a range of HR systems. Some studies blame poor integration for up to 70 per cent of all failed acquisitions.[10] This is not a strike rate that successful diversifiers could tolerate.

The golden rule is that in the pre-deal phases of strategy development and due diligence, people issues should be prioritized on par with finances. As Mark Clemente and David Greenspan have argued regarding inferior employee dealings: "Many [failures] can be traced to the exclusion of human resource professionals in the pre-deal planning phase and the function's last-minute inclusion after the transaction has closed. It's a classic case of 'too little, too late.'"[11]

The merger of European carmaker Daimler-Benz and US carmaker Chrysler in 1998 is often cited as one of the most tragic integration failures in history. The missing ingredient in this case was the American/German cultural integration. There was considerable pre-merger due diligence related to *finance*, but the anticipated "marriage of equals" failed to deliver the promised dividends to shareholders in the proposed time because the employee side was overlooked or taken for granted. While lifestyle differences and language barriers were expected when the deal was made, and programs were developed to overcome them, neither company considered the fundamental difference in the way their companies were run. Germans were surprised to find that American management practices supported segregation of personnel, such as reserved parking, and separate cafeterias for staff and administration. Also, in Chrysler there existed inflated management compensation packages that were not tied to performance. On the other hand, American employees were alarmed to hear that they were seen as the acquired ones. Integration can become very messy.

Hostile takeovers also become examples of "how not to." Take the Australian company Tabcorp's acquisition of TAB Limited in 2004. It will probably be recorded as one of Australia's worst company integrations and become a textbook example of how not to acquire another business. Following three mergers in three years, Tabcorp seemed to have the integration process down to a fine art. But the $AU2.2 billion purchase of the gaming operator in the State of New South Wales was hostile – TAB had developed plans to merge with another organization. Mistrust in both organizations produced a messy, and ultimately unsuccessful, integration process. In the end investors also suffered.

One member of the Tabcorp team recalls flying to Sydney the day after the Melbourne-based company acquired its controlling stake. The seven members of the team traveled to TAB's offices in Sydney to be there by 9 am. They walked in unannounced and took control of the business. "[TAB managing director] Warren Wilson pretty much left straight away and we put [wagering CEO] Michael Piggott in as an interim CEO," says the executive, who is no longer with the company. "We had put together a pretty detailed plan of the senior management we wanted to see, and who we wanted to keep and who we didn't. We camped in Warren's office and that was our room for the day. There wasn't anything they could do because it was Tabcorp's right to take over the business but it made it difficult for us to come across as a warm and fuzzy organization."[12]

The differences between both organizations' cultures were marked: Tabcorp had a formal style, which contrasted with TAB's informality. An "us and them" attitude developed as Tabcorp executives had to deal with TAB employees' anger towards their recently departed bosses. About three months beforehand, many TAB senior executives' contracts had been re-written, adding a two-year payout clause. This caused resentment from TAB employees, and Tabcorp added expense when it fired the managers. "There was a bit of resentment towards the previous management because of that … the fact they [management] were all given parachutes but no-one had looked after them," says another former executive. "Staff at more junior levels were reading the papers and just wanted to keep their jobs. Most had been at TAB for a long time."

Tabcorp's chief executive at the time, Matthew Slatter, was sacked in March 2007. On leaving, he said: "I'm disappointed in terms of timing only. I would have liked a bit more time to execute on the plan that we had. I actually feel very positive about what I've achieved over the last four and a half years with the acquisitions and the doubling in size of the business. And the second thing I feel very positive about is the good people I've brought into the organization. I'm very happy about that legacy."[13] But Tabcorp and TAB are still not fully integrated.

Relevant to this mess are the findings of Ron Langford and Collin Brown III. They conducted research to discover the lessons to be learned from the world's most successful acquirers. Analyzing six industries across three regions – US, Europe and Asia – they identified 51 acquisitive exemplars, companies that achieved high five-year total shareholder returns (share price increase plus dividends) and were significant acquirers of other companies.[14] Alcoa, one of the 51 acquisitive exemplars, achieves acquisition success by applying a rigid set of target selection rules *and* a disciplined integration process. People and processes are integrated quickly and performance is made the key focus. The company maintains a permanent team of managers who specialize in achieving a rapid integration of acquisitions and require the delivery of synergies within one year. Nestlé, another acquisitive exemplar, chooses targets with strong management teams, thereby increasing the chances of synergy capture. It also has a reputation for efficient post-deal integration. Others have emphasized the early appointment of a top team as a strong predictor of the long-term performance of any merger.[15]

Our successful diversifiers also avoid an integration mess by effective up-front planning and extensive follow-through. These are emphasized by Bidvest. Its CEO, Brian Joffe, maintains that a key to a successful acquisition is the communication that a company provides in the initial stages, post acquisition. Areas covered are future direction, corporate objectives, performance measures and all the things that go with helping people make sense of how they're going to be working under the new arrangement. If all this is clear, Joffe says, nine times out of ten a company will achieve a successful result. When Bidvest buys a business, it gets the key people together, explains its philosophies, describes its objectives, details its performance measures, and then empowers its staff to get on with the job.[16]

As another example, Wesfarmers has developed its own "integration framework" – a "how to" for integrating its acquisitions. The company follows it in every merger. This framework requires the allocation of a considerable amount of resources to the task. For example, in the case of the 2001 acquisition of the Howard Smith company, Wesfarmers assigned a senior manager and around 60 staff to the job of successfully integrating the new purchase. It took about six months. Progress was measured against a timeline that showed the tangible benefits to be achieved by Wesfarmers via the Howard Smith acquisition.

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PART THREE

LEARNING FROM SOME CORPORATE CASES

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CHAPTER 12

When Diversification Goes Pear-shaped

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We can learn a lot about diversification success by examining diversification failure. In this chapter I review one such case. My aim is to see what role diversification, in itself, played in Burns Philp's demise. I do this in part because of the habit commentators have of seizing on a firm's diversification as *the* reason for its failure. Interestingly, rarely do we hear from those commentators that the reason for a focused firm's collapse is that it is *too* focused. There are always other reasons. Perhaps there are other reasons, too, why diversified firms fail …?

SEARCHING FOR RELATEDNESS

Until late 2006 Burns Philp was a public company. It was, in fact, Australia's ninety-fifth largest company by market capitalization ($AU2.21 billion). But in December 2006, it was delisted, having been acquired by the Rank Group. My aim here is not to look at these events, but at those that occurred a decade earlier. Concentrating on the events leading up to 1997, the date of its near collapse, we'll look at how it sought its diversified utopia.

The history of Burns Philp and the manner in which it chose to expand from Pacific Island trader to diversified multinational food company follow, in many ways, a template used by companies wanting to expand rapidly. Globalization is the buzz word of modern-day boardroom strategy, but directors of companies in the 1970s and early 80s were equally keen to make their mark on the world. The catalyst which drove this expansionist push was the same then as now: the need to find more profits and, in some instances, to fulfill management ambition. In the late 1970s, Australia had become a small place and the companies that dominated their respective industry sectors were finding growth increasingly difficult to achieve.

Asia was still an uncharted market, although a number of Australian companies had established beachheads there in the 1960s, only to retreat back to Australia. European and North American markets remained the prizes corporate Australia hoped to capture. The boardroom strategy involved a simple formula: diversify.

It was an approach followed by a number of Australian companies, including Pacific Dunlop, Boral, BHP, Goodman Fielder, ANI and Foster's. As well, there was a strategic commonality among most companies eyeing the potentially rich markets of Europe and North America: they all had a strong domestic base, believed that growth and, therefore, profits were limited by the size and nature of their business, and came to the conclusion that it was necessary to expand internationally and find new revenue streams. As it happened, the usual method employed was diversification into other industries.

Before the 1970s, Burns Philp was largely concentrated on shipping and trading throughout the South Pacific, and the business grew steadily. By the 1970s, however, profits started to fall, and there were signs that the Pacific region nations were not as welcoming to foreign businesses as they used to be. It was time to change, and the chief executive, Philip Best, started buying Australian companies. The *Centenary Annual Report* in 1983 states:

"The principal activities of the corporations in the group during the year were: wholesale merchants; shipping, travel and general agents; importers; island traders; plantation owners; trustees; finance; steel, hardware, glass and liquor merchants; hardware and home handyman retailers; motor dealers; hotel owners; distributors of drink dispensing machines; electrical wholesalers; manufacturers; mining joint-venturer; office machinery distributors; cement distributors; manufacturers, wholesalers and distributors of audio, photographic, leisure and sporting goods; film processors; manufacturers, importers and marketers of supplies and equipment for the food, beverage, chemical and other industries."

Burns Philp had become extremely diversified, containing 175 businesses. In 1983, it produced a record low performance. It was time to change again.

In 1984, when Andrew Turnbull took over as chief executive, he had more than 50 managers reporting to him. From

1984 to 1996, searching for relatedness between its activities, Burns Philp sold businesses and investments worth $AU1.3 billion and bought businesses worth $AU1.7 billion. These sales included the company's 46 per cent share of QBE Insurance and the BBC Hardware chain, which Burns Philp had spent years consolidating through acquisitions; BBC Hardware sold in 1994 for $AU460 million. By the end of this restructure, company business was concentrated on three areas: yeast, antibiotics and spices. It had a proprietary technology in yeast production, which made it a world leader in technical terms, while spices related to yeast, as both were foods, and antibiotics related to yeast technologically.

However, the related diversification program achieved through sale and acquisition proved unsuccessful.

Antibiotics: in 1987 Burns Philp invested $AU195 million in the purchase of an Italian antibiotics business. It then had to spend another $AU100 million when environmental problems required building a new factory. From an investment of $AU295 million, the Italian business was finally sold for $AU44 million in 1995, incurring a loss of close to $AU250 million.

Spices: between 1992 and 1994, Burns Philp spent $AU500 million on acquisitions in North America and Europe. In the United States spices market, its competition was McCormick & Co., which held a 30 per cent share. McCormick fought back, as did Burns Philp's competitor in Germany. In the United States, for example, the battle took the form of escalating payments to retailers to get the best positions on supermarket shelves. These "slotting fees" cost Burns Philp $AU25 million in 1993 and $AU65 million in 1997. Its management had misread the situation, and the bidding war that took place saw McCormick prepared to "fight to the death" – to quote Burns Philp's CEO at the time.

In the space of just a few years, Burns Philp had made monumental changes, bought and sold large businesses and stretched management resources to the limit. Head office attention on business-unit needs became dissipated. The company found it difficult to hire good management to run its businesses and achieve competitive advantage. Ian Clack, the chief executive at the time, said, "We did the best job we could with the management we had, but we didn't bring in enough new management to do the job … management was not able to deliver at the rate we expected."[1] Following a $AU700 million write-down, the company was on the brink of collapse.

Yeast: on the positive side, during this period, Burns Philp was employing its proprietary technology in yeast to turn what was a one per cent share of the world market in 1981 into a seven per cent share in 1990 – and then into a 16 per cent share in 1995, becoming the global leader.

Why didn't the "new" Burns Philp work?

The tempting answer is because it was diversified, and highly diversified firms like Burns Philp are prone to failure. This is the argument of many analyses of failures of this type. But it is simplistic, as Burns Philp itself demonstrates.

Some of the drivers of Burns Philp's failure are:

- lack of effective management at the division level, identified by the CEO of the time,
- expansion overseas, with the cultural and regulatory differences and complexities this implies, e.g. Italy, US, Germany,
- expansion via acquisition, with all the consequent organizational integration requirements,
- overpayment for acquisitions, with the resulting expense burden,
- failure to exercise effective due diligence in acquisitions, e.g. checking for hidden liabilities,
- lack of understanding of the industries it was getting into, e.g. the US spices market and McCormick's fight-to-the-death mentality,

- too rapid expansion, resulting in head office staff being stretched and unable to react to crises effectively,
- lack of management discipline, i.e. inability to put in place the measures, systems and processes already noted in previous chapters as so essential.

CONFOUNDING EFFECTS

A confounding effect is one that muddies our view on cause and effect. Many of these occur in practice, as our above list illustrates. In Burns Philp's case, the first of these is acquisition.

Acquisition. Rapid growth by diversification is usually achieved through acquisition. Bidvest, for instance, describes itself as "an acquisitive or opportunistic company." Burns Philp's acquisitions made them newsworthy and were reported regularly in the press. Acquisition brings its own set of issues, however. For instance, in their haste to grow, diversifiers often *pay too much.* Burns Philp certainly did.

But Burns Philp isn't alone in this failing. In the 2005 piece, "Overpriced Acquisitions Under Scrutiny," Arindam Nag says that it's confession time for US companies that overpaid for past acquisitions.[2] These assets can no longer deliver as much growth as expected, and the companies have been forced to book billions of dollars in write-downs. The entertainment company, Viacom, took an $US18 billion "goodwill impairment" charge; Alpharma, in pharmaceuticals, also warned that it needed to book a "goodwill impairment" charge; Clear Channel Communications, the largest US radio chain, took a hit for $US5 billion. These are examples of admissions that former acquisitions were overpriced.

One way of guarding against overpaying is *due diligence.* This is the careful examination of all the pros and cons of a proposed acquisition. Burns Philp failed to do this well on the purchase of its Italian antibiotic business. This meant that it not only overpaid, which dealt the company a body blow that became obvious when it later sold the acquisition at a significant loss, but it was stuck with a liability – environmental problems that required building a new factory.

Post-acquisition *integration* of the acquired business is another essential factor in making an acquisition a success. Bidvest places great emphasis on it, as its acquisition of the car dealership, McCarthy, demonstrates. Integration requires a blending of both organizations and putting certain management systems in place. At Burns Philp so much was happening so quickly, and going so wrong, that effective integration wasn't possible. The parent company was always playing catch-up.

National Culture. Burns Philp's growth-through-diversification program involved global expansion. It made acquisitions in a host of national cultures, including the US, Germany, Italy, Ireland, China, Portugal, Canada, New Zealand and many others. Having businesses across numerous borders led to administrative, legal and accounting disorder at head office. Burns Philp's failure to understand cultural and consequently regulatory differences led to its Italian and US debacles.

In an article entitled "Overseas Acquisitions Usually Fail," Simon London reviews some United Kingdom examples and academic research.[3] He cites as an example Scottish Power, a UK utility, which at the time, 2005, was selling for $US9.4 billion the US business it had acquired for $10 billion in 1999. As he reports, a $US1.7 billion write-off was the result – there were other costs than the price difference involved. The article examines why such acquisitions fail, and but they're all the classic ones we see in Burns Philp.

Rapid Change. In its haste to grow, Burns Philp took on too much too soon. The result was disruption to its existing organization and an inability to put in place effective management at division level. Management was distracted from achieving bottom-line results by this continuous upheaval. As a result, the company ended up lacking the required management discipline. Whether a company's business units are related or not, it can only cope with a certain amount of churn in its composition. Too much and it implodes. Burns Philp imploded badly.

Ignorance. The haste to grow can also lead to diversifiers getting into businesses they don't understand. That was true of Burns Philp's move into the spices business in the US. Not fully appreciating the strategic factors in the industry, it suffered the consequences. General Electric, Wesfarmers, Bidvest and ITC demonstrate that diversification success can only be achieved if a thorough analysis is undertaken of the strategic factors relevant to *all* key stakeholders in the target industry.[4] The potential diversifier must come up with an answer to the question: how can we perform better on these factors in order to obtain a competitive advantage?

DIVERSIFICATION AND FAILURE

In cases like Burns Philp, the role of diversification in bringing firms down is difficult to pin down. I've listed eight possible causes of the company's failure in this chapter, but I'm sure there are several others I haven't identified. *All* of these could have been obviated by effective management practices. *None* is the inevitable consequence of diversification.

While we can learn much about diversification success by understanding the causes of a diversifier's failure, we can also learn plenty about how to manage a diversifier by reviewing the way in which a focused company attempted, unsuccessfully, to diversify. This is the subject of our next chapter.

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1 *The Sydney Morning Herald*, 1997, May 24.

2 Nag, A. 2005. Overpriced acquisitions under scrutiny. *Reuters Website*, February 27.

3 London, S. 2005. Overseas acquisitions usually fail. *The Australian*, May 31.

4 For a full explanation of "strategic factors," see Kenny, G. 2001. *Strategic factors: Develop and measure winning strategy*. Sydney: President Press; republished in 2005 as *Strategic planning and performance management*. Oxford: Elsevier Butterworth-Heinemann.

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CHAPTER 13

Dabbling in Diversification

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Many firms attempt to diversify only to get their fingers burnt. But we can learn much from these incendiary examples. Here's one such case, David Jones. It provides us with some do's and don'ts. It also forces us to address the essential nature of competitive advantage as it applies to divisions within diversifiers. Not coming to grips with this cost David Jones plenty.

DAVID JONES

David Jones is a chain of highly successful retail department stores spread across Australia. It started in 1838 when the Welsh-born Mr David Jones opened "large and commodious premises" in Sydney. His mission then, nearly 170 years ago, fits pretty well with the company today. It was to sell "the best and most exclusive goods" and to carry "a stock that embraces the everyday wants of mankind at large." A high-end department store, in other words, which is what David Jones is now.

The company has 35 stores spread across the nation. In 2006 it had sales of $AU1.82 billion, net profit after tax of $AU81.1 million and a return on shareholders' funds of 21.6 per cent. It is a public company, incorporated in 1906 and listed on the Australian Stock Exchange in 1920.

David Jones has always associated itself with prestige brands. For example, in 1947, just after WWII austerity had ended, it organized Paris-style fashion parades. Pierre Balmain had the women of Sydney enthralled. A year later came the collection of Christian Dior's famous "New Look." This was the first time that Dior had ever shown outside of Paris. Famous brands on a range of goods are still associated with David Jones today.

DJs, as it is affectionately known, grew from only three stores in 1952 to eight by 1959 and expanded steadily from 1959 to 1980. Seven stores were added in the 1990s.

Of course, there have been glitches over this 170-year history. But the ones we wish to concentrate on here occurred in the last decade. One was more a gradual drift than a particular incident. In the mid-90s David Jones lost its way. It slid down market and took on the likes of Target and K-Mart. The deterioration was clear, as store clutter, over-stocking and mixed messages became obvious to customers. As a result, DJs was punished financially.

In 1997, on sales of $AU1.44 billion, David Jones produced a net profit after tax of $AU7.1 million and a return on equity (shareholders' funds) of 1.5 per cent. (See Figure 13.1.) This saw a new CEO appointed, who immediately set about changing the focus of David Jones. Peter Wilkinson's aim, via a three-year turnaround program, was to reposition the company in its traditional place. This also involved a refocus – a word that has been much used at David Jones over the last several years – of its product range, the closing of several stores, a reduction in inventory and an emphasis on cost controls.

The company was rewarded by its customers with an immediate return to form. In 1998, on sales of $AU1.38 billion, it made $UA32.6 million and a return on equity of 6.9 per cent. The latter was still not good enough, though, but it also improved, so that in 2000, on sales of $AU1.53 billion and a net profit after tax of $35.8 million, it reached 8.8 per cent.

David Jones' strategy had achieved competitive advantage by focusing on the strategic factors relevant to its target market: the 30-to-54-year-old high-income woman. Those factors are *image* – achieved by associating the David Jones brand with prestige brands, by the style of its advertising and by the emphasis on its long history; *customer service* – attained by re-training staff, improving staff scheduling and employee presentation; *store location* – accomplished through the closure of several stores and the opening of others; *product range* – reached by narrowing it but making it more appropriate to its target customer; and *product quality* – achieved by discarding low-quality product ranges.[1]

The *2000 Annual Report* is noteworthy for the euphoria that this success brought. It recorded the launch of its website, davidjones.com.au – we forget what a big deal this once was – and, to quote, "the planned opening of our first Foodchain stores means our brand continues to evolve and grow for

Figure 13.1 **David Jones, Key Financial Results, 1997-2006**

	2006[1]	2005	2004[2]	2003	2002	2001	2000	1999[2]	1998	1997
Total sales [3]	$1,821.6	1,799.1	1,769.5	1,711.2	1,668.2	1,547.5	1,528.1	1,355.0	1,376.8	1,437.3
Net income (net profit after tax)	$81.1	$77.9	65.3	(25.5)	6.6	28.0	35.8	40.9	32.6	7.1
Shareholders' equity	$357.4	$475.9	447.9	420.0	455.3	406.3	409.7	405.4	475.1	469.1
Return on equity (%) [4]	21.6	17.4	15.5	(5.6)	1.6	6.8	8.8	8.6	6.9	1.5

(1) The figures for 2006 are based on AIFRS (Australian International Financial Reporting Standards). This is the first year that David Jones has adopted what are new standards. The return on equity figure of 21.6 is that which is derived by using the adjusted equity figure for 2005. The equity figure for 2005 adjusted according to AIFS is $374.6 not $475.9 as shown. This produces the ROE of 21.6 for 2006.

(2) 1999 and 2004 were 53-week years for accounting purposes.

(3) Dollars in Australian millions.

(4) Calculated by dividing end-year net income by beginning-year shareholders' equity. The 1997 figure is calculated by using end-year net income and end-year shareholders' equity.

shareholders." "Foodchain by David Jones" was DJs spreading its wings, and this diversification turned into a disaster.

Just as things started to look up in DJ's core business, its department stores, its management and board started to look for further growth opportunities. In the *2000 Annual Report,* the then CEO, Peter Wilkinson, replied to the question, "What is your strategy to build shareholder value?" with "As we move into the next phase of our corporate development, the David Jones business will continue to grow and diversify by broadening our focus."

Foodchain was a major component of that thrust. It involved the opening of several new specialty stores and the commitment to long-term leases. Each Foodchain store would incorporate a café, bakery, patisserie, deli, seafood providore and butcher. With a range of high-quality meals for all occasions, wine and 4,000 convenience items, these one-stop shopping locations were designed to provide competitively priced food by accessing a broad supply base. The customary David Jones' commitment to service would be in force, underpinned by staff, some of whom would come from their department stores. In-house experts would also be available in Foodchain to provide advice on the produce, meal suggestions and cooking in general.

But these stores failed, and the CEO and the Chairman of the Board lost their jobs.

The *Sydney Morning Herald* weekend edition, 21-22 September 2002, provided a review, by the commercial property editor, of David Jones' venture into Foodchain. What's interesting about the article is that, without ever using the term "strategic factors," the writer evaluates Foodchain precisely on its ability to obtain competitive advantage on these factors. Among the ones listed are location, product range, hours of operation, price and store presentation. David Jones misread each of these for Foodchain and suffered the consequences. Its competitive strategy left much to be desired, failing to effectively address Foodchain's position on each key factor.

The result, as the *Sydney Morning Herald* of the 18 September 2002 announced, "The meager net profit [of David

Jones] did not reflect the continued improvement in the core department and credit businesses which increased earnings before interest and tax by 20.5 per cent to $AU17.4 million." At that time, David Jones had to write down $AU19.5 million on Foodchain. It has since exited the Foodchain business entirely, taking a "$AU78 million hit" on its venture (*Australian Financial Review*, 4 June 2003).

Is David Jones' failure in Foodchain a nail in the coffin of diversification? Or is it a reminder that even if a diversification is not extreme – and Foodchain wasn't – *division* management needs to understand the strategic factors in its industry, and deliver competitive advantage on them? I hold the latter view.

COMPETITIVE ADVANTAGE – THE BASICS

It's important to return to basics. In his various publications, Michael Porter distinguishes between "two basic types of competitive advantage: lower cost and differentiation." Lower cost, he explains, "is the ability of a firm to design, produce, and market a comparable product more efficiently than its competitors. At prices at or near these competitors, lower cost translates into superior returns."[2]

Porter contrasts this type of competitive advantage with differentiation, which relies on differences in factors like product quality and customer service. A combination of factors such as these allows a firm to command a premium price, yet still provide superior value to the buyer. This framework has influenced many managers' thinking and can be found in numerous textbooks.

I'd here like to re-address the essential nature of competitive advantage, as this is important regarding the way divisions within successful diversifiers operate.

To define competitive advantage effectively, we must take an *external* frame of reference: stakeholders, such as customers or employees or shareholders. It's an "outside-in" reference point, viewing an organization from the outside looking in, not from the inside looking out.[3] Customers, for example, are not interested in operations, the activity within an organization. They're not concerned with how efficient a company is. But they *are* interested in how internal operations impact on them — in terms of price, service, delivery and product quality, among other factors. It's this outside-in view that raises the issue of differentiation. If a business differentiates itself on price, service, delivery, etc., it achieves a competitive edge. These items are *strategic factors*, a different set of which exists for each key stakeholder: customers, suppliers, employees, shareholders and so on.

For customers of a car manufacturer like Ford, the strategic factors are product quality, product features, customer service, product availability and price. When, as customers, we weigh up price with all the other strategic factors – an indication of what we'll receive for our dollars – we determine value. In other words, value is the result of balancing strategic factors. It follows, then, that competitive advantage is equivalent to delivering value on these factors superior to our competitors.

Approaching competitive advantage and differentiation in this way makes it impossible to see lower cost as anything but a change in the frame of reference. Through the lower-cost lens we're looking at competitive advantage not from the *outside-in*, as we do with differentiation, but from the *inside-out*. If we equate "lower cost" to "lower price" – which wasn't the original intention, but which many commentators do – it becomes just another form of differentiation: differentiation on price.

Peter Wilkinson, David Jones' CEO until 2002, addressed the *Australian Financial Review* Boss Club on November 11, 2002. When he laid out his and his company's thinking on competitive strategy, Porter's influence can be seen. Wilkinson described how management queried "whether you should go for price leadership, differentiation or for a very focused program."[4] What he's really asking in our terms is: how should we differentiate ourselves on the strategic factor, price, or on other strategic factors such as product range and customer service? And should it be for a broad target market or a narrow one?

COMPETITIVE ADVANTAGE AND A DIVERSIFIER'S DIVISIONS

Successful diversifiers realize that they're only as good as their divisions. And their divisions succeed because they know who their stakeholders are and they understand the strategic factors relevant to each. They then build strategies around these factors that deliver competitive advantage.

Sounds simple? In principle, it is. But as David Jones illustrates, in practice, it can all go terribly wrong. Because David Jones failed to put the principle into practice, it went belly up with its Foodchain diversification. But they got it right for its refocused, and now highly successful, department stores.

As David Jones illustrates, divisions within successful diversifiers achieve competitive advantage by differentiating themselves on the strategic factors relevant to *their* key stakeholders. They take positions on these factors and deliver superior value. However, they can only *sustain* these positions through operational efficiency, one form of which is cost containment. To maximize long-term profit, a division must produce effective competitive strategy *and* achieve lower cost.

Still, diversifiers have much to learn *from* successful focused firms – and certainly their divisions do. So in the next chapter, we examine how two successful focused firms go about their business.

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1 For a full explanation of "strategic factors," see Kenny, G. 2001. *Strategic factors: Develop and measure winning strategy*. Sydney: President Press; republished in 2005 as *Strategic planning and performance management*. Oxford: Elsevier Butterworth-Heinemann.

2 Porter, M.E. 1990. *The competitive advantage of nations*. London: The MacMillan Press, p. 37.

3 Kenny, G. 2001 and 2005, op.cit.

4 Wilkinson, P. 2002. Transcript of his address to the *Australian Financial Review* Boss Club, November, 11.

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CHAPTER 14

Diversification Genius?

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Could it be that one of the very richest people in the world is a diversification genius? Does Warren Buffett, CEO of Berkshire Hathaway, know something that the CEOs, management teams and boards of General Electric, Wesfarmers, Bidvest and ITC don't?

Let's find out.

THE COMPANY

Berkshire Hathaway is an interesting example of a diversified firm. It's not like General Electric, Wesfarmers, Bidvest and ITC, since it's also an investment firm, holding large parcels of shares in other companies, such as Coca Cola and Gillette.

Here we take a look at its operations and its performance on return on equity (ROE) and other measures. As Figure 14.1 demonstrates, Berkshire Hathaway didn't just miss the 14 per cent ROE benchmark occasionally; it didn't reach this level once in the last 10 years! It averaged just half of this figure, at 7.8 per cent, over this period.

Yet Berkshire Hathaway is listed eighth in Figure 3.1 for total shareholder return and is headed by the second richest man in the world, Warren Buffett.

How did this come about?

Berkshire Hathaway is composed of 40 separate companies. In 2006 it had a total revenue of $US98.5 billion, a net income of $US11.0 billion and around 180,000 employees. It owns businesses engaged in a range of diverse activities, as the *2006 Annual Report* shows. The major one is property and casualty insurance, conducted on both a direct and reinsurance basis through a number of subsidiaries. Included in this group is GEICO, one of the five largest auto insurers in the United States; General Re, one of the four largest reinsurers in the world; and the Berkshire Hathaway Reinsurance Group. Insurance premiums in 2006 amounted to $US24.0 billion, or 24 per cent of total revenue (Figure 14.1).

Berkshire Hathaway also has numerous businesses outside insurance, including several large manufacturers.

Figure 14.1 Berkshire Hathaway, Key Financial Results, 1997-2006

	2006	2005	2004	2003	2002	2001	2000	1999	1998	1997
Insurance premiums earned (1)	$23,964	21,997	21,085	21,493	19,182	17,905	19,343	14,306	5,481	4,761
Sales and service revenues	$51,803	46,138	43,222	32,098	16,958	14,507	7,000	5,918	4,675	3,615
Revenues of utilities and energy businesses	$10,644	-	-	-	-	-	-	-	-	-
Interest, dividend and other investment income	$ 4,382	3,487	2,816	3,098	2,943	2,765	2,685	2,314	1,049	916
Interest and other revenues of finance and financial products businesses	$ 5,111	4,633	3,788	3,087	2,214	1,792	1,322	125	212	32
Investment and derivative gains (2)	$ 2,635	5,408	3,471	4,083	838	1,624	4,499	1,365	2,415	1,106
Total revenue	$98,539	81,663	74,382	63,859	42,235	38,593	34,849	24,028	13,832	10,430
Net income (net profit after tax) (2) (3) (4)	$11,015	8,528	7,308	8,151	4,286	795	3,328	1,557	2,830	1,901
Net income per share (4)	$ 7,144	5,538	4,753	5,309	2,795	521	2,185	1,025	2,262	1,542
Shareholders' equity	$108,419	91,484	85,900	77,596	64,037	57,950	61,724	57,761	57,403	31,455
Shareholders' equity per share	$ 70,281	59,377	55,824	50,498	41,727	37,920	40,442	37,987	37,801	25,488
Return on equity (%)(5)	12.0	9.9	9.4	12.7	7.4	1.3	5.8	2.7	9.0	8.1

(1) *Dollars in US millions except per share data.*

(2) *The amount of investment gains and losses for any given period has no predictive value, and variations in amount from period to period have no practical analytical value, particularly in view of the unrealized appreciation now existing in Berkshire's consolidated investment portfolio. After-tax investment gains were $2,259 million in 2004, $2,729 million in 2003, $566 million in 2002, $923 million in 2001 and $2,746 million in 2000.*

(3) *Net income for the year ending December 31, 2001 includes pre-tax underwriting losses of $2.4 billion in connection with the September 11th terrorist attack. Such loss reduced net income by approximately $1.5 billion and earnings per share by $982.*

(4) *Effective January 1, 2002, Berkshire adopted Statement of Financial Accounting Standards ("SFAS") No. 142 "Goodwill and Other Intangible Assets." SFAS No. 142 changes the accounting for goodwill from a model that required amortization of goodwill, supplemented by impairment tests, to an accounting model that is based solely upon impairment tests.*

(5) *Calculated by dividing end-year net income by beginning-year shareholders' equity. The 1997 figure is calculated by using beginning-year shareholders' equity of $23,427 – equity at the end of 1996 (not listed above).*

Shaw Industries is the world's largest manufacturer of tufted broadloom carpet. *Benjamin Moore* is a formulator, manufacturer and retailer of architectural and industrial coatings. *Johns Manville* is a leading manufacturer of insulation and building products. *Acme Building Brands* manufactures face brick and concrete masonry products. *MiTek Inc.* produces steel connector products and engineering software for the building components market. *Fruit of the Loom, Garan, Fechheimer, H.H. Brown, Lowell, Justin Brands* and *Dexter* manufacture, license and distribute apparel and footwear under a variety of brand names. *McLane Company* is a wholesale distributor of groceries and nonfood items to convenience stores, wholesale clubs, mass merchandisers, quick service restaurants and others.

There are still more businesses. *FlightSafety International* provides training of aircraft and ship operators. *NetJets* provides fractional ownership programs for general aviation aircraft. *Nebraska Furniture Mart, R.C. Willey Home Furnishings, Star Furniture* and *Jordan's Furniture* are retailers of home furnishings. *Borsheim's, Helzberg Diamond Shops* and *Ben Bridge Jeweler* are retailers of fine jewelry.

The list continues: *Buffalo News*, a publisher of a daily and Sunday newspaper; *See's Candies*, a manufacturer and seller of boxed chocolates and other confectionery products; *Scott Fetzer*, a diversified manufacturer and distributor of commercial and industrial products, the principal ones sold under the *Kirby* and *Campbell Hausfeld* brand names; *Albecca,* a designer, manufacturer, and distributor of high-quality picture framing products; *CTB International,* a manufacturer of equipment for the livestock and agricultural industries; *International Dairy Queen*, a licensor and service provider to about 6,000 stores that offer prepared dairy treats and food; and *The Pampered Chef*, the premier direct seller of kitchen tools in the U.S. In all, service and sales revenues in 2006 amount to $US51.8 billion or 53 per cent of total revenue (Figure 14.1).

Berkshire's finance and financial products businesses primarily engage in proprietary investing strategies *(BH*

Finance), commercial and consumer lending *(Berkshire Hathaway Credit Corporation* and *Clayton Homes)*, transportation equipment and furniture leasing *(XTRA* and *CORT)* and risk management activities *(General Re Securities)*. With interest revenue, in 2006 this comes to $US5.1 billion or five per cent of total revenue (Figure 14.1).

To the CEOs of Berkshire Hathaway's operating businesses, Warren Buffett's message is simple: "Run your business as if it were the only asset your family will own over the next hundred years."[1]

ACQUISITION PRINCIPLES

In the same report, Buffett outlines Berkshire Hathaway's criteria for making acquisitions. In assessing potential acquisitions, it looks for:

"(1) Large purchases (at least $US75 million of pre-tax earnings unless the business will fit into one of our existing units),

(2) Demonstrated consistent earning power (future projections are of *no* interest to us, nor are "turnaround" situations),

(3) Businesses earning good *returns on equity* while employing little or no debt [my italics],

(4) Management in place (we can't supply it),

(5) Simple businesses (if there's lots of technology, we won't understand it),

(6) An offering price (we don't want to waste our time or that of the seller by talking, even preliminarily, about a transaction when price is unknown)."[2]

As Berkshire Hathaway says, the larger the company, the greater Berkshire's interest. It would like to make an acquisition in the $US5-20 billion range and is not interested in receiving suggestions about purchases it might make in the general stock market. Nor will Berkshire engage in unfriendly takeovers. It prefers to buy for cash, but would consider issuing stock if it were to receive as much in "intrinsic business value" as it is asked to give. It doesn't participate in auctions, it says.

ASSESSING INVESTOR PERFORMANCE

Assessing Berkshire Hathaway's performance starts with a fundamentally important difference between it and most other firms: *it doesn't pay dividends*. This means that all of its profits remain with the company as retained earnings and for additional investments. Unlike General Electric, for example, which in 2005 had retained earnings of only 41 per cent ($US6,706 million) of net income ($US16,353 million). Fifty-nine per cent of GE's net income was returned to its shareholders as dividends. The company tells them: "Our first priority is to pay your dividends. We are committed to return 50 per cent of our earnings back to you in dividends."[3] Over 40 years – the period during which the opposite policy has been in place at Berkshire Hathaway – this amounts to a *lot* of money.

The no-dividend policy and other drivers have seen Berkshire Hathaway accumulate large holdings of cash. A complaint of Warren Buffett is that he has all this cash and nothing to buy. He's currently sitting on more than $US40 billion, which is earning very little.[4] Consequently, there are differences in how investors may assess the company's performance.

Whereas with conventional public companies, investors compare yield (dividends divided by share price) with returns and interest rates from other sources, this isn't possible with Berkshire Hathaway. In the former case investors weigh up yield and capital gain (share price appreciation); with Berkshire Hathaway, they only have capital gain. The company's appearance in Figure 3.1 is purely on the basis of capital gain.

NO-DIVIDEND POLICY

To understand the no-dividend policy, we need to go back to Berkshire Hathaway's beginnings.

The Hathaway company was started in 1888 by Horatio Hathaway, one of its businesses being to mill cotton. In the 1950s the Hathaway Manufacturing Company merged with Berkshire Fine Spinning Associates Inc. The merged company, Berkshire Hathaway, was huge for its time, with 15 plants, 12,000 employees and revenue of over $US120 million. But by the end of the 50s, this public company had closed seven of its plants and laid off a large number of workers. Its share price had also fallen.

Enter Warren Buffett. In 1962 he started buying the company's shares. By 1963 Buffett and his associates had become the largest shareholder, gradually increasing their share to 49 per cent. Buffett used his voting rights to change the management of the company. By now the shares that he had bought for $US15 were worth $US18, but the company had been reduced to two operating mills and 2,300 employees. He thought he could operate the company profitably. It was never a success, however, and was finally sold in 1985.

Over this period Buffett discovered insurance – and *cash*. Around 1967 he purchased two Nebraska insurance companies. The cash from premiums provided him with funds to invest, but in something that was liquid. That became stocks and bonds. A further purchase a few years later of another insurance company, GEICO (General Insurance Company), provided Berkshire Hathaway with a huge cash flow that would allow further stock investments.

In 1967 Berkshire Hathaway, once and once only, *paid* a dividend – of 10 cents on its outstanding stock. It never happened again. Buffett has said, "I must have been in the bathroom when the dividend was declared."[5] (Dividends, of course, are not a business expense, but rather a distribution of company assets to shareholders, paid out of *net* income.)

Buffett has preferred ever since to retain *all* earnings, content in the knowledge that he'd do better with those earnings than his investors would, and pleased to see each Berkshire Hathaway share loaded with additional asset value, increasing in market price.

ECONOMIC PERFORMANCE

We know that the share market performance of Berkshire Hathaway has been impressive. Has its economic performance been equally so?

To answer this question, I looked especially at *return on equity* (ROE) in Figure 14.1. All the numbers *except for the return-on-equity line* come from Berkshire Hathaway's Annual Reports, as do all the notes except for note (5).

As I have previously pointed out, the ROE figures are poor when compared to the benchmark of 14 per cent and the results for GE, Wesfarmers, Bidvest and ITC. Could there be another way Berkshire Hathaway assesses its economic performance?

While Warren Buffett believes that the return a company obtains on its equity is one of the most important factors in selecting a stock for investment and has suggested that 14 per cent is desirable,[6] he also trumpets the importance of increasing the company's *intrinsic value*.

Let's take a look at this measure of economic performance.

Berkshire Hathaway's operating basis is to increase the intrinsic value of the company. A dollar invested today needs to increase the value of the enterprise by more than one dollar in the future. Of course, a one per cent return will do that! The company's *Owner's Manual* describes intrinsic value as "the discounted value of the cash that can be taken out of a business during its remaining life."[7] As it notes, calculating this is difficult and somewhat subjective – in fact, it's anyone's guess and a theoretical notion only. But the principle is important. The purpose of business endeavor, says Berkshire Hathaway, is not sales growth, nor increasing market share, nor having a larger organization; it is increasing the value of the business.

In pursuit of this goal, Berkshire Hathaway follows five basic "business principles," listed in its *Owner's Manual*.

The *first principle* is to maximize Berkshire's average annual rate of gain in intrinsic business value on a per-share basis. Note the *per-share basis*. The aim is to exceed that of the average large American corporation on this figure.

The *second principle* is to reach the company's goal by *directly* owning a diversified group of businesses – if not directly, to own parts of similar businesses, attained primarily through purchases of marketable common stocks by its insurance subsidiaries. (The price and availability of businesses and the need for insurance capital determine any given year's capital allocation.)

Berkshire Hathaway's *third principle* is to use debt sparingly and, when it does borrow, to structure its loans on a long-term fixed-rate basis. It is quite prepared to reject interesting opportunities rather than over-leverage its balance sheet.

Its *fourth principle* is not to diversify by purchasing entire businesses at control prices that ignore long-term economic consequences to its shareholders. In other words, Berkshire Hathaway doesn't want to pay "too much." As it says, it will only do with shareholders' money what it would do with its own, weighing up carefully the values shareholders can obtain by diversifying their own portfolios through direct purchases in the stock market.

Its *fifth principle* is to deliver shareholders at least $1 of market value for each $1 retained. (The *Manual* points out that to date, this test has been met.)

An Owner's Manual states that the calculation of intrinsic value involves an estimate and is not a precise figure. However, Warren Buffett points out that book value does serve as a tracking measure of Berkshire's intrinsic value. In other words, the percentage change in book value (also known as shareholders' funds, equity, net assets and net worth) in any given year is likely to be reasonably close to that year's change in intrinsic value.

The *2006 Annual Report*, for instance, announced a gain of "net worth" (i.e. equity, shareholders funds, net assets, book value) of $US16.935 billion. This figure is the difference between 2006 shareholders' equity of $US108.419 billion and the 2005 figure of $US91.484 billion. (See Figure 14.1.) Increasing net worth is achieved by firstly making a profit and then by retaining as much of that profit as you can as "retained earnings." If no profit, then no earnings, no opportunity to increase net worth. Increasing net worth (shareholders' equity – see Figure 14.1) per share annually is achieved by not issuing additional shares and retaining all earnings, i.e., *by not paying dividends*. The no-dividends policy has the two-edged effect of holding down the number of issued shares (the denominator) and increasing the shareholders' equity (net worth, the numerator). So the surrogate for intrinsic value per share, net worth per share, travels very well for Berkshire Hathaway.

But net worth per share is deceptive. Berkshire Hathaway does poorly when it comes to using shareholders' funds, as the return-on-equity numbers show in Figure 14.1.

BUFFETT MAGIC

Numerous books and many websites are dedicated to Warren Buffett's *investing* genius. From my analysis, however, they all miss an important point.

While Buffett has shown skill in picking stocks and companies to *buy*, he's had his share of losers, too. And there's nothing in his approach to the issue – based as it is on Benjamin Graham's book, *The Intelligent Investor* – that hasn't been known and applied for decades.[8] Buffett's investing-through-diversification genius lies elsewhere.

How did he become so wealthy in the course of 40-odd years?

The answer, and this is where his true genius lies, is: building an *investment model* that leads to individual wealth. It isn't based on a stock-picking technique, so what *does* this model look like?

Taking a *long-term view*, it requires holding stock or owning firms for a lengthy period of time. It means investing in stocks not by charting prices and their fluctuations, but by reviewing company fundamentals, such as return on equity. The problem in investing in this way, i.e., buying for the long term and never selling to take profits, is the need for cash. Buffett's problem was: how could he grow Berkshire Hathaway and retain significant ownership to produce abundant wealth? His answer allowed him to retain 31 per cent of the company and, I believe, therein lies his true genius.

His *first step* was to keep all cash. If you need cash, why give it away as dividends?

His *second step* was to buy only cash-producing stocks and businesses – businesses like Coca Cola and Gillette. He wouldn't consider investing in an embryonic bio-tech stock that may, or may not, produce products worth billions. The reason: no cash flow – and risky.

His *third step* also involved cash: buying businesses with large *cash reserves*. That led him to the insurance industry. Insurance companies sit on mountains of cash that they may never need to pay out. They invest those funds or have the funds invested for them. Buffett's insight was to spy the opportunity here and gain access to these cash pools by purchasing insurance companies.

Warren Buffett's diversification model, involving as it does cash, cash and more cash, didn't require the issue of additional stock to shareholders to raise cash. As a result, shareholders' equity (net worth) per share, and any other *per-share* measure you can name, looks good. While Buffett's model has been an effective one in his case and *for him*, has it been effective economically?

The answer is *no*. Berkshire Hathaway has *not* done well with shareholders' funds, as the return equity figures show in Figure 14.1. Why? From what we know of how Warren Buffett runs the company, I'd suggest the reason is that it doesn't follow through on the seven principles outlined in Chapters 5 to 11 as effectively as General Electric, Wesfarmers, Bidvest and ITC do.

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1 Berkshire Hathaway's *2004 Annual Report*, p.3.

2 Berkshire Hathaway's *2004 Annual Report*.

3 General Electric's *2006 Annual Report*, p.7.

4 Potts, D. 2006. Buffett, the benevolent beast of Wall St. *The Sun Herald*, p.3.

5 *Warren Buffett biography* on www.beginnersinvest.about.com.

6 *Return on equity* on www.buffettsecrets.com.

7 Part of Berkshire Hathaway's *2004 Annual Report*, p.77.

8 Graham, B. 1973. *The intelligent investor.* This is the fourth edition, with the first edition pre-dating 1950 when Warren Buffett first read it at age 19. In 2005 Jason Zweig reproduced the 1973 edition with his commentary. New York: Collins Business Essentials.

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CHAPTER 15

The Focused Message for Diversifiers

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Potential diversifiers can learn much from focused successes. The reason: the divisions and business units within a diversified firm are themselves focused businesses.

McDONALD'S

McDonald's, that global manufacturer of hamburgers and fries, is perhaps the most written-about of all businesses. What has been the secret to its very focused success? Let's look at its history and the reasons.

McDonald's was started by two brothers with a store in San Bernadino, California, to which Ray Kroc, then in his early fifties, sold eight electric food mixers. It was already a success and Kroc liked what he saw. The McDonald brothers had designed an assembly-line system for speedily turning out reliable hamburgers and crisp French fries. The shop was also clean and tidy and everything a customer wanted came across the counter in a pack. Ray Kroc spied an opportunity and bought into the business. He later bought the whole business. By 1972, with the aid of franchising, Kroc had opened 1,500 stores across the US.

The McDonald's Corporation is huge. It primarily operates and franchises McDonald's restaurants and has 31,046 of these in 118 countries. 8,166 are operated by the company, 18,685 are operated by franchisees/licensees and 4,195 are operated by affiliates.[1] Affiliates are businesses in which McDonald's participates but does not control. For example, McDonald's is engaged in Japan via a 50 per cent-owned local affiliate. In general, McDonald's owns the land and building or secures long-term leases for restaurant sites, regardless of who operates the restaurant. This arrangement ensures long-term occupancy rights and helps control related costs.

The corporation's revenue is derived from sales by company-operated restaurants and fees from restaurants operated by franchisees and affiliates. These fees primarily include rent, service charges, and royalties that are based on a percentage of sales. Along with occupancy and operating rights, the fees are laid out in franchise/license agreements that generally have 20-year terms.

McDonald's is managed in five distinct geographic segments: United States; Europe; Asia/Pacific, Middle East and Africa (APMEA); Latin America; and Canada. The U.S. and Europe segments together account for 70 per cent of total company revenue, with each accounting for approximately 35 per cent. France, Germany and the United Kingdom account for about 60 per cent of Europe's revenues; Australia, China and Japan (a 50-per-cent-owned affiliate) account for nearly 50 per cent of APMEA's revenues.[2]

Revenue and profitability figures are shown in Figure 15.1.

McDonald's phenomenal success, both in terms of growth and profit, lies partly in the growth mechanism employed: franchising. But no organization can continue to franchise an unsuccessful business. McDonald's success is also due partly to its production system, which guarantees consistency. But you can't sell food that people don't want to eat, no matter how reliably it's produced. No, the fact is that the fundamental reason for McDonald's success has been its effective positioning on strategic factors – for its customers and other key stakeholders, such as suppliers and store employees.[3] Ray Kroc, McDonald's CEO through its early growth years, is quoted in *In Search of Excellence* as saying: "If I had a brick for every time I've repeated the phrase Q.S.C. & V. (Quality, Service, Cleanliness and Value), I think I'd probably be able to bridge the Atlantic Ocean with them."[4] While the book was published more than 20 years ago, these factors are still drivers today. All employee training focuses on them and all franchisees and store managers are assessed on them.

We see these factors at work in McDonald's response to its recent – and rare – growth-and-profit hiccup, which culminated in a profit dip in the year 2002. (See Figure 15.1.) By this time, McDonald's had 1.6 million store employees, serving about 47 million customers every day. But after enjoying more than 35 years of non-stop growth since its stock market float in 1965, results faltered. Between 1997 and 2003, McDonald's share of the fast food market fell by three per cent. The board acted by replacing McDonald's CEO. The

Figure 15.1 **McDonald's Key Financial Results, 1997-2006**

	2006	2005	2004	2003	2002	2001	2000	1999	1998	1997
Company-operated sales [1]	$16,083	14,726	13,755	12,481	11,296	10,909	10,396	9,504	8,895	8,136
Franchised and affiliated revenue	$ 5,503	5,106	4,839	4,344	3,905	3,829	3,776	3,747	3,526	3,273
Total revenue	$21,586	19,832	18,594	16,825	15,201	14,738	14,172	13,251	12,421	11,409
Net income (net profit after tax)	$ 3,544	2,602	2,279	1,471	893	1,637	1,977	1,948	1,550	1,642
Shareholders' equity	$15,458	15,146	14,201	11,982	10,281	9,488	9,204	9,639	9,465	8,852
Return on equity (%) [2]	$23.4	18.3	19.0	14.3	9.4	17.8	20.5	20.6	17.5	18.8
Share price at year end	$44.33	33.72	32.06	24.83	16.08	26.47	34.00	40.31	38.41	23.88
Franchised and affiliated sales [3]	$41,380	38,913	$37,052	33,129	30,022	29,590	29,714	28,979	27,084	25,502

(1) Dollars in US millions

(2) Calculated by dividing end-year net income by beginning-year shareholders' equity. The 1997 figure is calculated by using beginning-year shareholders' equity of $8,718 million – equity at the end of 1996 (not listed above).

(3) While franchised and affiliated sales are not recorded as revenue by McDonald's, its management believes they are important in understanding the Company's financial performance because these sales are the basis on which the company calculates and records franchised and affiliated revenues and are indicative of the financial health of the franchisee base.

new chief, Jim Cantalupo, who started at the beginning of 2003, and who had previously held the position, re-focused the business and came back to basics. McDonald's describes 2003 as its "watershed year" – a turning point that marks a change of course.[5]

The aim was to grow revenue and profit by adding more sales to existing restaurants rather than by opening more restaurants. As a result McDonald's reduced its capital expenditures by $US700 million.

The strategy implemented was to improve product quality, which had slipped, by improving "food taste"; ratchet up customer service by improving its "speed, accuracy and friendliness" through "more hospitality training and rigorously measuring our operational performance"; lift the presentation of all stores by making them "clean, contemporary and welcoming"; and introduce new menu items – McCafé and Salads Plus Menu, for example.

The result for 2003 was a profit of close to $US1.5 billion, with global sales increasing by nearly 11 per cent over the previous year. The year 2004 saw sales grow by 24 per cent over the 2002 level. McDonald's share price doubled from 2002 to 2004. (See Figure 15.1.) The company's success has continued to soar as can be seen in the table.

WESTFIELD

The Westfield Group is the largest retail property group in the world by market capitalization and the ninth largest entity listed on the Australian Securities Exchange. Operating on a global platform, Westfield focuses on owning and managing large shopping centers. It employs in excess of 4,000 staff worldwide.

By the middle of 2007, the company had interests in 121 shopping centers valued in excess of $AU62.6 billion ($US53.2 billion) located in Australia, the United States, New Zealand and the United Kingdom.[6] These centers have strong positions in prime trade areas, with their geographic, retail and economic spread providing a strong and consistent income stream. The centers are also anchored by long-term tenancies with each incorporating a wide cross-section of high quality specialty retailers and national chain store operators.

Let's take a look at the spread of Westfield's portfolio in Figure 15.2.

Westfield's existence and current management is very much tied up with the Lowy family. A native of Czechoslovakia and currently Chairman of the Board, Frank Lowy migrated to Australia in 1951. He started out by delivering sandwiches for a Sydney delicatessen. Later, he and business partner John Saunders opened a delicatessen themselves. After this business proved successful, they purchased land nearby in Blacktown, a suburb of Sydney. They then built a shopping center that contained two department stores, twelve specialty shops, and parking for 50 cars. The pair named this center "Westfield Place" – "west" because it was located in Sydney's western suburbs, and "field" because it had a view to sprawling market gardens. The center's name was later simplified to "Westfield".

But it was 1960 when Westfield took off. In that year it became a public company. As the Westfield Development Corporation, it developed a new shopping center in Australia every year or two up until 1977. In that year, it expanded to the US with the acquisition of Trumbull in Connecticut. It continued its US expansion, while still expanding in Australia, with the acquisition in 1980 of three new centers in California and Michigan and another in Connecticut. Expansion went ahead in both countries, with further US centers being added in 1984, 1985, 1986, 1994, 1998, 2001 and annually since. In 2000 Westfield expanded to the United Kingdom and New Zealand and has continued to add to its portfolio in those countries ever since.

Westfield operates its shopping centers in geographic clusters. This, it says, provides a number of benefits, including management economies of scale, operating synergies and the reinforcement of the Westfield brand, for both its retail customers and retailers.

Westfield is highly focused. Like McDonalds, it sticks to its

Figure 15.2 **Westfield Shopping Center Portfolio**

	Australia	United States	New Zealand	United Kingdom	Total
No. of centers [(1)]	44	59	11	7	121
Total gross leasable area, million sqm (million sqft)	3.5 (37.7)	6.2 (66.7)	0.3 (3.2)	0.3 (3.2)	10.3 (110.9)
Retail Outlets	11,500	9,100	1,500	750	22,850
Asset Values [(2)] (billion)	$AU26.6	$US19.8	$NZ2.9	£4.3	$AU62.6

(1) *As at 30 June 2007*

(2) *Westfield and joint venture share of shopping center assets and includes work in progress and assets held for redevelopment. (Note: Exchange rates as at 30 June 2007 were AUD/USD 0.8505, AUD/GBP 0.4242, AUD/NZ 1.100.)*

knitting which, in Westfield's case, is the development and management of shopping centers. Its success has been founded on a basic business model that Westfield executes successfully – and churns – again, like McDonald's. This business model functions across the Group's entire international portfolio and aims to have every one of its shopping centers providing a consistent standard of retail customer service, shopping center marketing, operating systems and center management. The purpose is to deliver an outstanding retail shopping center experience to customers whether the center is in Chicago, San Diego, Auckland, Sydney or Melbourne. The cornerstone is the Westfield brand and its identification.

Westfield's reach extends beyond retail customers to the other stakeholders of the Westfield Group. For its retailers, it aims to present a dynamic and professionally managed place to trade; for its investors, it shoots to provide sound management and solid long-term returns; and for its staff, its goal is to produce an attractive and rewarding place to work.

Frank Lowy, Westfield's Chairman, attributes Westfield's success since 1960 to three basic ingredients.[7]

The first of these is the exchange of information. "Management at all levels," he says, "routinely exchange information on everything from construction techniques to retail trends to marketing campaigns." He points out that a design innovation used in Bondi Junction in Sydney is shared with architects working on the Century City redevelopment in Los Angeles and the Derby redevelopment in the UK.

The second is the way Westfield expands. First of all it makes a relatively small investment in a new country, typically by acquiring one or two properties. Then senior management familiar with Westfield's culture and management style are assigned to work with local executives. Together they get to understand the regional market and establish a strong foundation for future growth. Only then, when Westfield is familiar with the new market, does it expand – usually through corporate acquisitions. It has proceeded in this way in the US, New Zealand and, most recently, in the UK. In the latter, this method of expansion has transformed Westfield from being an "entry-level" participant in the UK in 1999 to being among the industry leaders in that market today.

A third ingredient of Westfield's success has been its ability to work closely with some of the world's leading retailers and align itself with their brands. Some of these include Nordstrom, Macy's, Bloomingdales, Nieman Marcus, Target and Wal-Mart in the US; Marks & Spencer, Debenhams and Sainsbury in the UK; and, in Australia, Coles, Myer, David Jones and Woolworths.

All this has led to considerable growth for Westfield and its investors. It has been calculated that $AU1,000 invested in Westfield in 1960, when it first publicly listed, would have been worth approximately $AU167 million in 2005 if all dividends and other benefits had been reinvested as Westfield shares.[8] Westfield's financial results, including its record on return on equity, are shown in Figure 15.3.

THE MESSAGE FOR DIVERSIFIERS

The argument *for* focus is fundamentally related to the power of specialization. The theory is that a firm that's focused in its scope is able to build expertise in a narrow range of activities and thereby achieve a competitive advantage over its competitors with a broader range of activities. Focused businesses that *execute* their strategies better than similarly focused firms will be even more successful.

We see this in the way that McDonald's and Westfield churn their business models. And it's focus that facilitates the repeated application of a basic business model. By this I mean that once a successful model is hit on, it can be replicated repeatedly to achieve great success as far as growth and profitability are concerned. McDonald's clearly clones its success through company stores and franchising. Westfield does it through its development and leasing programs. But this replication in both cases is founded on a working model that delivers a competitive advantage.

One lesson that McDonald's and Westfield's success teaches us, as far as the divisions of a diversifier are

Figure 15.3 **Westfield, Key Financial Results, 1999-2006**

	2006	2005	2004[2] (Jul-Dec)	2004	2003	2002	2001	2000	1999
Revenue [1]	$ 9,203	6,946	n.a.	1,253	1,147	967	1,267	1,548	873
Net income (net profit after tax)	$ 5,583	4,247	n.a.	(196.4)[4]	288.4	234.2	169.1	148.3	126.5
Shareholders' equity	$23,453	19,466	16,241	1,347.7	1,623.2	1,459.4	745.8	639.9	491.8
Return on equity [3] (%)	28.7	26.1	n.a.	n.a.	19.8	31.4	26.4	30.2	25.7

(1) *Dollars in Australian millions.*

(2) *During 2004 the three listed Westfield entities – Westfield Trust, Westfield America Trust and Westfield Holdings – merged. Westfield also shifted from financial year reporting (ending June 30) to calendar year reporting. Prior to 2004 the figures are for Westfield Holdings only.*

(3 *Calculated by dividing end-year net income by beginning-year shareholders' equity. The 1999 figure is calculated by using end-year net income and end-year shareholders' equity. The results for 1999-2003 inclusive are for Westfield Holdings. The result for 2004 (not shown) follows the consolidation of Westfield Holdings with Westfield Trust and Westfield America Trust and are for a different entity.*

(4 *Due to one-off charges from the amalgamation.*

concerned, is that focus pays. Yet it yields dividends only if the division concentrates on the strategic factors relevant not only to customers, but also to other key stakeholders, such as suppliers. In the case of McDonald's customers, strategic factors are product quality, customer service, store presentation, store location, range of products, hours of operation, image and reputation, and price. While customers are its primary concern, the company also concentrates on the strategic factors for store employees, suppliers and other key stakeholders.[9]

SUCCESSFUL DIVERSIFIERS HAVE THE MESSAGE

General Electric's businesses are given the authority and responsibility "to produce the goods," which results in localized competitive advantage. Thus, an individual business achieves an edge in its local market. It's at this interface that diversifiers have much in common with their focused counterparts. Unless a diversifier's varied businesses achieve a competitive edge, the diversifier is dead. And GE recognizes that fact. Its push in 2005 was to avoid bureaucracy, to keep from being trapped by size and to work hard to get the customer perspective inside each and every business.[10] In addressing this issue, it had much in common with IBM. Louis Gerstner faced very much the same problem in turning IBM around in the 1990s.[11]

Focus is also apparent in the way each of Wesfarmers' divisions and business units operates – like a mini-McDonald's. They are successful for the same reason: they focus on the strategic factors relevant to key stakeholders, such as customers, employees and the community, and build competitive advantage around them. Take the now-relabeled Home Improvement (previously Hardware) Division. This division is Wesfarmers' largest by far, employing as it does more than 22,000 of the group's 32,000 employees, and contributing half of the company's revenue. Trading under the name of Bunnings and modeled on the US Home Depot concept, it consists of large, warehouse-style retail stores in which customers serve themselves, but with a high level of often expert advice on hand to assist. Low price and a wide product range provide it with a competitive advantage. And the mix works. However, like McDonald's, Bunnings continually tweaks the formula. For example, part of that finessing involves the development of their new Series 3000 warehouse format to cater for regional centers.

Focus is also manifest at Bidvest, whereby its division managers are left to run their businesses as if they were their own small businesses. This is where Bidvest's "small business heart" comes in. This requires innovation and "new ways of looking at [how] a business can create competitive advantage and lead to sustained growth."[12]

In Bidvest's *2005 Annual Report*, the CEO reflected on the first full-year's results from McCarthy, which had been acquired by Bidvest in the previous year and which is South Africa's second largest motor retailer, with 100 wholly owned dealerships: "Perhaps even more meaningful is the transmission of the Bidvest culture to McCarthy business units. Past constraints are gone. Executives are free to plan a new future and set about its realization. Bidvest's entrepreneurial philosophy and decentralized business model have had a liberating effect. The results are apparent in a record contribution from our new colleagues at McCarthy."[13]

Finally, ITC has been labeled a "focused conglomerate."[14] Its focus comes about through its corporate governance structure, whereby the Board acts as a venture capitalist incubating new businesses and reviewing the progress of existing ones. This occurs while the executive management of the divisional businesses, free from collective strategic responsibilities for ITC as a whole, focuses on enhancing the quality, efficiency and effectiveness of each business. "Organizationally," says Deveshwar, "ITC is no different from focused companies, but has the advantage of institutionalized support." ITC's organization structure and management processes are set up to achieve localized competitive advantage via its individual businesses.

1 McDonald's *2006 Annual Report*.

2 Ibid.

3 For a full explanation of "strategic factors," see Kenny, G. 2001. *Strategic factors: Develop and measure winning strategy*. Sydney: President Press; republished in 2005 as *Strategic planning and performance management*. Oxford: Elsevier Butterworth-Heinemann.

4 Peters, T.J. & Waterman, R.H. 1982. *In search of excellence*. New York: Harper & Row, p. 172.

5 McDonald's *2004 Annual Report*.

6 Westfield's website.

7 Westfield's *2004 Annual Report.*

8 Australian Stock Exchange/S&P Index Services and Westfield sources.

9 Kenny, G. 2001 and 2005, op.cit.

10 GE's *2005 Annual Report*.

11 See Gerstner, L.V. 2002. *Who says elephants can't dance?* New York: Harper Business.

12 Bidvest's *2004 Annual Report*, p.26.

13 Bidvest's *2005 Annual Report*, p.27.

14 Gupta, D. 2003. Leading a focused conglomerate. Website of *The Financial Express*, April 5.

PART FOUR

CHANGING YOUR PERSPECTIVE

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CHAPTER 16

Adopting a Different View

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I'd like to challenge your thinking on diversifying and dealing with the issues of diversification. Specifically, I wish to draw your attention to whether you look at diversification from a corporate (head office) point of view or a business-unit (division or department) perspective.

Let's *start* by reviewing some research.

AN OPTIMUM VIEW

As human beings we're drawn to the idea of an optimum level of something. To take a mundane example, consider onions. A few onions in our food are good for us, but an excess can be fatal – literally. So is this true for diversification? Some diversification is actually beneficial, but too much leads to decline?

There are those who believe that to be true.

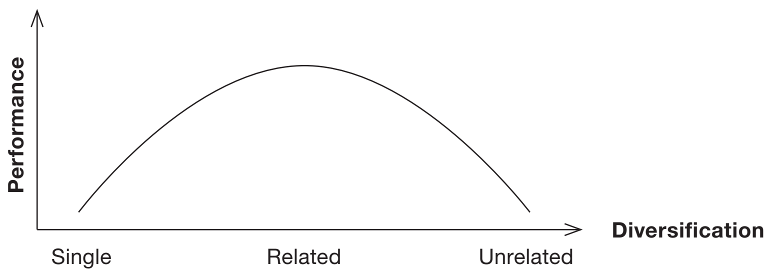
In 2000, three authors, Leslie Palich, Laura Cardinal and Chet Miller, published a paper entitled "Curvilinearity in Diversification-Performance Linkage: An Examination of Over Three Decades of Research."[1] In it they identified 82 relevant, quantitative studies of the diversification-performance linkage and found 71 different samples of correlational estimates of this linkage. Their aim was to quantitatively synthesize the previously published studies.

Using accounting-based measures of performance, they found a "positive diversification-performance relationship in samples that do not include firms with high levels of diversification."[2] In other words, looking at the inverted-U model in Figure 16.1, they found that the slope of the curve to the left of the peak was supported by one set of data – not the whole curve.

They also found a "negative relationship in samples that do not include firms with low levels of diversification."[3] Again, looking at the inverted-U model in Figure 16.1, they found that the slope of the curve to the right of the peak was supported by another set of data. Putting both results together, they concluded that the inverted-U shaped pattern was upheld. However, the correlation coefficients at around

0.25 in both the left and right sides of the curve in Figure 16.1 are really quite low.

***Figure 16.1* The Inverted-U Model**



In spite of this, the authors give a brief explanation of their support for the inverted-U hypothesis.

"Arguments for related diversification, in comparison to limited diversification, suggest that single-business firms suffer from limited economies of scope and other disadvantages. Related diversifiers have advantages whereby they can convert underutilized assets and achieve economies of scope by sharing resources and combining activities along the value chain. Concurrently, arguments concerning the downside of unrelated diversification suggest not only muted benefits of increased diversification after a critical point, but also actual costs that hamper performance. Expanded diversification has been found to increase strain on top management and decision making, and on control and governance. Further, effort losses and diseconomies are issues. As it becomes more difficult to share activities and transfer competencies between units, the costs of increased diversification seem to outweigh any potential benefits beyond a certain point of relatedness."[4]

The case is succinctly put. But let's take a closer look at Palich, Cardinal and Miller's reported correlation coefficients of 0.25 for the left and right sides of the curve in Figure 16.1.

The correlation coefficient squared produces a statistic known as the coefficient of determination. This reports the amount of variation in a dependent variable, in our case in Figure 16.1 "performance," which has been accounted for or explained by an independent variable, in our case, diversification.[5] The coefficient 0.25, squared equals 0.0625, which means that only 6.25 per cent of the variation in performance is accounted for by diversification. And this means, in turn, that there must be other drivers at work that explain the remaining variation – about 94 per cent of it.

So when Palich, Cardinal and Miller conclude that "diversification may not be quite as strong a player as some have imagined,"[6] we would have to agree and conclude that diversification may not be the culprit we thought it was.

TAKING A DIFFERENT VIEW

Palich, Cardinal and Miller's argument is based on taking a *corporate perspective* on diversification. This involves viewing the various activities and businesses of a diversified firm from *head office looking down*. It leads us to consider whether head office adds value by providing needed services and capabilities to the various businesses. And this is fine. But a corporate perspective also induces us to consider relatedness between businesses as an issue – whether they are related, unrelated, related in what way, and so on – as the quote above from the authors illustrates.

One problem is that the relatedness concept is difficult to operationalize in research and practice. As Graham Hubbard notes: "The various approaches to classifying diversification suggest that … we are still a long way from understanding exactly what constitutes 'relatedness' and just how 'related' a diversification has to be for its chances of success to be significantly altered. The many alternative ways in which one business could be 'related' to another business makes understanding relatedness difficult."[7] If, for example, a company has divisions in wine and the manufacture of refrigerators, were it to acquire another winemaker, this could be seen as a related diversification, since it already has a wine division.

On the other hand, it could be considered an unrelated diversification if manufacturing refrigerators is seen as the company's core business.

Figure 2.1 in Chapter 2 listed 25 ways in which one business could be related to another. But, as noted in Chapter 2, "one of the most striking problems introduced by the ambiguity of these [diversification/relatedness] indexes is the fact that findings which previously appeared to support the same position may actually contradict each other … The fact that the most widely used indicators of related diversification cannot be treated as reliable measures of 'relatedness' within corporate portfolios creates a real dilemma for researchers."[8] And for managers.

From a logical standpoint, the inverted-U-shaped case (Figure 16.1) posits that moderately diversified companies outperform focused companies on the one hand and highly diversified companies on the other. One reason is that as diversifiers such as Wesfarmers become increasingly diversified, there can be an ever-increasing strain on top management trying to manage an increasingly disparate (and therefore less familiar) portfolio of businesses – the parenting process. (This is the point made by Palich and her colleagues.)

Were senior management to be responsible for developing the competitive strategies and detailed operational plans across business units as diverse as home improvement, energy, industrial and safety products, insurance, and chemicals and fertilizers – to take Wesfarmers' situation – they would certainly experience "strain." *But they don't do this*. At Wesfarmers, General Electric, Bidvest and ITC, the CEO and the small core of head office managers act as support staff to these divisions. The "heavy lifting," as Warren Buffett, CEO of Berkshire Hathaway has put it – the development of business unit competitive strategies and operational plans – is delegated to division management. So the "strain" on head office is kept to a manageable level by being continually parceled out.

To advance the argument, we need to adopt a *business-unit perspective* rather than a *corporate* one and restate the inverted-

U-shaped case in relatedness terms: firms whose business units are *highly related*, in a focused company, are outperformed by those whose business units are *moderately unrelated*, and the latter outperform firms whose business units are *highly unrelated*. In other words, since business units drive the competitive strategy and the fundamental competitive advantage that a diversifier like Bidvest develops, they have to benefit from being unrelated to other business units, not identical, as in the case of, for example, McDonald's. However, the argument proceeds that this is true *only* up to a point, because being *highly* unrelated impedes their performance. Frankly, there seems no sense to this argument and we are therefore forced to question the inverted-U-shaped hypothesis on logical grounds as well as on statistical grounds.

THE AVERAGE AND THE EXCEPTIONAL

Further research evidence on the question of relatedness between divisions and corporate performance was provided from a different angle in 1999 by Caron St John and Jeffrey Harrison.[9] They investigated whether business units within manufacturing-based, diversified firms, whose units were related, outperformed business units within non-diversified (focused) firms. The firms were all from the one industry.

The authors support my point as they couldn't find any evidence of better performance and so concluded: "Although conventional economic and strategy theories suggest that relatedness should provide opportunities for synergies, we found no evidence to suggest that, *on average*, potential manufacturing synergies were converted into superior cost savings or improved competitive position, both of which should lead to improved profitability."[10]

Note the use of the phrase *on average*. It typifies a point of departure between many academic studies in management and the purpose of my study.

Many academic studies, maybe most, seek to explain what happens "in organizations" or how "organizations behave." In short, they seek to generalize about a broad range of organizational outcomes and usually – from my regular reading of academic journals in management – "performance" isn't one of them. So, for example, in Figure 16.1, the graph suggests the result *on average* as a firm moves from focused to highly diversified.

Even if this relationship were true, and clearly I have concerns, my purpose in this book as well as the purpose of books such as *Built to Last*,[11] *Good to Great*[12] and *Blue Ocean Strategy*[13] is to describe the exceptional – to describe successes. Managers want to know: How can I be one of them? This is in the same way that a swimmer, who has eyes on Olympic competition, wants to know how a champion like Ian Thorpe goes about achieving his success.

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1 Palich, L.E., Cardinal, L.B. & Miller, C.C. 2000. Curvilinearity in the diversification-performance linkage: An examination of over three decades of research. *Strategic Management Journal*, 21: 155-174.

2 Ibid, p.167.

3 Ibid, p.167.

4 Ibid, p.168.

5 Hamburg, M. 1996. *Statistical analysis for decision making*. New York: Harcourt Brace Jovanovich.

6. Palich, L.E., Cardinal, L.B. & Miller, C.C. 2000. op.cit, p.167.

7 Hubbard, G. 2000. *Strategic management: Thinking, analysis and action*. Frenchs Forest: Pearson Education, p. 180. See also Stimpert, J.L. & Duhaime, I.M. 1997. In the eyes of the beholder: Conceptualizations of relatedness held by the managers of large diversified firms. *Strategic Management Journal*, 18, 111-125.

8 Robins, J.A. & Wiersema, M.F. 2003. The measurement of corporate portfolio strategy: Analysis of the content validity of related diversification indexes. *Strategic Management Journal*, 24: 39-59.

9 St John, C.H. & Harrison, J.S. 1999. Manufacturing-based relatedness, synergy, and coordination. *Strategic Management Journal*, 20: 129-145.

10 Ibid. p.141.

11 Collins, J.C. & Porras, J.I. 1994. *Built to last*. London: Century.

12 Collins, J. 2001. *Good to great*. New York: Harper Business.

13 Kim. W.C. & Mauborgne, R. 2005. *Blue ocean strategy*. Boston: Harvard Business School Press.

CHAPTER 17

Diversification Lessons

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The great and prolific writer on management, Peter Drucker, once explained how he learnt by writing.[1] I'd go further by suggesting that I write in order to learn. You've *read* in order to learn. So what lessons do you and I take from this book? Here's what I've learnt (and I hope you have, too), listed roughly in chapter order, not in order of importance:

"Di-worsification" Isn't Accurate. I have to admit that until I undertook the research for this book I, like many others, went with the flow on diversification. The conventional wisdom for me was, as it is for many, that firms shouldn't diversify. I had my doubts about my position, sure, as I'd previously researched the collapse of Burns Philp (Chapter 12), but I didn't have any evidence to put forward as a counter argument. I now do. Diversification doesn't have to be management's leper (Chapter 1).

"Diversification" Is Elusive. Everyone talks about diversification, and it's a topic familiar to most managers. But what does it mean in practice? (Chapter 2.) It turns out that, if you want to make it so, it's complex. And the more one digs into the topic, the more complex it becomes – differentiating as to whether a diversification is related or unrelated, as well as other variations. My concern is: Do these nuances take us anywhere when it comes to managing diversification more effectively? For instance, I'd have difficulty distinguishing the related from the unrelated diversifications in General Electric, Wesfarmers, Bidvest and ITC – as I'm sure their managers would. So while we can split hairs on the issue, it doesn't appear to be all that productive.

Put simply, something is diverse if it is different in some way. In Chapter 2, I proposed this definition: Diversification is the variation between businesses within a company. This variation can be by products or services, e.g., food vs. clothing; customer type, e.g., domestic versus industrial customers in washing machines; manufacturing processes, e.g. tailor-made clothing versus factory-made clothing, and so the variations go on. The degree of diversity is determined by two factors. The first is the degree of difference in one dimension, such as products produced. The second is the number of dimensions in variation – products produced, customer type, technology employed, delivery mechanism, and so on. Mining iron ore and running a general hospital are highly diverse because differences exist in a number of dimensions, e.g., skills, clients, processes, risk to life, etc., and because these differences are, in most cases, extreme, e.g., client needs.

Diversification Is Widespread. Small and large businesses everywhere, as well as organizations in the public and not-for-profit sectors, are diversified. Yet the prevailing view is that focused firms are the norm. This perspective holds that the world is made up of numerous, very focused companies and there are these oddities called "diversified firms." This simply isn't true. I haven't carried out a head count, but I'm of the view that diversified firms are in the majority – diversity is widespread. Far from being freaks, diversified businesses are normal.

Look Beyond the Hype. It's important in evaluating alternatives, such as being a focused firm or a diversified one, not to get caught up in the prevailing orthodoxy, share market hype or press hysteria. These are often uninformed by fact but fueled by prejudice, special interests and rumor. So I had to cut through all of this to look for a metric that I could use to identify my successful-diversifier candidates. I used, in the main, return on equity (ROE) (Chapter 3). While I fully recognize that there is no such thing as *the* perfect measure, ROE is widely viewed as a sound metric for assessing overall corporate performance.[2] In the process I found General Electric, Wesfarmers, Bidvest and ITC (Chapter 4). But I also encountered a surprise – Berkshire Hathaway (Chapter 14). This diversifier and especially its founder and CEO, Warren Buffett, are widely known in business circles. Called the "Sage of Omaha", he himself is a great advocate of return on equity as an important measure of what managers do with shareholders' funds. But in my search for successful diversifiers, his company didn't make the cut. I've included Berkshire Hathaway in the book because of the hype that surrounds the company and because it's an informative case study.

Change Your Perspective. There's been much academic research conducted on diversification. It is one of the major foci of corporate strategy literature. What's interesting to me is how one views the issue. If, as academics and managers usually do, you take a corporate perspective on diversification and look from on high down to the diverse divisions of a firm, then the immediate issue becomes: How can I (management) manage these different entities? Let me throw you this one. Your company runs a chain of hamburger stores and you want to diversify into women's fashion clothing as well. Your reaction is visceral, isn't it? – bordering on panic. The reason: If I know about managing hamburger joints, what do I know about women's fashion! And so we get concerned about how related the different businesses are (relatedness) – which is the obverse of how diversified the firm is becoming (Chapter 16).

But change your perspective and a lot of this concern disappears. Look at it from the division or business-unit point of view and it looks like this. The managers of two divisions might say: "We know how to run our focused businesses, hamburgers and women's fashion, and we're quite successful at it. But we'd be more successful if we had better systems and support" – which is precisely the head office function in my four successful diversifiers. "*But* – and it's an important 'but' – *our* success in running our hamburger stores has nothing to do with the managers' success in operating the women's clothing stores." So from *this* point of view, whether a firm's diversifications are related or unrelated has no impact on division performance and hence firm performance. Changing your perspective on diversification has a huge impact on your approach to the issue *and* how you manage it.

There Are Levers You Can Pull. I've identified seven characteristics of successful diversifiers which I've turned into actions: establish a supportive corporate center; select capable division managers; install appropriate performance measures; set effective incentives; align the corporate culture; secure competitive advantage; buy well and integrate. (Chapters 5 to 11.) Follow these and you'll be well on your way to diversification success. Don't follow them or just overlook one, and you may face failure. Diversification will drag you down. For this reason, you can't *dabble* in diversification. Those who do get their fingers burnt. (Chapter 13.)

Diversification Gets a Bad Reputation. Managers and the press are quick to blame diversification if a company goes belly up. You hear repeatedly that the reason a company failed is because it was "too diversified." Note the "too" in this description. Not just "diversified," since managers know, as I've already suggested, that most firms are diversified to some extent – hence, "too diversified." So to see if diversification's bad reputation is warranted, I reviewed a case where going diversified went horribly wrong (Chapter 12). The press screamed "too diversified." Yet I found at least eight drivers of Burns Philp's failure, each of which was powerful enough to cause major problems. In combination they proved to be fatal. Not one of those causes was "too diversified."

Diversified Firms Can Learn a Lot from Focused Firms and Vice Versa. A diversified company is a collection of focused firms. So it stands to reason that any diversified company would do well to study their focused counterparts. There are lessons there for a diversifier's divisions and business units. I reviewed McDonald's, Westfield and David Jones in my journey and what I found was a focus on stakeholders, especially customers and staff; a clear understanding of the strategic factors relevant to each;[3] and strategies built around these factors that provided competitive advantage (Chapters 13 and 15). The message for diversified firms? Make sure your divisions and business units do likewise *and* don't let head office get in the way in this quest by divisional management. The latter has been a problem for diversifiers.

And what can focused firms learn from diversified companies? How to handle diversity! Successful diversified firms are masters at keeping it simple and at establishing systems and procedures that ensure it remains that way. We think of focused firms as *not* being diverse because they operate in a single industry. Yes, but *within* any organization diversity exists. For example, within a company there are departments of finance, accounting, human resources, marketing and production. Each of these has its own set of skills, which are quite different from those of other departments, each has a different culture engendered by the varied professional orientations and skills, and there's a natural antipathy between departments that can lead to "turf wars." Diversified firms handle issues such as these via the seven mechanisms in this book (Chapters 5 to 11).

My Successful Diversifiers May Stumble and Fall. There are no guarantees in life. And I can't warrant that General Electric, Wesfarmers, Bidvest and ITC won't have their problems – and they could be major. There are those who are fond of pointing out that some companies featured in books such as *In Search of Excellence*,[4] *Built to Last*[5] and *Good to Great*[6] have later either not performed so well or have collapsed. This could happen to my four exemplars. But one thing I feel confident of is that, if either of these outcomes eventuates, it will be because my four successful diversifiers have violated one or more of the seven precepts detailed in Chapters 5 to 11.

---

1 Drucker, P.F. 2001. *Management challenges for the 21st century*. New York: Harper Business.

2 Walsh, C. 2006. *Key management ratios*. Harlow: Prentice Hall.

3 For more on strategic factors, see Kenny, G. 2001. *Strategic factors: Develop and measure winning strategy*. Sydney: President Press; republished in 2005 as *Strategic planning and performance management*. Oxford: Elsevier Butterworth-Heinemann.

4 Peters, T.J. & Waterman, R.H. 1982. *In search of excellence*. New York: Harper & Row.

5 Collins, J.C. & Porras, J.I. 1994. *Built to last*. London: Century.

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