Strategic Management - The Competitive Edge

Professor R Srinivasan
Department of Management Studies
Indian Institute of Science Bengaluru

Lecture 32

Risk, Corporate Diversification

So, in the last session we were looking at diversification. So, how do you really classify a portfolio according to risk, when should it really diversify, this is what we were looking at. So, risk can be low, moderate, high. So, when does risk become low? Example, suppose you have no competition in the market, that is you are the leading player in the market. Then your market share is good. You do not visualize too many threats in marketplace, then the risk for your portfolio is low.

Suppose, there comes some entrants into the market, though they may not be an immediate threat for you. There may be a thought lingering in your mind that they may pose a threat a little later on. That is they may be able to really imitate your product or substitute your product in the marketplace, then the risk is moderate. This happens to so many businesses.

In fact, there are very few businesses where there is low risk in the present day setup. So, we were discussing the other day about the Iraq-Kuwait war and Kuwait oil wells being set on fire before the Saddam Hussein army retreated.

At that point of time, there was only one company who could douse these oil fires and that was in the US. So, for all practical purposes, if you look at the risk for such a company, it is very low, it is a market leader, it is perhaps the only company. Then compare to this when you are looking at high risk that means there may be substitutes coming to the market place for your product anytime. So, then the portfolio is having high risk.

So, the courses of action that you can think of is niche - creating a small segment where you say this is the segment where I specialize. Some companies specialize in fire extinguishing that is niche for them. So, any office if you go you find that there are fire extinguishers in almost all places.

Now, it is a common to see these fire extinguishers in almost all high rise buildings. So that is a niche market for them. Now, what is this vertical integration? This vertical integration can be either can be either backward or forward. Backward meaning where you take control of the raw materials the supply line, forward meaning where you take control of the distribution line.

So, you can have a horizontal expansion, meaning that you do not have to tinker with your production lines. The existing production lines will be sufficient to come out with the products may be a little change here and there. Then diversification is where you may have to really look at it very closely, your production lines, the way your production systems are going, they may have to change. So, all this is dependent on the growth that you desire.

So, this is where very importantly, suppose you are put as a strategic planner, that this company can grow at this percentage that is the percentage can be not more than 5 percent when you put it up to the management, they will say, why not you look at 10 percent instead of 5 percent. You make the desired growth rate at 10 percent. So, what will be the role of the strategic planner, he has to think of methods by which this gap can be bridged. So, it can be through your different methods of integration that you can think of. So, the last being the diversification.

Suppose, you are not able to get this backward and forward going. Then think of diversifying, whether you can meet the desired growth through diversification. Diversification itself can be related or unrelated as we discussed in the last class. So, these alternatives can be internal expansion where you add more capacity or internal stability where you augment resources or internal retrenchment or turnaround. So, if you really look at the case of Hindustan Photo-Film in Ooty, this is what happened.

A good company found itself in the throes of acute competition added to that the internal problems of leadership. So, faced with this, this company resorted to this turnaround strategies and it is not doing greatly right now, but still there. External retrenchment or divestiture, this happened with respect to ITDC hotels. Some of the best known brand names like Hotel Ashok whether in Delhi or in Bangalore they were run by ITDC. Now, no longer with ITDC. So, it was also running hotel Akbar in Delhi.

Now, no longer so, it has been divested from ITDC and run by other private outfits. For example, Bangalore is known as Hotel Lalit Ashok, the Lalit group running that. So, the other alternatives you can think of is to have external expansion through mergers. So, whether you can merge with an existing company and make a mark in the market.

So, the last one is look at a combination of all this. So, the selection of the strategy itself, as we discussed depends on the growth objectives, the resources, the strengths and weaknesses government policy and best method to close the gap between the projected performance and the desired performance. PLC plays a great role in the whole process. So, suppose the product is in the decline stage, there is no point in bringing in your best strategy to move it up. It would not move up. So, it has come to the stage of dogs. So, when it is come to the stage of dogs, better to divest the whole thing and have salvage value.

So, this is what we discussed with reference to the structure of the organizations depending on the type of products or functional areas you are having. You can have either a matrix structure or you can have a network structure as we said.

And we looked at two examples of with respect to diversification. One of the examples we looked at was JK from textiles to synthetic fibres and also Nirlon. So, we also looked at the type of questions one should ask before we look at either diversification or considering mergers with different companies.

So, this is when you are looking at an unrelated diversification, it can be through setting up new projects, through mergers, takeovers of running businesses. So, I have taken an example of a company in Hyderabad which was manufacturing bus bodies.

So, the name of this company was Hyderabad Allwyn. This company from bus body building, moved over to refrigerators, to deep freezers, then water coolers, ACs, etc. So, this is unrelated diversification, but the company thought that in order to stay in the market, it would be better to go in the unrelated way instead of just sticking on to bus body building.

Now, if you really look at the present day, the cost of fuel is fairly high even with some reductions coming in the way. Now, with this high cost of fuel what is the alternative that is open for transport companies. The transport companies should look at alternatives to reduce fuel consumption if possible or to switch over to different modes. So, if you look at the automotive cars, many are switching over to electric cars, some are coming out with hybrid cars.

So, when a company like Honda comes out with a hybrid car, it is not related diversification. It is unrelated diversification because your fuel itself, really the core competence, that is the petrol engine of Honda. You are changing it. You are bringing in the electric component also. So, there has to be an expertise which has to be built up to bring this hybrid on to the table.

Now, suppose you are looking at planned diversification. So, if you are looking at planned diversification, then there are some options which are available to the management. So, one of the easiest options that management can think of is to have keep status quo that is do not do anything. This is what many government companies do. They are resistant to change, this resistance to change will disappear once the market becomes competitive.

The second one is sail with the wind. Sail with the wind meaning that so things are going, you sail with the wind, so do not keep on changing. Then go on moving in the direction. So, a typical of the governmental PSU's. Private enterprise- would be a new direction in a planned manner.

Do not stick to the old things for a long time. You may be knocked off from the business in the competitive set up anytime.

So, what does all this tell you? What it tells you is this diversification is an ongoing process, in the present day context. In the present day context, you must have diversification on your table. So, you must look at diversification as one of the possible processes that an organization should consider.

So, for keeping this on your table these are the things which you should have what is your business, define your business. Are you in the transport industry? Are you in the automotive industry? If you are in the automotive industry, which type of automotive industry are you in? Then do a SWOT analysis. So, this is what we call the environmental scan. This environmental scan helps you to do come out with a gap analysis. What is the type of gaps that you find with respect to the company in the marketplace?

Now looking at the gaps, looking at the competition, looking at the risk, you take a call on diversification. The most important thing in the present day setup that is in 2022 is diversification to be considered as an option. It is not to be considered as a last option. Companies should be willing to diversify. They should be willing to take risks and if they are not willing to take risks, if they are not willing to compete then the field may get closed for them very soon, this is what happened to most of these MSMEs operating from Bangalore. So, many new entrants came from well-known brands.

Now, these MSMEs were really hard pressed to compete with them. So, most of them during the COVID time I was given to understand that nearly 50 percent of the MSMEs operating in Bangalore were close to shutting shop. So, somebody's area of concern also poses somebody's area for opportunity. So, these MSMEs area of concern that they are not able to really put up with this COVID fears was was an opportunity for some other companies; they came in, substituted in the marketplace even during the COVID times.

So, the result is many of these MSMEs were in for a shock, how did this happen? Added to the operating problems, the most common operating problem that they used to face and they are still facing is the working capital. So, they have to find resources on a continual basis.

In other words, these MSMEs have very low reserves. They cannot draw on their reserves like the big companies say big IT companies, example Infosys. These big companies can draw upon their reserves to disperse salaries, whereas, with respect to these MSMEs they found that even dispersal of salaries was a big problem. So this is the type of scenario which you will have in a competitive market.

Now, if you look at this Indian scenario which we are talking continuously, this diversification is actively pursued due to liberalization. One good point is Indian entrepreneur is willing to think big and grow big. So, he does not want to confine himself to his small frog in a well type of policy, higher risk bearing attitude by financial institutions. So, the present day setup is where MSMEs themselves have financial props given by the government and other financial institutions.

The next point which these MSMEs are cashing in on is there is a middle class confidence in the country in the equity market. They think that the equity market can do well. So, when these companies come out with IPOs you find many of these IPOs being oversubscribed very fast not to mention big companies.

So, shrinking demand for Indian commodities abroad. So, joint ventures in India NRI scheme for technology and finance flow. So, this is where the present government is keeping on saying Make in India. It is also saying now the Indian Prime Minister is trying to woo foreign investments by saying you make in India, to these Japanese companies. He is saying okay make in India you can still sell abroad.

If you think that the foreign market is more attractive than the Indian market, still you make in India cost of production will be low, we would still welcome this foreign investment. So, this is a type of scenario which you are in.

So, this is and the most important noticeable thing in the Indian condition is the largely middle class domestic market. You are seeing this large middle class domestic market. This middle class domestic market is really contributing to all these types of if you want to call them adventures by the entrepreneur.

Now, this integration which we were talking of horizontal owning or controlling a number of similar but separate activities in the same industry or business. So, this is what we mentioned. The vertical integration could be backward diversifying into raw materials and other supplies for the company's products may enable a company to improve the quality of the final product. So, if you look at this Vimal fabrics, he did that. Reliance group took control of the supply line. So, that your supply line glitches will not be there. There is a continuous supply of raw materials.

Now, if you operate your production line properly, then the product flow will be continuous without any breaks to the market. So, forward diversification for further down the line to final consumer. Direct control and distribution and logistics channel, this was done by this company Nirlon as we discussed earlier.

So, this whole concept of diversification is based on synergy. What is this synergy? To put in a very simple language. The sum of addition of two numbers should be more than that additive number. Example 2 plus 2 gives you 4. In synergy, 2 plus 2 should give you more than 4, you should be able to get to 5 maybe you do that, through your experience in production or reducing cost of manufacturing through different methods, may be cost of raw materials, you try to prune all those types of things. So, all that comes under what we call the production synergy.

So, company, manufacturing coolers, refrigerators getting into room heaters, ovens, that is happening in the present day market. Then a marketing synergy, so, this company manufacturing cricket balls and bats, Symonds came to tennis balls and rackets also. So, that is a well-known brand name in the global market even to this day. Financial synergy- Fan manufacturers offering discount in winter. This is how a company like Khaitan tried to disturb the equilibrium of the market - possible when you are in an oligopolistic market. The new player can shake well established players in the market.

The organization synergy refers to manufacturing, suppose a manufacturing organization it starts consulting services. So, you take the example of MECON (Metallurgical Consultants India Limited). Over the years, these engineers who came to MECON were involved in mining and metallurgy projects.So, they thought that their expertise was such that suppose some new entrant or some new players come into the field or even existing players are having problems then they can offer consultative services. So, MECON is a well-known consultative organization in metallurgical field.

So, this is an example of organization synergy. There is sometimes a question which people ask, should you really diversify can it not be expansion? True. Before diversification company should consider expansion in existing product line. It will take care of most problems, you do not have to change the production line, you do not have to look for an alternative setup, all those types of things are there. But suppose, you are not able to do that, you think that is not an option, then you do not have any other option other than to go in for diversification.

So, in all these things, there is a certain amount of risk that is involved. This is brought out to you through this in the book at page number 158. So, when you look at page number 158 there is a caution which is mentioned with respect to diversification and its synergy what we just looked at. Before a company diversifies, it is advisable to check whether it can expand. If this results in increased market share, it is not advisable to diversify. Note that.

Now we look at one aspect of this strategy valuation. One of the methods that was given for strategy evaluation was this balanced scorecard. What is this balanced scorecard. If you really see this balanced scorecard makes use of four parameters for strategy evaluation, these are discussed in page number 181 of my book, which I am quoting here also. One is the financial perspective.

The second is the customer perspective. The third is the internal business perspective. The fourth is learning and growth. So, when you are looking at strategy in a competitive market and make use of this balanced scorecard, you should look at the parameters for evaluation of strategy. And along with these four parameters, there are also four processes to manage the strategy. This managing the strategy could be translating the vision, communicating and linking, business planning, feedback and learning.

The question comes what will be the use of this balanced scorecard for companies. So, this BS in short, balanced scorecard as a tool can help the companies to clarify and update strategy. Communicate throughout the company. Align unit and individual goals throughout the company. Identify and align strategy strategic Initiatives. Conduct periodic performance reviews.

So, this was in fact this was attempted when a company came in the mission mode. It was CDOT Centre for development of telematics. So, what was the objective of setting up CDOT back in the 80s. The objective of CDOT was to come out with an Indian telephone exchange which can operate in Indian conditions that is extreme conditions of heat and this telephone exchange should not choke in such conditions. So, the time given to develop this was 36 months.

So, the Department of Electronics and the Department of telecommunications joined together to set up this organization CDOT in a mission mode. And this CDOT responded to this challenge by coming out with the exchange in 33 months. In fact, they tried to get the cost estimates from a well-known player Alcatel- what will be the cost of this exchange?

At that point of time in the 80s, they found that Alcatel was quoting around 400 crores for this exchange to be manufactured for the type of conditions put. And CDOT did it in 36 crores that is one tenth of that quote. And this exchange was made operable in a place called Kittur in Karnataka near Belguam, and where the temperature goes up to 40 to 45 degrees Centigrade in summer, and it functioned very well.

So, the one of the organizations to make use of all these management techniques to come out with a clear strategy, clear vision. In a mission mode was this company CDOT back in mid 80s only. So, through the initiative then Prime Minister, Mr. Rajiv Gandhi, who invited Sam Pitroda to come out with this CDOT; and CDOT delivered using the help of engineers from ITI only. So, that in fact raised so many question marks, why the engineers who are working in ITI for so many years could not come out with a product.

When they came to CDOT how did they come out with this product? Then, so, many answers were coming out, it is the environment which created this whole change. So, you create a proper environment, this will act as a synergistic tool and this balanced scorecard proved the whole point. Balanced scorecard is given on page number 181 and 182 of the book.

Note that this balanced scorecard is not the utopia; it has limitations. It is a scorecard only not a decision making tool. It cannot be used as a tool, though it can help in assessing performance. Focusing on scoreboards can lead to a lack of focus on the underlying actions that produce a good score. An example is that of a tennis player who watches the scoreboard instead of the ball court and the opponent. He would not be able to win a game much less a match no matter how well designed the scorecard is.

Scorecard are a top down focus for the business. It avoids the bottom up perspective. An organization should blend both top down and bottom up perspectives and not focus solely on one or the other.

The balanced scorecard lacks direct explicit links between financial and non-financial segments that also to be noted and hence relegates the non-financial segments to the back of the bus whenever there is a conflict with the financial segments. So, some of these by finance discipline, not getting the due in the balanced scorecard.

we will stop here. We will take up mergers and acquisitions in the next session. Thank you.