

↑ GOOGLE

THE US COMPANY BECAME FAMOUS FOR ITS INTERNET SEARCH ENGINE. TODAY, THE AMERICANS ARE BETTING ON RELATED INDUSTRIES LIKE VIDEO PORTALS.

57%

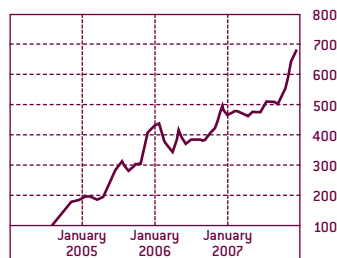
is the growth rate for Google's revenues in the third quarter of 2007.



“We should always attempt things that scare most other people.”

LARRY PAGE, GOOGLE FOUNDER

DEVELOPMENTS OF GOOGLE STOCK PRICES



The stock has climbed almost steadily in the last few years. Shares are currently worth almost \$700.

Source: Yahoo Finance



You can also listen to this article on our audio CD (page 63).

Long view, not tunnel vision

It has long been said that conglomerates are on the way out. Managers and investors have preferred focused companies. But now they're beginning to reconsider. Why? The answer is simple: Diversified companies tend to be more successful than those with a single focus.

↓ **ANYONE WHO OWNS STOCK** in US-based Google has reason to smile almost every day when glancing at the business news. Since its initial IPO in the summer of 2004, the stock's value has increased more than eightfold. Diversification is the reason for investors' euphoria: Google has long since branched out beyond its original industry segment. In addition to the search engine, the company provides card and e-mail services. And the Google execs have been buying extensively in recent years. They've taken over the YouTube video portal, and recent news that the company was negotiating collaboration with mobile communications provider Verizon Wireless sent stocks soaring again. The deal would be a good fit for the company's strategy. Google is one of the newer examples of a company that doesn't limit itself to one industry. Instead it's betting on diversification.

The concept of diversification originated on the desk of Harry Igor Ansoff, the management thinker. The Russian mathematician and economist is considered the father of strategic management, not least because of his ideas about growth management. Ansoff said there are four ways a company can grow. It can penetrate its own market more effectively, develop new products, tap into new markets with existing products or grow in an entirely new direction, with new products in new markets. Ansoff called the last of these “diversification.”

SUCH AN APPROACH eventually came to be thought of as outdated. Conglomerates were considered to be over the hill, and instead the number one priority was to focus on core competencies. Secondary markets and marginal activities were to be cast aside. However, this very management dogma is now growing shakier, and success stories such as that of Google support this notion. “Diversification strategies are growing more appealing for companies

again,” says Hauke Moje, a partner at Roland Berger Strategy Consultants and the author of a new study on the performance of conglomerates. “The recent trend of focusing on core business seems to be reversing itself.” Success stories like Wuerth, a German company, give others hope. The Wuerth Group combines a clearly defined core business with other business activities, succeeding in achieving healthy growth in the process.

MOJE'S TEAM STUDIED the development of the world's 1200 largest companies between 1995 and 2004. The finding: Despite the fact that the majority of companies still consider concentrating on one industry and achieving top prices as a strategic ideal, and despite the fact that the capital market still devalues conglomerates by 10 percent to 15 percent—the so-called conglomerate discount—a key truth remains: Whether a company is diversified or not has no influence on revenues or return on investment.

Contrary to the theory, the diversified companies proved themselves to be even more successful. Eighty percent of them increased their revenues and EBIT. Among the companies with limited focus, only 73 percent showed similar growth. “The conglomerate discount isn't justified,” Moje concludes. “Diversification absolutely can generate value.”

Companies are increasingly finding that the step toward entering new markets often becomes a question of survival. A Roland Berger survey of 40 German corporate groups and medium-sized businesses showed that half could only grow in their own core industries by edging out the competition. Only 30 percent generated new revenues without price wars or takeovers. This is the main reason more than 80 percent entered at least one completely new industry within the last five years. Once again it seems worthwhile to strive for a broader horizon.

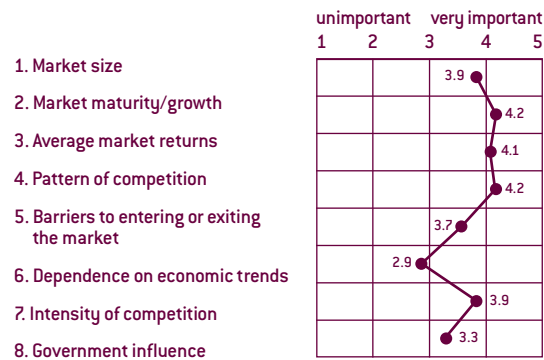
India-based Tata Group is a company that manages this almost without equal. The company sells tea and clocks right along with steel. One of its commercials illustrates the group's breadth very well. An average Indian wakes up in the morning with a Tata alarm clock. He drinks his morning Tata tea. The salt on his egg comes from Tata Chemicals. Then he drives to work in his Tata Indigo. It's a life with Tata.

Tata also proves that a broad approach does not mean sacrificing its own identity. In fact, identity plays a far more important role in companies whose activities are diversified. Says Chairman Ratan Tata, "Whatever we produce, we must be at the technological forefront. We have to be seen as a company that produces exciting products."

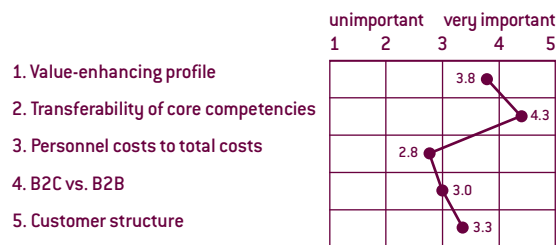
ONE OF THE PRIMARY MOTIVES for diversification is growing your company's core business. This option becomes particularly attractive when the margins there become more slender. For example, many retail grocery businesses are now confronting this problem, and their profits are under pressure. Market share can only be gained through price wars. For this reason, many companies are trying to tap into new market segments with new products. British grocery giant J. Sainsbury is among them. Since 1997 the company has offered financial products such as savings accounts, insurance and consumer credit in its nearly eight hundred stores. Because it also addresses customers who may not yet shop at Sainsbury, the company has chosen a path more akin to diversification than to product development. For this step the retailer has embarked on a joint venture with HBOS Bank. "We want to accelerate the development of additional non-food products," says Sainsbury CEO Justin King of the company's direction. The banking business is a major building block in this strategy. "It offers very promising opportunities for growth," King adds.

DIVERSIFICATION? SURE, BUT WHAT KIND?

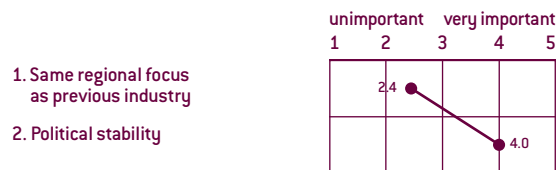
The most important market filters are market maturity/growth and pattern of competition. Strong dependence on economic trends does not scare companies off.



The most important strategic filter is the transferability of core competencies.



Companies place a great degree of importance on the political stability of a location.



think:act chart, source: Roland Berger Strategy Consultants

↑ WUERTH GROUP

THE WUERTH GROUP'S CORE BUSINESS IS THE WHOLESALE TRADE OF CONNECTING AND ASSEMBLY TECHNOLOGIES. THE COMPANY HAS EXPANDED, THOUGH. APPROXIMATELY 350 COMPANIES NOW BELONG TO THE GROUP.

54 906

is the number of employees at Wuerth worldwide.

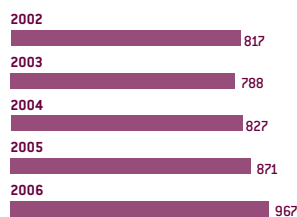


“Diversification is neither good nor bad in itself, but companies can do it well or do it poorly.”

REINHOLD WUERTH, CHAIRMAN OF THE ADVISORY BOARD OF THE WUERTH GROUP

REVENUES FOR ADOLF WUERTH GMBH & CO. KG

(million euros)



Source: Adolf Wuerth GmbH

The company has enjoyed steady growth since 2004. The only dip came in 2003. Diversification notwithstanding, its core competency remained the wholesale trade of connecting and assembly technology.

According to the Roland Berger study, half the new industries that companies enter as part of a diversification effort generate significantly higher returns than expected. Only one-fifth of expansion attempts flop, and in such cases failure is usually due to the same reasons economists and managers cite as drawbacks of diversification: The number of different, small business segments simply overwhelms management. The company gets sidetracked and has insufficient competencies in the new industry.

THE EXAMPLE OF INDITEX, a Spanish company, illustrates the degree to which diversification can drive growth. Founder Amancio Ortega Gaona began producing textiles in his hometown of La Coruña in 1973. After just two years he expanded his business activities and opened Zara, a retail store.

The business world refers to such a strategy as “vertical integration.” It was a wise decision, from Inditex’s perspective: While the textile industry has moved out of Europe almost entirely, Gaona has established an impressive track record in terms of growth. Today his company sells his clothing in more than 3500 stores in 68 different countries, and Inditex recently added bedding, tablecloths and cutlery to its product line.

Companies like these are doing the smart thing, says strategy researcher Michael Raynor, author of the book *The Strategy Paradox*. He warns companies of concentrating on too few industries. Put all of your eggs in one basket, and you might lose them all if your core business stumbles into a crisis. “The strategic profile of companies that no longer exist today is shockingly similar to the profile of particularly successful companies.”

THE FIRST FINANCIAL BACKERS are, in any case, viewing conglomerates through new eyes. “Major shareholders, owners of large family businesses and private equity companies have become more willing to finance expansions into new industries,” notes Hauke Moje, “but they have high expectations.” They demand a profit margin of about 15 percent in these new business segments, within a period of just four to five years.

It is no surprise that private equity investors were the first to shift their thinking. That’s because today’s conglomerates don’t have much in common with their traditional counterparts. They are rarely interested in hanging onto the largest possible number of industries for as long as possible. Instead, they buy their way into promising markets and quickly cut ties with ventures that prove unprofitable. This strategy resembles that of private equity companies.

Other investors also will buy shares in diversified companies—if their strategies are convincing. The example of French conglomerate Saint-Gobain proves this point. Its stock value has tripled over the past five years. Investors are rewarding the company’s diversification strategy of recent years, but that strategy was something Saint-Gobain certainly had not practiced in the past. The company was founded in the 17th century, with emphasis on the production of glass and mirrors. For centuries it stayed out of other industries. But that all changed in the 1970s: Saint-Gobain merged with an iron-producing company and also purchased a company that manufactured insulation materials.

SAINT-GOBAIN’S DIVERSIFICATION accelerated in the 1990s as the company went into industrial ceramics manufacturing, glass containers, construction materials and pipeline construction. CEO Jean-Louis Beffa was responsible for the lion’s share of the company’s diversification. Since taking office in 1986, Beffa has been quick to purchase new companies. He always faced critics with confidence: “It’s better to have a mix of businesses with a strong cash flow to draw upon.” Success has proved him right. When Beffa left his job as CEO last spring, he produced record numbers as a parting gift, as it were.

Despite such positive examples, many investors fear that diversification could put pressure on stock prices. Researchers, however, have refuted this prejudice. “Diversification doesn’t destroy value,” states John R. Graham, a professor of finance at Duke University. He has studied the consequences of diversification on a company’s stock value finding that if companies expand into new industries under their own steam, there is no threat of negative effects.

APPARENTLY THAT APPLIES only to specific forms of diversification, as Julio Pindado has learned. The finance professor at the University of Salamanca has shown that each company has its own ideal level of diversification. “When companies diversify, their value increases at first,” he says. “But at a certain turning point the situation reverses itself.” Where this turning point lies depends on the type of diversification. If a company stays close to its core business industry, it can venture into new markets without suffering a decrease in value.

The story of Harold Geneen and International Telegraph and Telephone Company (ITT) is a perfect example of the problems excessive diversification can cause. After coming to power as CEO at ITT, Geneen began purchasing a variety of companies in the 1960s, and bought approximately three hundred of them within a period of 10 years.

It didn’t seem to matter which industry the companies belonged to—the main thing was that they were profitable. Geneen once declared, “I never met a company I didn’t find interesting.” After the strategy was freshly launched, ITT sparkled with big profits, thanks again to Geneen’s fundamental approach to business management, namely strict control of the finances and razor-sharp analysis.

Nevertheless, as the company grew larger, it became increasingly difficult to monitor and control. Profits started to tumble in the mid-1970s. When Geneen stepped down from his leadership position in 1977, his successors were unable to plug the holes. They sold off many parts of the business and split ITT up into three separate companies.

“COMPANIES NEED TO FOLLOW a structured selection process with clear criteria in order to successfully enter a market,” stated Moje, the Roland Berger expert. Approximately 80 percent of companies surveyed by Moje use benchmarking and industry analysis to determine whether a market is suitable for a new business venture. “Companies need to examine how mature the market is, how fast it’s growing and what kind of return they can expect. Then they need to analyze whether their core competencies can transfer profitably to the new market and how easily

they can recruit suitable employees. Moreover, it is crucial to choose the correct method of integration. Centralized management may make sense at the start, followed by a transition to a phase of more decentralized management.

If a diversification effort is successful, it can even enhance a company’s image. Daniel Beneish, a professor at the Kelley School of Business in Indiana, has demonstrated this idea. In a 2006 study he showed that “sin companies” such as tobacco giant Philip Morris, which bought food giant Kraft, to name but one, have managed to secure their positions against political attacks by purchasing companies in other industries that have a positive image, thus diluting their former perception as suppliers of nefarious products. RJR, another tobacco maker, notoriously acquired Nabisco, also a food group.

Tata, too, is a prime example of using diversification as an image factor. Its broad exposure keeps the Tata name in the mind of every Indian. To a certain extent, Tata is part of the family. That creates trust.

THE BOTTOM LINE: FIVE APPROACHES TO ENSURE SUCCESSFUL DIVERSIFICATION

1. Often growth in a company’s current core business is only possible by edging out the competition.
2. Diversification adds value. Returns often ended up higher than expected for most of the companies surveyed.
3. Investors’ willingness to finance diversification will continue to rise.
4. Enabler number one: a structured selection process with clearly defined criteria
5. Enabler number two: consistent integration, finding the right balance between centralized and decentralized management

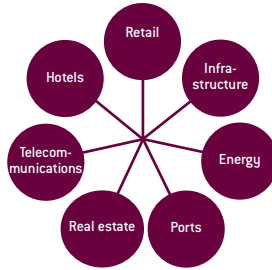
Broadened horizons

Six stories of growth and diversification



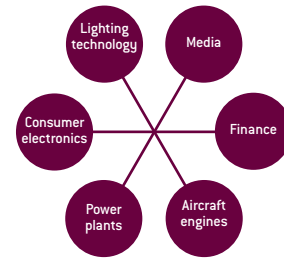
FRUIT, JAM, CREDIT CARDS

British supermarket chain J. Sainsbury began providing financial services to customers in 1997. Today the company offers savings accounts, credit cards, insurance and consumer loans in a joint venture with HBOS Bank. In this way Sainsbury hopes to strengthen ties with its customer base while becoming less dependent on the grocery industry, which is known for its low margins.



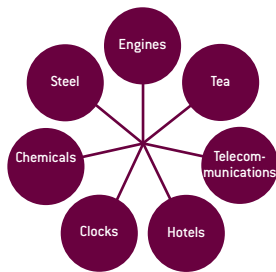
HARBORS, RETAIL, HOTELS

Hong Kong-based conglomerate Hutchison Whampoa was created in 1977 through the merger of Hutchison International and Hong Kong-based Whampoa Dock. Today the company's core businesses are port operations, real estate and hotels, retail, energy, infrastructure, and telecommunications. Truly a global concern, it has more than 200,000 employees worldwide.



LAMPS, POWER PLANTS, FINANCIAL SERVICES

General Electric (GE) is a good model of diversification. It sells household appliances and lighting technologies, but it also builds jet engines and power plants. GE also owns financial service providers and media companies such as NBC Universal. Management visionary Jack Welch led the company during the period from 1981 to 2001.



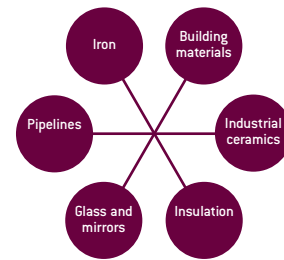
STEEL, TEA AND ENGINES

India's Tata Group is the subcontinent's largest industrial company. President Ratan Tata rules an empire of companies spanning widely divergent industries. Today Tata is one of the world's leading steel producers, but it also manufactures engines, clocks, chemical products and tea. Moreover, the Tata Group is also active in the hotel and telecommunications industries.



TROUSERS, JACKETS, CUTLERY

Spanish clothing manufacturer Inditex began producing textiles in 1973. It then began opening retail stores, and the latest tally amounts to more than 3500 of them. In addition to Zara, its original brand, Inditex has introduced several others. Today it also markets bedding, table linens, cutlery and glassware under its Zara Home brand.



GLASS, IRON, INSULATION

France's Saint-Gobain Group has its roots in glass and mirror production. Managers first diversified the company in the 1970s: They purchased an iron company and an insulation manufacturer, and became involved with industrial ceramics manufacturing, the glass container industry, construction materials and pipeline construction.

Fight imperial bosses!

Analysts can make mistakes, too—for instance, when they slap a discount on the value of diversified firms. Harvard economist Belén Villalonga discusses why the quest for broad-based corporations is gathering pace anyway.

THINK:ACT Professor Villalonga, why is it that the diversification strategy been less in favor in recent years?

BELÉN VILLALONGA *Perhaps because the failure of some of the acquisitions in earlier merger waves led observers to blame it on diversification—rather than on poor management.*

Is a rethinking happening in this respect?

Investor sentiment with respect to diversification has been swinging like a pendulum for decades. It hit one end in the late 1980s/1990s and has swung back since then. However, the underlying economics have not changed.

Which companies do it really well? Why?

General Electric is a classic example. Their skills are a combination of good selection (they only invest or stay invested in industries where they can be leaders) and value-adding management (their training and performance-evaluation practices ensure that their top executives are good general managers and able to transfer their skills from one business to another).

Which diversification strategies are popular today, and what is changing about the ways diversification is carried out?

Perhaps the most popular these days are the ones carried out by private equity (PE) funds. Their strategies include both related diversification (e.g., funds that only invest in infrastructure, energy or biotech, but with a broad portfolio of businesses in those areas) and unrelated diversification (what most PE funds do).

Are companies doing more related or unrelated diversification today?

I don't know the actual stats on this, but my sense is that most of the diversification happening through PE funds is unrelated, whereas most diversification happening within companies is related to some degree.

Are there companies that are more willing than others and more successful when diversifying?

Aside from PE funds, much of the world's diversification is housed within business groups from emerging markets like those in Asia and South America, and there are good economic reasons for it. In those economies where markets are often inefficient, business groups can create valuable internal markets for capital, labor and managerial talent.

The capital markets' discount on conglomerates is really an undervaluation. Why?

Undervaluation is just one explanation for the finding of a diversification discount—if there is indeed one. Stock market analysts tend to be specialized by industry. As a result, they are rarely able to understand diversified companies, and so they value them at a discount. In addition to this behavioral story, there are two sound economic arguments for the diversification discount: managerial empire-building, and managerial incompetence. In either case, shareholders are viewed as victims who pay the price of managerial abuse or errors. These arguments may indeed be true for certain companies; I just don't think that diversification, on average, is value-destroying.

Is that not an argument in itself *not* to diversify—because the stock markets make the rules?

Indeed, that explains why a great deal of diversification in the US today is carried out by PE firms, outside of public stock markets.



BELÉN VILLALONGA is associate professor of finance at Harvard Business School. She has been teaching there since 2001, having received her management Ph.D. at the University of California in Los Angeles, and is involved in executive education. She later went on to obtain a Ph.D. in business economics from Madrid's Complutense University.