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Myth versus reality

Setting the record straight on diversification as a business strategy.

Accountants and managers are often placed in the special position of giving the green or red light to diversification opportunities within a business. Unfortunately, because diversification has received a bad reputation in some circles, accountants are often left ill-equipped to address the issue – beyond a blind prejudice against any diversifying whatsoever.

This article seeks to set the record straight. Based on research I undertook for my book *Diversification Blueprint*, I've drawn up a list of issues concerning diversification – issues that accountants need to address if they are to fulfil their responsibilities as their organisation's promoters and protectors.

Myths, attitudes, practices – here's what I've learnt, based on sifting through 22 successful diversified firms across the globe to identify four that met a return on equity target of 14 per cent or more for each year over 10 years. I also reviewed three cases of diversified failures and two cases of focused successes.

Three lessons learnt

First, diversification is elusive. Everyone talks about diversification, and it's a topic familiar to most accountants. But what does it mean in practice? 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 business activity 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 diversified companies such as General Electric and Wesfarmers – as I'm sure their accountants 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. Diversification is the variation between businesses within a company. This variation can be by products or services (for instance, food versus clothing), customer type (eg, domestic versus industrial customers for washing machines), manufacturing processes (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 – skills, clients, processes, risk to life, etc, and because these differences are, in most cases, extreme, eg, patients versus shipping companies.

Second, diversification is widespread. Small and large businesses everywhere, as well as organisations in the public and not-for-profit sectors, are diversified. Yet the prevailing view is that focused firms, those that concentrate on a single industry, 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. Diversified firms are in the majority – diversification is widespread. Far from being freaks, diversified businesses are the norm.

Third, diversification does not mean 'di-worsification'. I have to admit that until I undertook my research 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, a company that ended up in antibiotics, spices and yeast. 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.

How to measure diversification success

It's important in evaluating alternatives – focused firm or diversified – not to get caught up in the prevailing orthodoxy, share market hype or media hysteria. These are often not informed by fact but fuelled by prejudice, special interests and rumour.

In researching businesses, I looked for a metric to identify successful diversifiers. I used in the main return on equity (ROE). While I fully recognise that there is no such thing as the perfect measure, ROE is widely viewed as a sound metric for assessing overall corporate performance. In the process I identified General Electric, Wesfarmers, Bidvest and ITC as successful diversifiers.

A change in perspective

If, as academics and accountants usually do, you take a head-office perspective on diversification and look from on high down to the diverse divisions of a firm, then

Reality checklist

1 Successful diversified firms set up clear systems and procedures and follow these strictly.

2 Contrary to common beliefs, more businesses are diversified than focused in their operations.

3 All business divisions need to build on key strategic factors to gain a competitive advantage.

the immediate issue becomes: how can I (head office) manage these different entities?

Let me throw you this one. Say your company runs a chain of hamburger stores and you want to diversify into women's 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. But look at it from the division point of view and you're forced to conclude that the success of one division is independent of the success of the other. From this point of view, whether a firm's diversifications are related or unrelated has no impact on division performance and hence company performance.

Seven key actions

There are seven characteristic steps undertaken by successful diversifiers:

- establish a supportive corporate centre
- select capable division managers
- install appropriate performance measures
- set effective incentives
- align the corporate culture
- secure competitive advantage
- buy well and integrate.

If accountants follow these they'll be well on the way to diversification success. Don't follow them, or just overlook one step, and your company may face failure; diversification will drag you down. For this reason, you can't dabble in diversification. Those who do get their fingers burnt, as I found out in examining the retailer David Jones.

Diversification gets the blame

Managers and the press are quick to blame diversification if a company goes belly up. You hear



it 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 organisations are diversified to some extent.

Learning from focused firms

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.

In reviewing McDonald's, Westfield and David Jones, what I found was a focus on stakeholders, especially customers and staff; a clear understanding of the strategic factors relevant to each; and strategies built around these factors that provided competitive advantage.

The message for diversified firms? Make sure your divisions and business units do likewise

and don't let head office get in the way by meddling in detailed division issues. The latter has been a problem for diversifiers in the past.

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 organisation, 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 key actions listed above.

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No guarantees of success

Successful diversifiers may stumble and fall. There are no guarantees in life. 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*, *Built to Last* and *Good to Great* 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 does eventuate, it will be because my successful diversifiers have violated one or more of the seven precepts.

In these uncertain times accountants would do well not to shy away from diversification. Their organisations should consider this option and not treat it as management's leper. Naturally, as we've seen, there are right and wrong ways to handle the issue, but turning a blind eye to diversification opportunities doesn't do an organisation any favours. ▀

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