Making diversification a winner for your business

How can you go about planning a successful diversification strategy for your brokerage? 

Graham Kenny reveals the secrets of successfully diversified organisations
Diversifying a business away from its core has its critics. Some say it's madness, others say it's the way to go. I've conducted plenty of research on successful diversified firms, which has been published in my book Diversification Blueprint. As a result I've reached a number of conclusions on why managers come to negative views on the issue, as well as how successful diversifiers achieve their results. Let me share a few of these with you in the hope that you'll be able to make diversification a winner for your business.

GET 'DIVERSIFICATION' CLEAR
There's a lot of talk about diversification, and not all of it is informed. Here's my definition of the concept, which should clarify where your company is situated on the issue. Diversification is the variation between businesses within a company. This variation can be by products (or services), e.g. food versus clothing. It may also be by customer type, e.g. domestic versus industrial customers.

Far from being the freaks, diversified businesses are the norm

The degree of diversification in your company 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. To take an extreme example, a company that is in mining iron ore and running a general hospital is highly diverse because of the degree of difference between service type, as well as the differences in other dimensions such as skills, clients, processes, risk to life, etc. Remember this definition when assessing how diverse your business is or how diverse you'd like it to be.

DIVERSIFICATION IS THE NORM
The prevailing view in business is that focused firms are the norm. This perspective holds that the world is made up of numerous, very focused, companies - and then there are these oddities called 'diversified firms'. This simply isn't the case. Small and large businesses everywhere are diversified. Organisations in the public and not-for-
profit sectors operate across a range of industries as well. Take your local council as an example and think of how many diverse activities it takes on, from road repairs to childcare. Far from being the freaks, diversified businesses are the norm.

**DIVERSIFICATION GETS WRONGLY ACCUSED**

When a diversified company goes belly up, managers outside the organisation as well as the press are quick to point out that being 'too diversified' was the cause. 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.

Avoid opinions that are often uninformed by fact but fuelled by prejudice, special interests and rumour.

In the course of my research I reviewed a case where diversification went horribly wrong. The press screamed 'too diversified'. The company was Burns Philp, which no longer exists. When I took an in-depth look at the business I found at least eight drivers of Burns Philp's corporate failure - and not one of these could be labelled 'too diversified'. I also concluded that each of these factors was powerful enough to cause major problems for the company. From the ultimate result we now know that the combination proved fatal.

**MAKE UP YOUR OWN MIND**

When you're evaluating whether to be a focused business or a diversified one, don't get caught up in the prevailing orthodoxy, share market hype or press hysteria. Avoid opinions that are often uninformed by fact but fuelled by prejudice, special interests and rumour.

Might I suggest that you cut through all of this by employing a metric that I used to identify the successful diversifiers in my research? It's return on equity (ROE). (Equity comes with other labels - shareholders' equity, shareholders' funds, net assets, net worth and book value - all highly confusing but they're the same thing.) ROE has been labelled the single most important ratio in business and is widely recognised as the measure for assessing overall financial performance.

**TAKE A FRESH LOOK**

It's important to be aware of how you view the issue. If, as academics and many managers 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's say that your company runs a chain of hamburger stores and you want to diversify into women's fashion as well. Your reaction is probably visceral - 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 - which is the converse of how diversified the firm is becoming.

I invite you to change your perspective. Look at it now from the division point of view. It looks like this: The managers of the two divisions, hamburgers and women's fashion, might say: "We know how to run our focused businesses, hamburgers and women's fashion, and we're quite successful at it. But - and it's an important "but" - in the case of the hamburger stores, our success in running them has nothing to do with the managers' success in operating the women's clothing stores. They're independent."

So from this point of view, how diversified a firm is has no impact on division performance and hence firm performance. It depends on the skills of the management team heading each division. Changing how you look at diversification has a huge impact on your approach to it as well as how you manage it.

**KEEP AN OPEN MIND**

It's worth remembering that a diversified company is really just a collection of focused firms. As you go on your diversification journey, keep an eye on your focused counterparts. There are lessons there for your diverse divisions and business units.

In my research I reviewed focused companies such as McDonald's, Westfield and David Jones. What I found in them was a focus on stakeholders, especially customers and staff, and a considerable amount of effort expended to obtain a clear understanding of the strategic factors relevant to
each; factors such as customer service and product quality for customers. These companies also built strategies around these factors for stakeholders to produce competitive advantage. The message for diversified firms? Make sure your divisions and business units do likewise.

**PULL THE RIGHT LEVERS**

My research identified seven characteristics of successful diversifiers, which I suggest you follow in your quest to make diversification a winner:

1. **Establish a supportive corporate centre**
   The emphasis here is on ‘supportive’. Avoid a head office that interferes in divisional management trying to run the division itself.

2. **Select capable division managers**
   Managers who know the industries of their divisions.

3. **Install appropriate performance measures**
   In Wesfarmers, for instance, a central focus of its corporate measurement is return on equity. All division measures are linked to this.

4. **Set effective incentives**
   This means motivate your staff through financial or non-financial means. In large companies this might entail some hefty bonuses – but bonuses are not a must.

5. **Align the corporate culture**
   As a CEO of a major diversifier put it to me: getting the culture right is essential, it’s difficult to establish and easy to destroy.

6. **Secure competitive advantage**
   By this I mean each division needs to focus on gaining an edge in its territory.

7. **Buy well and Integrate**
   This applies if you intend to diversify via acquisition. In short, don’t pay too much and after acquisition work hard on having new staff feel part of the total entity.

Follow these and you’ll be well on your way to diversification success.

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