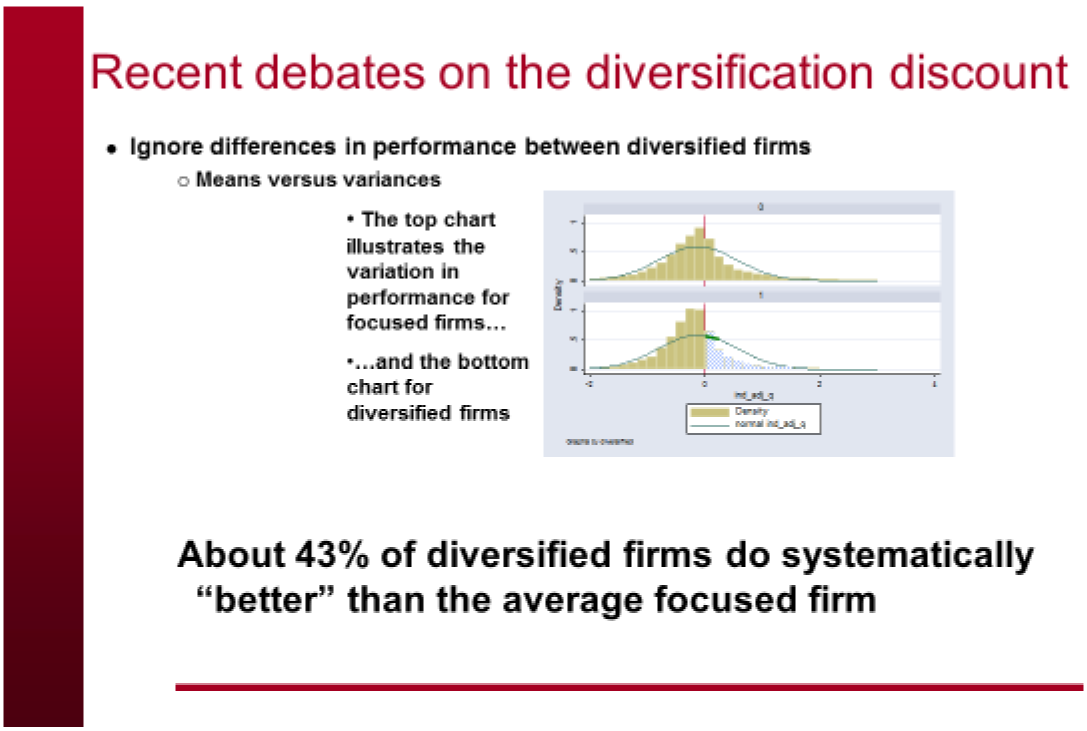
THE HARD PART OF EFFECTIVE CORPORATE STRATEGY

The practice of corporate strategy has been a failure. On average diversified companies destroy shareholder value. Many studies appear to validate the "conglomerate discount" demonstrating that the market capitalization of such companies is on average about 15% less than the combined value of their separate businesses – the so called "sum of the parts"[1]. And yet multi-business firms remain the dominant form of corporate organization in developed countries, accounting for about 60% of economic activity[2]. How can we improve a situation where so much economic activity is destroying value[3]. How can we improve the execution of corporate strategy?

We start by recognizing that the conglomerate discount is an average, not an absolute, effect. Detailed research shows that about 40% of diversified companies actually do create shareholder value (Exhibit)[4]! The problem is not that there is a law of nature which prevents such companies having effective corporate strategies, it is that the practice of corporate strategy is, by and large, very poor. We just need to show why that practice is poor and demonstrate how to improve it.



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[1]Berger, Philip G., and Eli Ofek. "Diversification's effect on firm value." *Journal of financial economics* 37.1 (1995): 39-65. We acknowledge that there are problems of reverse causation in the research and that there is also evidence of a diversification premium Villalonga, Belen. "Does diversification cause the" diversification discount"?." *Financial Management* (2004): 5-27

[2]Menz, Markus, Sven Kunisch, and David J. Collis. "The corporate headquarters in the contemporary corporation: Advancing a multimarket firm perspective." *Academy of Management Annals* 9.1 (2015): 633-714

[3] The arithmetic is that 60% of diversified firms which account for 60% of GDP are destroying value. This is roughly one third of economic activity.

[4] Anand and Byzalov 2019

To achieve this, we separate corporate strategy into two, discrete, although related, components. First is the assembly of the corporate portfolio of businesses. Second is the ongoing management of that portfolio. And the latter is more important. While it has a less immediate impact on corporate performance than portfolio transformation, it is ultimately how the value inherent in any set of businesses is realized over the long term. If choosing the scope of the corporation defines its strategic potential, the harder task of managing the corporation determines the success of its execution.

Sadly looking to create shareholder value by altering the corporate portfolio, while an important part of corporate strategy, features too prominently in many CEO's actions. Making an acquisition, spinning off a business, championing a disruptive business model, are levers directly under the control of chief executive. As one of the few initiatives a CEO can undertake that "moves the dial" in a substantive way, portfolio reconfiguration becomes a favourite tool of the CEO[5].

The propensity to use the lever is compounded by ready access to advice from those with a vested interest in completing a transaction – investment bankers, activist shareholders, consulting firms, lawyers, and private equity. Each can articulate a good reason for expanding the portfolio - often only to advance equally good reasons to shrink the portfolio. The classic example was the AOL Time Warner merger. This was lauded at the time by the same set of outsiders who later lobbied to split the company apart – often by simply reversing their previous argument, so that merging to exploit scale economies in corporate overhead, miraculously morphed into an argument that separate and specialized companies would actually be able to reduce overhead cost![6]

Similarly, seeking to find the optimal scope for the corporation has long been a subject of the academic literature[7]. Much empirical research and many review papers have sought to describe the relationship between the extent of diversification and firm performance[8]. At best these have found an inverted "U shaped" relationship.

But there is no single optimal level of diversification for all firms. Nor is there one right corporate strategy. Rather there is an underlying logic that delivers effective corporate strategy for any scope provided there is fit between that portfolio and the corporation's organisation structure and administrative systems[9]. This suggests the way the portfolio is managed is ultimately the key to success, regardless of scope.

BOX

The strategic logic that justifies the expansion of corporate scope identifies a company's valuable resources – its distinctive and competitively superior set of assets and capabilities[10]. When

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[5] This is not to deny the value of proactive resource allocation among businesses – see later

[6]AOL/TimeWarner: To Merge or Demerge?" HBS Case # 707-556

[7] Merely asking the question won Ronald Coase the Nobel Prize in Economics

[8] Refs to studies and review papers from Rumelt onwards see Rumelt, Richard P. "Diversification strategy and profitability." *Strategic management journal* 3.4 (1982): 359-369.

[9]Collis and Montgomery, Corporate Strategy: Resources and the Scope of the Firm. Burr Ridge, IL: Irwin 1997

[10] If any. Resources can vary from being assets to liabilities and many firms do not possess any resources that are competitively superior Leonard-Barton, D. "Core capabilities and core rigidities: A paradox in managing new product development." *Strategic management journal* 13.S1 (1992): 111-125.

deployed in businesses in which those resources improve competitive advantage – if they make the business unit "better off" by reducing cost, raising willingness to pay, or increasing volume – it is value creating to diversify into that business. To justify internalizing that business within the corporate hierarchy rather than capturing the value through a market contract (as Disney licenses Mickey Mouse to a toy company rather than owning a toy company itself), there also have to be lower transaction costs inside the organization[11] - the "ownership" test[12].

END BOX

Examples abound of companies that do this effectively from the Walt Disney Company, which leverages its franchises, from Mickey Mouse to Woody and Darth Vader, across multiple platforms from movies and toys to theme parks and video games, to Danaher which deploys the Danaher Business System in acquisitions from dental drills to water treatment[13].

But the optimal scope of Disney is not going to be the same as that of Danaher, or of a private equity firm, or a FMCG firm, like Clorox. All have their own limit to expansion, and each requires the appropriate organization structure and management processes. Yet this aspect of corporate strategy has received much less attention.

To provide pragmatic guidance for the design and administration of the corporate structure, systems and processes, we introduce a CONTINUUM OF EFFECTIVE CORPORATE STRATEGY. Strategy is about fit and consistency, and the continuum illustrates how to align the governance of the corporate portfolio according to the resources which underpin value creation across that portfolio. It concerns the appropriate size, roles, responsibilities and authority of the corporate parent (Exhibit).

While not definitive, that continuum is arrayed along a dimension that loosely summarises the entire corporate strategy – the degree of product relatedness in the portfolio. At one extreme is a mutual fund that can own any stock, regardless of the product or service it delivers. At the other extreme would be a single product entity or a vertically integrated manufacturer. In between are corporations arrayed from private equity partnerships, through "conglomerates", to diversified firms within a broad sector, like Disney in family entertainment and, at the more related end of the continuum, a company like Clorox that historically only competed in "middle of the grocery store, mid sized" products.

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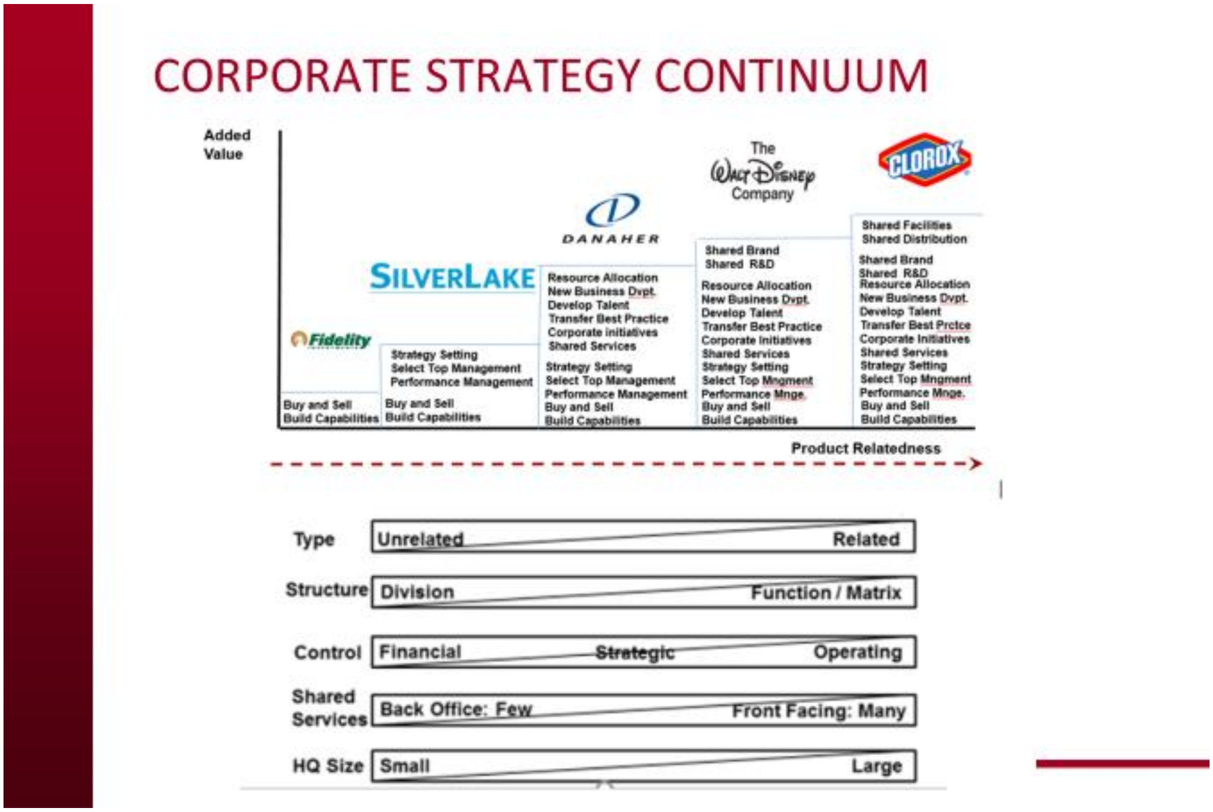
[11]Williamson, Oliver E. "The economics of organization: The transaction cost approach." *American journal of sociology* 87.3 (1981): 548-577

[12] Piskorski, Mikolaj Jan. *Note on corporate strategy*. Harvard Business School Publishing, 2006

[13] "Reawakening the Magic: Bob Iger and the Walt Disney Company" HBS Case # 717-483 and Danaher Corporation" HBS Case # 708-445



Note that there is not one best corporate strategy. Any strategy along the continuum can be successful provided that the corporation adopts the organizational practices appropriate to its location. BCG, for example, argues that even if the added value of performing more activities towards the right hand end of the continuum is potentially higher, so too are the costs associated with intervention in the independent operation of the businesses[14]. This reflects the classic centralization/ decentralization tradeoff. The greater the autonomy granted the operational units, the more entrepreneurial and accountable for performance they can be. However, it leaves money on the table as possibilities for cooperation and synergy are overlooked. Danaher, the US most successful conglomerate, for example only recently introduced a shared purchasing function. At the other extreme, if there are shared activities, there is less accountability for a business. Ciba-Geigy at one time had a matrix structure that left only 40% of the cost of a business under each unit's direct control.

As the management tasks increase along the continuum, other elements of organization design have to be aligned so that, for example, the structure of the entity will vary from discrete operating units through to a functional organization or perhaps a matrix structure. If there is very little that is shared between the product divisions, there need not be any organizational overlap. In

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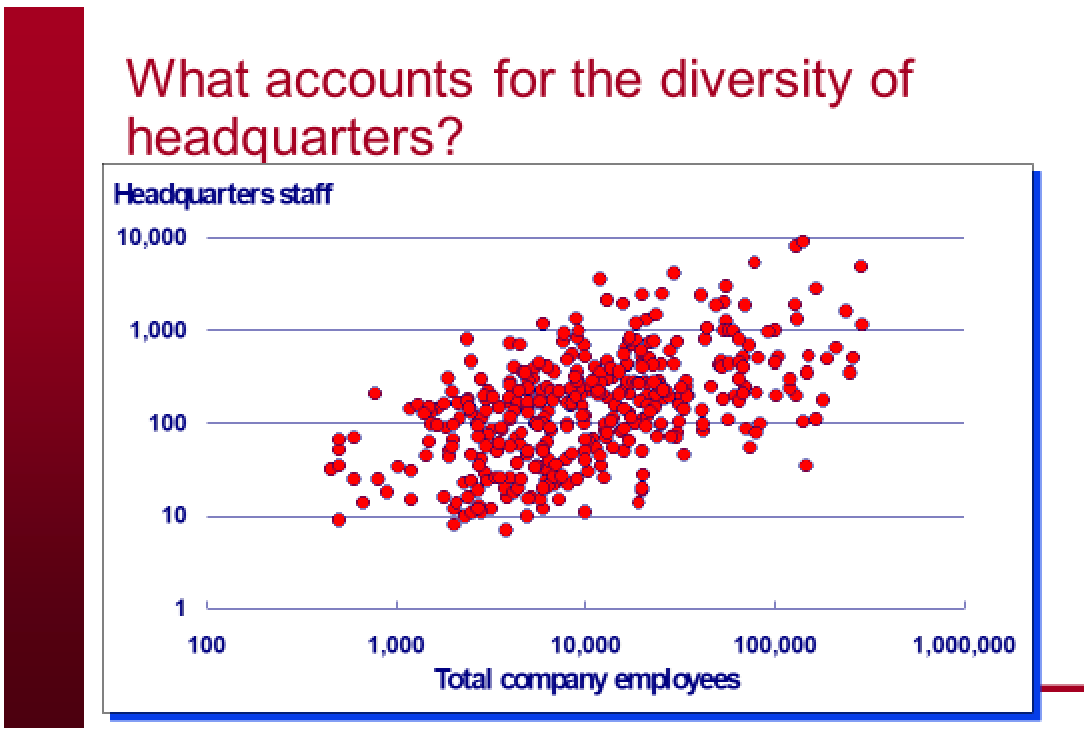
[14] M. Krühler, U. Pidun, H. Rubner: *First Do No Harm*, BCG Report, March 2012

contrast, when there are many activities in common, the need to integrate shared functions overwhelms the advantages of differentiation[15].

This explains why there is such a range in the size of corporate headquarters (Exhibit). There is not one right size of headquarters since that depends on what roles headquarters has to fulfill. At 10,000 employees, a successful financial services company with a large IT function might employ 1,000 people at headquarters (it is located at the right end of the continuum), whereas a successful private equity firm might employ 10 professionals (at the left hand end of the continuum). The variation in the size of headquarters is to be expected[16] since the tasks for headquarters become more demanding as the strategy shifts to the right of the continuum.



To illustrate how to consistently implement a corporate strategy anywhere along the continuum we examine the organization design levers the CEO has available, and which cumulate from left to right along the continuum (Exhibit).

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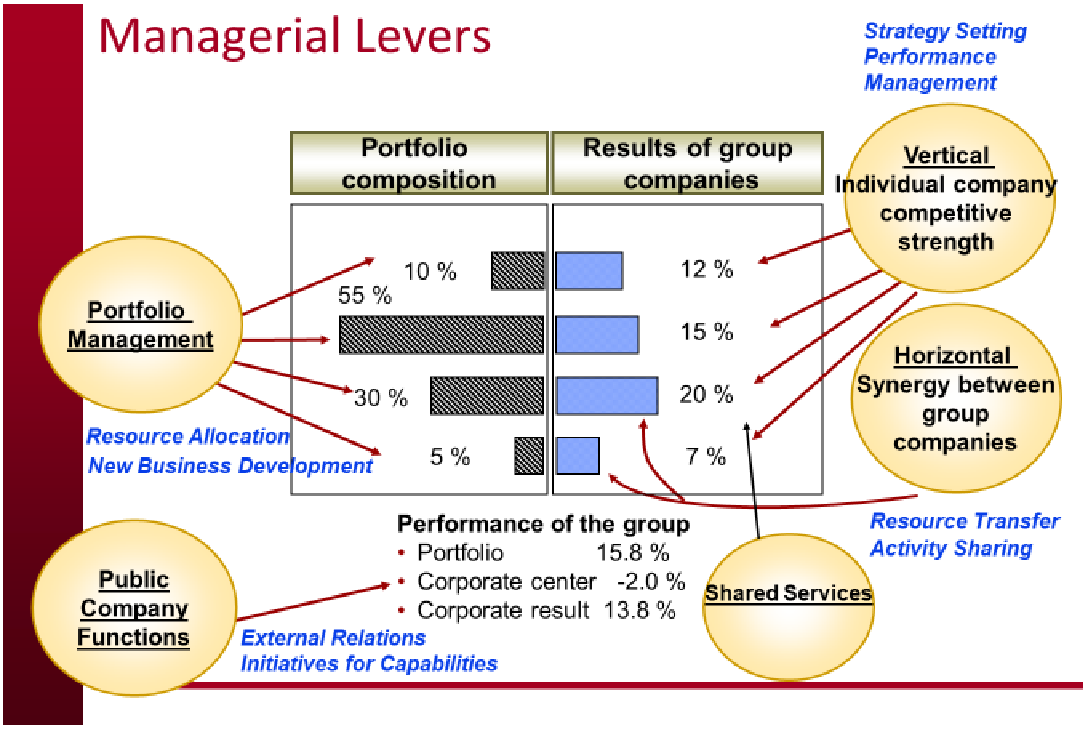
[15] Lawrence, Paul R., and Jay W. Lorsch. "Differentiation and integration in complex organizations." *Administrative science quarterly* (1967): 1-47

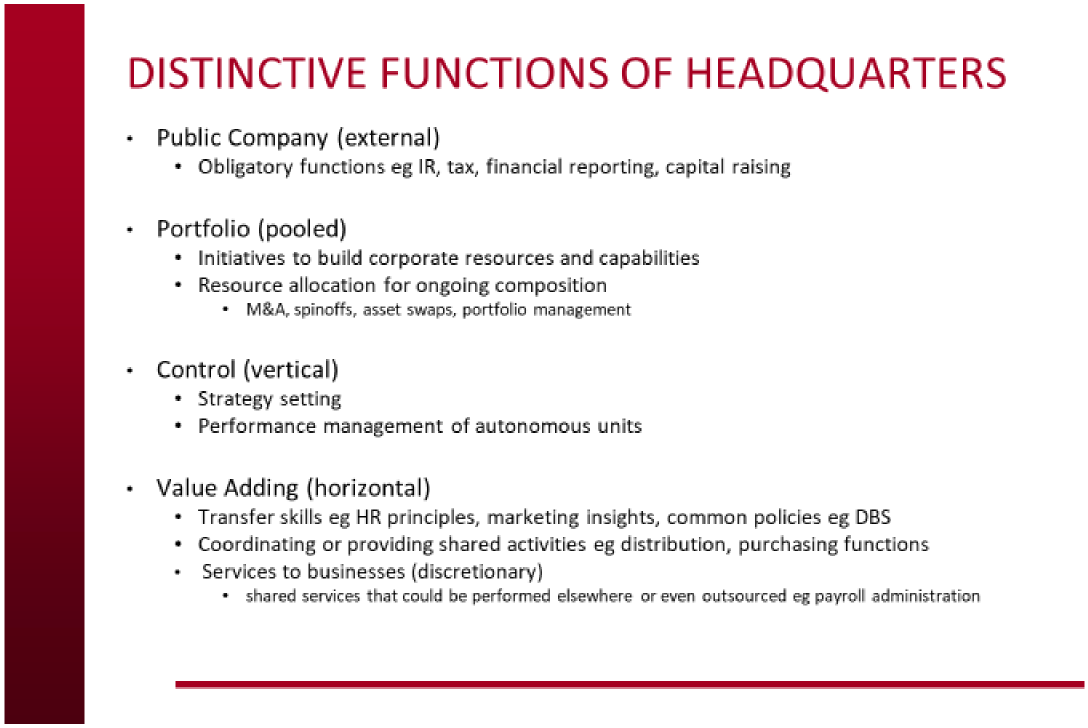
[16] Goold, Young and Collis Corporate Headquarters: An International Analysis of their Roles and Staffing", London: Financial Times\Prentice Hall 2000.



All corporations have to perform the obligatory functions required of a legal entity – tax and financial reporting, investor relations, regulatory filings etc. Similarly, all corporations have to develop a unique set of resources or capabilities that underlie value creation across the portfolio. A mutual fund needs a distinctive approach to stockpicking; a conglomerate needs a unique operating system, like DBS at Danaher. Thus every corporation has to pursue initiatives to invest in such resources – as Disney invests in high quality branded franchise content.

The levers used to exploit those corporate capabilities start with the decision to buy and sell businesses (the only decision that is made by a mutual fund) and includes resource allocation between independent businesses; adds a set of processes designed to improve the performance of each discrete business (which involves the VERTICAL relationship between headquarters and businesses); includes the transferring of skills, like talent and best practices, across businesses; before culminating in sharing activities to benefit from synergies among the business units (which requires HORIZONTAL relationships across businesses).

How much more difficult the managerial task becomes, as the strategy moves from left to right, should be apparent with this framing.



So how do we use the levers in practice? Let's start from the one that all corporations have to employ – the minimal corporate headquarters (EXTERNAL) including financial reporting, external relations, including capital raising, and responsibility for oversight of the individual businesses by corporate executives – and for which all seek to minimize the cost. Perhaps surprisingly, this can be done with a very small office – thirty people for even a 20,000 person company. Just look at private equity firms that control entities employing hundreds of thousands with a tiny staff - Silver Lake, for example employs 400,000 in their portfolio companies, but only 150 professionals itself. Benchmarking this is possible with the intent to build a lean headquarters that has minimal interference in the operation of the businesses[17].

Similarly it is the role of the CEO to drive corporate initiatives that ensure adequate investment is being made in the unique corporate capabilities that underpin value creation in the enterprise. Only the CEO has the line of sight and responsibility for the overall investment in those resources. Bob Iger, for example, committed to producing high quality branded entertainment content as the key to creating value at Disney.

Second is the POOLED portfolio management role. This includes radical restructurings through M&A, divestment and spinoff we suggest are overused because the CEO can so easily pull that lever with the expectation of a dramatic and immediate impact on performance. More relevant because it is a requirement for managing the corporation is the ongoing allocation of resources between units in the portfolio. Typically this involves the annual allocation of capital between units, although in most companies that use some form of portfolio management (68% in one survey) based on the original

[17] Goold et al op cit

BCG growth/share matrix or its derivatives, such as the McKinsey grid, this also includes allocation of talent and attributing different performance objectives to different business units[18].

Third are VERTICAL relations with each of the business units. These includes strategy setting and performance management processes. It is here that there is a profound distinction between the two ends of the continuum. At the private equity end, outcome control is practiced with financial metrics. At the related end of the continuum, it is behavioral or operational control[19]. When the portfolio can range from radio stations to bakeries, a small headquarters staff do not have the insight, experience or dominant logic to evaluate anything other than performance relative to prespecified metrics. Any variance and any risk has to be borne by business unit management. In contrast, when corporate management have had a long exposure to very similar businesses and have operational experience in those businesses, they can evaluate performance from the perspective of the actions taken by unit managers. At Clorox, for example, corporate management can study daily reports of sales through channels of distribution.

Fourth are exploiting potential synergies across business units. Those can usefully be divided into transferring resources (such as a brand) skills or knowhow (such as the application of DBS at Danaher, or the best practices developed by a corporate centre of excellence) between otherwise independent units; and those that come from sharing activities which requires active coordination between units and so involves tradeoffs. Importantly, the former can be realized towards the left of the continuum, while sharing activities only become salient at the right hand end of the continuum. As the strategy becomes more related, the value of sharing activities, such as the supply chain at Clorox, increases and so does the type and size of the function at headquarters.

Last are shared services, from basic activities that might benefit from scale economies (and might even be outsourced to third parties), such as payroll processing, to a common supply chain organization that supports a range of product divisions, such as at Clorox.

For each of these activities a key question concerns the relationship between corporate headquarters and the operating units – the extent to which the former has authority over the latter. Those vary from acting as a "policeman" with full authority to mandate behavior in every business unit, such as for cash management or safety, health and environmental compliance; through "partnering" as a coach or consultant to the business units, as in a corporate centre of excellence that develops but does not compel adoption of certain best practices; to "provider" as for shared services where the business unit is "in charge" and can negotiate a Service Level Agreement, or even go outside the corporation if desired.

Critical to effective management is for corporate staff to understand which role they are playing as they interact with business unit executives. Elements of the task of any corporate function

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[18] "Corporate portfolio management: Theory and Practice" Journal of Applied Corporate Finance

[19] Eisenhardt, Kathleen M. "Agency theory: An assessment and review." *Academy of management review* 14.1 (1989): 57-74 and Strategies and styles: The role of the centre in managing diversified corporations: Michael Goold and Andrew Campbell, Basil Blackwell 1987

can fall into all three categories and success requires knowing what role to play. The HR staff, for example, may be a "policeman" when succession planning for the top 100 executive; "partner" when setting the structure (but not the level) of compensation packages; and be a "provider" when administering a corporate 401K platform.

ROLES OF THE CENTER

Corporate Functions	Number of FTE's	Role	Typical Activity	Assessment Methodology
CORE "POLICEMAN"	# # #	Guardian: Compliance and Authority	Examples: • Corporate executives • Financial reporting • Mgmt Reporting	• Measure against external benchmarks and statistics
VALUE ADDED "PARTNER"	# # #	Advisor: Education of Client	Examples: • Human Development • Strategic Planning • Business Development • Globalization •Innovation	• Develop a strategy statement for each function • Measure performance against the deliverable
SHARED SERVICES "PROVIDER"	# # #	Implementer: Order Taker Service to the Business	Examples: • IT •Pension Administration	• Develop a service-level agreement • Use a "market test" (likelihood of being outsourced)

The most important lessons for the development of an effective corporate strategy is not to agonise about optimizing the scope of the portfolio, but for the CEO to know where along the continuum she wants to firm to be, and then to align the organizational levers to fit with that location. And that location can vary over time. Maersk, the Danish shipping and logistics company has made two moves along the continuum in the last twenty years[20]. Under Nils Andersen a tightly integrated and centralized company was moved to become a "Premium conglomerate" (a move to the left along the continuum). This did involve some portfolio restructuring but mainly focused on moving to an independent divisional structure (including arms length agreements between the shipping line and the container terminal business) with a substantially reduced role and size of corporate headquarters. Under his successor, Soren Skou, and once the portfolio had been focused on the shipping and logistics businesses after the divestment of oil and gas (a move to the right), the business units were reintegrated and the corporate staff roles increased. Both moves were successful, because both understood the need to align structure, systems and processes, however hard the execution might be, with the choice of overall corporate strategy.

[20] Group Functions at the Maersk Group" HBS Case # 715-432