Role of the Board in managing Diversified Business

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> *"Being a conglomerate, each of our businesses has a different **challenge**; business landscape is different for each business. It makes it **challenging** as well as **exciting**."*
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> ***— Mr. Kumar Mangalam Birla, Chairman, Aditya Birla Group***

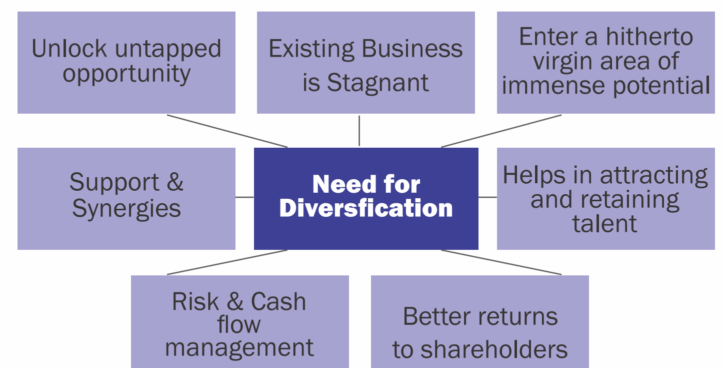
In today's dynamic and unpredictable corporate world, the Board realises the importance for the companies to be more agile and continuously evolve in order to grow and maintain competitive edge. Boards need to constantly review and monitor their business position and accordingly adopt corporate strategies that fits the best which may include introducing new products and services, expand, vertically integrate, consolidate, divest or enter into new business altogether. Many of the executives and board members firmly believe that diversifying into unrelated industries reduces risks for investors or that diversified businesses can better allocate capital across businesses.

Diversification is one of the choices for companies to develop and create value. Mr Fujio Mitarai, Chairman, Canon said "***Diversification and globalization are the keys to the future***". Also, when company's opportunities for growth in their existing businesses deplete, they strategize for diversification into different line of business. It is natural that a financially solvent company will move to the segments of market providing more opportunities from the existing segment of operation where opportunities are becoming restrictive. This diversification essentially can offer a financially solvent company, a competitive advantage over their competitors and help enhance their market share.

During most of the 20th century, the majority of conglomerates were created under the licence-quota raj after independence. Some of the business houses snapped up the opportunities and this gave rise to the growth of the businesses across unrelated sectors of the economy leading to the early conglomerates in India. Some have adjusted, while the others have either disappeared or may do so unless they change how they conduct business.

Through this article, we aim to focus primarily on Unrelated Diversification (Conglomerate) which is one of the forms of diversification when the business moves to new or unrelated product lines and reach out to new markets beyond its current capabilities. There is no direct connection with the company´s existing business and is described as conglomerate strategy. The Board of the company aspires to achieve competitive advantage by allocating capital internally and use it efficiently and utilize the market opportunities for better cash flows and revenue. This is essentially an alternative initiative of the company to achieve capability to deliver better internal capital and labour resources than externally available to its competitive advantage.

Need for Diversification



- **Unlock untapped opportunity**: A scenario, wherein an opportunity exists in the market space which remains unexplored or has not been fully exploited yet.

  For e.g. In the 1970s, times of 'License Raj' in the country, Shri Aditya Vikram Birla recognized constraints of further growing the business in India. Unthinkable in that era, he foresaw huge market potential in the South East Asia, and undertook the challenge to move in successfully into countries of Thailand, Philippines, Malaysia and Indonesia and into products as diverse as synthetic yarns, viscose staple fibre, carbon black, palm oil, acrylic fibre and chemicals.

- **Existing business is stagnant**: New technologies/ substitute products may have made the existing domain stagnate or may become unviable in the near future. Diversification may work as an insurance to remain healthy and viable.

  For e.g. Chairman of one of the major auto manufacturers asked his team to scout for opportunities beyond his group's auto business. Among the pitches he received was one for a time-share-based hospitality business. Back then, time shares in India were associated with shady operators and had a bad name. Company sensed an opportunity and invested seed capital in the business. Today, its hospitality business is one of the major pillars of the group. It has built a base of more than 150,000 members today, delivered high levels of service and wiped away the sector's unsavoury image in the country.

- **To enter a hitherto virgin area of immense potential in the future**: With cash coffers swelling in corporate treasuries, companies expand into non-core businesses citing huge growth potential.

  For e.g. each one of Elon Musk's endeavours is paired with a vision and mission more ambitious and far-sighted than the last. His vision for Tesla involves a future of completely sustainable transportation that will leave internal combustion engines behind, while his Hyperloop vision sees customers travelling around the world in a fraction of the current possible time. Meanwhile, perhaps his most ambitious vision is for SpaceX, which imagines people traveling to and from other planets making our species multi-planetary.

- **Better returns for shareholders**: Utilize surplus or retained cash for a higher rate of return through moving into more attractive areas.

  For e.g. one of the prominent players in the Pharma space, divested the business in 2010 and even though there was an intense pressure to return the cash to the shareholders. He went onto invest in various potential businesses over the six years and created more than 40% annual [market] value year on-year and beaten every index. Thus, he envisaged how best value could be created for the shareholders.

- **Risk & cash flow management**: In a diversified, portfolio risk is distributed among multiple businesses. Cash cow stagnant businesses can fund new potential businesses thereby mitigating the risk for a new business to fail. Also, volatility in one business can be hedged from other stable businesses. Due to huge cash flows and reserves, funds could be mobilized from internal resources and international capital market at very competitive rates. And hence, well-diversified companies are in a better position to sustain growth across business cycles. If one business segment slumps, the company's presence in other segments can lend stability to its earnings.

  For e.g. For a major tobacco player, the stable tobacco business provided steady cash flows which allowed it to foray into highly competitive and price sensitive FMCG sector.

- **Support & Synergies**: Diversified conglomerates can invest in information and technology across businesses and have common standard strategic management initiative of the group to improve synergy and to create strategic fit under the group providing competitive edge for the businesses. The synergy between the group companies under central strategic control provides opportunities of learning from different group businesses and implement in their own businesses to improve their performances and create competitive advantage by being the first movers in the market.

- **Help in attracting and retaining talent**: Large conglomerates operating in diverse businesses offers scale and brand value that appeals to varied talent pool. Also, it provides an opportunity of wide-ranging learning and development that helps in advancement of their career. Many such companies also have platforms that allow employees to shift to different roles among businesses, hence keeping them more engaged and motivated.

Challenges in Managing Diversified Business

- **Skill set**: Skills needed to run the diversified entity may be different and at variance with the parent entity. Diversification poses a challenge to the managerial skills/aspirations of managers. It provides an opportunity to exhibit personal mettle at the same time, it requires managers to be open to learning and quick at adaptation. Each business requires different skill sets provided by professionals & supervised by an independent board of directors. The common thread running through such diverse business is the ethical and governance standards of the corporate parent. Diversification is risky. It entails *decision risk* (choice & means of diversification may be wrong), *implementation risk* (structure, processes, systems, leadership, talent may be inadequate)

and *financial risk* (the return to stockholders may be considerably reduced.

- **Aligning values & goals**: In unrelated diversified company, various businesses might carry different values & goals. Alignment might get difficult if lines of business are totally different. For e.g. a major tobacco company which also has a highly successful FMCG business. The two businesses cater to a very different customer base. Thus, it becomes a daunting task for the Board to devise strategy that aligns with the values & goals of each business.
- **Spread too much; too thin**: Many times, when companies spread out much beyond their core competencies, it can lead to problems, especially if the management does not possess the execution capabilities to run those businesses. This is called non-core diversification.

  Without a proper strategy in place, such diversification can weigh down the company's core business as well. Often, the stronger core business ends up subsidising the weaker peripheral businesses. This is the reason investors and shareholders need to be circumspect when a company is planning to diversify. Head of research, of one of the prominent companies says, "If the core business is weakening and the company still tries to diversify in unrelated areas, it poses a big risk." Just because a company has deep pockets does not mean it has the expertise or capabilities to run multiple and diverse businesses. While there is an opportunity cost to having excess cash, spending it on such ventures, without proper strategy and skill sets, can prove far costlier for the company.

  For eg. A major Real Estate Developer made a foray into the malls and entertainment business, chalking out major sum for amusement parks and entertainment centres. Further, buoyed by a strong cash flow, it expanded into telecom. Company envisioned; this would add value to the group. However, due to various issues emerging in telecom sector, it was forced to sell its entire stake in the telecom business. Faced with a huge debt burden, the group has gone on a chopping spree, selling everything, including hotel properties, school plots and its sprawling 2 million sq. ft. headquarters. Its financial health has improved considerably since its exit from the telecom business.

SWOT Analysis

SWOT analysis of 'Strategies of unrelated diversification' can lead the company towards making effective and wise business strategies. The scanning of internal environmental can help an organisation to identify its core strengths and weaknesses. Whereas, scanning of external environmental can help the organisation to identify opportunities and threats that must be considered to ensure long-term business survival.

- Some examples of internal factors (strengths/weaknesses) are- leadership competencies, intellectual property rights, locational advantages and geographic presence.
- Some examples of external factors (opportunities/threats) are- customers' changing tastes and interests, competitive trends, inflation and population growth.

'Strategies of Unrelated Diversification' can use the SWOT matrix as under to exploit the opportunities and minimise the threats by leveraging its strengths and overcoming its weaknesses:

	Strength	Weakness
INTERNAL	• Steady profitability & cashflow in all circumstances • Stronger Brand image: Wider scale • Economics of Scale: Better cost structure • Diversified workforce: Sharing knowledge, learnings & skills • Common support services: Leverage IT & R&D platforms • Risk: Hedging risk from cyclical business	• Less focus on a particular business • Resource allocation: Cash flow from profitable & potential business supporting unprofitable non potential business • Aligning workforce for common values and goals • Opaque accounting and/or inability of the headquarters to cope with different businesses
	Opportunity	**Threat**
EXTERNAL	• Sharing of supply chain: Vendors, service providers, distribution network, customers • Better bargaining power with external partners especially with banks for credit • Edge to scale up faster over single business competitor	• One of the business's poor performance or misconducts or failure to adhere to applicable regulatory or governmental norms impact company's brand image with external partners and stakeholders

Managing a Well-Diversified Business

Diversification has its own advantages and disadvantages which are more in control of the management and type of diversification i.e. product diversification or business diversification than to external forces as the skill sets required in a diversified company is totally different than compared to the focused companies. Board recognizes that it is possible to create superior value with carefully thought out diversification strategy that caters to the needs of the market. The key

leadership attributes *(as seen in a BCG article - "Managing for Value – How the World's Top Diversified Companies Produce Superior Shareholder's Returns" – Dec'06)* to manage a well-diversified business are as under -

- **Efficient capital allocation**: Board of a well-managed company, on an average, invest significantly more in profitable units than the underperformers, that is to say an asset allocation decision is a prerequisite for value creation. They also more systematically fix or divest unprofitable, value destroying units and progressively shift a higher proportion of their assets toward their value creators over time.
- **Clear and consistent portfolio strategy**: Top diversified companies also approach acquisitions and disposals more systematically and decisively, indicating a clearer strategic orientation than the underperformers. Board of such companies are either very active, buying and selling units in roughly equal proportions by value, or they adopt a relatively passive position, content to concentrate on their existing units.
- **Well-defined organization structure with clear responsi bilities**: Larger issue in failure of companies or its business segments points towards the potential pitfall of having a complex organisational structure with crossholdings between various group entities. Add to this a quest to raise capital for shoring up its holding in group companies, thereby getting greater dividends and protecting them from attempted hostile takeovers, which has led to a complex web of cross holdings, which is confusing to say the least. One of the reasons conglomerates are getting a bad rap is because of the sheer complexity of holdings, typical in most Indian conglomerates. Though, one of the prominent Indian conglomerates having businesses from Edible Oil to Ports, have taken a different path. They function with a simple structure; every compan operates a different business which makes it crystal clear for the investor community.
- **CEO-Driven Management Initiatives**: Top diversified Companies often single-mindedly pursue one management initiative at a time and ensure it has top- level support. Each initiative is repeatedly communicated throughout the organization and is championed by one unit supported by a cross-functional implementation team.
- **Management Development and Skills Transfer**: The top players often rotate senior executives and technicians supported by financial incentives among business, functions, and geographies in order to transfer skills and best practices.
- **Other Levers**: Strict corporate governance, transparent reporting (notably reporting by segment); optimization of tax and financial advantages; a rigorous value-management system; and capital market guidance, not subservience. If the diversified companies pull the right levers at the right time, they not only can generate higher shareholder returns but also can avoid the distracting and often unwarranted calls to focus on fewer businesses.

Conclusion

We are all aware of the famous saying: "*Don't put all your eggs in one basket*." The same applies to the fact that when the company operates in one single business it exposes itself to various risks that come with it. On the contrary, for a diversified company running various businesses, the downs in one can be compensated by the ups in another. A properly managed diversification offers profitable potential beyond the core that can significantly improve shareholders value. Thus, diversification has its own 'pros & Cons' which are more in control of the management and therefore it becomes imperative for the Board to back such long-term diversification strategy that has a strong business model and sustainable competitive advantage. ■

> "Companies will need to pursue a more diversified business model, but I think those companies that have what I call a focused diversified business model will be more successful."
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> \- **Kenneth Chenault**
> Former Chairman, American Express

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