

Manager Update

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A quarterly summary of topical management ideas, focusing on four key issues.



**Faculty of Finance
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Manager Update

... is produced in parallel with the Braybrooke Press publication of the same name.

Manager Update helps the general manager keep abreast of the latest articles in specialist management journals. The most useful ideas in the fields of strategy and organisation, marketing, accounting and finance, and human resources management are carefully selected from a wide range of publications with the busy general manager in mind.

Experts in each field explain and discuss the relevance, practicality and usefulness of the key new concepts and ideas, thus enabling the senior executive to keep really up-to-date.

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The Faculty committee intends that **Manager Update** will act as an aide-memoire for members, provide new ideas, and encourage good practice, but cannot accept responsibility for their accuracy or completeness. Responses from the membership will be a very important part of the successful development of the series.

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Assessing the real value of brands

The financial success of many businesses is said to lie in the value of their brands. But how can managers put a financial value on their brands and those of other businesses? **Roger Mills**, professor of accounting and finance at Henley Management College, reviews the latest methodologies used to value brands in financial terms and identifies their strengths and weaknesses.

Brand valuation would, you might think, more typically appear in the marketing section of *Manager Update*. It is, though, an issue of concern to both marketing and finance specialists, even if the focus of attention for the two can be very different. "Among the many disciplines in business, few have so antagonistic a relationship as marketing and finance", says Knowles (2003)¹, who argues one major source of friction is that each discipline uses the same words to mean different things. This is particularly the case, he says, in terms of brand valuation and the use of the term 'brand equity'.

Whereas the marketing professional seems to use the term to describe the strength of the brand with its customers, the financial professional more typically uses it to characterise the brand as an economic asset. In theory, though, the two perspectives should be compatible: a brand cannot realistically deliver premium margins unless its customers hold it in high regard and strong brand health must relate to the ability to drive growth through customer preference.

In practice, however, Knowles argues it can be extraordinarily difficult to evaluate the connection between many of the most popular marketing metrics and financial performance.

The concept of brand equity has developed over the last decade, but, as we shall argue, a clear way to value brands remains elusive (Aaker, 1991, 1996²; Keller, 1998³). Several approaches are available to managers, but it is still uncertain which approach is best (Kapferer, 1997)⁴.

Why value brands?

Many writers have acknowledged that capital is now less of a constraint on businesses than in the past and that physical assets can be replicated with ease. Now, the emphasis is more on how capital can be used creatively to differentiate the organisation from competitors (Drucker, 1998)⁵. Many analysts, for example, have argued that differentiation (and increased shareholder value) can stem from 'intangible' assets like brands. In fact, two pieces of research provide powerful evidence of the impact of brands on shareholder value.

The first, by Madden et al (2002)⁶, demonstrated the impact of brands in both increasing earnings and reducing their volatility.

The second, by the company BrandEconomics LLC, is reviewed later. It has combined the BrandAsset® Valuator (BAV) brand health database (developed and maintained by the corporate research group at Young & Rubicam Inc) with the Economic Value Added (EVA®) database developed and maintained by Stern Stewart & Co. Importantly, ascertaining the correct brand value should ensure that resources are appropriately channelled to where they will deliver the greatest value to the organisation.

From the financial perspective, a key issue has been how to recognise brands on the balance sheet, since there are accounting problems related to the uncertainty of dealing with the future nature of the benefits associated with brands, and hence the reliability of the information presented (Barwise, Higson, Likierman and Marsh, 1989⁷; Oldroyd, 1994,



Capital can be used creatively to differentiate the organisation

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1998⁸). The potential dilemma is clear: if a brand's value is not to be expressed on the balance sheet then the 'full' value of a company is not being reported; but, in the absence of a professional consensus on their valuation, there might be a free-for-all that would discredit the entire process.

Further studies within finance have investigated the impact on the stock price of customer perceptions of perceived quality, a component of brand equity, and on the linkage between shareholder value and the financial value of a company's brands (Aaker and Jacobson, 1994⁹; Kerin and Sethuraman, 1998¹⁰). However, there is currently a more specific managerial concern with brand valuation often from an internal perspective in terms of effective resource allocation, such as for acquisition purposes. In this regard, Haigh and Knowles (2004)¹¹, have summarised two critical issues.

The first is to be quite clear about exactly what is being valued. Is it the trademark, the brand itself, or the branded business? Secondly, the purpose of the valuation is essential to understand and an important distinction must be made between technical and commercial valuations. Technical valuations are conducted for balance sheet reporting, tax planning, litigation, securitisation, licensing, mergers and acquisitions, and investor relations. The primary purpose of technical valuations is to give a point-in-time valuation and, frequently, they relate to a valuation of the trademarks. Commercial valuations are more typically for internal management purposes and often relate to issues associated with market strategy, budget allocation, and scorecards.

Despite this, modern financial theory postulates that calculating a brand's value is fairly straightforward; ie it is the cumulative value of all the cash flows the brand itself is expected to generate over time, discounted to the present at an interest rate appropriate to the riskiness of the cash flows. The value of the branded business is, though, made up of a number of tangible and intangible assets.

Trademarks, for example, are simply one of these and brands are more like a bundle of trademark and other, related intangibles. The value of Microsoft Windows, for example, is partly trademark-related or brand-related, but also largely attributable to the patent and other marketing intangibles. There is a need to establish what are the intangible assets creating the value, and usually there are a variety

of these. There could be excellence in managing business processes, distribution rights, or patents. Hence the concept of attributing cash flows to the brand itself is basically elusive and disputable.

Brand valuation methods

Value, like beauty, is in the eye of the beholder, and has different meanings for different people – it isn't an objective concept. The valuation approach used is effectively the objective of the valuation. The objective of the valuation is determined by its use. Some of the more common valuation approaches can be classified into five categories:

- cost-based approaches;
- market-based approaches;
- economic use or income-based approaches;
- formula-based approaches; and
- liquidation approaches.

Cost-based approaches consider the costs associated with creating the brand or replacing the brand, including research and development of the product concept, market testing, promotion, and product improvement. The accumulated cost approach will determine the value of the brand as the sum of accumulated costs expended on the brand to date. This method is the easiest to perform, as all the data should be readily available. Unfortunately, though, this historic valuation usually doesn't bear any resemblance to the economic value.

Another approach, known as replacement cost, determines, quite simply, what it would cost to replace the asset. This method provides a better reflection of the true cost of the brand, but the cost does not bear a relation to the open market value. Over-investing in that brand, for example, might result in not recovering the full investment if sold.

Market-based approaches are based on the amount for which a brand can be sold. The open market valuation is the highest value that a willing buyer and willing seller would be prepared to pay for the brand. Barwise et al (1989) suggest that the market value of an asset should reflect the possible alternative uses; the value of future options as well as its value in existing activities; and realism rather than conservatism.

Economic use approaches, also referred to as income-based approaches, consider the

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valuation of future net earnings directly attributable to the brand to help determine the value of the brand in its current use. Haigh and Knowles (2004) argue that these are the most productive approaches and identify a number of different economic use valuation techniques. The price premium, or gross margin approaches consider price premiums or superior margins versus a generic business as the metric for quantifying the value that the brand contributes.

However, as the authors point out, the rise of the private labels means it is often hard to identify a generic against which the price or margin differential should be measured. One alternative is economic substitution analysis, which assesses what the financial performance of the branded business would be and how the volumes, values, and costs would be affected if the brand did not exist. This approach, though, relies on subjective judgments as to what the alternative substitute might be.

Because of the difficulties associated with these two economic use valuation approaches, Haigh and Knowles argue that it can be particularly insightful to use either an earnings split or royalty relief approach. In the former case, earnings are attributed above a break-even economic return to the intangible capital. These excess earnings are split between the various classes of intangible assets, one of which is the trademark or brand. The royalty relief approach imagines that the business licenses its trademarks from another business at a market rate – where the royalty rate is usually expressed as a percentage of sales – rather than owning the trademark.

This, it seems, is a popular approach since tax authorities and courts often recognise it, largely because there are many comparable licensing agreements in the public domain and it is relatively easy to calculate a specific percentage that might be paid to the trademark or brand owner. Having determined the slice of earnings attributable to the trademark or brand, now and for each year in the forecast period, it is necessary to discount them back to a net present value – the trademark or brand value.

One problem, though, arises if intangible assets are valued separately without reference to one another because the sum of intangible assets may possibly be greater than the value of the branded business. In this case it is nec-

essary to reconcile all asset values back to the branded business valuation initially calculated. It is then necessary to consider the value of each intangible asset in the context of the others and to apply a similar approach to each of the major intangible assets.

Formula-based approaches consider multiple criteria to determine the value of a brand. While similar in certain respects to income-based or economic use approaches, they are included as a separate category due to their extensive commercial usage by consulting and other organisations.

The liquidation value is the value that the asset would fetch in a 'distress' sale. The value under a liquidation sale is normally substantially lower than that in a willing buyer-and-seller arrangement. The costs of liquidating the asset should normally be deducted in determining the value of the asset.

These aren't the only approaches and discounted cash flow methods, (even though there is no straightforward way to translate theory into practical reality), are now used more frequently. The principal problem is that none of the key variables are directly measurable, as is evident if we consider the cash flows attributable to the brand. They are distinctly different from the cash flows derived from all products (or services) that carry a brand. A portion of those cash flows is properly attributable to the capital employed to create the products, while other portions may arise from a host of intangibles other than the brand. These include, but are not limited to, research and development, business processes and superior management expertise.

One other problem is that many conventional approaches to brand valuation start with an estimate of the total profits attributable to the branded business, but there is a real problem if multi-brand companies do not organise their reporting in a way that allows them to calculate profits by brand. In fact, what evidence there is suggests that the majority measure operating results by product lines or business units (Ehrbar and Bergesen, 2002)¹². Even if one accepts the estimate of profit by branded business, the problem of isolating the portion attributable to the brand itself remains.

The conventional approach, typically, is to do this by calling on the opinions of 'industry experts'. In sum, the estimation of the first

Liquidation value is the value the asset would fetch in a 'distress' sale

Many companies measure operating results by product lines or business units

Conventional
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key variable, current profit attributable to the brand, is the product of subjective judgments and 'guesstimates'. The other key element in conventional brand valuation usually is an equally subjective assessment of brand strength, which is used to discount future brand profits.

BrandEconomics, EVA® and brand valuation

(Ehrbar and Bergesen, 2002).

BrandEconomics uses a top-down approach of estimating the valuation framework combining two methodologies introduced at the beginning of this article, Young & Rubicam's BrandAsset® Valuator measure of a brand's consumer franchise and Stern Stewart's EVA® model for performance measurement and business valuation. Their brand valuation framework begins with an empirical calculation of the role of brands in driving business value in specific product and service categories. This enables an estimate of the value of individual brands based on the sectors within which they operate, their strength in those sectors, and the scale on which a brand is employed.

BrandEconomics starts the valuation process by separating a company's total market or enterprise value (market value of equity plus book value of debt) into two components: tangible capital and what they call intangible value. Tangible capital is the book value of the assets on a company's balance sheet and intangible value is simply total market value minus tangible capital.

This definition of intangible value reflects the presumption that tangible assets will simply earn a cost-of-capital return. Any return in excess of the cost of capital represents a return on intangible assets, which they define as including superior management. As a result, tangible capital always will be valued at book, and any variation between market value and the book value of tangible capital reflects the expected profit contribution from all intangible assets. Relating this to the EVA valuation model, intangible value is equal to the present value of current and expected future EVA, which is mathematically identical to the net present value of forecasted free cash flows.

The empirical challenge in the top-down valuation approach used by BrandEconomics is to determine the degree to which differences

in brand health, however measured, explain differences in intangible values. The key element in their modelling process is brand health as measured by BAV, the world's largest database on consumer perceptions of brands.

BrandEconomics argues that intrinsic brand values can also hold important keys to strategy, particularly for companies with portfolios of branded businesses. They distinguish between 'current operations value' (COV™), which is the annuitised value of current profits, discounted at the cost of capital – ie it is the value of the business under the assumption that current profits continue unchanged in perpetuity – and 'intrinsic future growth value' (FGV®), which is the value of the business that represents opportunities for future profit growth based on the potential of all intangible assets in the business, including intrinsic brand value.

If we consider branded businesses whose brand health, especially differentiation, has been in decline for the last five or 10 years, these typically are brands that enjoy huge, though possibly declining, operating margins, large market shares, high consumer awareness, and seeming brand loyalty. Given their high current profitability, managers may be lulled into focusing too much attention on maintaining market share by price discounting (which only hastens the brand's decline) and maintaining operating efficiency. Unless drastic action is taken to reverse the erosion and revitalise the brand, the products often become commodities and operating margins ultimately will follow the downward trajectory of the brand's health.

Arguably, failing to exploit the full potential in these brands is like leaving large sums in non-interest-bearing demand deposits and the company's market value will probably reflect the presumption that its brands will remain under-exploited. Nevertheless, the company may receive unsolicited offers to buy the brands from others who may be better situated to realise their potential through geographic expansion, new distribution channels, brand extensions, partnering, or co-marketing deals – and put it to work for shareholders.

Best practice according to this view is to identify the strategies that will realise existing growth opportunities and create new ones, communicate the strategies to key players so that the company receives proper credit in the stock market, and execute well.

Tangible
capital is the
book value of
the assets on a
company's
balance sheet

Focused management of the drivers of brand value can play a vital role in identifying, developing, and exploiting the intrinsic potential in brand assets.

The point is that in an environment in which

innovation can quickly make many competitive advantages obsolete, brands can be among the most durable sources of market power. Around this point there is a convergence, not antagonism, between the concerns of marketing and financial analysis. **MU**

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Marketing and non-profit organisations

Many companies make charitable donations or have decided to implement corporate social responsibility programmes. **Susan Foreman**, professor of marketing at Henley Management College, explores how marketing can be used to derive significant benefits from such activities.

While there may sometimes seem to be many high-profile and wealthy non-profit organisations, others clearly have trouble making ends meet. According to Kingston and Bolton, (2004)¹ a large proportion of charitable and non-profit organisations in the UK have neither substantial, nor regular, sources of income. In addition, they often face intense competition from a growing number of registered non-profit organisations.

Income from donations, legacies, investments and grants waning

Traditional income from donations (corporate and personal), legacies, investments and grants, it seems, is waning while demand for non-profit services is increasing. In response to such a challenge, say Berger, Cunningham, Drumwright et al (2004)², non-profits must be more entrepreneurial and market-driven. What, though, in practical terms, does this mean for the non-profit organisation?

One important option is the development of social partnerships and alliances with commercial organisations. The authors identify three stages in these alliances. Relationships start with philanthropy in the form of corporate donations. As the relationships develop they move to a more transactional stage, which is dominated by cause-related marketing, until they reach the mature final stage when there is a close relationship and collaboration – the integrative stage. This article will consider each of these stages, starting with corporate sponsorship.

The impact of corporate donations and sponsorship on customer behaviour

Many organisations and individuals support charities and non-profit organisations through personal donations, sponsorship or other contributions like time or gifts. These are simple

exchanges which fall firmly into the marketing arena. Sponsorship, clearly, makes an important contribution to non-profit funding and has reached significant levels. In 2001, for example, the top 25 UK companies donating to charities gave approximately £102 million with individual donations of as much as £31 million (Smyth, 2002)³. Yet whilst it is clear the recipients benefit from these exchanges, what is in it for the donors?

Cornwell and Coote (2005)⁴ have asked what benefits accrue to companies who sponsor non-profit organisations or charitable events such as the London Marathon. Does the sponsorship affect customer behaviour and, put crudely, will it encourage customers to spend more? Will such sponsorship attract new customers and improve existing customer retention? The authors believe that a customer's self image is an important factor influencing their behaviour.

If someone believes that their self image is compatible with the values of the organisation – and they can identify with what the company is trying to achieve – they are more likely to purchase that company's products and services. Thus, the role of self image and identification is key to the research. Consumers, they argue, may be more likely to purchase the sponsors' products because it gives them 'personal meaning'. In addition, supporters of the non-profits may be drawn to the products or services of a company they don't know or buy from purely because it supports their cause.

In developing this research, Cornwell and Coote examine a number of different factors, which they feel might have an impact on identification with non-profits and their sponsors. They include:

- *organisational prestige* – customers are more likely to identify with an organisation if it is perceived to be prestigious;
- *affiliation* – the longer someone is connected to a non-profit or an event, the more they identify with an event like the London Marathon. Cornwell and Coote argue that regular contact will improve the level of identification with the organisation. This is particularly important when there is so much competition for someone's time and money. On the other hand, if people are linked to many non-profits it may be that they will not feel as strongly about one particular organisation. Thus the impact of the sponsorship is diluted;
- *motivation* – here Cornwell and Coote think that where there is a strong link between the goals of the sponsor, the non-profit organisation and individuals, the relationship with the non-profit organisation and the levels of identification will be strong; and
- *previous experience* – life events have an impact on self image and identification with certain organisations. Thus, people who have suffered illness often have strong affiliations with medical or disease-related charities. Some companies have been hesitant and concerned about negative connotations attached to these charities. However, according to Cornwell and Coote companies that once thought it unhelpful to be linked to 'disease' seem now to be able to see the benefits of these associations because some existing and potential customers strongly identify with them.

This extensive research, which focused on a heavily-sponsored event, showed that strong levels of organisational identification with a non-profit organisation will affect customers' purchasing habits. Customers will buy a sponsor's products or services because they feel like they are making a contribution to the cause. Ultimately, this leads to repeat business for the sponsor and a degree of loyalty. By purchasing the products, some customers feel they show support, especially if they are unable or unwilling to volunteer or make a direct financial contribution.

In this way they can assist the organisation that provides the financial support to the non-profit. Their research into the previous experience of the customers and affiliation shows that long-term links also encourage customers to buy products from the sponsors. In sum, the advice to non-profits seeking a corporate sponsor is to build a business case which shows the probable impact of the sponsorship on sales

revenue and loyalty and make this a key part of their relationship marketing strategy. Furthermore, they should emphasise to the sponsor the benefits and the value of investing in a long-term relationship marketing approach to gain maximum impact.

Cause-related marketing

Thus far we have considered philanthropic unconditional donations. In this instance the sponsorship comes first in the hope, as we noted above, that it will lead to a change in customer behaviour and, consequently, to sales growth for the sponsor. However as Berger, Cunningham and Drumwright have noted, companies are increasingly engaging in more 'transactional' partnerships with non-profit organisations. Here, the transaction is the focal point, such as when the charity obtains a share of the revenue generated from the sale of a certain product. The charity Christmas card is an obvious example. The strategic relationship between the sponsor and the non-profit organisation is developed but the donation comes only after consumer purchase. Dean, whose work we will consider in detail, refers to this as cause-related marketing.⁵

As Dean says, there are pros and cons to this approach. On one hand, he notes that consumers and some non-profit organisations have suggested that cause-related marketing is opportunistic and driven by corporate self interest. Indeed, the opponents of such conditional donations are often critical of the high amounts of promotional spend dedicated to a campaign, which can often cost more than the actual donation the company makes to the charity. On the other, its supporters say it can lead to a longer term strategy and partnership, which may have more enduring benefits than 'one-off' donations. Dean has conducted a fascinating piece of experimental research, which studied the impact of different types of donation and cause-related marketing on revenue (of the sponsor) and on corporate reputation. In particular, he examined customers' regard for the firm, management appropriateness, scruples, mercenary intent and responsibility. Notably, the research tried to gauge whether there will be any negative effect on sponsors if they are only prepared to make conditional donations.

It seems that whilst cause-related marketing is often seen as mercenary 'there is little downside' to this marketing strategy and, interestingly, it does not seem to have a negative impact on reputation, according to Dean. However,

Companies are increasingly engaging in 'transactional' relationships with non-profit organisations

Little downside to cause-related marketing strategy

Sponsors who make long-term commitments can engender trust and allay fears

much depends on the perceived status of the sponsor at the start of a campaign. In other words, for the typical sponsor, goodwill is not lost by engaging in cause-related marketing. Sponsors who make long-term commitments can engender mutual trust and allay critics' fears. An unconditional donation or sponsorship can, however, improve reputation. From Dean's research, a sponsor should develop clear and consistent marketing strategies, because changing strategies can be problematic.

Changing from unconditional sponsorship to a cause-related marketing strategy, for example, might result in a loss of support by customers who notice the change. As Dean notes, sponsorship and cause-related marketing are important parts of a long-term marketing strategy. Certainly, charitable donations in particular show customers that companies are dedicated 'to issues that resonate with their customers' and help to facilitate the development of satisfaction, loyalty, profits and growth.

The impact of corporate donations on social responsibility and branding

As we have seen, sponsorship and donations can be mutually beneficial for companies and non-profit organisations. In Cornwell and Coote's article, the authors argued sponsorship had an impact on customer purchasing habits, while Dean showed the benefits non-profits gained from their share of revenue derived from cause-related campaigns. Lichtenstein, Drumwright and Braig (2004)⁶ examine the issue from another perspective. At the core of their research is an interest in corporate social responsibility, but they specifically examine whether corporate sponsorship and donations will lead to an increase in their customers' personal donations to the non-profit organisation.

To Lichtenstein, Drumwright and Braig – as for Cornwell and Coote – understanding the customers' self-image and self-perceptions is key to learning about their behaviour. As noted earlier, people are more likely to buy products that are linked to causes, or to donate money themselves, if they think there is an overlap between their own values and those of the organisation. An overlap, for example, can exist when someone identifies with the organisation's beliefs, philosophy, and values and, as a result, their own self esteem is enhanced. The authors call this corporate-customer (c-c) identification. Their extensive study in a retail environment, combining interviews, surveys and experimental research, found benefits for both the compa-

ny and the non-profit organisation. From their study, non-profits did receive a double benefit as corporate donations can also lead to personal donations from customers. Thus, there are lessons here for the strategic positioning of non-profit organisations. Non-profits should assess the reputation of potential partners to develop relationships which bring benefits derived from their shared values and close c-c identification.

In addition to increased donations, their research shows companies have been able to build their corporate reputation, and more specifically their brand identity, through association with non-profits. The link to branding made by Lichtenstein, Drumwright and Braig is important, as branding is more than a symbol and a sign of recognition – it is a combination of meanings, attributes, benefits and values. Where customers, companies and non-profits share these features and identify with each other, brand equity can also be enhanced. To emphasise this point Lichtenstein, Drumwright and Braig draw on the work of Aaker (1996)⁷ who argues that the brand and organisational attributes which are not likely to appear on the balance sheet are intangible assets which are difficult to copy and which, thus, can help to generate competitive advantage.

Close relationships and alliances

The next level in deepening the relationship between companies and non-profits after philanthropic donations and cause-related marketing is 'integration.' Berger, Cunningham and Drumwright suggest that this develops when the missions, values, products, management approach, customers and cultures of two organisations overlap and they work together both to generate value and provide benefits to the community. While such co-operation can be rare, Berger, Cunningham and Drumwright argue those organisations which do co-operate in this way can enjoy 'significant benefits'. Where they exist they have to overcome a number of difficulties and problems which could, according to this research, hinder the development of the relationship if left unmanaged. Four key issues outlined in this research are highlighted below.

Trust is needed to underpin the relationship. Without trust, the alliance will falter and partners will go their separate ways. To develop trust, each of the partners needs to convince the other that they are committed to the relationship. Then as the partners work together and early promises turn into actions, trust develops.

Self image and self perceptions key to customer behaviour

Power, it is often assumed, lies in the hands of the for-profit organisation but this should not be taken for granted as research shows that some non-profits held the upper hand because of their brand equity. More commonly, though, the non-profit organisation is the junior partner. Here some non-profits found it difficult when the companies they allied with tried to impose their own strategy and agenda for change. These problems could be compounded when exclusivity agreements prevent non-profits from working with other organisations.

The allocation of costs and benefits needs to be considered because if there is a perceived mismatch, the relationship can suffer. Some companies may be disappointed by the returns they receive, either because the returns are not forthcoming or because the managers do not appreciate the 'intangible' contributions made by the non-profits. However, non-profits cannot always match their partner's resources and thus need to explain the value they bring to the partnership and set these expectations at the start of the relationship. The establishment of expectations is an important part of any relationship. Just as non-profits have concerns, companies can also become concerned about the nature of the relationship, especially if the non-profit becomes a dependent partner, rather than a self-sufficient one.

Time changes relationships. As relationships mature the novelty wears off and the initial benefits may diminish, unless continuous efforts are made to support the company, its

aims and the social benefits demanded by non-profits. Berger, Cunningham and Drumwright state that if long-term strategies are to be pursued, the partnerships need to be institutionalised, trust is the norm and operating procedures are agreed. In this way the relationship is less vulnerable to staff turnovers and especially to the loss of a champion.

Clearly, though, such issues are not unusual to the management of any business-to-business relationship. They need to be managed throughout their lifetime from the early negotiations to a more stable stage where they work on joint projects and learn more about each other. Trust and commitment grow as the relationship grows and as it matures, each side needs a 'full and rich understanding of the factors and processes that will drive, sustain and support' it. Until, finally, the relationship itself can become an important asset for both partners and society.

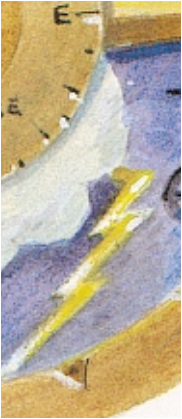
Non-profits, (whether they are charities or voluntary sector organisations), have, it seems, risen to the business challenge they face and developed their business acumen to minimise costs and maximise aid. Whether one agrees philosophically, morally or not with the use of marketing in this sector, many non-profits have now developed sophisticated marketing infrastructures and engage in complex and multifaceted marketing campaigns and relationships. They have no choice if they want to generate regular income in an intensely competitive environment. **MU**

Non-profits have risen to the business challenge they face

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Appreciating the value of human and social capital

Much of the value of organisations is tied up in human and social capital. But how can we make these intangible assets more tangible and can we make this complex subject easier to understand? **Richard McBain**, director of distance learning programmes at Henley Management College, explores the latest research.

Organisations increasingly recognise human and social capital to be key

Interest in the concepts of human and social capital has been growing in recent years, in part as a result of competitive, demographic and cultural changes that have important consequences for both organisations and employees. Organisations are increasingly recognising that human and social capital is key to developing competitive advantage. Employees must also take greater responsibility for developing their own human 'capital' as the psychological contract between individuals and organisations changes.

Human capital comprises the intellectual, emotional and social capital of individuals and organisations (Gratton and Ghoshal, 2003)¹. Intellectual capital refers to knowledge, skills and expertise, while emotional capital refers to courage and resilience in taking actions. Social capital represents the resources, such as psychological states and behavioural expectations, embedded within and available through a network of relationships and is typically seen as having two or three dimensions. Nahapiet and Ghoshal (1998)², whose framework was considered in an earlier *Manager Update* article (1999)³, have identified structural, cognitive and relational dimensions of social capital:

- *structural*: the overall pattern of relationships or connections between the individuals or organisations in the network;
- *relational*: the resources created through relationships and especially outcomes of interactions such as trust, norms, expectations and identification; and
- *cognitive*: the resources providing shared meaning and understanding between the network members, for example, shared goals and shared culture.

Social capital can be seen as both a private

good that benefits individuals – as in the case of career advancement and access to new knowledge – as well as a public good that benefits the wider community. Examples of the latter might be, for example, information transfer, trust, and social norms. High levels of social capital as a public good create an environment that promotes valued discretionary behaviours and lowers the costs and barriers to maintaining relationships. This article will consider recent research that links the concepts of human and social capital to executive pay, group effectiveness, organisational survival, and to knowledge transfer and creation. It will also look at the creation of social capital, measurement practices and research recognising that developing social capital comes at a cost.

Human capital and executive pay premiums

Many wonder why some top executives can obtain pay premiums above the level predicted by firm and job characteristics. One explanation may be the 'managerialism' theory, according to which top executives' power allows them to gain control over their firms' compensation process and introduce their own pay preferences in place of those of the shareholders. Alternatively, human capital theory sees pay premiums as compensation for unique and valuable managerial skills and experience which can, it posits, be a source of competitive advantage for the business and the individual.

To test such theories, Combs and Skill (2003)⁴ have examined the impact on a firm's stock performance of the sudden death of 77 key executives between January 1978 and December 1994. A managerialist perspective

would suggest that shareholders should respond 'positively' to the news that an 'entrenched' key executive has died suddenly, while human capital theory would predict a negative reaction to the sudden death of executives who earned pay premiums. In other words, where pay premiums were the result of executive power (measured by board tenure and founder status) shareholders should see the death as a welcome opportunity to replace the executive, and the stock price should rise. In contrast, with greater governance strength within the business (measured by board independence and the presence of a nominating committee) the relationship between pay premiums and stock performance following sudden death should become increasingly negative.

The results of the study provide support for a contingency view. As pay premiums and executive power jointly increased, abnormal stock returns increased following sudden death and as pay premiums and governance strength jointly increased, abnormal stock returns declined. On this basis, both managerialism and human capital theories receive some support: shareholders bear the cost of excessive pay when the executive has notable power, while, on the other hand, the pay premiums may be justified by human capital considerations when governance is strong.

Human capital accounting practices

Given the contribution of human capital to organisational performance, it is increasingly important for businesses to understand and measure the value of their employee base. Elias and Scarborough (2004)⁵ argue that although distinct schools of thought on human capital evaluation exist, all share a commitment to developing metrics to help firms and investors identify the drivers of human performance and value. Their study considered management practices which evaluated human capital in 11 major UK firms.

The authors found a preference for internal management accounting reporting above external accountancy-based reporting. More sophisticated companies, for example, sought to use traditional human resources (HR) metrics, such as data from appraisals and customer feedback, alongside 'balanced scorecard' approaches to produce more aggregate measures of employee performance both for

strategic decision-making and for operational HR decisions, on issues like training and remuneration. They identified four distinct styles of human capital evaluation:

- the 'talent-focused' approach centred on evaluation of an elite group, such as senior managers, who were seen as having a strategic value to the business;
- the 'customer-focused' approach had a broader focus on the process of evaluating a firms' employee base for strategic purposes;
- a more narrow focus on evaluating key individuals exclusively on financial performance outcomes for the purpose of retaining these individuals through attractive rewards; and
- the final approach identified collected data on workforce competencies but used it only at the level of the individual, rather than aggregating it to provide a more rounded view of human capital at firm level.

In all 11 firms studied, human capital evaluation was an initiative of human resources, which reflects that discipline's increasing professionalism and desire to enhance its credibility and strategic role. While there may be no single formula for the evaluation of human capital, the human capital concept and the process of seeking to measure it is important because of the way it frames the relationship between employee contribution and the competitive performance of the business. It may also provide a link between 'hard' and 'soft' approaches to HR management.

Social capital as a transformational shield

Significant transformational change, such as changes to organisational goals, boundaries or activities, may increase the possibility of organisational failure as resources and attention are diverted from normal operations to helping make the change. One such change is the transition from public to private ownership – a firm that has recently undergone an initial public offering (IPO) is at a significant risk of failure. Certain firm characteristics or resources, though, may serve as transformational 'shields' to protect them. Fischer and Pollock (2004)⁶ argue that IPO firms may possess socio-political resources, including internal and external social capital, which can serve as such protection.

The human capital concept frames the relationship between the employee and the business

Certain characteristics may serve as transformational 'shields'

Their study of 218 US companies considered whether the presence of a company founder as chief executive officer (CEO) after the IPO, the concentration of stock ownership in the hands of the CEO, internal social capital measured in terms of average top management team (TMT) tenure and finally external social capital, viewed in terms of the network of investors marshalled by the lead investment bank, could protect the IPO firm at this time. Their key findings were that:

Internal and external social capital can provide effective transformational shields

- internal and external social capital can provide effective transformational shields: high average TMT tenure may enhance effectiveness and information flows, and a company's external ownership structure may help the firm resist environmental pressures;
- both the presence of a founder CEO and CEO-ownership of shares were necessary to create an effective transformational shield: the former indicates commitment to the organisation, while the latter indicates CEO power; and
- high retained venture capitalist ownership following an IPO increased the probability that a firm would fail unless its CEO retained substantial ownership: this may enable the firm to resist short-termist pressures from the venture capitalists.

Accordingly, firms and their investors must think carefully about replacing founders with new CEOs on going public. They should develop stable and trusting social and political ties prior to the IPO and consider the social capital in the network of relationships of the underwriter who is leading the IPO.

Social capital, networks and knowledge transfer

Networks between organisations are based on repeated exchanges

Networks between organisations are based on repeated exchanges and provide firms with access to knowledge, resources, markets or technologies. Inkpen and Tsang (2005)⁷ offer a model of networks classified on two dimensions: the extent to which members are linked by a value chain, and the level of governance structure in the network. Three types of strategic networks are considered, ranging from the highly structured to the unstructured:

- *intracorporate network*: a group of organisations operating under a unified corporate identity, with the headquarters of the net-

work having controlling ownership interest in its subsidiaries;

- *strategic alliance*: a group of firms entering into voluntary arrangements that involve exchange, sharing or co-development of products, technologies, or services; and
- *industrial district*: a network comprising independent firms operating in the same or related market segment and a shared geographic locality benefiting from external economies of scale and scope for agglomeration.

The type of network determines the way in which the dimensions of social capital influence knowledge transfer in the network, and the three network types involve different dynamics between organisational and individual social capital. For example, organisational social capital takes priority over individual social capital in strategic alliances – while the reverse is true in industrial districts. In intracorporate networks, the social capital that promotes knowledge transfer will begin at an organisational level and then be enhanced by developments at the individual level. However, this latter suggestion may be challenged by other recent research.

The development of social capital in MNCs

Multinational corporations (MNCs) often face issues of co-ordination and control and Kostova and Roth (2003)⁸ consider these issues from the perspective of social capital formation. They examine the role of boundary-spanning individuals in social capital formation in those organisations. MNCs differ in terms of both the degree and complexity of interdependence between the sub-units, and the role of social capital will vary accordingly.

The authors identified four types of MNC, with the degree of interdependence ranging from low to high and the type of interdependence ranging from simple to complex: multinational, international, global, and transnational. While simple interdependence can be managed through formal structural arrangements, complex interdependence requires more informal means of co-ordination and control. In such organisations the role of social capital becomes more important.

Boundary-spanning individuals, who are employed at the sub-unit with direct relationships with headquarters' representatives, play

a central role in the micro-macro processes of social capital formation. These relationships lead to beliefs and attitudes that constitute a basis for their own private social capital. In addition, their experiences and personal attitudes toward headquarters are conveyed to other employees in their sub-unit. Thus, the social capital of the boundary spanners may be diffused among sub-unit employees and the privately held social capital transformed into a public good of the sub-unit.

There are key practical implications of this theoretical work for managers. To create social capital at the sub-unit, level managers need to increase both the number of boundary spanners as well as the extent of their interaction with headquarters. This alone, though, will not automatically result in higher levels of social capital. Not only must the cross-border and unit interaction be directed towards mutually beneficial work-related goals, but also the boundary spanners must be motivated and able to provide clear information cues and influence people. Clearly, their personality characteristics may be relevant in selection for this role.

Social capital and knowledge creation

Social capital has both costs and benefits. On the one hand, social capital should help knowledge creation, because social relationships offer the opportunity to exchange and combine information and create new knowledge. It may, for example, be particularly important in the field of scientific discovery, where much knowledge is tacit and embedded in relationships within the scientific community. On the other hand, interpersonal networks over time can produce strong norms and mutual identification that limit openness to new information and diversity of views. They also take time and effort to create and maintain. The tension between the need to access new resources and the need to maintain jointly-held resources was studied by McFadyen and Cannella (2004)⁹, who examined more than 7,000 scientific discoveries by 173 biomedical research scientists over 11 years. They found that the relationship between social capital and the amount of knowledge creation might at some point lead to diminishing returns.

The key findings of their research were that:

- the strength of direct relationships between scientists, as measured by the number of

co-authorships, impacts on new knowledge creation in terms of the number of publications. However, this relationship is non-linear, and it eventually becomes negative;

- the number of different exchange partners, or co-authors, that a scientist has at first has a positive effect on the amount of new knowledge created, but then also becomes negative; and
- the strength of relationships had a higher marginal effect on knowledge creation than did the number of relationships.

This research is interesting to all those who manage knowledge workers. Sharing experiences with others develops knowledge and the strength of relationships with others seems to be more important than the number of possible relationships a person has. However, collaborative work with the same others may also be potentially limiting because the exchange partners may eventually develop homogeneous knowledge stocks and become subject to group norms, obligations and expectations. There is thus an opportunity cost in nurturing existing relationships – sharing experiences with others should not be done at the expense of recognising and seeking new resources.

There is an opportunity cost in nurturing existing relationships

Group social capital and group effectiveness

Groups are increasingly used to enable organisations to respond flexibly to changing environments and thus it is important to understand the factors contributing to group effectiveness. These include internal social ties between group members and external ties with other groups or individuals. Through such ties an individual or a group can access a wide range of resources, such as emotional support, political support, strategic information, work information, and task-related advice. Oh, Chung and Labianca (2004)¹⁰ in a study of 60 work groups in 11 Korean organisations, examined the impact of one type of social tie, that of informal socialising outside the workplace with other members of the group and with others in the broader organisation.

The authors offer the concept of 'group social capital' to refer to the configuration of social relationships within the group and in the broader social structure of the organisation to which the group belongs. Their aim was to test a model that would identify the optimal configuration of social ties within and outside a group.

Group social capital used to refer to configuration of social relationships within group

Social capital flows through two types of relationships:

- *closure relationships*, which connect members of the group to each other and greater connectedness may lead to more solidarity, reciprocity and trust which in turn reduces opportunism, transaction costs and the need for monitoring behaviour; and
- *bridging relationships* are cross-boundary in nature and the boundaries may be horizontal between different areas or functions, for example, or vertical such as between leaders and followers. They give access to resources outside the group including timely information, diverse ideas, tacit knowledge and political resources and support.

Group effectiveness is maximised at moderate levels of closure

The study found that group effectiveness, as measured by a CEO or high-level manager's evaluation, was maximised at moderate levels of closure and reduced at low and high levels of closure. The authors found no support for a link between horizontal ties and group effectiveness, but groups with a greater number of informal socialising relationships with the formal leaders of other groups were seen as more effective. Thus, the optimal configuration of informal socialising ties within a

group is a moderate level of internal closure and a large number of bridging relationships to other groups' leaders. A key implication of this research is that whilst it is important to develop closure, too much of this kind of social capital may, in fact, reduce group effectiveness.

Furthermore, traditional team building activities focusing on building highly cohesive teams may be counter-productive, and greater emphasis should be placed on bridging ties and on considering the social ties of team members in group composition decisions.

Concluding comments

Clearly, the notions of human and social capital have captured the imagination of many researchers in management and it is an interest that is leading to increasing numbers of publications in respected management journals. It probably will not come as a surprise to many astute executives and managers that there are resources embedded in social networks. Nevertheless, the formalisation of these concepts is helping shed more light on organisational behaviour. **MU**

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When to diversify – and when not to

Is diversification good or bad for your company? Does it destroy or add to shareholder value? And what types of diversification are appropriate to different companies? **Ian Turner**, professor of management studies and director of graduate business studies at Henley Management College, offers some practical tips for a diversification strategy.

Diversification, particularly into unrelated areas, has been almost universally associated with higher business risk and poorer performance. We've all heard authors like Peters and Waterman (1982)¹ repeatedly intone that the secret to business success is 'sticking to one's knitting'. With relentless pressure from competition and shareholders clamouring for greater transparency, isn't a focused corporate strategy now obligatory?

Not necessarily, perhaps, as some recent examples will testify. Last year, US coffee shop chain Starbucks launched what might be regarded as a risky diversification by starting an in-store music download service, partnering with Hewlett Packard, in a move that was "essentially pitching itself against high street record retailers," as *Business Week* (2004)² reported in March last year. 'Why buy CDs in Virgin or Tower when you can create your own compilations while enjoying your coffee?' was the company's pitch which, it seems, thousands of customers found irresistible. Indeed, one of the year's recording hits – a new Ray Charles compilation – owes much of its success to the uptake from Starbucks' customers.

An interesting but isolated example? Probably not, as this author also received a flyer from UK-based insurer Norwich Union while researching this article which informed him that the insurance and financial services company has now diversified into selling electrical products on-line. One successful purchase later he began questioning the whole debate about diversification and his own scepticism.

A brief history of diversification

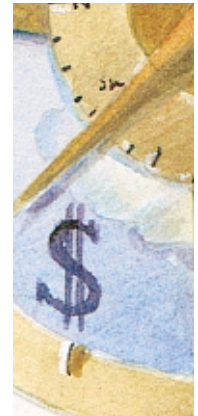
The influential business writer Theodore Levitt (1960)³ published his famous critique

of US companies who, he claimed, had become victims of 'marketing myopia'. His thesis was that they defined their scope too narrowly and should instead be guided on such decisions by their customers' needs. US railway companies, for example, faced with a maturing market, should have redefined themselves as transport companies rather than focusing on the technology of the railways, he argued.

Many readers and captains of industry apparently agreed, and in the '60s and '70s diversification became a fashionable remedy for companies faced with maturity in their core businesses. Indeed, some once sensible companies began true diversification sprees. Take, for example, Blue Circle; a well established cement company which moved into home-building, real estate, brick manufacturing, gas stoves, bathtubs and even lawnmowers. One of the company's retired executives, reflecting rather ruefully after the event, remarked that the logic for lawnmowers was that you needed a lawnmower for your garden – which, after all, was next to your house!

By this stage, though, academics were publishing their research on diversification and it didn't make for edifying executive reading. The most famous of the early studies on the subject was by Richard Rumelt (1974)⁴. His work on the pharmaceutical industry concluded that unrelated diversification in particular, was associated with poorer performance.

From the 1980s onwards, the pendulum swung back and focus became the mantra for researchers and executives. Companies were urged to sell non-core businesses and focus on a much smaller, more manageable, portfolio of businesses. The ideal was for businesses



US companies victims of 'marketing myopia'?

In the 1980s
'predator'
companies
bucked the
trend

to occupy dominant market positions and be related to each other to capture synergy effects. Even in the 1980s, though, some companies bucked the trend. 'Predator' companies, like Hanson, for example, were adept at buying under-valued assets, selling off parts of the business and exercising tight financial controls to generate cash. By the start of the 1990s, though, even Hanson had to change its strategy, focusing on a narrower range of businesses and ultimately de-merging entirely.

Indeed, by this time it was fashionable to talk about the 'diversification discount', or the amount by which the stock market discounted the shares of some companies because analysts and investors could not see the value of certain parts of the business or were unsure of the logic behind its strategy. And yet, diversification has never entirely disappeared from the business landscape. Some of the world's most successful companies – General Electric, Disney and Virgin to name just three – are all highly diversified and in countries like India, China, Japan and Korea many companies remain highly diversified, if not always successfully so.

Nor has the dominance of focus stopped companies in mature markets from chasing profits in different but related areas. Many of the largest car manufacturers now generate more profit, for example, from financial services connected with the process of buying and selling cars than they do from the product itself. Volkswagen, though, made a disastrous acquisition of a computer company in the early 1980s and Ford did not have much more luck with its acquisition of Kwik Fit, more recently. That said, a less dogmatic approach to diversification does seem to be emerging.

A less
dogmatic
approach to
diversification
seems to be
emerging

Are you too focused?

A case in point is Harper and Viguerie's article in *McKinsey Quarterly* (2004)⁵. Of course, studies on diversification are often bedeviled by issues of definition. In particular, what exactly do we mean by being diversified? Harper and Viguerie's work focuses on Standard & Poor's 500 companies in the US. Their research excluded conglomerates entirely, arguing that their under-performance is now so uncontroversial it made no sense to concentrate on them. Instead, they focused on three categories:

- *focused* companies (which generated at least 67% of their revenues from one business segment);

- *moderately diversified* (with at least 67% of revenues from two segments); and
- *diversified* (with less than 67% of revenues from two segments).

Tracking results over a 10 and 20 year period from 1990 revealed that the moderately diversified group consistently outperformed the fully diversified companies and also, more surprisingly perhaps, even companies in the focused category.

For Harper and Viguerie, deciding whether to be more focused or more diversified largely depends on a company's current position. Those in emerging or growth industries should probably focus their attention on the core business and resist diversifying. By contrast, those in more mature industries could benefit from moderate diversification. 'Logically, companies with little diversification and low expected long-term growth would do well to diversify by introducing growth businesses into their stagnating portfolios. Conversely, highly diversified companies in which the market lacks confidence would benefit from focusing their portfolios.'

Companies, even moderately diversified ones, should regularly review their portfolios and sell businesses – especially those that aren't performing well and which do not fit with the rest of the portfolio – the authors argue.

The dynamics of diversification

Entering new markets in related areas and exiting declining markets is critical for organisational survival and growth, according to authors Helfat and Eisenhardt (2004)⁶, who urge us to revisit the benefits of related diversification by taking a dynamic perspective. The traditional rationale for the diversified company is that related businesses within the same firm can share resources and, as a result, the total costs of producing all the various products offered by the company is lower than that of producing them separately.

This phenomenon is technically known as 'economies of scope' and may arise, for example, where separate products are generated from a common process or the products share common equipment, distribution channels or other intangible assets. The theory of economies of scope also allows for benefits to be generated on the demand side of the equation, when for example, firms use excess

resources to diversify into other markets and, as a result, generate higher revenues.

This rationale is generated from economics and is referred to by the authors as intra-temporal economies of scope, in the sense that they provide a justification for companies to maintain different businesses, within a common entity, at any one particular time through shared resources. However, they believe that this explanation has ignored the importance of so-called inter-temporal economies of scope, where a company redeploys resources within the organisation to exit one market and enter a new one.

If the new rationale for diversification lies in these inter-temporal economies of scope, then, it is argued, a new approach to corporate structure and management is required. The traditional approach to managing related diversification emphasises centralised control over the strategic and operating decisions of the divisions, as well as co-ordinating and integrating mechanisms amongst them to realise the economies of scope. By contrast, Helfat and Eisenhardt advocate a less centralised approach, which they term 'patching'. Here, the role of top management is to add, split, combine and remove business units over time as markets change, the authors say. In this model, they see less justification for ongoing co-ordination between divisions. The function of central management, as depicted in their case study, would appear to be one of identifying and redeploying responsibilities for particular product market areas, across traditional divisional barriers, to ensure that there is a match with available capability and resource.

Intra-industry diversification

Logically, the same economies of scale and synergies that are available to companies that diversify into different but related industries should also be available to companies which diversify into other market segments within the same industry. This, at least, is the starting point of Li and Greenwood's article (2004)⁷, who also believe other benefits accrue to companies that diversify. These include 'multi-market contacts.' Essentially, as companies diversify and explore other market segments, the authors say, they will come into more frequent contact with their competitors. As competitors become aware of one another, particularly in oligopolistic markets, they will try to offset the full rigours of

competition through the practice of 'mutual forbearance'. Collusion will result and spheres of influence will be explicitly or implicitly agreed. For the authors, this 'forbearance' should result in increased profitability for the firm.

A further benefit of related diversification is the emergence of well-defined market niches. As the authors explain, new market niches are a social construction: the greater the number of companies which enter a market niche, the more related the market niche becomes. Inter-firm learning is likely to take place, due to exchanges of personnel across organisational boundaries. Demand is created for the emergence of support services and suppliers and a new institutional infrastructure will develop around the market niche. This infrastructure will, in turn, lower the cost of production for the company and increase the relatedness of the market niches.

Thus superior performance is generated as a result of related diversification: partly because competition declines within the industry under certain circumstances and partly because where many players adopt the same niche strategies the niche becomes legitimised and the infrastructure develops accordingly. Indeed, as the authors point out, this legitimisation effect can in some cases be so great that institutions that are not diversified enough – and which cannot provide a full service offering – can be discriminated against by clients or institutional investors, for example.

Consumption of economies of scope

As already discussed, the traditional rationale for diversification has tended to revolve around economies of scope in production and distribution. But, as Cottrell and Nault (2004)⁸ point out, in some high-tech industries like, for example, the software industry, scope economies in consumption can be more important than in production. In an earlier *Manager Update* article, we discussed how in the knowledge-based economy increasingly the value of a product like a piece of software is not intrinsic but related more to whether the product can work effectively with other widely-used pieces of software. In part this preference for products as part of systems may reflect consumers' preferences for a well-known brand, particularly if the investment in software is extensive, but it seems that consumers in this sector have a

Forbearance will result in collusion and the development of spheres of influence

Increasingly the value of a product is not intrinsic

preference for purchasing products with a standardised look and feel and functional inter-operability. Indeed, Cottrell and Nault's study of diversification in the software industry revealed dis-economies of scope in production: the extension of existing software products to new platforms reduced the chances of both the product and the firm's survival.

Does the diversification discount really exist?

As mentioned above, it has been common to assume that conglomerates with highly diversified portfolios attract a discounted share price because of a sceptical market. According to Miller (2004)⁹, part of the explanation for this scepticism comes from agency theory. Agency theory holds that managers act in ways to maximise their own benefit, rather than that of the shareholders. If financial rewards for managers are related more to the size of the organisation than its performance, the theory predicts over-diversification and market under-performance.

Agency theory holds that managers act to maximise their own benefit

The original research on diversification, starting from Rumelt, tended to show that diversified companies generated lower returns on investment than more focused businesses. But, as Miller points out, more recent strategy and finance research may indicate complex explanations for this. It may be that it's not so much the act of diversification which destroys shareholder value, but rather some other characteristic which accounts for both the diversification itself and for the weak performance.

Miller, for example, distinguishes further between the motivation of successful companies and their weaker counterparts. Thus, companies whose research and development has led to the most valuable innovations in an industry tend to focus more on innovation within their existing scope. By contrast, companies which perform less well may rationally be tempted to diversify into other areas where they can deploy their assets and resources with some expectation of a better return. The important point here is that such companies may, through diversification, secure better returns than would have been the case had they concentrated on their core businesses. Yet these returns are still likely to be lower overall than successful companies who focus on innovation within the core business. Miller's research work largely confirms that diversifying firms tend to be less successful at innovation. Their poor performance, therefore, has

Companies may, through diversification, secure better returns

its antecedents before diversification rather than it being – as some authors have suggested – a consequence of the diversification act itself.

A further explanation for the difference in performance is that diversifying companies tend, disproportionately, to resort to acquisitions to boost the business, while non-diversifying companies rely more on internal growth. Diversification through the acquisition of under-performing target companies will generally depress financial performance. Thus, diversification may not itself be the prime factor explaining differences in performance. It may, in the first place, be a symptom of relative weakness that induces firms to flee in the face of superior competitors. Lacklustre performance may then be perpetuated through ill-judged acquisitions.

Closing reflections on diversification

Is diversification as a strategy, then, a positive or a negative thing? A modest amount of related diversification may well be desirable, particularly for companies in mature industries. Here, diversification is itself, many will argue, a form of organisational innovation and in the long term essential for organisational growth and survival. Economies of scope can still be a powerful source of competitive advantage, especially for companies that have established successful brands with high levels of customer loyalty and frequent customer contact, like Virgin or Tesco. In addition, there are also consumption economies of scale, particularly in the information technology industry. Here, customers often prefer to purchase and use families of products which have the same look and feel, explaining the strategies of companies like Microsoft and Google.

Some diversification, such as that engaged in by the automobile manufacturers mentioned above, is a consequence of the core business becoming 'commoditised.' Firms thus diversify from producing and selling products to 'bundling' related services to increase margins. While this type of diversification can be difficult because the skill sets are very different, the move from products to systems may be a legitimate diversification path in these types of circumstance. Yet, just because a firm has excess capacity or expertise that can be deployed elsewhere does not mean it should necessarily diversify. In fact, exiting a market may often be a more suitable strategy and may actually be required if the company's portfolio

is not to expand beyond the limits of what is manageable.

The rationale for completely unrelated diversification (however that be defined) is, though, much less easy to justify. Here, the key is that in all diversified companies, the benefit which the corporation provides to the businesses in its portfolio must exceed the cost to the businesses of central over-

heads. The more highly-developed the market, the more sophisticated the technical infrastructure, and the more intense competitor activity, the less likely it is that this calculation will be positive. As a result, it is more likely that transaction costs can be minimised in other ways than through internalisation and other looser forms of collaboration are preferable to outright diversification. **MU**

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1	Feb 97	'Evolving rules of the game'
2	Jun 97	'Financial planning and reporting' <i>Ruth Bender</i>
3	Nov 97	'Competitive advantage period'
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5	May 98	'Developments in international accounting'
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30	Sep 04	'Behavioural finance'
31	Nov 04	'Accounting, finance and executive compensation'
32	Feb 05	'The euro zone and the corporate debt market'

MARKETING

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All the articles on this topic are by Ian Turner

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