

Strategy and the Uses of M&A to Grow or Restructure the Firm

INTRODUCTION

Strategy influences M&A outcomes. It should be the engine driving M&A search, analysis, deal design, negotiation, integration, and process management; this chapter explores this linkage and describes how M&A fits into the broad spectrum of transactions that can expand or restructure the firm. Lessons include these:

- To be strategic is to plan moves by looking ahead. A firm's strategy is part of the three-legged stool: *mission*, *objectives*, and *strategy*.
- Setting strategy begins with an assessment of the firm's resources and competitive position. The situation of the firm can be summarized in an analysis of its strengths, weaknesses, opportunities, and threats (SWOT). Numerous tools and frameworks help assess the firm's SWOT.
- Three successful strategies are (1) low cost leadership, (2) differentiation, and (3) focus. Many firms try to blend these, to be all things at once—but this can be dangerous. You must choose.
- The firm can grow organically (by internal investment) or inorganically by acquisitions, joint ventures, alliances, and contractual agreements. The right choice of the method of inorganic growth depends on the need for a business relationship, the need to be in control, and the need to manage risk exposure.
- The firm can restructure in a variety of ways to enhance its efficiency and create value. Key alternatives are divestiture, spin-off, carve-out, split-off, tracking stock, and liquidation. The choice of method of restructuring will depend on the relationship of the business to the core operations of the firm, the need for control, and whether the business or asset can operate as an independent entity.
- Whether diversification creates value for shareholders is a matter of sharp controversy. Conventional wisdom and some research hold that strategies of focus are better than strategies of diversification. Recent research raises the possibility that the diversification-versus-focus dichotomy may be false: Instead, the right stance may be to focus on relentless restructuring, through either diversification or focus, in response to changes in the firm's strategic environment. Continue to watch the evolving research on this question.

SETTING STRATEGY

The design of a firm's strategy springs from an understanding of the firm's mission, objectives, SWOT, and market position. This section describes these foundational elements in more detail.

Mission, Objectives, and Strategy

Setting strategy begins with the definition of a *mission* for the enterprise. A mission defines the business focus of the firm and implicitly what the enterprise will *not* do. Mission statements address a range of questions:

- Who are we?
- Whom do we serve?
- What do we do?
- What do we value? How do we measure ourselves?
- Why do we do this? What is our cause?

To draft succinct statements based on questions such as these is very challenging, and will absorb time of the CEO, senior executives, and directors. The best mission statements are short, and therefore easily communicated and repeated at all levels of the organization. Mission statements that are long and complicated sacrifice motive power. Furthermore, great mission statements express *strategic intent*—that is, what the firm aims to do or be. Exhibit 6.1 gives a sample of mission statements for some major U.S. corporations: notice their brevity and expression of intent.

Often accompanying the mission statement is a list of *strategic objectives*—these are overarching goals that flesh out the strategic intent and set the direction of the firm. In effect, they answer the question, “Where are we headed?” These are usually stated in the most general terms and mainly frame the effort for the organization: “To be the quality and cost leader . . .” “To be recognized as the premier service provider . . .” These objectives are expressed in terms of *market position*. “To be a Total Quality organization . . .” “We aim for zero defects.” “To achieve a perfect safety record . . .” “To be responsible to our environment and community. . .” These objectives are aspirations for the *operational management* of the firm. “To create value . . .” “To deliver shareholder returns greater than those of our peer group . . .” “To achieve average growth of 15 percent and shareholder returns of 15 percent for the next five years. . .” These are examples of *financial objectives*. “To create the premium market franchise. . .” Ultimately, firms often express the aim to “be the best” or “become the best.” Expressions such as these litter the annual reports and press releases of corporations. Taken seriously, they can galvanize the organization into meaningful action.

The abstract tone of a mission statement and the many possible objectives for a firm may confuse rather than clarify aims for the executive. The key corporate objective (the “first among equals”) observed in many firms and assumed as the baseline goal in this book is *to create value within ethical norms*. This should serve as the key test of reasonableness for individual proposal and for the priority among competing strategies. Shareholder wealth maximization pursued ethically promotes

EXHIBIT 8.1 Examples of Mission Statements

American Family Insurance Group	"The mission of the American Family Insurance Group is to provide financial protection for qualified individuals, families, and business enterprises. We will do so on a profitable basis in an expanding geographic territory. Our primary business focus will be to deliver personal lines insurance products through an exclusive agency force." (p. 59)
Anheuser-Busch Companies, Inc.	"The mission of Anheuser-Busch is to <ul style="list-style-type: none"> • Be the world's beer company • Enrich and entertain a global audience • Deliver superior returns to our shareholders." (p. 71)
Autodesk, Inc.	"To create quality software solutions and support services that foster innovation, creativity, and productivity for customers and partners around the world." (p. 78)
Blockbuster Inc.	"To be a global leader in rentable home entertainment by providing outstanding service, selection, convenience, and value." (p. 99)
Coca-Cola	"We exist to create value for our share owners on a long-term basis. We refresh the world. We do this by developing superior beverage products that create value for our Company, our bottling partners and our customers." (p. 132)
ConAgra	"Our mission is to increase stockholders' wealth. Our job is to feed people better." (p. 139)
Duke Power Company	"We produce and supply electricity, provide related products and services and pursue opportunities that complement our business. We will continually improve our products and services to better meet our customers' needs and expectations, helping our customers, employees, owners, and communities to prosper." (p. 169)
Hershey Foods Corporation	"Our mission is to be a focused food company in North America and selected international markets and a leader in every aspect of our business." (p. 226)
Merck & Co., Inc.	"The Mission of Merck is to provide society with superior products and services—innovations and solutions that improve the quality of life and satisfy customer needs—to provide employees with meaningful work and advancement opportunities and investors with a superior rate of return." (p. 300)
Pioneer Hi-Bred International, Inc.	"Our mission is to provide products and services which increase the efficiency and profitability of the world's farmers. Our core business is the broad application of the science of genetics. We will ensure the growth of our core business and develop new opportunities which enhance the core business." (p. 349)
Charles Schwab Corporation	"Our mission as a company is to serve the needs of investors. We have all kinds of customers. . . . We will focus our resources on the financial services that best meet our customers' needs, whether they are transactional, informational, custodial services, or something new." (p. 381)

Source: These examples (and page numbers) are drawn from Abrams (1999), a useful resource for developers and critics of mission statements.

the survival and prosperity of the firm. As Chapter 26 discusses, directors of a firm are obliged to make decisions in the shareholders' best interests.

The *strategy* is a plan for fulfilling the mission and achieving the strategic objectives. To be *strategic* is to behave like a chess player, looking several moves ahead and assessing the possible countermoves of the opponent to determine the next move. The opposite of "strategic" is *myopic*, looking ahead only one move at a time. Strategic chess players beat myopic players. The *Oxford English Dictionary* defines strategy as "a plan for successful action based on the rationality and interdependence of the moves of the opposing participants."¹ Major corporations typically prepare detailed strategy documents each year for each business unit. These begin with an assessment of the external environment and the internal condition of the unit; this results in an inventory of the strengths, weaknesses, opportunities, and threats for the unit. Then the document outlines actions to be taken in the next year (and possibly also over a longer time horizon) to address weaknesses and threats, and exploit strengths and opportunities. Specific attention is given to sources of growth, whether *organic* (i.e., by internal investment) or *inorganic* (i.e., externally, using acquisitions, joint ventures, alliances, etc.). The plan might also address restructuring steps (e.g., divestitures, spin-offs, plant closings, etc.). Usually the plan culminates in a financial forecast for the next year that becomes the benchmark against which the performance of managers is evaluated. A corporate strategy is the aggregation of strategies for the various business units. Properly developed, strategy follows mission and objectives.

Planning Strategy Starts with SWOT

Firms approach the planning process in a variety of ways. For instance, a bottom-up approach drives the development of business unit strategy beginning with the front-line managers of the unit: The strategy is reviewed by senior management who critique and approve the unit strategy. A top-down approach uses a central staff to cast the corporate mission and objectives into strategies, which are then imposed on the business units; this is sometimes called a "command-and-control" approach to setting strategy. The process chosen usually reflects the complexity of the firm, its culture and history, and the relative talents of operating managers. Current conventional wisdom probably favors a bottom-up approach in the belief that people closest to the front line see the strategic field most clearly. Jack Welch, the former CEO of General Electric, was a leading proponent of the bottom-up approach to strategic planning.

The strategic planning process begins with an assessment of the business unit. This focuses both inward on the condition and resources of the unit, and outward on the shape of its environment and the unit's position in the competitive field.

RESOURCES These may entail physical and financial assets, as well as talent and intellectual capital. Resources are like raw material; what matters is how the firm integrates resources to reach its objectives. *Capabilities* integrate resources to reach an objective. For instance, to produce custom-designed furniture, a firm must integrate across marketing, design, purchasing, manufacturing, and finance. *Core competencies* are strategic capabilities: those skills and activities that translate resources into special advantage for the firm. Home Depot, for instance, has a strategic capability in site location and store openings—design, construction, staffing, training, and marketing had

to be coordinated to support the firm's strategic goal of 25 percent annual increase in store space *profitably*. Core competencies that are difficult for competitors to imitate create *sustainable competitive advantage* and are key drivers of superior investment returns. Examples of core competencies are Wal-Mart's logistics and inventory management, Honda's ability in new product innovation, Sony's skills at miniaturization, and Pixar's skills at computer-based animation. The competitive advantage that these core competencies create is generated from resources within the firm and does not rely on external resources; this *competitive advantage* is sustainable when current and potential competitors cannot or will not attempt to duplicate it.

COMPETITIVE POSITION Strength of position is also correlated with investment returns: the stronger the position, the higher the returns. For instance, a monopolist can extract higher returns than can a marginal player in a highly competitive industry. It is not only one's own share of market that matters, but also the distribution of shares among other players. In the abstract, a stronger *competitive position* should result in higher returns to investors. This is what Schoeffler, Buzzell, and Heaney (1974) found in their analysis of returns on investment by market position. Exhibit 6.2 gives their results: Return on investment rises with market share.

The relationship between a stronger market position and returns to investors has been the focus of considerable research. Shapiro (1999) summarized the sources of economic value as *barriers to entry*, *economies of scale*, *product differentiation*, access to special *distribution channels*, and advantageous government policy. He argues that "the essence of corporate strategy [is] creating and then taking advantage of imperfections in product and factor markets. . . . More important, a good understanding of corporate strategy should help uncover new and potentially profitable projects." (Pages 105, 106)

The aim of strategic assessment is to draw a profile of the strengths, weaknesses, opportunities, and threats of the business. Exhibit 6.3 presents a SWOT table such as confronted Chrysler Corporation and Daimler-Benz A.G. as they began merger negotiations in early 1998—this shows important areas of strategic fit of the two firms. Notice especially the complementary positions in products (luxury sedans versus SUVs, minivans, pickup trucks), cost leadership versus quality leadership, financial strength, and market presence. *SWOT analysis* is invaluable for preparing negotiators, deal designers, due diligence researchers, and integration planners.

EXHIBIT 6.2 Relationship between Market Share and Return on Investment

Market Share	Return on Investment
Over 36%	30.2%
22–36%	17.9%
14–22%	13.5%
7–14%	12.0%
0–7%	9.6%

Source of data: Schoeffler, Buzzell, and Heaney (1974), page 141.

EXHIBIT 8.3 SWOT Analysis of Chrysler and Daimler-Benz Just before the Announcement of Their Merger in 1998

	Daimler-Benz A.G.	Chrysler Corporation
Strengths	<p>Dominates "quality" niche; protected from trough of auto cycle.</p> <p>Strong international brand.</p> <p>New plant in Brazil, hot market.</p> <p>Strong new products: SLK, M-class, A-class, Smart Car.</p> <p>High share price; good acquisition currency.</p> <p>Good access to capital: Deutsche Bank is key stakeholder.</p>	<p>Strength in specific product segments such as minivans, trucks, SUVs.</p> <p>Manufacturing advantages: short product cycle; low supplier cost.</p> <p>Good position for Jeep worldwide and for Chrysler in Latin America.</p> <p>Cash and unused debt capacity.</p> <p>Engineering culture.</p>
Weaknesses	<p>High labor costs.</p> <p>High labor content: 60–80 hours/car (vs. 20 for Lexus).</p> <p>Declining unit volume in big luxury cars.</p> <p>Labor union on supervisory board may limit flexibility to change work practices.</p> <p>Losing large tax shields from operating loss carryforwards.</p>	<p>As third-largest North American player, very sensitive to economic cycle.</p> <p>Chronic financial weakness; near-demise in 1980.</p> <p>Products: not as much attention to detail and image.</p> <p>The least vertically integrated big manufacturer.</p> <p>Possibly undervalued in stock market.</p>
Opportunities	<p>Implement a shareholder value orientation (the so-called "Anglo-Saxon" perspective).</p> <p>Enter faster-growth product segments (e.g., SUVs) and geographic markets (e.g., Asia, Latin America).</p> <p>Distinguish the brand through distinct model platforms.</p> <p>Manufacture outside of Germany.</p> <p>Exploit synergies of \$1.4–\$3 billion.</p>	<p>"Long-term upside with no negative impact."</p> <p>A deal that is good for shareholders.</p> <p>Enter faster-growth product segments (e.g., SUVs) and geographic markets (e.g., Asia, Latin America).</p> <p>Get out from under the shadow of Ford and GM.</p> <p>Manufacture outside of United States.</p> <p>Exploit synergies of \$1.4–\$3 billion.</p>
Threats	<p>Industry overcapacity.</p> <p>Saturation of European market.</p> <p>Entry of other firms into key segments such as luxury sedans.</p> <p>European/North American trade war.</p>	<p>Industry overcapacity. Saturation of North American market.</p> <p>Entry of other firms into key segments such as minivans, SUVs, pickup trucks.</p> <p>Next recession.</p>

Assessing Competitive Position

Determining the firm's position in its competitive environment and its internal resources and capabilities is the foundation for setting strategy. This assessment aims to profile the industry, and the firm's position in it, along several dimensions:

- Structure of the industry and intensity of rivalry.
- Sources of change and turbulence that may trigger a shift in industry structure. Chapter 4 highlights a number of the classic forces of change.
- Dimensions of relative strength and weakness among players in the industry.
- Propensity of individual players to take action, exploit change forces, and alter the industry structure.
- Drivers of competitive strength and weakness in the industry.
- Outlook for profitability of investment in the industry.

To prepare the executive for strategic planning, a number of analytic tools are worth noting because of their practical popularity and usefulness. As Exhibit 6.4 illustrates, none of these tools dictate strategy. But they lend insights useful in the effort to inventory the firm's SWOTs. This is the foundation for *strategic planning*.

GROWTH-SHARE MATRIX: WHO HAS AN ATTRACTIVE POSITION? This first tool seeks to identify the relative positions of firms in an industry or divisions within a firm along three dimensions: size, growth, and relative share of market. This was popularized by Boston Consulting Group (BCG) in the 1970s and is used to indicate positions of weakness and strength. The choice of the three criteria for comparison reveals an underlying view about competitive advantage: some economic research supports the view that large absolute size and large market share are associated with competitive power and higher returns. Relative market share is measured as the ratio of your own share of market to that of your largest competitor. Growth should be measured in real, not nominal, terms. High real growth and pricing power derived from strong competition position are important drivers of value creation. A stalemate where competitors grow rapidly but slug it out with heavy investment while failing to obtain the profits envisioned with growth can destroy value. In the parlance of BCG, this leads to four broad categories of positions, as sketched in Exhibit 6.5, and available to the reader on the CD-ROM in the spreadsheet model "Growth Share.xls."

1. A "*cash cow*" (lower left quadrant) is a business with high market share and low growth, and hence low ongoing investment to sustain the business; firms in this segment are net providers of cash. Within multibusiness firms, cash cows are often milked to support growth of other divisions.
2. A "*star*" (upper left quadrant) is a firm with high market share and high growth: It generates plenty of cash for its ongoing expansion. And because of its strong market position, the continued investment to grow that business is attractive.
3. A "*dog*" (lower right quadrant) is a business with low growth and low market share. This business has low competitive power in the marketplace and has low prospects for growing into a more attractive position. Unless the position is changed, a business in this quadrant will be a sump for cash.

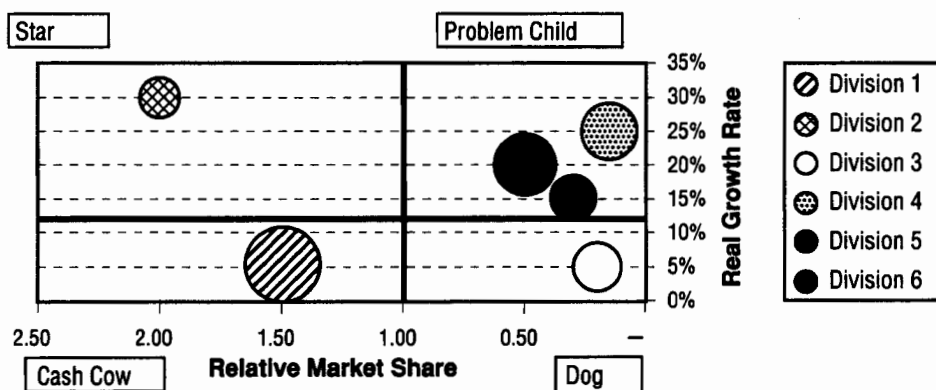
EXHIBIT 8.4 Overview of Tools for Strategic Analysis

What It Is	How to Use It	Pros and Cons
Growth-share matrix Illustrates the relative competitive position of firms or divisions on three dimensions: growth rate, relative share of market, and size.	Load data into "Growth Share.xls" on the CD-ROM and interpret the resulting figure. <ul style="list-style-type: none"> • Cash cow generates cash with which to sustain other businesses. • Star generates cash and grows rapidly. A keeper. • Dog uses cash and grows slowly. Earmark for serious improvement or sale. • Problem child. Grows rapidly but has a disadvantageous market share. Earmark for improvement but watch closely. 	<ul style="list-style-type: none"> + A helpful graphic depiction of business units or competitors. + Highlights the different kinds of attention the various units might warrant. - Focused on market position, not directly on shareholder value. - Makes no clear action recommendation about the four categories—ultimately this remains a matter of judgment.
Porter model A diagram illustrating how the structure of competition in an industry drives conduct and outcomes.	Use the model as a general guide in assessing a firm's competitive position: <ol style="list-style-type: none"> 1. What are the barriers to entry? 2. What power do customers have? 3. What power do suppliers have? 4. Do substitutes affect pricing? 5. What are the patterns of competitive conduct in the industry? 	<ul style="list-style-type: none"> + A useful guide and discipline for industry and competitor analysis. + Adds the idea that <i>power</i> from barriers or outside players affects outcomes. - Focused on market position and only indirectly on shareholder value. - Prescriptions are a matter of judgment.
Learning curve A graph that depicts the decline in costs as cumulative volume grows.	Load the data into "Learning Curve.xls" on the CD-ROM and interpret the resulting figure. The curve lends a prediction for the future path of production costs for your firm and competitors. Think critically about what might cause the curve to change slope or kink.	<ul style="list-style-type: none"> + A foundation for setting goals for internal transformation and cost management. - The curve smooths over the results of many observations. Inspect the specific points and inquire into sources of deviation from the curve.
Strategic map A generic figure for comparing the relative positions of competitors on three dimensions.	Load the data into "Strategic Map.xls" and interpret the resulting figure. Of particular interest will be the appearance of groups or "strategic clusters" as well as areas of the map that are unoccupied by any competitors.	<ul style="list-style-type: none"> + A useful illustration of the relative positions of competitors. - Not guided by any theory that specifies which criteria matter.

(Continued)

EXHIBIT 8.4 (Continued)

What It Is	How to Use It	Pros and Cons
Strategic canvas A generic figure for comparing the strategies of competitors on a number of dimensions.	Load the data into "Strategic Canvas.xls" and interpret the resulting figure. Of particular interest are points of similarity and difference.	+ A useful illustration of the relative positions of competitors. – Not guided by any theory that specifies which criteria matter.
Attractiveness-strength matrix A grid for comparing business units of a diversified firm on the basis of industry attractiveness and the competitive strength of the unit within that industry.	Select a range of criteria for scoring industries for their attractiveness and business units for their competitive strength. Score the units and their industries. Position the unit in the nine-cell matrix. Interpret the resulting table.	+ A useful illustration of the relative positions of competitors. – Not guided by any theory that specifies which criteria matter.
Self-sustainable growth rate A formula for determining the rate at which the firm can grow its assets without issuing new equity or altering its capital structure.	Insert values into the formulas outlined in Appendix 6.1 and interpret the resulting estimates of self-sustainable growth rate (SSGR). Compare the SSGR to growth rates of competitors, industry, or internal goals as a test of feasibility of strategy.	+ An easy test of strategic feasibility and source of critical thinking about financial sustainability. – Not directly focused on value creation.

Growth-Share Matrix for Divisions in a Firm**EXHIBIT 8.5** Illustration of Growth-Share Matrix

Note: The crosshairs separating the categories are to be placed as a matter of judgment by the analyst—the convention is to place the vertical line between 0.75 and 1.00, and the horizontal line at the average growth rate for the industry. Relative share of market is measured as the ratio of your share of market to that of your largest competitor. The rate of growth should be real (i.e., net of inflation) rather than nominal.

Source: Author's analysis.

4. A “*problem child*” or “question mark” (upper right quadrant) has a high growth rate and low market share—this business demands high rates of investment to grow the business but does not command the position in the market that might justify the investment.

A chart such as this can be used to depict the position of the units within a corporation for the purpose of assisting resource allocation decisions, as well as of competitors within an industry.² Also, one could prepare this chart based on current conditions and again based on expected performance over the next two- to five-year horizon—this before-and-after presentation would give a sense of competitive dynamics within the industry. The advantages of this chart are its strong graphic presentation and its appeal to marketers and strategists. On the other hand, the growth-share matrix relies heavily on historical data (rather than forecast data) and says nothing about the capabilities necessary for success in the various businesses. The model implies that market power matters most and that market power is driven by size, share of market, and growth. Yet theories of valuation and value creation indicate a broader set of drivers than market power alone. Stewart and Glassman (1999) criticized the growth-share matrix, writing, “A company’s cash cows were supposed to fund the growth of promising businesses (‘question marks’) into highly performing ‘stars.’ By making a company self-funding and self-perpetuating, the BCG approach appealed to corporate managers because it circumvented the monitoring processes of the capital markets. In reality, the poorly performing “dogs” ate the cash while the “question marks” were either starved, overmanaged, or were acquired for obscene premiums.” (Page 628)

DRIVERS OF INDUSTRY ATTRACTIVENESS (PORTER MODEL): HOW ATTRACTIVE WILL THIS INDUSTRY BE? Drawing on research in the subfield of economics, called industrial organization, Michael Porter (1980) presented a framework that characterized industry structure and competitive conduct as drivers of competitive success in an industry. His framework highlighted the role of five factors as driving economic attractiveness of an industry:

1. **Barriers to entry.** In theory, if an industry offers high returns, new entrants will be attracted into it, thus driving returns to a more normal level. But barriers may exist (or may be constructed) that prevent this from happening and enable current players in an industry to enjoy sustained high returns. Classic examples of entry barriers include regulatory restrictions (e.g., you must have a banking or broadcasting license from the government to compete), brand names (hard to develop and/or imitate), patents (illegal to exploit without ownership or license), high capital requirements (you must build a large greenfield plant to become a viable competitor), and unique know-how (Wal-Mart’s “hot docking” technique of logistics management). Porter highlighted the role of accumulated experience as a potential barrier—this *learning curve* effect is illustrated in Exhibit 6.6 and consists in reducing one’s cost of production as know-how accumulates. The effect of learning is apparent, for instance, in the substantial decline in the price of semiconductors over time: Unit costs decline by about 20 percent with each doubling of accumulated production. The learning curve gives a competitive advantage to the first or early mover. This benefit can be

achieved in either of two ways. First, one can accumulate experience faster than one's competitors can (e.g., through higher volume production or more rapid product changes) and thus get farther down the common learning curve faster. Second, one can try to steepen the slope of learning through larger leaps in internal development or the acquisition of know-how from outside the firm. Exhibit 6.6 shows the dramatic effects on unit cost of differing rates of cost reduction. Abernathy and Wayne (1974) discuss the impact of experience in various industries.

2. **Customer power.** Powerful customers can strongly influence prices and product quality in an industry. Examples are Wal-Mart and Federated Department Stores for consumer goods, and the U.S. government for the U.S. defense industry. Weak customers, on the other hand, are likely to be mere price-takers—examples would be consumers of filmed entertainment, cigarettes, and education. In those industries, the suppliers have been able to sustain prices increases well ahead of the rate of inflation.

	10% Cost Reduction	20% Cost Reduction	30% Cost Reduction
Slope	0.1	0.2	0.3
Base Cost	\$100.00	\$100.00	\$100.00
Cumulative Unit Production			
0	\$100.00	\$100.00	\$100.00
10	\$ 90.00	\$ 80.00	\$ 70.00
20	\$ 81.00	\$ 64.00	\$ 49.00
40	\$ 72.90	\$ 51.20	\$ 34.30
80	\$ 65.61	\$ 40.96	\$ 24.01
160	\$ 59.05	\$ 32.77	\$ 16.81
320	\$ 53.14	\$ 26.21	\$ 11.76

Learning Curves for a Single Product

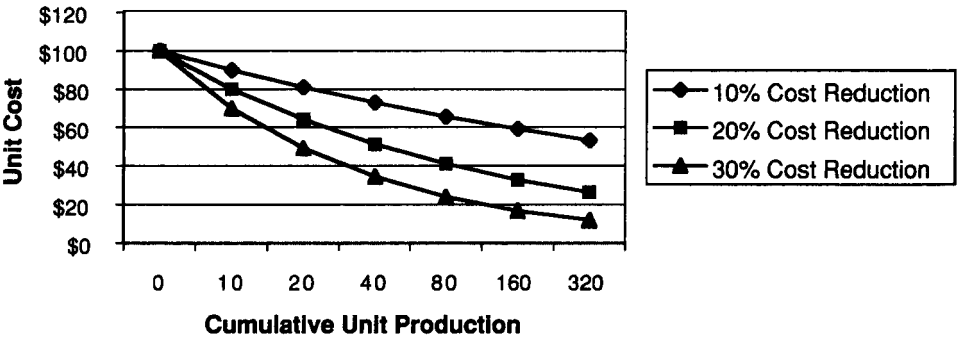


EXHIBIT 6.6 Illustration of Learning Curve
 Source: Author's analysis.

3. **Supplier power.** Similarly, powerful suppliers (e.g., monopolists) can extract high prices from firms in an industry. Weak suppliers can be a source of positive value to an industry—through most of the 1990s, the U.S. auto industry extracted material price reductions and quality improvements from its suppliers.
4. **Threat of substitutes.** Substitutes limit the pricing power of competitors in an industry. For instance, the price of coal quoted to electric power generators is influenced by the prices of Btu (British thermal unit) substitutes such as oil and natural gas.
5. **Rivalry conduct.** This final force captures the effects of dynamic competition among players in an industry. Investment in new product or process innovation, opening new channels of distribution, and entry into new geographic markets can alter the balance of competitive advantage. Cartel agreements (banned under the antitrust regulations in most countries) create industries with few adverse surprises for its players. At the other extreme, predatory pricing aimed at driving peers out of business can produce sharp variations in profitability. Porter noted that rivalry may be sharper where the players are similar in size, the barriers to exit from an industry are high, fixed costs are high, growth is slow, and products or services are not differentiated.

STRATEGIC MAP AND STRATEGIC CANVAS: HOW DOES OUR STRATEGY COMPARE WITH OTHERS?

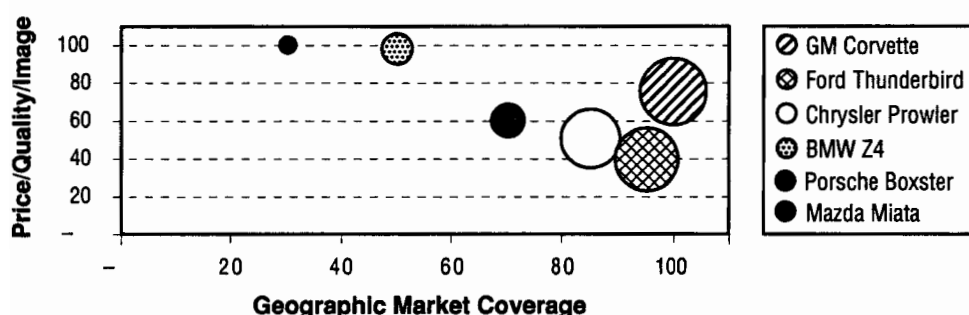
Assessing the industry and comparing the market shares of the players tells little about how they got there, and where they might be headed next. It is necessary to profile the strategies of competitors as a foundation for developing a strategy for your own business. Two tools are particularly useful here:

The first is a *strategic map* that, like a growth-share matrix, positions the players in an industry on the basis of size and two other dimensions that are strategically meaningful. Exhibit 6.7 gives an example of competing brands of sporty cars in the U.S. market, mapped on the basis of size, price/quality/image, and geographic market coverage. A map such as this helps to reveal niches of competition or *strategic groups* of competitors, as well as gaps in the competitive field where a firm might find unserved demand and/or a relatively safer haven from competition. In the example one observes two clusters: (1) high price/quality/image with small size and restricted geographic base and (2) medium price/quality/image with larger size and geographic base. Porter (1980) discusses the import of strategic group analysis at more length.

The second tool is a *strategic canvas* that illustrates in graphic form the similarity or difference among competitors' strategies. Exhibit 6.8 gives an example of a strategic canvas for two retailers, Brooks Brothers (a high-end primarily men's apparel retailer) and the Big & Tall Men's Shop (a mass-market men's apparel retailer). The exhibit shows that the two retailers' strategies vary markedly. Writing about the strategic canvas, Kim and Mauborgne (2002) said, "It does three things in one picture. First, it shows the strategic profile of an industry by depicting very clearly the factors that affect competition among industry players, as well as those that might in the future. Second, it shows the strategic profile of current and potential competitors, identifying which factors they invest in strategically. Finally our approach draws the company's strategic profile . . . showing how it invests in the factors of competition and how it might invest in them in the future." (Page 78)

	Price/ Quality/ Image (Max = 100)	Geographic Market Coverage (Max = 100)	Relative Size (Max = 100)
GM Corvette	75	100	100
Ford Thunderbird	40	95	95
Chrysler Prowler	50	85	80
BMW Z4	98	50	20
Porsche Boxster	100	30	5
Mazda Miata	60	70	30

Strategic Map: Sporty Cars

**EXHIBIT 6.7** Illustration of Strategic Map

Source: Qualitative assessment based on author's analysis.

Excel templates for the strategic map and strategic canvas are given in two programs on the CD-ROM, "Strategic Map.xls," and "Strategic Canvas.xls."

ATTRACTIVENESS-STRENGTH MATRIX: HOW DO RETURNS VARY WITH INDUSTRY POSITION AND INDUSTRY ATTRACTIVENESS? General Electric sought to combine an assessment of the attractiveness of an industry (i.e., the ability of the industry to generate attractive investment returns) and the attractiveness of the *position* within the industry, drawing on the research that showed a direct correlation between market share and returns. Industry attractiveness would be assessed through a Porter-style analysis of growth and prospective returns based on structure and conduct of the industry, and the drivers of change. The firm's position would be assessed through measures such as market share and costs to produce, and qualitative assessments of resources, capabilities, and core competencies. The firm's business units and their industries are typically scored by means of a weighted average of ratings on various dimensions. These scores are used to place the various units in the nine-cell grid shown in Exhibit 6.9. The cells located toward the upper-left corner of the grid will be more attractive business/industry combinations—the grid implies that these should merit priority treatment for investment. Similarly, the lower right cells are

Strategic Criteria for Comparison	Brooks Brothers	Big & Tall Men's Shop
Product quality	4.5	2.0
Service quality	4.5	2.0
Location quality	4.0	2.5
Price	5.0	1.0
Advertising	1.0	3.0
Inventory turns	2.0	4.0

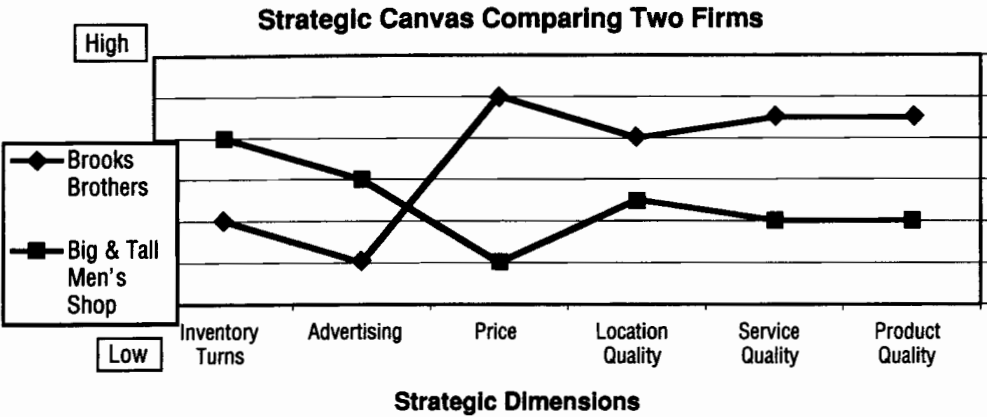


EXHIBIT 8.8 Illustration of Strategic Canvas
Source: Qualitative assessment based on author's analysis.

EXHIBIT 8.9 Illustration of Attractiveness-Strength Matrix

Industry Attractiveness	Competitive Position of the Unit		
	Strong	Average	Weak
High	Most attractive: Invest and build.		Question mark: Assess unit's profitability and prospects for improving position.
Medium	Moderate: restructure to improve.		
Low	Question mark: Analyze long-term profitability and prospects for endgame	Least attractive: Restructure or exit.	

least attractive and would be candidates for divestment or at least a highly skeptical investment stance. Compared to the *BCG growth-share matrix*, this matrix admits a wider range of criteria on which to judge the attractiveness of a business and its industry. But the scoring system for producing the ratings for business and industry attractiveness is arbitrary and may not be linked to financial returns in an obvious way. This exposes the analyst and audience to possible abuses.

The resources of the firm will dictate the rate at which it can grow organically—this is the *self-sustainable growth rate (SSGR)* and is a test of fit between the firm's current capabilities and its aspirations. In its simplest form, SSGR is determined by the firm's return on equity (ROE) and dividend payout (DPO) ratio as follows:

$$\frac{\text{Self-sustainable}}{\text{book value assets}} = \text{ROE} \cdot (1 - \text{DPO})$$

This indicates that the maximum internally sustainable rate of asset growth will be a direct result of the firm's profitability (ROE) and retention rate— $(1 - \text{DPO})$ or one less the percentage of earnings paid out in dividends. This rate can be compared to projected asset growth rates for the firm, its competitors, and its industry as a test of financial feasibility. Appendix 6.1 discusses various models of the self-sustainable growth rate and illustrates their application.

Business Definitions Are Key

All of the analytic tools described in this chapter are judgment-intensive. They depend on proper definition of the business and the product being analyzed.

DEFINING THE BUSINESS The industry position of a multibusiness or multiproduct firm, such as General Motors (GM), is less useful to analyze in the aggregate than are the positions of its individual products or business units. GM has relatively stronger and weaker segments. To aggregate them into a single assessment for GM yields none of the richness of the strategy problem GM faces. Salter and Weinhold (1979, page 268) argue that the level at which to define the unit of analysis is typically driven by strategic considerations (are there well-defined strategic sectors?), resources (are there special capabilities, patents, know-how, etc. that would justify defining a business in a certain way?), and organizational factors (how does the organization chart define business units, divisions, and sectors?).

DEFINING THE PEER GROUP For instance, consider the example of the sporty cars segment (given in the strategic map of Exhibit 6.7). Is the relevant industry for the Porsche Boxster actually automobiles in general, or should it be two-seat European roadsters? Or transportation? Peers are those products or services that are reasonable substitutes in the customer's mind. For instance, most brands of ketchup are peers in narrow definition—but considered in terms of competition in "sauces," brands of ketchup, salsa, steak sauce, and gravy might be peers. One can aim to identify peer groups through competitive analysis, the use of focus groups, or the U.S. government's "SIC"³ code. As discussed elsewhere in this book, the selection of a peer group for comparison will have a huge impact on the insights to be derived.

Classic Successful Strategies

To illustrate the importance of positioning, Porter (1985) described three classic strategies that seemed to yield special competitive advantage:

1. **Low-cost leadership.** This seeks to create a sustainable cost advantage over competitors and is often seen in industries where the product or service is a commodity. The attainment of this leadership position permeates the firm and is achieved through focusing on cost containment, strict asset management, an annual budgeting process characterized by great scrutiny, tough negotiation of union and raw materials agreements, and low-overhead central office operations. The advantage of this strategy is that the low-cost leader can't be undersold: This company will always win in a price war. A disadvantage of this strategy is that cost-minimization often requires a commitment to a particular product or process technology; such a commitment sacrifices flexibility. With technological innovation by competitors, this commitment can quickly turn from an advantage to a disadvantage.
2. **Differentiation.** This seeks to create a sustainable competitive advantage through distinguishing the firm or its products sufficiently to command a higher price and/or a strong customer franchise. It is seen in industries where customer demand is diverse and therefore unable to be satisfied with a commodity product. In pursuing this strategy, one must ask whether the pricing power achieved through differentiation is sufficient to compensate for the investment necessary to achieve it. Differentiation succeeds to the extent that it is hard to imitate and that it generates superior investment returns. Firms pursuing a differentiation strategy will focus on innovation, techniques of market segmentation, brand management, product quality, customer service, and warranties.
3. **Focus or specialization.** The focuser creates a competitive advantage by finding and dominating a market niche—there, the advantage springs from cost leadership or differentiation. This will be attractive where one can identify a niche of sufficient size to permit profitable and growing operations and where the firm has capabilities sufficient to serve demand. The disadvantage of a focus strategy is that the firm has all its eggs in one basket: Should the niche be successfully penetrated by a competitor, there will be no other market positions with which to mitigate the consequences.

In addition to defining these classic success strategies, Porter's analysis raises an equally important point: Don't get stuck in the middle. He argues that it is very difficult to establish a sustainable competitive advantage through hybrids of these approaches. By trying to be all things to all people, hybrids may become nothing to anyone. Skeptics of this point to Wal-Mart and Toyota, firms that successfully pursue cost leadership and the differentiation of products or services. Still, the difficulty of finding successful hybrids may justify them as the exception, rather than the rule.

EXPANSION BY INORGANIC GROWTH

M&A transactions should flow from the business strategy for the firm. Yet mergers and acquisitions are only part of the range of possible transactions a firm might

contemplate in seeking to implement its strategy. Exhibit 6.10 charts the variety of tactics and shows that they extend from transactions that grow or *diversify* the firm to transactions that restructure or *focus* the firm.

In contemplating expansion of the business, executives first must decide upon the classic “make versus buy” decision: Should growth be *organic* (i.e., through internal investment) or *inorganic* (i.e., by investing or structuring an affiliation outside the firm)? A decision about make versus buy will typically follow from a strategic analysis and estimation of the prospective returns on investment from the alternatives.

Motives for Inorganic Growth

Strategists and scholars point to five main reasons why firms pursue *inorganic growth*:

1. Maturing product line.
2. Regulatory or antitrust limits.
3. Value creation through horizontal and vertical integration.
4. Acquisition of resources and capabilities.
5. Value creation through diversification.

GROWTH IN THE CONTEXT OF A MATURING PRODUCT LINE Many businesses experience a life cycle of growth, as depicted in Part A of Exhibit 6.11. The explosive growth rates of the start-up phase of the business are eventually replaced by more sedentary growth. This is to be expected: High growth tends to attract imitators, who may sap the growth of the leader. Also, all the forces of turbulence (see Chapter 4) such as technological innovation, demographic change, deregulation, and globalization render products (and industries) obsolete. This degradation of the business

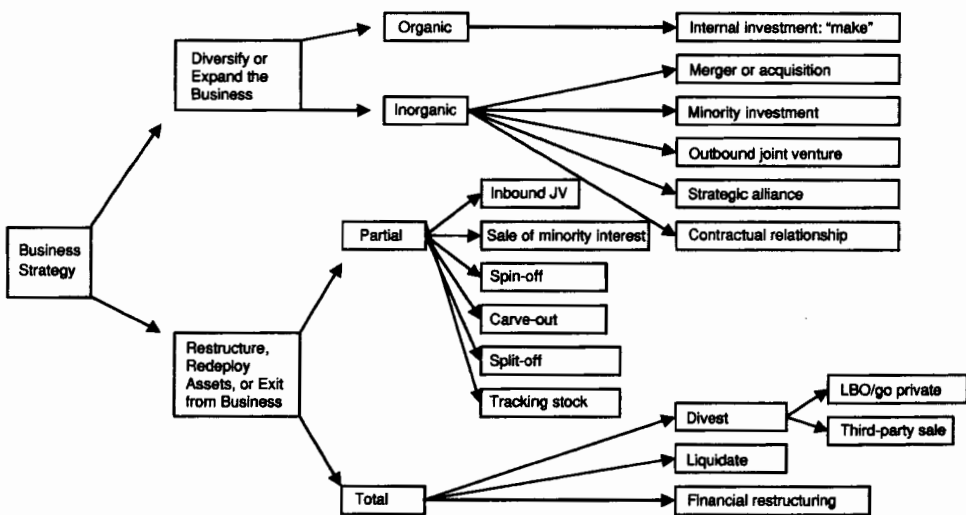
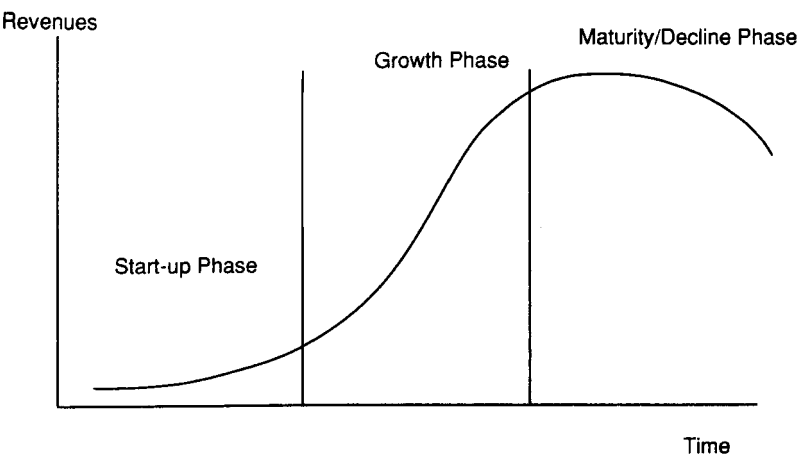


EXHIBIT 6.10 Range of Transactions in a Decision Framework

Part A: The Basic Cycle and Its Phases



Part B: Aggregate Growth from Finding New Businesses to Supplement Maturing or Declining Businesses

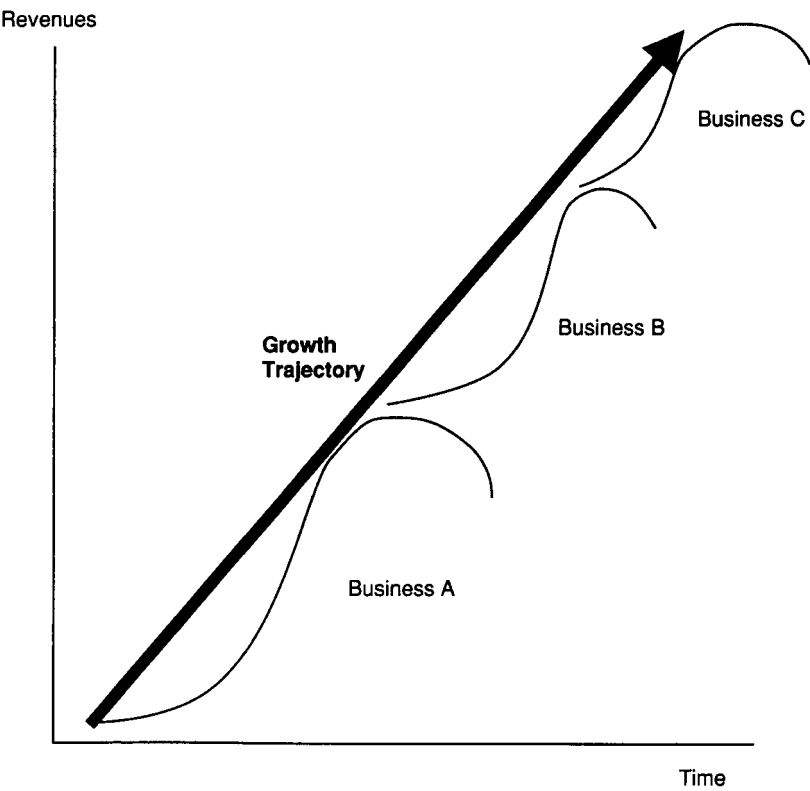


EXHIBIT 8.11 Life Cycle of the Firm

in its maturity years can produce headaches for CEOs. A common response is to acquire new businesses, still early in their life cycles, to create a total growth trajectory. This strategy of buying growth to sustain a growth curve is illustrated in Part B of Exhibit 6.11. The executive must retain two criticisms about this motive:

1. **May harm shareholder value.** This product life cycle perspective can create a frenzy for added revenue or earnings that ignores costs, investments, risks, and the time value of money. It is possible to achieve higher revenue growth and at the same time destroy shareholder value. See Chapters 9 and 17 for more about this.
2. **Is it sustainable?** In the limit, a trajectory of a high real growth rate (i.e., relative to the real growth rate of the economy) is bounded by the size of the economy. Growing at an excessive rate for a sufficiently long period of time, the firm will eventually own the entire economy.

GROWTH TO CIRCUMVENT REGULATORY OR ANTITRUST LIMITS Simply reinvesting in the core business may not be feasible if the firm operates under regulatory constraints. For instance, at various times broadcasters and banks have been limited in the scope of their operations. Inorganic growth through diversifying acquisition permits the maintenance of a growth trend. But like the previous point, one must critically assess the sustainability of growth and the impact on shareholder value of this kind of circumvention. The thoughtful CEO must relentlessly ask, "Is the shareholder better off if we return the cash through a dividend, and stop this growth program?"

VALUE CREATION THROUGH HORIZONTAL OR VERTICAL INTEGRATION Improving economic efficiency may be served by integration of the firm with peers, or with suppliers and customers. Chapter 4 described the first two large waves of M&A activity in the United States as waves of integration.

1. **Horizontal integration** entails combination with peer firms in an industry. This may exploit *economies of scale*, which will reduce costs, and *market power*, which may result in increased prices. Antitrust regulation seeks to forestall *monopoly power* in horizontal combinations (see Chapter 28).
2. **Vertical integration** combines firms along the value chain. For instance, a steel manufacturer might acquire upstream operations (such as iron ore mines) and downstream operations (such as fabricators of steel products). Harrigan (1985) noted that vertical integration can create value if it improves economic efficiency by cutting out intermediaries and reducing overhead expense and redundant assets. Improved coordination through inventory and purchasing business processes may create further efficiencies. And strategically it may guarantee a source of supply in a tight market, preempting competitors and preventing being locked out. But vertical integration also has potential disadvantages: Locking in suppliers and customers makes your firm an equity participant in their fortunes; if they fail to remain competitive, their problems can harm your core business. Furthermore, the creation of internal markets can lead to the loss of economic discipline and a distancing from the information conveyed by external markets.

ACQUISITION OF UNIQUE RESOURCES AND CAPABILITIES In some situations, it may be impossible to create internally those resources that are vital to the continued

success of the firm. In fields such as biotechnology, computer software, defense electronics, and filmed entertainment, large corporations regularly reach beyond their internal operations to acquire intellectual property, patents, creative talent, and managerial know-how.

VALUE CREATION THROUGH DIVERSIFICATION The classic motive for diversification is to create a portfolio of businesses whose cash flows are imperfectly correlated, and therefore might be able to sustain one another through episodes of adversity—this is a straightforward application of the theory of portfolio diversification that Levy and Sarnat (1970) explored at the corporate level. It is not clear what value this kind of portfolio management adds to shareholders' wealth—couldn't shareholders build these portfolios on their own? If so, why should they pay managers to do this for them? Salter and Weinhold (1979) argued that corporate diversification could do things that shareholder portfolio formation cannot. Thus, diversification might pay if it:

- **Promotes knowledge transfer across divisions.** This might lift the productivity of weak divisions. For instance, General Electric practices Total Quality Management and extends its productivity-enhancing techniques to new businesses that it acquires.
- **Reduces costs.** Where the diversification is into related fields, it may be possible for the diversified firm to reduce costs through improved bargaining power with suppliers. Also, the cost of financing may be lower thanks to the portfolio diversification effect. Lewellen (1971) suggested that combining two unrelated businesses whose cash flows are imperfectly correlated can reduce the risk of default of the entire enterprise, and therefore expand debt capacity and reduce interest rates.⁴
- **Creates critical mass for facing the competition.** Diversification may bring an aggregation of resources that can be shaped into core competencies that create competitive advantage.
- **Exploits better transparency and monitoring through internal capital markets.** Internal markets might function better than external markets. First, there may be lower transaction costs: shifting funds from cash cows to cash users may not entail the contracting costs associated with loan agreements or equity underwritings. Coase (1932) argued that the chief explanation of why some firms internalize activities that could, in theory, be conducted among independent firms was that high transaction costs made it cheaper for the firm to do so. Weston (1970), Alchian (1969), and Williamson (1975) offered supporting arguments that internal markets may be more efficient in some circumstances than external markets; Stein (1997) highlights one of these circumstances to be where the corporate headquarters is competent in "winner-picking," the shifting of funds to the best projects. Second, disclosure is probably greater: within the confines of the diversified firm, senior executives can obtain sensitive information that might not be available to outside sources of funds. Chandler (1977) documented the rise of the modern corporation and showed that enhanced methods of monitoring and information transfer enabled senior executives to manage larger and more diverse operations effectively. But the evidence about the effectiveness of internal capital markets is mixed. For instance, Lam-

ont (1997) studied the behavior of oil companies during the oil price collapse of the mid-1980s and found evidence consistent with the story that "large diversified companies overinvest in and subsidize underperforming segments." (Page 106)

Transactions for Inorganic Growth

Executives enjoy a wide range of tactical alternatives for inorganic growth. Mergers and acquisitions are often the focus of financial advisers seeking to generate fee income by assisting firms on M&A. But the executive should consider at least four other avenues before embarking on an M&A effort. These include *contractual relationships*, *strategic alliances*, *joint ventures*, and *minority investments*.

CONTRACTUAL RELATIONSHIPS This is the simplest of all inorganic expansions; it may assume strategic significance if the relationship extends over the long term, if there is a two-way exchange of information; if the two firms are linked into each other's business processes (e.g., inventory management systems), and/or if it entails an exchange of managers. These relationships can take many forms. Several classic arrangements are these:

- **Licensing agreements.** Your firm simply "rents" the technology, brand name, or other assets that are the focus of your interest.
- **Co-marketing agreements.** Your firm and the partner each agree to sell the products of the other party. The owner of the product permits another firm to make and market the product under a different brand name in return for a fee and profits on ingredients sold to the partner.
- **Co-development agreements.** Your firm and the partner each agree to share the costs of R&D or creative work necessary to develop a new product or process.
- **Joint purchasing agreements.** Your firm and the partner each agree to combine purchase orders for raw materials or other resources, to exploit economies of scale in purchasing.
- **Franchising.** Your firm grants an exclusive market territory to the partner in return for a one-time payment or annual fee.
- **Long-term supply or toll agreement.** Your firm commits to a predictable volume of unit purchases over the long term, in return for advantageous pricing.

These kinds of agreements are widespread in business. For instance, Glaxo Holdings, a pharmaceutical company established a co-marketing agreement with Hoffmann-La Roche to market its best-selling product, Zantac, an antiulcer drug. Bruner et al. (1992) detail the economics of these agreements: The trade-off for Glaxo was between lost direct sales versus fee income, profits on ingredients, and faster time to market within a limited period of patent protection.

STRATEGIC ALLIANCE In comparison with a contractual relationship, an alliance is typically more complicated and expresses a more serious commitment between the parties. A contract may formalize the alliance. But it is the exchange of managerial talent, resources, capabilities, and possibly even equity investment that elevates the alliance beyond a mere contractual agreement. An equity investment under the

alliance may be structured across a range of possible deals, including a joint venture or minority investment.

JOINT VENTURE A joint venture (JV) creates a separate entity in which your firm and the counterparty will invest. The JV agreement between the venture partners specifies investment rights, operational responsibilities, voting control, exit alternatives, and generally the allocation of risks and rewards. The entity could be a division carved out of one of the venture partners, or an entirely new business established for the venture. The agreement for large JVs may be as complicated as for an acquisition.

MINORITY INVESTMENT Here, your firm invests directly in the counterparty firm, rather than in an intermediate firm (like the joint venture). Sometimes firms take mutual *minority interests* in each other; this is called a *cross-shareholding arrangement* and is common among large Japanese and Continental European firms. Taking a direct equity interest in another firm is a strong signal of commitment and participation in the fortunes of that firm.

Research Findings about Joint Ventures, Alliances, and Minority Equity Investments

Continuing a trend of several decades, the formation of joint ventures and alliances grew dramatically during the 1990s, as shown in Exhibit 6.12. Robinson (2001) argued that the growth of JVs and alliances was due to their success as commitment devices between organizations—alliances bind the partners not to divert resources in inefficient ways. Also, he found that alliances are more likely than acquisitions where the risk of the venture is greater than the risk of the partner's core business.

Incidence of Joint Venture and Alliance Formations
by Year

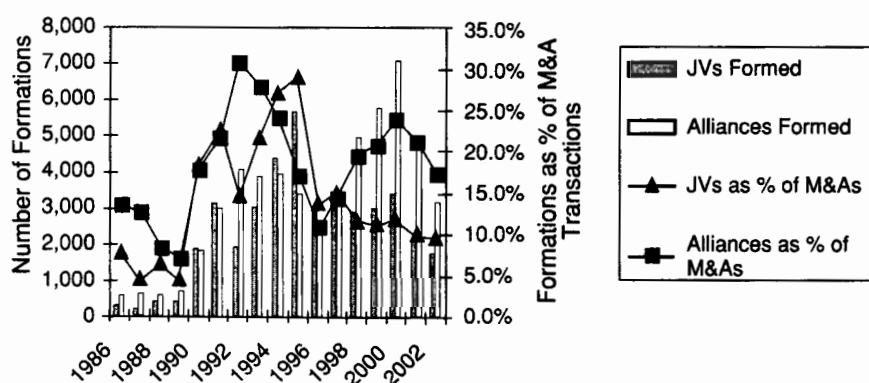


EXHIBIT 6.12 Formation of Joint Ventures and Alliances by Year and as a Percentage of Total M&A Activity

Source of data: Thomson Financial SDC, Platinum Joint Ventures Database.

Desai, Foley, and Hines (2002) studied the formation of international joint ventures and found a trend away from minority ownership and toward whole ownership. They speculated that this change might reflect relaxation of restrictions on whole ownership or changes in the geographic mix of investments. They found that "whole ownership is most common when firms coordinate integrated production activities across different locations, transfer technology, and benefit from world-wide tax planning" (page 1) and that this propensity toward global organization explained a declining tendency to organize foreign operations as joint ventures.

Lerner, Shane, and Tsai (2003) studied R&D ventures formed by small biotechnology firms. They found that when external equity financing is unavailable or limited in supply, these firms are more likely to fund their R&D by organizing research JVs with large corporations. And the agreements structured under these circumstances tend to assign the bulk of control to the large corporate partner. Such agreements are likely to be renegotiated and to be significantly less successful than others. Robinson and Stuart (2002) found that the staging of investment is ubiquitous between small biotechnology R&D firms and their partners. Staging releases investment funds as the R&D firm passes preset milestones—this is discussed in more detail in Chapter 14.

The overarching conclusion about the profitability of joint ventures, alliances, and minority equity investments is that, like M&A, it is profitable for targets, a break-even proposition for purchasers, and for both target and purchaser combined, an economically positive activity. Exhibit 6.13 summarizes findings across 12 studies and shows significantly positive abnormal returns of 0.5 to 1.0 percent to firms announcing investments in JVs. JVs seem to pay. The findings suggest that JV partners do better when:

- Buyers have good investment opportunities. Chen et al. (2000) find that where the buyer has a good record of investment returns, the announcement of a JV is associated with gains to shareholders. But where the buyer's record is weak, the JV announcement could be taken as a signal of pessimism about the buyer's internal opportunities.
- JV increases focus for the buyer. Ferris et al. (2002) find materially better returns for buyers where the JV increases the business focus of the firm.
- JV reduces agency costs. Allen and Phillips (2000) concluded that intercorporate equity investments in the form of JVs, alliances, and minority stakes reduced "the costs of creating, expanding, or monitoring the alliances or ventures between firms and their corporate block holders." (Page 2813) Robinson (2001) argued that JVs help to shelter "underdog" projects from the adverse behavior sometimes found in internal capital markets (e.g., winner-picking). Allen and Phillips (2000) found that the returns from JVs and alliances were greatest in the instance of R&D intensive industries. These gains may stem from alleviating the problems of information asymmetries arising from the development of new technology.
- JV is in a favorable foreign environment, in terms of laws and regulations. Returns from JVs vary by country and region, consistent with the discussion in Chapter 5 that variations in deregulation and rule of law will affect investment returns.

EXHIBIT 6.13 Summary of Studies of Market Returns to Parent Shareholders at Announcements about Joint Ventures, Alliances, and Minority Equity Investments

Study	Cumulative Abnormal Returns at the Event	Cumulative Abnormal Returns after the Event	Sample Size	Sample Period	Notes
Gleason, Mathur, Wiggins (2003)	+0.51%* full sample +0.45%* domestic +0.60%* international +0.61%* horizontal +0.47%* diversifying (days -1,0)	+7.94% [†] full sample +9.40% [†] domestic +4.05% international +14.79% [†] horizontal +5.10% diversifying (months +1,+18)	638 311 197 134 376	1985-1998	Sample of deals involving financial services institutions.
Ferris et al. (2002)	+0.52%* whole sample +0.71%* focus-increasing JVs 0.11% focus-decreasing JVs (all estimates are around days -1,0)	+5.31% whole sample +9.43% [†] focus-increasing -1.42% focus-decreasing (estimates around months 1,36)	325 200 125	1987-1996	Sample of international JVs by Singaporean firms.
Johnson, Houston (2000)	+1.67% horizontal JVs +5.0% suppliers in vertical JVs 0.0% buyers in vertical JVs	N/A	85 horizontal JVs 106 Vertical JVs	1991-1995	Compared returns to JV investors with returns to firms using simple contracts.
Schut, van Frederikslust (undated)	+0.40% (days -1,0) *		233	1987-1998	Sample of Dutch JVs.
Chen, Ho, Lee, Yeo (2000)	+0.96% (days -1,0) *		174	1979-1993	International JV announcements by Singaporean firms.

Allen, Phillips (2000)	+9.1% * alliance, JV target +0.1% alliance, JV purchaser +5.5% * no alliance, JV target -1.1% no alliance, JV purchaser +8.3% * alliance, JV with board representation, target -0.4% alliance, JV with board representation, purchaser (all estimates are around days -10,+10)	150 150 252 252 92 92	1980- 1991
Chan, Kensinger, Keown, Martin (1997)	+0.64% * whole sample, day 0 +3.45% * horizontal alliance involving tech transfer +1.00% horiz, nontech +1.45% * nonhoriz, nontech +0.27% nonhoriz, tech transfer +0.87% * full sample +0.80% * tech exchanges subsample 0.40% licensing agreements 0.01% marketing agreements -0.13% supply agreements +0.71% * full sample (days -1,0)	345	1983- 1992
Koh, Venkatraman (1991)	+1.05% [†] U.S. partner returns +1.08% [†] Japanese partner returns -0.466% [†] full sample	175	1972- 1986
Chen, Hu, Shieh (1991)	+0.73% full sample (days -1,0) +1.10% small firm subsample +0.63% large firm subsample	88	1979- 1990
Crutchley et al. (1991)		82	1979- 1987
Lee, Wyatt (1990)		109	1974- 1986
McConnell, Nantel (1985)		210	1972- 1979

International JVs in
China by U.S. firms.
Japanese-U.S. JVs.

Unless otherwise noted, event date is announcement date of transaction.

*Significant at the 0.99 level or better.

[†]Significant at the 0.95 level.

RESTRUCTURING, REDEPLOYMENT, AND SALE

Restructuring is a lengthy process. Donaldson (1990) documented a restructuring program (consisting of many discrete transactions) at General Mills that spanned two decades. Kaiser and Stouraitis (2001) described the restructuring of Thorn-EMI that encompassed numerous transactions and lasted 13 years. Boone and Mulherin (2001, 2002) found that the median length of targeted restructuring events is 345 days and that the investor reactions to the initial and subsequent announcements are significantly positive. Their analysis of the auction processes in these restructurings finds the highest returns from asset sales to be associated with the entry of multiple publicly owned bidders.

Motives

The motives for exit mirror those for entry: the adverse effects of industry turbulence; the need to exit from unattractive businesses. As Chapter 3 reveals, not all acquisitions are successes. And even for good businesses, the forces of competition, turbulence, and the life cycle can bring an end to a period of good performance. Jensen (1999) noted that "Exit problems appear to be particularly severe in companies that for long periods enjoyed rapid growth, commanding market positions, and high cash flow and profits." (Page 583) He cited the reluctance of U.S. automobile tire manufacturers to close factories that produced the bias-ply tire when it became apparent that the radial tire product would displace it.

SHARPEN STRATEGIC FOCUS A portfolio of unrelated business activities requires senior management to master a wide variety of industrial concepts and to monitor disparate businesses. A portfolio organized around a focused strategy can exploit executive expertise in neighboring businesses. Weston (1989) argued that dismantling inefficient conglomerates was an important motive for divestitures and restructurings.

CORRECT "MISTAKES" AND HARVEST "LEARNING" Porter (1987) studied the acquisitions of diversified firms and found high rates of *divestiture* in the years following acquisition—on average, they divested 53 percent of their acquisitions within a few years. This implied to Porter a large failure rate in corporate acquisition. Weston (1989) replied that this rate of divestiture could be explained by a variety of effects such as antitrust enforcement and the harvesting of mature investments. He wrote, "Divestitures seem as likely to reflect past successes as mistaken attempts at diversification. Some are pre-planned for good business reasons. Some represent harvesting of sound investments. And some reflect organizational learning that contributes to improvements in future strategies. . . . Regardless of which version one accepts as the dominant explanation for divestitures—'mistakes' or 'learning'—the persistently high numbers and values of such transactions constitute reliable evidence that the market system is working, ensuring the mobility of resources essential to the effective operation of an enterprise economy." (Pages 75–76)

CORRECT THE MARKET VALUATION OF ASSETS Executives frequently complain that the stock market doesn't understand their firms and that it is worth more than the current price suggests. Restructuring can monetize undervalued assets. The firm may

contain business units to which investors attribute little or no value. Restructuring can help to establish a monetary value for those assets. If certain business units would be worth more standing alone, a restructuring can exploit a pure-play premium (avoid a diversification discount). Investors may have an appetite for single-segment firms—the common argument is that these kinds of firms are easier to understand, and permit the investor more easily to construct efficient portfolios of securities. Finally, there may be a known buyer to whom the assets or business unit are worth significantly more than to your firm. A restructuring can redeploy assets to higher-valued uses. Your firm may be operating an asset effectively, but there may be alternative uses for the asset that create even more value.

IMPROVE THE INTERNAL CAPITAL MARKET Diversified firms can suffer from failures in the internal capital market to allocate resources effectively—the most prominent kind of failure is the subsidization of inefficient units by efficient units. By shedding the inefficient operations, a restructuring program can eliminate the cross-subsidies.

OPTIMIZE FINANCIAL LEVERAGE AND REDUCE TAX EXPENSE Many restructurings that entail a change in capital structure for the firm seek to create value for shareholders by reducing the risk of default to acceptable levels or exploiting the tax deductibility of interest expense. The valuation of debt tax shields is discussed in more detail in Chapter 13, and Chapter 34 gives a detailed discussion of leveraged restructuring.

STRENGTHEN MANAGERIAL INCENTIVES/ALIGN THEM WITH THE INTERESTS OF SHAREHOLDERS Financial restructurings and leveraged buyouts often result in management holding a meaningful investment in the equity of the firm. This tends to focus management attention on the efficiency of the business and align their interests more tightly with those of the other equity investors.

RESPOND TO CAPITAL MARKET DISCIPLINE Financial underperformance by firms can trigger a range of reactions from capital markets, from adverse comments by journalists and securities analysts to depressed share prices, higher interest rates, shareholder proxy contests to replace the board of directors, and hostile takeover attempts. A defensive restructuring is a prominent response to capital market discipline. Chapter 36 describes the case of American Standard's defensive restructuring.

GAIN FINANCING WHEN EXTERNAL FUNDS ARE LIMITED Firms with poor access to debt or equity markets may turn to the sale of assets to raise funds. Thus, divestiture may relax capital constraints. Consistent with this financing motive, Schlingemann et al. (2002) found that the liquidity of the market for the particular corporate assets is a significant determinant of *which* assets are likely to be divested. Kruse (2002) found that there is a greater probability of asset sales if the firm is performing poorly and suffers from low debt capacity.

Transactions to Restructure, Redeploy, or Sell

A strategic decision to focus or restructure the firm poses the choice about degree (partial deployment or outright exit) and method. Here, the possible transactions also span a wide range of alternatives.

SALE OF MINORITY INTEREST The sale of a block of shares to another firm gains the selling firm fresh capital and attracts a committed partner who might be induced to contribute know-how or other resources. This alternative should be compared to a public offering of shares (i.e., for pricing and costs). The investor may seek advantageous (i.e., low) pricing, arguing that it amounts to a private transaction. The trade-off for the issuer is whether the other resources the investor might contribute will compensate for any private transaction discount. An added consideration is political: How will the minority stake affect the balance of voting power in the firm, and how will other equity investors respond? Sometimes a minority stake is prelude to a takeover.

SALE OF JOINT VENTURE INTEREST The sale of a partial interest in a joint venture to a partner attracts fresh capital for the venture and the participation of a partner with know-how and other resources. Compared to the minority stake, this has the virtue of less political impact and affords more transparency about the contributions of the respective sides.

DIVESTITURE OR ASSET SALE The business unit, or certain assets in the unit (such as a factory), could be sold outright to an unrelated party. This raises funds for your firm and possibly frees it from a money-losing proposition. While divestitures account for a large proportion of M&A activity (26 to 35 percent of all deals are divestitures), two types of sales deserve special mention. In the *leveraged buyout/going private transaction*, the management of the unit will organize an investor group and debt financing with which to pay for the unit. Usually the ability to sell a unit into an LBO depends on its capacity to succeed as a stand-alone entity and on its capacity to bear debt used to finance the transaction. Chapter 13 discusses LBOs and other highly leveraged transactions in more detail. The *liquidation* is the extreme divestiture strategy: the firm sells *all* of its assets, pays any outstanding liabilities, dividends the net proceeds to shareholders, and then dissolves. Bruner et al. (1979) explored the liquidation of UV Industries, a Fortune 500-ranked firm, in 1979. Triggered by a hostile raid, the firm commenced a voluntary liquidation that yielded a return of 163 percent over its preraid value. Exhibit 6.14 illustrates the divestiture alternative.

CARVE-OUT This tactic organizes the business unit as a separate entity and sells to the public an interest in the equity of the unit through an initial public offering (IPO). This generates cash for the parent, monetizes the parent's interest in the subsidiary, and creates more transparency for investors to assess its value. Exhibit 6.14 presents the *carve-out* alternative.

SPIN-OFF Like the carve-out, the *spin-off* creates a separate entity for the business and results in public trading of its shares with majority ownership retained by the parent. But in the case of a spin-off, the shares are *given* to the parent's shareholders in the form of a dividend. No money is exchanged. Where one firm existed before, two firms exist after. At the point of spin-off, the same shareholder group owns both companies (though ownership will probably change once trading commences in the new firm's shares). Exhibit 6.14 diagrams the *spin-off* alternative.

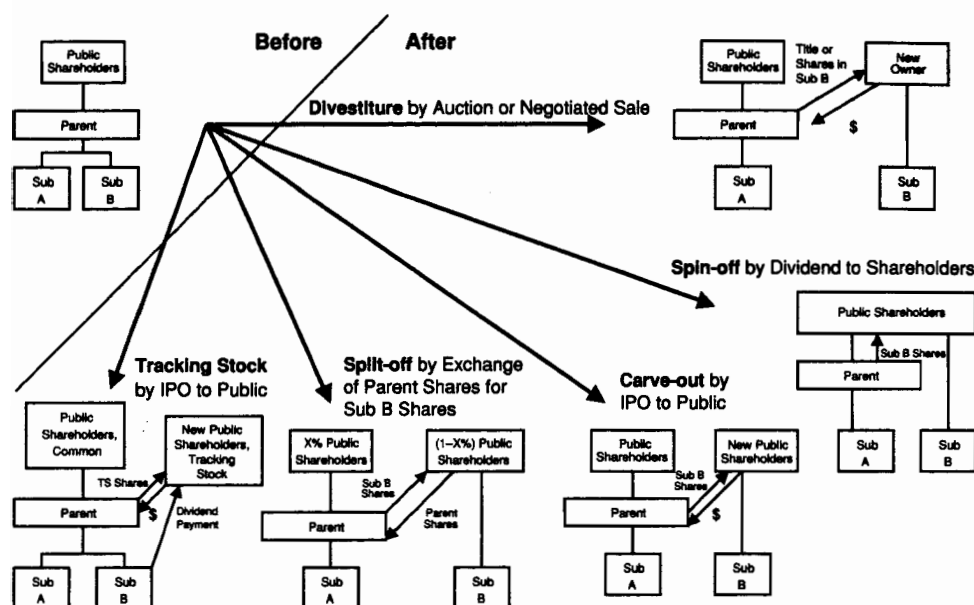


EXHIBIT 6.14 Comparison of Divestiture, Spin-off, Carve-out, Split-off, and Tracking Stock Where the Parent Considers Redeploying Subsidiary B

SPLIT-OFF, OR EXCHANGE In this instance, shares of the subsidiary business are swapped by shareholders of the parent for shares in the subsidiary. This results in a freestanding firm, no longer a subsidiary of the parent, owned initially by a subgroup of the former parent's shareholders. Exhibit 6.14 illustrates the *split-off* alternative.

TRACKING STOCK Here, there is no transfer of ownership of a business or its assets. But a special equity claim *on the subsidiary business* is created, the dividend of which is tied to the net earnings of the subsidiary. This results in monetization of the subsidiary and in greater transparency. Exhibit 6.14 illustrates the *tracking stock* alternative.

FINANCIAL RECAPITALIZATION This focuses on changes in the firm's capital structure.⁵ The intent is usually to optimize the mix of debt or equity, or to adjust the equity interests in the business. Regarding the debt/equity mix, firms might undertake a *leveraged restructuring* in which the firm borrows debt to repurchase shares or pay an extraordinary dividend. Chapters 13, 20, and 34 explore the implications of capital structure altering transactions. Regarding changes in the equity base, firms could contemplate an *ESOP restructuring* in which the firm purchases its own shares (or issues them from its treasury) for sale to an employee stock ownership plan. Alteration of both the capital mix and equity ownership is seen in *reorganization in bankruptcy* in which the firm exchanges debt obligations for equity interests to reduce its debt burden under the protection of the court.

Exhibit 6.15 summarizes the activity in divestitures, spin-offs, and carve-outs from 1986 to 2002. The number of divestitures increased dramatically over this

EXHIBIT 8.15 Volume of Divestitures, Spin-offs, and Carve-outs by Year and as a Percentage of Total M&A Activity

	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
Number of transactions																	
Divestitures	1,357	1,474	2,103	2,895	3,701	5,128	5,002	5,241	5,414	6,261	6,580	7,063	7,044	7,811	7,735	6,998	6,283
Spin-offs	34	28	38	37	48	31	42	46	39	63	76	76	118	81	102	63	35
Carve-outs	3	5	6	21	40	70	76	167	240	176	142	64	32	32	44	45	20
As a % of M&A deals																	
Divestitures	35.8%	30.8%	31.8%	31.5%	36.8%	37.2%	37.8%	37.8%	33.2%	31.8%	31.4%	30.9%	28.0%	28.5%	26.3%	31.3%	34.3%
Spin-offs	0.9%	0.6%	0.6%	0.4%	0.5%	0.2%	0.3%	0.3%	0.2%	0.3%	0.4%	0.3%	0.5%	0.3%	0.3%	0.3%	0.2%
Carve-outs	0.1%	0.1%	0.1%	0.2%	0.4%	0.5%	0.6%	1.2%	1.5%	0.9%	0.7%	0.3%	0.1%	0.1%	0.1%	0.2%	0.1%

Source of data: Thomson SDC Financial Services.

period, by almost five times. Also, relative to the total number of M&A transactions, divestitures account for about one-quarter to one-third of the total over time. The number of spin-offs and carve-outs is highly variable over this period and, relative to M&A activity, quite small.

Research on the Profitability of Unit Divestitures, Asset Sales, and Liquidation

Exhibit 6.16 summarizes studies of the shareholder wealth implications of divestiture: Announcements of divestitures uniformly create value for shareholders of sellers, on the order of a 1 to 3 percent significant abnormal return. The results for buyers are mixed: One study reports positive and significant returns (Hite et al. 1987); a second reports positive and insignificant returns (John and Ofek 1995); and a third reports negative and insignificant returns to buyers (Allen and Phillips 2000). The small absolute returns for buyers seen in the exhibit should be viewed with the same caution as discussed in Chapter 3. First, these returns occur over short time periods and should be annualized before being compared with other conventional returns to investors. Second, the divested assets are typically a fraction of the market value of the buyer or seller firm—this comparative size effect can make the profitability of divestiture seem inconsequential, when it may remain economically profitable in absolute terms.

Beneath the general results of Exhibit 6.16 are some interesting insights. First, the *redeployment of assets* seems to be what matters, not merely the sale. This is apparent in three sets of findings.

1. Lang et al. (1995) found an announcement return of almost 4 percent when the firm committed to returning the divestiture proceeds to investors (e.g., in the form of reducing the firm's debt). In comparison, the announcement return was insignificantly different from zero for cases where the firm planned to reinvest in the business.
2. Announcements of plant closings (Blackwell et al. 1990) are frequently the prelude to divestiture or *liquidation* and produce small but significantly negative returns to shareholders. Announcements of plant closings can be a surprising signal to investors of the failure of a strategy. The pattern of returns in the entire exhibit suggests that it is the redeployment of assets (e.g., through divestiture) that matters. The uncertainty about the future disposition of the investment in that plant is resolved only at the divestiture announcement.
3. Voluntary liquidations, the ultimate program of divestiture, deliver the highest returns to shareholders, in the range of 12 to 13 percent, market-adjusted. Liquidations completely disengage from business and return the funds to shareholders.

Second, the market seems to reward *divestitures that focus* the firm. John and Ofek (1995) document a significant relation between the announcement returns at divestiture and the degree of increase in strategic focus of the firm after divestiture. In his study of a 20-year restructuring program at General Mills, Donaldson (1990) found that announcements of the sale of noncore assets was associated with higher abnormal returns than was the sale of core-related assets (+2.03 versus -0.43 percent). Kaiser and Stouraitis (2001) studied the refocusing effort of Thorn-EMI and reported positive and significant abnormal returns.

EXHIBIT 6.18 Summary of Studies of Market Returns to Parent Shareholders at Unit Divestitures, Asset Sales, and Liquidations

Study	Cumulative Abnormal Returns at the Event	Cumulative Abnormal Returns after the Event	Sample Size	Sample Period	Notes
Boone, Mulherin (2001)	+6.40% * full sample +12.16% * possible sale +2.93% general restructuring (days -1,0)		298 97 75	1989-1998	Sample of announcements of corporate restructurings.
Allen, Phillips (2000)	+0.8% selling firm -1.1% purchaser firm (days -10,+10)		48	1982-1991	
Ditmar, Shivdasani (2002)	+2.6% * full sample sellers +3.0% * sellers who remain diversified +2.2% * sellers who become single-segment firms (days -1,0)	+12% full sample +14% remain diversified +17% become single (change in value estimated year t-1 to t+1)	188 91 97	1983-1994	Sample of asset sales. Finds significant negative correlation between event returns and change in the diversification discount.
Berger, Ofek (1999)	+3.0% * restructuring announcements +3.6% [†] first announcement +1.3% [†] second or later anncts. +7.3% [†] all sale related anncts. (days -1,0)		29 105 299 105	1984-1993	Sample of asset sales and spin-offs.
John, Ofek (1995)	+1.5% [†] full sample sellers +0.4% full sample buyers (days -2,0)		258 167	1986-1988	Sample of asset sales. Increasing focus is associated with larger returns.
Slovins, Sushka, Ferraro (1995)	+1.70% * full sample sellers (days -1,0)	-0.20% full sample (returns estimated days +2,+11)	179	1980-1991	Sample of asset sales.

Lang, Poulsen, Sulz (1995)	+1.41%* full sample +3.92%* proceeds used to pay dividend or reduce debt -0.48% proceeds to be reinvested (days -1,0)	93	Sample of asset sales.
		40	Difference between repay and reinvest subsamples is significant.*
Donaldson (1990)	+1.13%† full sample +2.03%* noncore sales -0.43% core sales	11	Divestitures by General Mills only.
		7	
		4	
Blackwell, Marr, Spivey (1990)	-0.55%* full sample -0.59%* operation not profitable -0.24% labor-management dispute	244	Sample of announcements of plant closings.
		196	
		9	
Sicherman, Petway (1987)	Buyers returns +4.026%* related businesses 0.047% unrelated businesses (days -10,+10)	147	
		1983- 1985	
Hite, Owers, Rogers (1987)	+1.66%* full sample, sellers in completed deals +0.83%‡ buyers in completed deals (returns estimated days -1,0)	55	Sample of asset sales.
		41	
		215	
Klein (1985)	+1.11%* sample of sellers (days -2,0)		Sample of asset sales.
		1970- 1979	
Hearth, Zaima (1986)	1.42%* divesting firms 0.25% acquiring firms (days -1,0)	73	Sample of asset sales.
Jain (1985)	+0.07% sample of sellers +0.04% sample of buyers (days -5,-1)		
		304	Sample of asset sales.
		1976- 1978	
Rosenfeld (1984)	+0.34% sellers (day -1) +2.33%* full sample	35	
		1963- 1981	

(Continued)

EXHIBIT 8.18 (Continued)

Study	Cumulative Abnormal Returns at the Event	Cumulative Abnormal Returns after the Event	Sample Size	Sample Period	Notes
Alexander, Benson, Kampmeyer (1984)	+0.17% full sample (days -1,0)	-2.47% (days +1,+30)	53	1964-1973	
Hite, Owers, Rogers (1987)	+12.24%* at press date, full sample +5.97%* liquidations with prior control bids +18.26%* liquidations with no prior control bids (returns estimated days -1,0)	-5.96% full sample -4.79%* liquidations with prior control bids -7.08%* liquidations with no prior control bids (returns est'd. months 1,12)	49 24 25	1963-1978	Sample of voluntary liquidations.
Kim, Schatzberg (1987)	+13.53%* at announcement date +2.84%* at stockholder confirmation date (returns estimated days -2,0)		73	1963-1982	Sample of voluntary liquidations.

Unless otherwise noted, event date is announcement date of transaction.

*Significant at the 0.99 level or better.

†Significant at the 0.90 level.

‡Significant at the 0.95 level.

Third, firms selling assets tend to suffer from *lower profitability or high leverage*. Lang et al. (1995) concluded, "Management sells assets to obtain funds to pursue its objectives when alternative funding is either too expensive given its objectives or unavailable. . . . A successful sale means that the firm received enough money to make the sale worthwhile. . . . Firms selling assets typically are poor performers and they are more likely to pay out the proceeds when they find it difficult to service their debt." (Page 22)

Research on the Profitability of Carve-outs, Spin-offs, Split-offs, and Tracking Stock

The general finding is that carve-outs, spin-offs, and tracking stock are neutral to beneficial for shareholders. Exhibits 6.17 and 6.18 summarize studies of the event returns associated with spin-offs and carve-outs; these are generally profitable to investors. Exhibit 6.19 on page 164 shows that tracking stock is value neutral to slightly positive for investors.

Research amplifies some of the insights. First, the investment behavior and financial performance of spun-off units improves following the spin-off. Gernter, Powers, and Scharfstein (2002) found that spun-off units tended to cut investment in unprofitable businesses and increase investment in profitable industries. Chemmanur and Paeglis (2001) found material increases in the price-earnings and price-sales ratios for parents and subsidiaries as a result of the transactions. Cusatis, Miles, and Woolridge (1993) documented significant returns over the longer term following spin-offs. Hurlburt et al. (2002) found that sales, assets, and capital expenditures of carved-out subsidiaries grew significantly faster than industry peers in the first year after the transaction; but the parent firm shrank. Ahn and Denis (2001) reported that diversified firms improved their investment efficiency and eliminated the *diversification discount* following spin-offs. In contrast, Haushalter and Mikkelson (2001) found no material improvement in long-term performance following tracking stock or carve-outs.

Second, relatedness matters in the choice of transaction. Chemmanur and Paeglis (2001) found that carve-outs and spin-offs tend to involve business units that are less related to the core than do tracking stocks. McNeil and Moore (2001) reported that announcement returns are larger at the spin-off of unrelated businesses than related businesses.

Third, the findings are consistent with benefits of increased focus. Hite and Owers (1983), Schipper and Smith (1983), Daley, Mehrotra, and Sivakumjar (1997), and Desai and Jain (1998) argue that spin-offs resolve "information asymmetry" problems—these arise from the complexity of multidivisional firms and the lack of transparency for investors to monitor the managers. Krisnaswami and Subramaniam (1999) find that firms undertaking spin-offs have higher levels of information asymmetry and that these problems decrease after the spin-offs. Best, Best, and Agapos (1998) find that securities analysts significantly increase their short-term earnings forecasts after spin-offs. Daley, Mehrotra, and Sivakumar (1997) find significant value creation around cross-industry spin-offs (rather than same-industry spin-offs). Vijh (2000) reports higher carve-out returns when the subsidiary is in a different two-digit SIC code from the parent. Veld and Veld-Merkoulova (2002) report significantly higher returns at spin-offs that are focus-increasing.

EXHIBIT 6.17 Summary of Studies of Market Returns to Parent and Subsidiary Shareholders at Spin-Offs

Panel A: Returns to Shareholders of Parent				
Study	Cumulative Abnormal Returns at the Event	Cumulative Abnormal Returns after the Event	Sample Size	Sample Periods
Davis, Leblond (2002)	+2.92%* full sample +2.14%* industrial +3.87%* high tech (days -1,0)		93	1980-1999
Veld, Veld-Meruklova (2002)	+2.66%* full sample +2.41% U.K. subsample +3.57% focus-increasing +0.76% not focus-increasing (days -1,+1) +2.11% [†] (days -1,+1)	-0.41% full sample +5.20% focus-increasing -12.96%* not focus-increasing (months 0,+36)	200	1987-2000
Chemmanur, Paeglis (2001)	(days -1,+1)		19	1984-1998
McNeil, Moore (2001)	+3.53%* full sample +4.05%* unrelated +2.39% [†] related (days -1,+1) +3.8%		152 104 48	1980-1996
Desai, Jain (1999)		+25.4% (3 yrs.)	155	1975-1991
Krishnaswami, Subramaniam (1999)	+3.28%* full sample (days -1,+1)		118	1979-1993
Arbanell, Bushee, Raede (1998)		+3.23% return to parents -0.86% return to spin-off (days -1,+60)	245	1980-1996
Best, Best, Agapos (1998)	+3.41%* announcement date +2.94%* ex-date (day 0)		72 63	1979-1993

Daley, Mehrotra, Sivakumar (1997)	+3.4%* full sample +4.3%* focus-increasing +1.4% not focus-increasing +13.19% announcement date +41.12% five event dates	85	1975-1991
Parrino (1997) Clinical study of one spin-off by Marriott Corporation		1	1993
Johnson, Klein, Thibodeaux (1996)	+3.96%* full sample +5.42%* "back to basic" subsample +1.3%	104	1975-1988
Slovin, Sushka, Ferraro (1995)	N/A	37	1980-1991
Cusatis, Miles, Woolridge (1993)		146	1965-1988
Vijh (1994)	+2.9% [†] annct. date +0.79% completion date +3.03% [†] ex-date +5.56%* full sample +2.8% +3.3% +3.34%* full sample (days -1,0)	113	1964-1990
Rosenfeld (1984)		35	1963-1981
Schipper, Smith (1983)		93	1963-1981
Hite, Owers (1983)		123	1963-1981
Miles, Rosenfeld (1983)		55	1963-1980

(Continued)

EXHIBIT 6.17 (Continued)

Panel B: Returns to Shareholders of Subsidiary				
Study	Cumulative Abnormal Returns at the Event	Cumulative Abnormal Returns after the Event	Sample Size	Sample Period
Desai, Jain (1999)	N/A	+15.7% (1 yr.) +36.2% (2 yrs.) +32.3% (3 yrs.)	155	1975–1991
Cusatis, Miles, Woolridge (1994)	N/A	+4.5% (1 yr.) +25.0% (2 yrs.) +33.6% (3 yrs.)	161	1965–1990

Unless otherwise noted, event date is announcement date of transaction.

*Significant at the 0.99 level or better.

†Significant at the 0.90 level.

‡Significant at the 0.95 level.

EXHIBIT 8.18 Summary of Studies of Market Returns to Parent and Subsidiary Shareholders at Carve-Outs

Panel A: Returns to Shareholders of Parent

Study	Cumulative Abnormal Returns at the Event	Cumulative Abnormal Returns after the Event	Sample Size	Sample Period	Notes
Vijh (2002)	+1.94%* full sample +4.92%* sub is large +1.19%* sub is small (days -1,+1)		336	1980-1997	Tests reject the asymmetric information hypothesis and support the divestiture gains hypothesis.
Hurlburt, Miles, Woolridge (2002)	+1.92%* full sample +2.10%* cross-industry -0.39% own industry		185 153 30	1981-1994	Finds negative effect of carve-out announcement on rival firms.
Hogan, Olsen (2002)	+11.42% carve-outs +16.53% IPOs matched (day 0)		219	1991-2000	Carve-out returns are lower than returns in a matched sample of IPOs at offering.
Schill, Zhou (2001)	+11.3%† (days -1,+1)		11	2000	Focus on carve-outs of Internet subsidiaries.
Haushalter, Mikkelsen (2001)	+3.39%* full sample (days -2,+2)		13	1994-1996	
Hulburt, Miles, Woolridge (2000)	+1.9%* (days -1,0)		185	1981-1994	

(Continued)

EXHIBIT 6.18 (Continued)**Panel A: Returns to Shareholders of Parent**

Study	Cumulative Abnormal Returns at the Event	Cumulative Abnormal Returns after the Event	Sample Size	Sample Period	Notes
Vijh (2000)	+1.94%* full sample +2.25%* sub not related industry +0.80% sub is related (days -1,+1) +5.83%* (day 0)		336 221 100	1980-1997	
Prezas, Tarimcilar, Vasudevan (2000)		7.61%* (6 mos.) 11.75%* (1 yr.) 21.07%* (3 yrs.)	237	1986-1995	Carve-out returns are lower than returns in a matched sample of IPOs at offering and over the postoffering time periods.
Allen (1998)		+33.2% HPR (0,12 months) +229.3% HPR (0,60) Holding period returns adjusted for industry returns	1	1983-1995	Clinical study of 11 carve-outs by Thermo Electric
Allen, McConnell (1998)	+2.12%* full sample +6.63%* proceeds paid out -0.01% proceeds are retained (days -1,+1)		186 54 60	1978-1993	
Slovin, Sushka, Ferraro (1995)	+1.2%† (days -1,0)		32	1982-1991	

Klein, Rosenfeld, Beranek (1991)	+2.75%* full sample	52	1966– 1980
Schipper, Smith (1986)	+1.83% [‡] subsidiary –3.5%* parent (days –4,0)	76	1965– 1983
Chemmanur, Paeglis (2001)	+1.96% [‡] (days –1,+1)	19	1984– 1998

Panel B: Returns to Shareholders of Subsidiary in Carve-Out

Study	Cumulative Abnormal Returns at the Event	Cumulative Abnormal Returns after the Event	Sample Size	Sample Period	Notes
Hulburt, Miles, Woolridge (1994)	N/A	+12.5% (1 yr.) +14.4% (2 yrs.) +24.7% (3 yrs.)	80	1981– 1989	

Unless otherwise noted, event date is announcement date of transaction.

*Significant at the 0.99 level or better.

[‡]Significant at the 0.90 level.

[‡]Significant at the 0.95 level.

EXHIBIT 6.19 Summary of Studies of Market Returns to Parent Shareholders at Creation of Tracking Stocks

Study	Cumulative Abnormal Returns at the Event	Cumulative Abnormal Returns after the Event	Sample Size	Sample Period
Haushalter, Mikkelsen (2001)	+3.00%* full sample (days -2,+2)		31	1994-1996
Billet, Vijh (2000)	+2.67%*	Parent company 1.07% (1 yr.) -5.77% (2 yrs.) -4.15% (3 yrs.) Tracking stock +9.74% (1 yr.) -15.26% (2 yrs.) -40.05%† (3 yrs.)	20	1984-1998
Elder, Westra (2000)	+3.1%* full sample (days -1,0)	N/A	35	1984-1999
D'Souza, Jacob (1999)	+3.61%* full sample (days -1,+1)		64	1984-1997
Logue, Seward, Walsh (1996)	+2.9%† (days -1,0)	N/A	8	1985-1994
Chemmanur, Paeglis (2001)	+3.09%* (days -1,+1)		19	1984-1998

Unless otherwise noted, event date is announcement date of transaction.

*Significant at the 0.99 level or better.

†Significant at the 0.95 level.

Fourth, the types of transactions do differ in their effects. Though the diagrams in Exhibit 6.14 suggest a strong similarity in their resulting structures, in fact the transaction types have materially different impacts: Tracking stocks do not result in increased focus, tax, or regulatory benefits, only increased transparency. Split-offs alter the ownership of the parent; carve-outs, like divestitures, change the ownership of the subsidiary. In a spin-off, no new funds flow to the parent—Anderson (2002) finds that the need to raise additional capital is significant in explaining the type of transaction chosen. Parrino (1997) documents a major transfer of wealth from bondholders to stockholders from a spin-off effected by Marriott Corporation. The variation in returns across transaction type could be explained by any of these factors: agency costs, internal capital markets, information, control, and so on. Notwithstanding the differences among the forms of these transactions, abnormal returns from these transactions are generally consistent: spin-offs return roughly 2 to 4 percent, compared to carve-outs of 2 to 3 percent, and tracking stocks of 3 percent.

Fifth, as with divestitures, deployment of funds raised in these transactions makes a difference. Allen and McConnell (1998) found a large difference in announcement day returns: Investors reacted positively to carve-outs that would generate cash to be paid to creditors; instances where the funds were to be reinvested in the business were met with zero response from investors.

Sixth, the restructuring has an impact on the rivals of the firm. Hurlburt et al. (2002) found that the effect of carve-out announcements on the returns of rival firms was significantly negative.

Seventh, the timing and type of the restructuring seems to be associated with the valuation of the parent and subsidiary in the capital markets. Nanda (1991) suggests that opportunistic behavior by managers will motivate them to favor carve-outs over divestitures when the parent's shares are relatively undervalued and the subsidiary's shares are relatively overvalued. Thus, a sale of equity in the subsidiary would become a signal to investors of the parent's undervaluation. The findings on carve-out announcement returns in Exhibit 6.18 generally support such a hypothesis. For instance, Schill and Zhou (2001) write, "Overall, the evidence can best be explained with models where clienteles of investors with optimistically biased expectations drive the prices of subsidiaries above parent valuations and arbitrage costs prohibit market forces from eliminating the disparity between parent-subsidiary valuations." (Page 27)

The hypotheses about the sources of gains from restructuring center predominantly on two: an agency cost argument that increased focus cures ills of internal capital markets; and hypotheses about exploiting misvaluations in the market. These hypotheses are not mutually exclusive. But the research supports the existence of both sources, giving, perhaps, more weight to the agency cost hypothesis on the grounds of the number of studies confirming the value of corporate focus.

FRAMEWORK FOR CHOOSING A PATH FOR INORGANIC GROWTH

The wide range of possible instruments for inorganic growth easily bewilders the senior executive. Yet the advantages and disadvantages of each alternative raise a number of considerations that can help the executive sort out the alternatives. These considerations help form a decision path:

1. **Benefits from a relationship: learning and coordination gains.** If one of the strategic objectives is knowledge transfer from the partner to your firm, a closer engagement would be warranted. Some targets of inorganic growth programs may be highly related to the main business activities of the buyer. In these instances, the demands of close integration necessary to realize benefits may dictate closer business ties. But other targets may have a weaker relationship to the core and thus may not require close ties.
2. **Need for ownership and control.** Control would be a priority in cases where the intentions of the partner are unclear and there is a risk that the partner will defect to a competitor, or worse, become a competitor. High control might also be dictated where the partner holds assets of strategic value to your firm, which would create a disadvantage if they fell into a competitor's hands. In many cases, total ownership is not required. Partial ownership may deliver a place on the board of directors and a say in management. But in other cases, simply doing business through a contractual agreement (i.e., with no ownership) may be sufficient to deliver the strategic needs.
3. **Manage risk exposure.** The risks of some target operations will be well known to the buyer, appear to be manageable, and may be at an acceptable level. But

for other targets, the risks will be uncertain, unmanageable, and potentially large—in these cases it may be desirable to isolate the target with legal “firewalls” that will contain the risk exposure to your firm. Another aspect of managing risk is in being able to intervene in the operations and financing of a weak partner with know-how and funds. As detailed in Chapter 19, a variety of acquisition structures permit the management of risks in a target. Nevertheless, the limited liability of minority investment or joint venture permits your firm to acquire a stake in the expansion business pending the resolution of uncertainty. Staged investing through these intermediate structures is a time-honored way to deal with uncertainty.

These three criteria convey the complexity of the choice. One could compound the complexity further with considerations of the desirability of a local identity (as in cross-border expansions) and size of the deal (i.e., large transaction costs for lawyers, due diligence, and financial advice may not be warranted for small transactions).

These considerations suggest a decision flowchart such as presented in Exhibit 6.20. First, one confronts the strategic perspective: How material are the benefits from a relationship in the expansion opportunity? Next is the need for control: Is this high or low? The third regards the risk exposure in the opportunity, and the possible need to isolate the risks: Are the risks and the need to isolate them high? Will the expansion opportunity need our capital? Is it financially weak? Tracing the branches of this decision tree over to the right-hand side one sees the array of transaction alternatives from merger or acquisition at the top extreme, to a simple contractual arrangement at the bottom. This tree was built from just these three considerations. Other considerations may dominate the thinking of senior executives, or they may bear influence in a different order of priority. But this decision

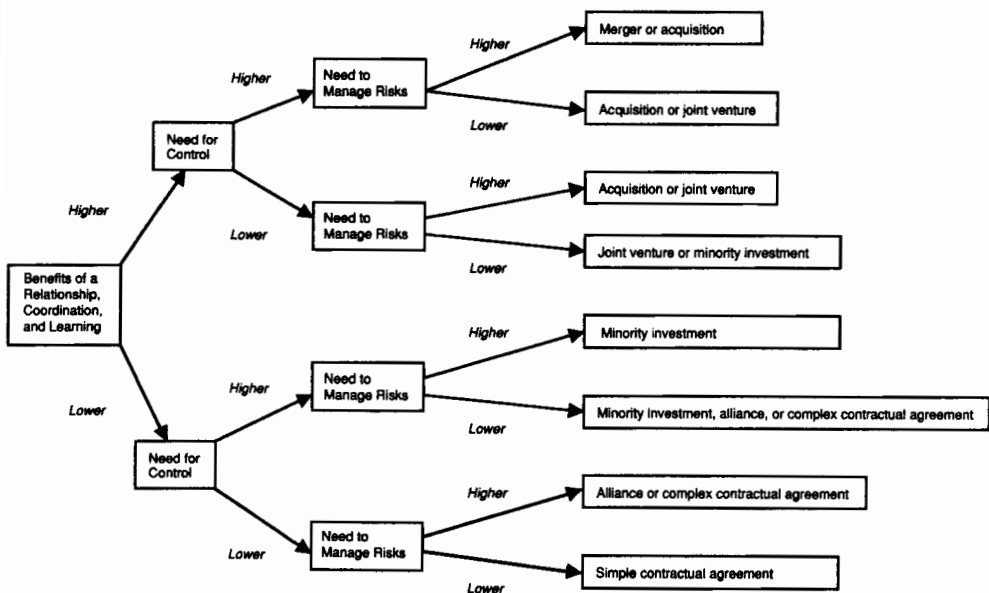


EXHIBIT 6.20 Decision Tree for Selecting among Inorganic Growth Opportunities

tree is sufficient to illustrate a few conclusions about the choice among inorganic growth alternatives:

- **One kind of transaction does not fit all needs.** Be skeptical of “one-trick ponies,” those proposals by brokers and advisers that always amount to an acquisition. As the diagram suggests, you can achieve strategic aims of inorganic growth through a variety of alternatives.
- **The choice among the alternatives is a logical result of balancing important considerations.** Start the process by making a careful inventory of the decision criteria that are important to you. The three illustrated in Exhibit 6.20, relationship benefits, control, and risk management, will appear often in studies of inorganic growth alternatives. However, other considerations may be unique to a particular company or time, but no less important.
- **Retain a bias for simplicity.** Contractual arrangements are probably easier to structure than relationships based on an equity investment. Also, simple agreements may be a better foundation for getting to know a partner; with complexity come more opportunities for misunderstanding.
- **Consider starting small.** Staged investing will dominate lump-sum investing where risks are material. More is said about staged investing in Chapter 22.
- **Remember value creation.** The subtext for any comparison of alternatives should be their impacts on shareholder welfare.

FRAMEWORK FOR CHOOSING A PATH FOR RESTRUCTURING

The selection among alternatives for restructuring rests on the considerations illustrated in the decision tree of Exhibit 6.21.

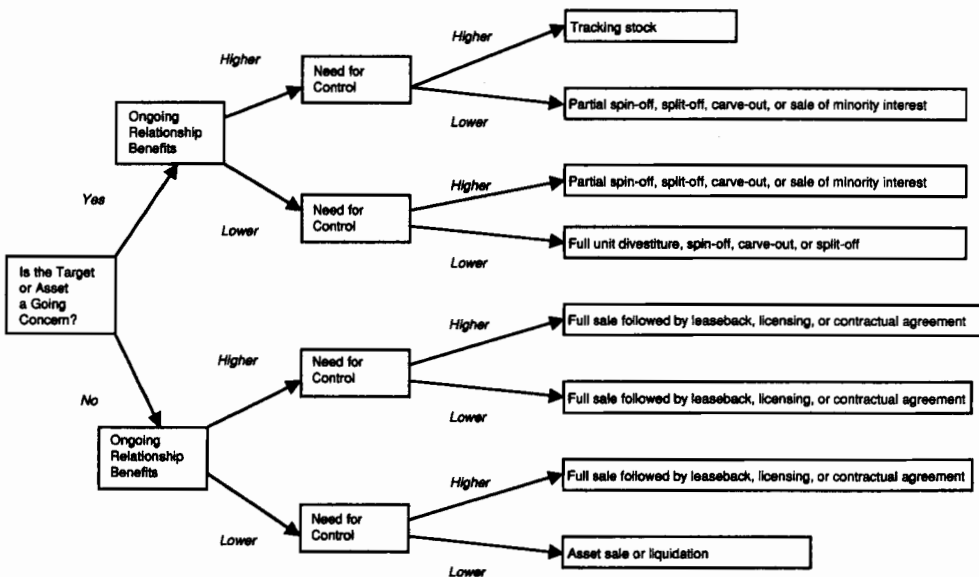


EXHIBIT 6.21 Decision Tree for Redeployment and Restructuring

- **Relationship to the core business of the parent.** If the target operation is unrelated to the core it might be sold outright with no adverse effect on the rest of the firm. But if the benefits of relationship are material, your firm might consider retaining a partial interest in the target either as a joint venture or as a minority investment.
- **Need for control.** Whether or not the asset or business remains strategically significant, your firm may want to retain some influence or control over the target if for no other reason than to assure that it does not fall into the hands of a competitor.
- **Can the business or asset operate as an independent entity?** Assets such as land, factories, or equipment may be too small or isolated to sustain an independent existence. Such assets might be earmarked for outright sale. On the other hand, disposing of an ongoing *business* in the form of a firm can capture for the seller a premium reflecting growth prospects and franchise value.

Here again, *to complete any strategic analysis of alternatives, one must assess the implications of each choice for shareholder value.* This is done by means of a valuation analysis. No choice should be final until its implications for your firm's share price are estimated and understood. The capital markets perspective embedded in valuation analysis may presuppose very different outlooks than the product markets perspective of the strategist. Also, there may be an information asymmetry reflected in the perspectives of the insiders and capital market outsiders (e.g., perhaps the discount rate derived from the capital markets is inconsistent with the inside strategic perspective).

DOES IT PAY TO DIVERSIFY OR FOCUS THE FIRM?

One of the robust debates today deals with whether and how the strategic efforts to diversify or focus the firm pay. The question is significant because of the prevalence of diversification-based business strategies among large firms today, and because of the relatively high volume of transactions motivated in part by a theory of the need to diversify or focus. Villalonga (2003) noted that between 1990 and 1996, diversified firms accounted for half of the employment in the United States, and 60 percent of the assets of traded firms. Following World War II, the U.S., European, and Japanese economies witnessed a dramatic increase in diversification and divisionalization.⁶ Rumelt (1974) found that 70 percent of the Fortune 500 firms were heavily or exclusively focused on one segment. By 1969, that group had fallen to 35 percent, as shown in Exhibit 6.22. The icon of this trend was the conglomerate firm, which pursued a strategy of unrelated diversification. The conglomerate arose in the 1960s and then gradually receded in the 1970s and 1980s as firms returned to a greater emphasis on strategies of focused business operations.

Rumelt also found that profitability varied by type of diversification strategy: As the firm moved from great focus (a "single business" strategy) to great diversity (an "unrelated business" strategy), the accounting returns of firms varied materially by type of strategy. Exhibit 6.23 summarizes these returns by category; see Rumelt (1974, pages 92, 94). Suggesting that a strategy of close relatedness in diversification yields the best returns, Rumelt's findings were influential in prompting a critical reappraisal of conglomerate or unrelated diversification and became part of a general trend in the 1970s and 1980s toward increasing emphasis on strategic focus.

EXHIBIT 8.22 Changing Mix of Diversification Strategies for the Fortune 500 Firms

Strategic Category	Percentage of Firms in Each Strategic Category		
	1949	1959	1969
Single business	34.5%	16.2%	6.2%
Dominant business	35.4%	37.3%	29.2%
Related business	26.7%	40.0%	45.2%
Unrelated business	3.4%	6.5%	19.4%

Note: "Single business" indicates firms focused entirely on one industry segment—not multibusiness firms.

"Dominant business" indicates firms deriving between 70 and 95 percent of their revenues from one segment and 70 to 100 percent from the largest related group of businesses.

"Related business" indicates firms deriving up to 70 percent of revenues from one segment *and* 70 to 100 percent from the largest related group of businesses.

"Unrelated business" indicates firms with relatively low influence from one single segment or group of related segments.

Source of data: Rumelt (1974), page 51.

EXHIBIT 8.23 Returns by Diversification Strategy

Category	Return on Capital	Return on Equity
Single business	10.81%	13.20%
Dominant business	9.64%	11.64%
Related business	11.49%	13.55%
Unrelated business	9.49%	11.92%

Note: "Single business" indicates firms focused entirely on one industry segment—not multibusiness firms.

"Dominant business" indicates firms deriving between 70 and 95 percent of their revenues from one segment and 70 to 100 percent from the largest related group of businesses.

"Related business" indicates firms deriving up to 70 percent of revenues from one segment *and* 70 to 100 percent from the largest related group of businesses.

"Unrelated business" indicates firms with relatively low influence from one single segment or group of related segments.

Source of data: Rumelt (1974), page 91.

Value Drivers in Diversification and Focus

Numerous hypotheses about the profitability of diversification and focus boil down to two lines of argument:

EFFICIENCY (OR INEFFICIENCY) OF INTERNAL CAPITAL MARKETS The diversified firm internalizes the capital market by acting as an allocator of resources among businesses

in the portfolio. Advocates of diversification claim that the closer proximity to the companies and access to better information about them permits the internal capital market to operate more efficiently than external markets. Advocates of focus argue that behavioral and agency considerations intervene to make the internal capital markets less efficient; people avoid unpleasant decisions about starving or selling unprofitable businesses and therefore tend to subsidize poorly performing units from the resources of high-performing units. Four papers⁷ make the basic argument for efficiency of internal capital markets. Also, Matsusaka and Nanda (1996) have argued that the internal capital market creates real option value for the firm by virtue of the strategic investment flexibility it affords.

COSTS OF INFORMATION AND AGENCY Multidivisional firms are complicated to understand; investors require considerable information to value these firms. Yet most diversified firms provide no more information about their operations than do more focused firms. This opacity creates an asymmetry of information that might cause investors to discount the value of diversified firms more than focused firms. Also, the opacity shelters managers of diversified firms from the scrutiny and discipline of capital markets, creating the threat of agency costs and the manager's expropriation of private benefits. This, too, leads to lower profitability. Scharfstein and Stein (2000) and Rajan, Servaes, and Zingales (2000) argued that unrelated diversification is inefficient and is a result of agency costs. Cross subsidization of business units within the firm is inefficient. Agency costs appear principally in efforts by managers to reduce risk of the firm out of self-interest only, and extract private benefits of control.

Summary of Research Findings

Studies of the economic impact of diversification or focus approach the question from among six methodologies. Each approach lends a different perspective and has its peculiar strengths and weaknesses. As with the general summary of the profitability of M&A (see Chapter 3), the findings lend no ironclad conclusions. Rather, one needs to look for tendencies. In general terms, here is a breakdown of the research approaches and their findings.

EVENT STUDIES A number of papers consider the differences in return associated with the announcement of diversifying or focusing acquisitions, divestitures, spin-offs, and carve-outs. If diversification pays, it should be reflected in higher returns for acquisitions and disposals that result in a more diverse business portfolio for the firm. If focusing pays, announcements that herald acquisitions or disposals that will focus the firm should result in higher returns. The event study approach has the strength of focusing on investor reactions and on market prices. The weaknesses stem from possible noise in the market from conflicting events and questions about market efficiency.

- **Acquisitions.** Seven studies⁸ find cumulative average residuals (CARs) at the announcements of transactions are significantly more negative for diversifying deals than for focusing deals. These studies suggest that mergers that focus the firm enhance the buyer's share value by 1 to 3 percent more than diversifying deals. Yet six other studies⁹ show significantly positive CARs for diversifying acquisitions. Most of these, however, are studies of conglomerate acquisitions

in the 1960s (e.g., Hubbard and Palia 1999) or are associated with the relaxation of regulatory constraints on diversifying acquisitions (e.g., Carow 2001). On balance, the event studies of acquisition announcements suggest that focus pays more than diversification.

- **Joint ventures and alliances.** Three studies consider the effect of focusing or diversifying JVs. Ferris et al. (2002) find focus-increasing JVs show materially larger CARs than diversifying JVs. Chan et al. (1997) report that horizontal alliances involving technology transfer have a materially higher CAR. And Gleason et al. (2003) find that horizontal deals in the financial services industry have materially higher CARs than diversifying deals. The event studies of JV and alliance announcements suggest that focus pays more than diversification.
- **Divestitures, spin-offs, and carve-outs.** Generally, divestitures, spin-offs, and carve-outs are good news for investors: Since these deals shed assets, the results would seem to be roughly supportive of focusing. But what matters is the nature of the assets being disposed. Two studies of carve-outs reported in Exhibit 6.18 suggest a materially larger announcement CAR when the carved-out unit is not from an industry related to the parent's core business (Hurlburt et al. 2002; Vijh 2000). Three studies of spin-offs in Exhibit 6.17 show a materially larger announcement CAR when the transaction is focus-increasing (Veld and Veld-Meruklova 2002; McNeil and Moore 2001; Johnson et al. 1996). Regarding divestitures, Donaldson (1990) reports materially larger positive CARs at the announcement of sale of noncore assets compared to core asset sales. Dittmar and Shivdasani (undated) report that over the year following the divestiture, firms that became single-business firms had a 3 percent higher return than those that remained diversified. In short, the event studies of divestitures, spin-offs, and carve-outs are consistent with benefits from focusing and penalties from diversification.

Q TESTS *Tobin's Q* is a measure of economic efficiency estimated as the ratio of the market value of assets divided by book value. The higher the *Q*, the higher is efficiency. Typically, these studies regress *Q* against a variety of independent variables, including measures of diversification and focus. Four studies give findings consistent with the benefits of focus. Lang and Stulz (1994) find that diversified firms have lower *Q*s than single-business firms. Morck and Yeung (1998) find that diversification is associated with lower *Q* except where the industry is information-intensive. Aggarwal and Samwick (2003) report that diversification has a significantly negative effect on *Q*.

EXCESS VALUE STUDIES: TESTS FOR A DIVERSIFICATION DISCOUNT A logical test of the impact of diversification on value is to compare the actual market value of the firm with its "sum of the parts" value, where each part of the firm is valued at multiples consistent with industry peers. The "excess value" of a diversified firm is simply the difference between actual and imputed values. Nine studies¹⁰ find negative excess values for diversified firms, in the range of 8 to 15 percent—this is the famous "diversification discount"¹¹ that is often cited in debates over the unprofitability of diversification. On the basis of these findings Lamont and Polk (2002, page 75) asserted, "Diversification destroys value." Yet, more recent studies have challenged the size and even the existence of the diversification discount. The line of attack is that certain data sources contain an inadvertent bias in favor of the diversification

discount and that many of the units acquired by diversified firms were already discounted *before* their acquisition—this means that the existence of a discount has little to do with a strategy of diversification. Finally, some studies use more granular data arguing that business segments are too large to capture the costs or benefits of diversification. Nine studies¹² report *no* discount, or even a diversification premium using these revised research approaches. If one believes in the power of the newer techniques, the excess value studies would suggest that diversification has a neutral or positive effect on value.

PRODUCTIVITY STUDIES Another line of research is to consider the impact of diversification or focus on the productivity of business units and plants. Lichtenberg (1992) found lower total factor productivity with increases in diversification. But Schoar (2002) reported that plants in diversified firms were 7 percent *more* productive than plants in single-business firms. Nevertheless, increases in diversification are associated with a net decrease in productivity. Plants that had been acquired actually increased their productivity, whereas incumbent plants decreased in productivity—but since there were fewer acquired than incumbent plants, the total effect on productivity was negative. Schoar wrote, “Diversified firms experience a ‘new toy’ effect, whereby management focus shifts towards new segments at the expense of existing divisions. As a whole, these results indicate that diversified firms have a productivity advantage over their stand-alone counterparts. They even increase the productivity of their acquired assets. With each diversifying move, however, these firms lose some of their productivity advantage.” (Page 2380)

PROPENSITY TOWARD DIVESTITURES Scholars have studied the characteristics of those firms that undertake divestment. Porter (1987) and Ravenscraft (1987) found that divestiture follows acquisition: Firms may buy, but are not assured of *retaining* their purchases. Their reading was that growth through acquisition was not a stable growth strategy. Weston (1989) offered the rebuttal noted earlier. Kaplan and Weisbach (1992) found that firms were more likely to divest unrelated acquisitions than related acquisitions, suggesting that unrelated acquisitions don’t pay.

STUDIES OF LONG-TERM REPORTED FINANCIAL RESULTS Though accounting results are easily “managed” by executives and are vulnerable to exogenous effects unrelated to diversification, they are an ongoing focus of investigation. Four studies¹³ showed that firms following strategies of unrelated diversification underperform those firms who focus more. Yet four other studies¹⁴ found *improvements* in operating performance following diversifying acquisitions. In addition, Anslinger and Copeland (1996) found that firms pursuing a conscious strategy of unrelated diversification have realized high abnormal returns for sustained periods. Baker and Smith (1998) documented high absolute returns to Kohlberg, Kravis, and Roberts, a well-known leveraged buyout firm and owner of a diversified portfolio of industrial interests. Fluck and Lynch (1999) presented a model of corporate strategy in which *both* diversifying acquisition and then focusing divestiture create value: This relies on the existence of positive net present value (NPV) projects that are unable to obtain financing in public markets. The large firm acquires, finances, grows, and then divests these businesses profitably. In sum, it seems that diversification or focus may not help to discriminate among firms on the basis of long-term performance.

Anslinger and Copeland (1996) argued that it is the postacquisition management strategy and structure, rather than the strategy of diversification or focus, that matters in producing long-term performance.

Practical Implications of the Research Debate over Diversification versus Focus

How are we to make sense of these disparate and contradictory findings? Villalonga (2003b) argues that the debate revolves around three categories of tests, of differing strength. Like the old research on capital market efficiency, there are three forms of assertions about whether diversification destroys value:

1. **Weak form.** Does the diversified firm trade at a discount relative to stand-alone businesses in the same industry? The evidence is mixed here, and the more recent studies favor "no" as an answer.
2. **Semistrong form.** Does the diversified firm trade at a discount relative to its "bust-up" value? A positive answer here asserts that the diversified firm destroys value by staying diversified, and is supported by the numerous studies finding that value is created when firms divest, spin off, or carve out their businesses. Villalonga (2003b) writes, "When firms are outperformed by their competitors, any change in their current strategy is welcomed by the stock market. There is as much evidence that firms are destroying value by staying diversified as there is evidence that single-segment firms are destroying value by not diversifying." (Page 4)
3. **Strong form.** Does the diversified firm trade at a discount relative to what it would be worth *if it had not diversified*? A positive answer here asserts that the act of diversification destroys value. Unfortunately, this "had not diversified" value is unobservable and efforts to find an implied value are challenged by a strong selection bias: Firms that diversify are found to be significantly different from those that don't.

The conclusion from this survey is that one cannot confidently condemn diversification or endorse focus. Still, the research holds some useful implications for the practitioner.

DIVERSIFY ONLY WITH A SOUND ECONOMIC RATIONALE Even if there is no diversification discount, the distribution of outcomes is large, meaning that a nontrivial portion of diversifiers destroy value. The solution is to use an economics perspective to guide your strategic planning and transaction design. The research shows that diversification may be successful under certain circumstances.

- **Where there is high relatedness in terms of industry focus between the target and buyer.** Richard Rumelt (1974, 1982) found that returns on equity were higher for strategies of related diversification than for strategies of unrelated diversification or for single-business focus.
- **Where the internal markets for talent and capital are truly disciplined, and managers are properly rewarded.** Studies by Amihud and Lev (1981) and Denis et al. (1997) suggest that diversification imposes a kind of agency cost: Manager-controlled firms do more diversifying deals than shareholder-controlled firms.¹⁵

Anslinger and Copeland (1996) studied 21 firms with little or no internal relatedness, and found that they produced returns of 18 to 35 percent per year by making nonsynergistic acquisitions. They explained the superior performance of these firms as due to seven principles: "Insist on innovating operating strategies. Don't do the deal if you can't find the leader. Offer big incentives to top-level executives. Link compensation to changes in cash flow. Push the pace of change. Foster dynamic relationships among owners, managers, and the board. Hire the best acquirers." (Page 127)

- ***Where the public capital market is less effective.*** Hubbard and Palia (1999) found that returns from conglomeration were positive and significant during the 1960s, a time when the authors believed the U.S. capital markets were less efficient in allocating capital than they are today. Khanna and Palepu (1997, 2000) made a similar argument in studying conglomerates in India. The authors concluded that these industrial groups enjoyed greater efficiency because of their ability to allocate resources better than the capital market there. And Fauver, Houston, and Naranjo (2002) studied 8,000 companies in 35 countries, concluding, "Internal capital markets generated through corporate diversification are more valuable (or less costly) in countries where there is less shareholder protection and where firms find it more difficult to raise external capital." (Page 1) The distinction between developed and developing countries is therefore interesting as a possible focus for diversification strategies. The research of Lins and Servaes (1999, 2002) lends such a comparison. They found a diversification discount of zero percent in Germany, 10 percent in Japan, and 15 percent in the United Kingdom. But in seven emerging markets, they found a diversification discount of about 7 percent, and concluded that the discount was concentrated among firms that are members of industrial groups. This contradicts the idea that diversification pays where public markets are less efficient, and suggests that differences in corporate governance and/or rule of law across countries may have a material impact on the benefits of a diversification strategy.
- ***Where product markets are experiencing an episode of deregulation or other turbulence.*** Deregulation of markets invites entry by firms in related industries. The merger of Citicorp and Travelers insurance (see Carow 2002) reflected the deregulation of commercial banking in the United States permitting "bancassurance," the convergence of commercial banking and insurance industries. Also, during periods of product market uncertainty, a disciplined and patient investor may be better at allocating capital into that industry than would a more volatile public capital market.
- ***Where one or both firms have significant information-based assets.*** There is evidence that diversified firms transfer knowledge and intellectual capital more efficiently than do public markets. Thus, Morck and Yeung (1997) find that diversification pays when the parent and target are in information-intensive industries.

VALUE CREATION DISCIPLINE IS VITAL; AVOID MOMENTUM LOGIC Growth can become a narcotic, such that growing well matters less than growing by any means. Chapter 17 describes the economics of momentum strategies in detail. If strong discipline is maintained, it is possible to grow in a way that creates value for shareholders. In-

deed, one of the best-performing stocks of the past 40 years has been Berkshire Hathaway, nominally an insurance company but actually a quirky conglomerate run by Warren Buffett, with interests in furniture retailing, razor blades, airlines, paper, broadcasting, soft drinks, and publishing. Buffett's success seems to say that instead of debating diversification and focus, one should simply concentrate on sound investing and value-oriented management. Study Warren Buffett not as a stock investor but as a CEO of a conglomerate. While we know a lot about his philosophy of value-oriented investing, we know much less about how he finds and manages his diversifying acquisitions.

PERHAPS DIVERSIFICATION AND FOCUS ARE PROXIES FOR SOMETHING ELSE If the choice of strategy (diversification or focus) does not help us discriminate well across outcomes, then perhaps we should look elsewhere for explanations of where strategy has an impact. One could look more deeply to the drivers of the returns in these transactions, such as governance systems, financial discipline, transparency of results, managerial talent, incentive compensation, and so on. Research on these is discussed elsewhere in this book and finds that the drivers are significant in explaining outcomes.

PRESUPPOSE RATIONALITY, BUT GUARD AGAINST STUPIDITY Pay attention as future research unfolds. Growth by diversification is one of the strategic staples for corporations, easily abused and misused. If, as Nobel laureate George Stigler once argued, rational people don't do stupid things repeatedly, firms must be diversifying because there is something in it. One wants to understand the economic consequences of diversification. The evolution from one view to another evokes similar shifts in other areas of M&A, such as poison pills and the perennial question of whether M&A destroys value for bidders.

CONCLUSIONS

The design of good M&A transactions takes root in good strategy. This chapter explores the role of strategy in deciding to grow by acquisition or restructure the firm. Strategy picks positions and capabilities. Analysis of positions and capabilities using a variety of tools outlined here should underpin the effort to profile your firm's strengths, weaknesses, opportunities, and threats (SWOT).

M&A is one of the tactical instruments of strategy. This chapter outlines the variety of alternatives by which the firm could grow inorganically, ranging across contractual agreements, alliances, joint ventures, minority investments, acquisitions, and mergers. The choice among these alternatives is driven by at least three considerations: the benefits from relatedness of the target business to the core of the acquirer, the need for control, and the need to manage risk.

Restructuring activity is a significant source of M&A activity: one-quarter to one-third of all deals annually are divestitures by other firms. But divestiture is only one of the tactical instruments of a strategy of restructuring. This chapter outlines other alternatives, including liquidations, minority investments, spin-offs, carve-outs, split-offs, and tracking stock. (Financial restructurings are reserved for discussion in Chapter 13.) The selection among the various tactical alternatives will be

driven by the relatedness of the unit to the core of the parent, the need for control, and whether the unit can survive as an independent entity.

The survey of research in this chapter suggests that restructuring creates value: Divestiture, spin-offs, carve-outs, and tracking stock are associated with significant positive returns at the announcement of those transactions.

However, the costs and benefits of a strategy of diversification remain unsettled. That diversification destroys value is the conventional wisdom in 2003, but the latest research challenges its certainty. This suggests that the practitioner should think critically about blanket assertions about the value of a strategy of diversification or focus. Future research will likely give a more contingent explanation, such as "diversification pays in these circumstances." In the interim, it is too early to tell.

APPENDIX 6.1

A Critical Look at the Self-Sustainable Rate of Growth Concept and Formulas

The self-sustainable growth rate (SSGR) is the maximum rate at which a firm can grow without sales of new common equity. A firm that has a high SSGR relative to its targeted growth rate can execute its business strategy without having to dilute the interests of existing shareholders, submit its plans and intentions to the scrutiny of a stock offering, and incur the relatively high costs of stock issuance. Also, a firm that has a high SSGR relative to its competitors is bound to have some strategic advantage in exploiting the random flow of growth opportunities that come to every industry. Regardless of the popularity of this concept, the financial adviser and analyst must understand its possible application and limitations in order to put it to best use.

BEGINNINGS: A FOCUS ON VALUE

The interest in self-sustainable growth had its origins in the work of two academicians, Merton Miller and Franco Modigliani (1961) (M&M), who asked the question: At what rate will the market value of the firm grow? They argued that the only kind of growth on which operating managers should focus is growth of *value* because any of the other bases of growth (e.g., sales or assets) are flawed guides¹⁶ for corporate policy; only growth of market value was consistent with an interest in *value creation*. M&M showed that the growth rate in market value is simply the product of two variables: the internal rate of return (IRR) of expected future cash flows, and the rate of reinvestment of that cash flow back into the firm.

$$g_{\text{Self-sustainable market value}} = \rho \cdot K \quad (1)$$

Here K is the reinvestment rate of the cash flows, and ρ (or "rho," a Greek letter) is the IRR of cash flows. The virtue of the M&M growth rate model is that it is economically correct: (1) it focuses on cash flow; and (2) it takes into account the time value of an entire stream of cash. The formula is deceptively simple: Whether the firm can reinvest in the same activities that produce a given IRR depends on a

wide range of strategic assumptions such as the rate of technological change, the length of a product life cycle, or the persistence of competitive advantage. In short, the application of this model takes careful thought.

THE POPULAR MODEL FOR ASSET GROWTH

As a shorthand for estimating the self-sustainable growth rate, many analysts use the model shown in equation (2) and its variants, equations (3 and 4):

$$g_{\text{book value assets}}^{\text{Self-sustainable}} = \text{ROE} \cdot (1 - \text{DPO}) \quad (2)$$

$$g_{\text{book value assets}}^{\text{Self-sustainable}} = \left[\text{ROTC} + (\text{ROTC} - K_d) \frac{\text{Debt}}{\text{Equity}} \right] \cdot (1 - \text{DPO}) \quad (3)$$

$$g_{\text{book value assets}}^{\text{Self-sustainable}} = \left(\frac{\text{New income}}{\text{Sales}} \cdot \frac{\text{Sales}}{\text{Assets}} \cdot \frac{\text{Assets}}{\text{Equity}} \right) \cdot (1 - \text{DPO}) \quad (4)$$

In the formulas, ROE is the accounting return on equity, ROTC is return on total capital¹⁷, K_d is the after-tax cost of debt, and DPO is the dividend payout ratio.¹⁸ Equation (2) is simply an accrual-accounting version of M&M's formula: $(1 - \text{DPO})$ is equivalent to M&M's K . For ROE, many analysts use the expected return for the next few years. A less sensible assumption is to use the past few years' average ROE.

Equation (3) expands the preceding equation by inserting a well-known formula for the ROE of a levered firm. The virtue of this form of the model is that it allows the analyst to tinker with a possible interdependence between the firm's mix of capital and its cost of debt. For instance, the firm's cost of debt might be supposed to rise as the firm increased its debt/equity ratio past some moderate level.

Equation (4) also expands equation (2) by inserting the well-known DuPont system of ratios for ROE. This version is appealing to operating managers since it decomposes ROE into a measure of margin profitability (net income/sales), a measure of asset turnover (sales/assets), and a measure of leverage (assets/equity). With the aid of this model, one can see more directly the effects of price or cost improvements and better asset utilization.

INSIGHTS TO BE GAINED FROM THE POPULAR ASSET GROWTH MODEL

Comparisons across Firms

The popular self-sustainable growth model can yield insights into the comparative strategic robustness of competitors within an industry. For instance, Exhibit 6A.1 gives the calculations for the self-sustainable growth rates for five retailers competing in selling women's apparel. The data, drawn from Value Line,¹⁹ are forecasts of

EXHIBIT 6A.1 Self-Sustainable Growth Rates for Five Retailers

Name	Self-Sustainable Growth Rate	Dividend Payout Ratio	Return on Total Capital	Hypothetical Bond Rating and After-Tax Cost of Debt	Debt-to-Equity Ratio
Charming Shoppes, Inc.	13.2%	15%	14.5%	A 6.1%	12.6%
Deb Shops, Inc.	11.3%	20%	14.0%	Baa 6.6%	2.0%
The Dress Barn	17.5%	0%	17.5%	Baa 6.6%	0.0%
Petrie Stores Corporation	8.0%	25%	10.0%	Baa 6.6%	19.0%
The Limited, Inc.	27.6%	22%	23.0%	A 6.1%	53.8%

the variables for each firm in early 1991 for the period through 1995. Consider each firm's strategic ability to grow and the sources of that strength.

The exhibit reveals dramatic strategic disparities among these competitors. The Limited enjoys an unusually robust self-sustainable growth rate of 27.6 percent, stemming in large part from its high internal profitability and its relatively more aggressive use of debt capital. At the other end of the spectrum, Petrie Stores Corporation appears to be able to self-sustain only an 8 percent annual growth rate; this is due largely to its relatively low internal profitability. The Dress Barn stands out for its unusual set of financial policies: no debt and no dividends. Given that this firm has the second-highest internal profitability in the competitive group, The Dress Barn could probably boost its self-sustainable growth rate materially by even modest use of leverage.

Analysis of Policies within a Firm

The popular self-sustainable growth model may be solved in reverse to show what policy (or policies) can be changed, and with what effect, in order to achieve a *targeted* growth rate. Used in this way, the model can help an analyst prepare policy recommendations. As an illustration, suppose that the CEO of Acme Corporation, a privately held manufacturer of specialized machine tools, feels compelled by competitive conditions to set a target for the firm to grow at a 15 percent annual rate in order to survive and prosper in its market niche. Can this rate of growth be sustained? Exhibit 6A.2 summarizes the modeling assumptions and the results.

Because Acme Corporation can self-sustain a growth rate of only 6.5 percent and needs to grow at 15 percent, management has a problem: how to increase the firm's self-sustainable rate of growth. The CEO continues to analyze the operations of the firm and determines that any of the policy changes presented in Exhibit 6A.3 would raise the self-sustainable growth rate to 15 percent.

EXHIBIT 8A.2 Summary of Modeling Assumptions

Acme Corporation Self-Sustainable Growth Rate Analysis	Assumptions and Result
Dividend payout ratio	50%
Target debt/equity ratio	25%
Expected return on equity	13%
Expected return on total capital	11.4%
Expected after-tax cost of debt	5%
New issues of common equity	Nil
Self-sustainable growth rate	6.5%

EXHIBIT 8A.3 Policy Changes to Raise Self-Sustainable Growth Rate

Change in Policy	New Policy Target	Existing Policy	Required Change
1. Increase debt/equity ratio. Finance the growth with debt.	D/E = 2.9	D/E = .25	Tenfold relevering.
2. Sell equity.	DPO = -115% (i.e., sell about as much equity each year as you generate internally)	DPO = 50% (i.e., no equity sales)	Drop the dividend. Sell equity.
3. Improve internal profitability.	ROE = 30% ROTC = 25%	ROE = 13% ROTC = 11.4%	More than double the margins.
4. Improve internal profitability and increase debt/equity ratio.	ROTC = 18% D/E = .667	ROTC = 11.4% D/E = .25	Increase margins and leverage a lot.
5. Cut dividend payout ratio and improve internal profitability and increase debt/equity ratio.	DPO = 11.8% ROTC = 13% D/E = .50	DPO = 25% ROTC = 11.4% D/E = .25	Cut dividend in half. Double the leverage. Increase margins.

Considering the various advantages and disadvantages, the fifth alternative, which involves a blend of changes in all policy areas, seems most attractive. A higher debt/equity ratio could still be consistent with average ratios in the industry and with the firm's internal debt rating preferences. While the owners of the firm would feel the cut in dividend payments, the improvement in competitive standing might translate into capital gains later. Of all the policy changes, an increase in ROTC from 11.4 percent to 13 percent would be the hardest to implement, though management believes it is obtainable.

Analysis like this can be performed at a more detailed level, using spreadsheet forecasts. Churchill and Mullins (2001) illustrate the spreadsheet approach and show that, to avoid running out of cash, the firm can consider speeding up the cycle of operating cash within the firm, reducing costs, or raising prices.

SOME CAVEATS ABOUT THE POPULAR SELF-SUSTAINABLE GROWTH MODEL OF ASSETS

In the hands of an artful analyst, the popular model can yield valuable insights. But it can be abused and misused easily. Financial executives and their advisers should beware of six potential problems:

1. *The model says nothing about value creation.* The popular model describes the maximum growth rate in *assets*, not *market value*. All too often, financial advisers take for granted the wisdom of stated growth targets—but such growth targets are usually stated in terms of sales or assets and may be realizable only with the destruction of market value of equity and/or debt. The model should not be used without some complementary analysis proving the economic attractiveness of the growth goals. A much more detailed analysis of self-sustainable growth and its sources may be gained from a forecast of financial statements, or cash receipts and disbursements. The self-sustainable growth model is nothing more than a summary of such a forecast. This detailed model could be prepared as a computer spreadsheet with various operating and financial policy variables as assumptions or outputs, depending on whether the objective is to determine growth-sustaining policies or merely to compute the cash flow and time-value-adjusted self-sustainable growth rate.
2. *The popular model is an accrual-accounting-based, one-year measure.* ROE and ROTC are measured over one year, typically from historical performance. Can this performance be sustained over the long term into the future? Moreover, by focusing on reported earnings, the model ignores cash flow items such as deferred taxes, which might be the basis for much higher self-sustainable growth.
3. *The popular model assumes fixed assets grow at the rate of sales.* This would be inappropriate for firms whose fixed asset additions are large, lumpy, and intermittent. Also, firms that have spare productive capacity may not need to add assets in a particular year.
4. *The popular model estimates the nominal self-sustainable growth rate; yet it is the real self-sustainable growth rate that is of strategic interest.* Under inflation, the real growth rate will be smaller than the nominal rate, and indeed, could even be negative even though the nominal rate is large and positive. Roughly speaking, the real self-sustainable rate will be equal to the difference between the nominal self-sustainable rate and the rate of inflation.
5. *The self-sustainable growth rate is no panacea.* Rarely are the remedies indicated by the model easy to implement. This is because many of the variables in the model are exogenous to the firm: (1) interest rates are set in the capital markets; (2) product and factor prices are determined by competitive conditions; (3) internal programs to cut costs may be limited by managerial talent; and so on.

6. *The assumption of only internal equity financing violates a basic premise of modern finance theory.* The premise is that capital is always accessible to firms having profitable investment opportunities. Indeed, from a macroeconomic point of view, society should want managers to fund all profitable opportunities. Why managers choose to constrain their own growth is not well understood, though many of the reasons suggested at the opening of this note probably explain why: concerns about control, confidentiality, transaction costs, and so on. In any event, the fact is that the American business economy relies very little on equity financing: From 1950 to 1990, only 4 percent of all capital investment was financed by the sales of new equity. In short, even though equity capital is always accessible, most executives make little use of it.

NOTES

1. *Oxford English Dictionary*, 2nd ed., Oxford: Oxford University Press, 1998, Vol. 16, page 852.
2. For a more detailed discussion of the growth-share matrix in strategic planning, see Hax and Majluf (1984), Chapter 7.
3. SIC stands for "Standard Industrial Classification." The U.S. Commerce Department's classification of firms in an industry should be checked for reasonableness.
4. This financial rationale for conglomerate mergers presupposes that shareholders are unable to replicate this through their own investing and homemade leverage. Taxes, transaction costs, margin requirements, and high consumer loan rates can frustrate the individual investor's attempt to synthesize this benefit.
5. Financial recapitalizations may also affect the operations and asset mix of the firm. These deals are often predicated on asset sales, plant closings, spin-offs, and so on.
6. To "divisionalize" is to adopt an organizational structure for the firm that shapes major segments or divisions around product groups.
7. See Weston (1970), Chandler (1977), Alchian (1969), and Williamson (1975).
8. See Morck, Schleifer, and Vishny (1990), Sicherman and Pettway (1987), Morck (1990), Maqueira et al. (1998), Nail, Megginson, and Maqueira (1998), Delong (2001), and Megginson, Morgan, and Nail (2002).
9. See Carow (2001), Hubbard and Palia (1999), Schipper and Thompson (1983), Elgers and Clark (1980), Matsusaka (1993), and Ferris et al. (2002).
10. See Berger and Ofek (1995, 1999), Lang and Stulz (1994), Servaes (1996), Comment and Jarrell (1995), Lins and Servaes (1999), Mansi and Reeb (2002), Denis, Denis, and Yost (2002), and Lamont and Polk (2002).
11. Berger and Ofek (1995) compute the diversification discount as excess value divided by the imputed value of the firm. The actual value is the market value of equity plus the book value of liabilities. The imputed value is the sum of segment values estimated by the product of a valuation multiple for single-business peers (total capital divided by assets, sales, or operating earnings) times the accounting value for the segment.

12. See Chevalier (2000), Hyland and Diltz (2002), Klein (2001), Graham, Lemmon, and Wolf (1998), Campa and Kedia (1999), Villalonga (1999, 2003a), Mansi and Reeb (2002), and Whited (2001).
13. See Rumelt (1974, 1982), Ravenscraft and Scherer (1987), and Kaplan and Weisbach (1992).
14. See Kruse (2002), Healey, Palepu, and Ruback (1992), Parrino and Harris (1999), and Cornett and Tehranian (1992).
15. Amihud and Lev (1991) concluded, "Risk reduction through conglomerate merger may be convincingly rejected on *a priori* grounds as a merger motive from the stockholders' point of view." (Page 615)
16. It is easy to grow sales or assets by investing willy-nilly, without attention to value creation. For instance, it is possible for many firms to expand sales by relaxing credit standards and investing in more accounts receivable. But doing so without giving attention to the pricing of that credit or the probability of being repaid can, in the long run, destroy firm value.
17. Return on total capital is computed by dividing earnings before interest and after taxes (EBIAT) by the total capital of the firm (i.e., debt plus equity). This is also sometimes called "return on net assets" and is computed as EBIAT divided by net assets (i.e., total assets less current liabilities).
18. The dividend payout ratio is computed as dividends divided by earnings.
19. The hypothetical bond rating is inferred from Value Line's rating of financial stability. The after-tax cost of debt is associated with that bond rating as of early 1991.