Lecture Text

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Resources and Corporate Strategy

(*edited for clarity*)

Introduction

This is the vehicle that we use for thinking about corporate-level strategy, as we transition from business-level strategy to corporate-level strategy—thinking about multiple businesses within one corporate umbrella.

This is our definition of corporate strategy as opposed to business strategy: the way a company seeks to create value through the configuration and coordination of its multimarket activities. Configuration says, “OK, what’s going to be inside the company? What businesses are going to be part of our corporate whole?” And the coordination is, what are you going to do with them once you get them in there? So how are you going to get this scale to lead to economies of scale? How will you really get this scope to work to economies of scope—both things? How are you going to unlock this value potential that you see?

And this is the model that we have for corporate strategy that’s analogous to the strategy wheel at the business level. The Harvard Business School, for example, is a multibusiness organization. We’re in education, but if you look at the aspects of education, we’re in MBA education, executive education, we’re in Ph.D. education; we have our own publishing company, and what we want is to make the whole more than the sum of the parts. And that’s what this model is about.

It starts in the middle with a vision. Just as we were talking about inspiration at the business level, we find this in large multibusiness companies as well. GE, with Jack Welch, had a marvelous vision of what he wanted GE to be as a company. It’s a simple idea of how you’re going to create value as a multibusiness company. What's the economic rationale for the existence of a company? The world with you versus the world without you. Why are you there? It’s the vision.

Then we need to look at the resources. We’re going to talk a lot about that coming forward, so I won’t talk more about that now. Look at the businesses. Which businesses are inside the portfolio?

So it’s figuring out what the vision is, what the resources are that you have as a company. Because it’s the resources that are at the core of the company that determine the scope, determine the set of businesses.

And then, lastly, the organization, which is the structure, systems, and processes that you put in place to unlock the potential of leveraging those resources into those businesses. So the critical junctures are competitive advantage; that the scope of the businesses is limited by the range of the resources that you have. This is not product similarity. It’s not whether or not it’s the same industry; whether or not it’s the same product. It’s whether or not the businesses need the same resources. So, can the resources be leveraged to competitive advantage in the business?

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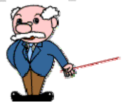

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Then you get, is the organization in place to enable that coordination to work, to get those resources into the businesses, and do you have a control structure in place to manage multiple businesses. So those are the critical junctures in corporate strategy. But, again, it's a system. Just like business strategy is a system, there has to be a vision in the center of the wheel, there has to be internal consistency, and there has to be external consistency.

This is a major change in how we think about corporate strategy because we used to think about it primarily as a financial portfolio. Think about someone who is a portfolio manager at a place like Fidelity or Merrill Lynch, and they have a bunch of assets in their portfolio. All they can do is buy and sell. And if that was our model for corporate strategy, that's not very encouraging because what it's saying is that you can buy businesses, you can sell them. But the guts of corporate strategy has to do with making those businesses better; being a good corporate parent to those businesses. That's what makes the whole more than the sum of the parts. The only lever that the portfolio manager of Fidelity has is risk reduction. And the only way they can increase return is by buying and selling—holding, buying, and selling. They can't impact the actions of those firms.

So the portfolio manager model was badly inadequate for corporate strategy. And what we've done here is to connect it to everything we know that you've been doing in the course so far about competitive advantage and business strategy and the five forces analysis. You can't ever forget those things, because corporate strategy just works with those parts. Those are realities, those are givens that we have to work with. And the whole raison d'être for a corporate strategy is it makes you more effective, business by business by business.

So, everything that you've talked about—sustainable competitive advantage, added value, five forces analysis—all of that doesn't go away. It's still important. But what we want to do is to give you wind beneath your wings. Is there something that we could do, something that we could leverage in from the corporation that could make your life easier; that could make you more effective in serving your customers; could make you more effective relative to your competitors, business by business?

It all comes back to competitive advantage at the business level. That's what this model is about: using the resources of the corporation and leveraging them into the business. But we need to spend a lot of time to think about, "OK, if my whole kingdom is resting on top of these resources, it's pretty darned important what these resources are. It's pretty important that these be economically valuable resources." Otherwise, you're going to have the castle sitting on top of resources that aren't going to lead to competitive advantage in the businesses.

So this is the model and this is how it works. You take the resources. You can think on either the supply side or on the demand side: shared R&D, shared manufacturing, shared management systems and practices; or common customers, common channels, brand value. This all has to do with the key success factors, business by business by business, and the resources that it takes to meet those key success factors.

And the notion is that if you have those resources in the company, it's not just a theoretical possibility. You have to figure out, first of all, what are the resources that are important? How do you get those resources into the business units to enhance their competitive advantage? So instead of working down here and thinking about similarities in the products at this level—business unit competitive advantage—think a lot more upstream, behind the scene, about: what are the resources that are necessary to gain competitive advantage in those markets? And that's the level of analysis you want to be working at.

What Are Resources?

So what are resources? We think about three broad buckets, or categories, of resources: tangible assets, intangible assets, and capabilities.

Tangible assets

Tangible assets: These are the ones that are on the balance sheet. Physical plant, distribution channels, whatever it is that's tangible and that we can put an accounting value on.

I remember once, we were talking about the oil tanker shipping industry. And the MBAs were talking about how the barriers to entry in oil tanker shipping are really high. And we were saying, "Why is that so?" They said, "Because of the boats." We said, "Oh, is there something really unusual about the boats?" "Yeah, they're big boats, big boats." And what you find is oftentimes the physical plant, even though those are the assets that are on the balance sheet, they're rarely the source of competitive advantage, but they're what we can account. It's sort of like, well, these are the ones that are the easiest to account for, so those are the assets we tend to think of in asset value. But what strategists know is that a lot of the most valuable resources in the company are not the ones that are on the balance sheet. And they're in these last two categories: intangible assets and capabilities.

Intangible assets

So if you look at intangible assets: Brand name, for example, is an intangible asset of the company; if you think about something like a reputation that the company might have with suppliers or with customers; or you think about a type of technology that they might have within the company—a know-how, a technical know-how.

Capabilities

Capabilities: speed of product development, marketing and product innovation for branded consumer package goods.

In thinking about your own companies, think about what are the resources in the company. But it's very important that this doesn't turn into what we call a navel-gazing activity.

There is an article that was published about ten years ago, called "The Core Competence of the Firm." Do you know that article? What it talks about is that at the corporate level, it's the competences of the firm that are the platform for growth. But the problem, not with the ideas, but with the way that a lot of companies have implemented the ideas, is that they've sat down and they've said, "OK, we have to figure out what our core competences are." There was a heyday for consultants going in and holding their hands and talking with them, and they'd all sit down and talk about what are their competences. What do they do really well as a company?

How many of them, do you think, ended up at the end of the day, saying, "Nothing. We don't do anything particularly well." Do you think that happened? No, it doesn't happen. Never happens. Having been there, done that, I'll tell you, it doesn't happen. What they do is, by gosh, they find something that they do well. And what they do is that they look at, of all the things they do, what do they do best. And that's their core competence, and they define it relative to themselves. You see the problem with that?

So what we're trying to do here—and that's why we use the word "resources" rather than "competence"—is we're trying to look at this from a competitive analysis standpoint; again, linking up with the five forces, linking up with everything you've been talking about in the course so far, and to think about economically valuable resources.

What makes resources that are at the core of your company economically valuable? How does that compare to others who have that same capability? And how good is that capability relative to theirs?

What Makes a Resource Valuable?

What makes resources valuable? What you're doing is you're getting me right here.

Appropriability

Appropriability. What this has to do with is who can keep the profits that the resource generates? Because what you think is that the profits that a resource generates should go to the resource that generates it. And if it's your people, who should be appropriating the value of that resource? The people. And where we see this, for example, is in investment banking. They used to say that, too: "Hey, we've got the star system. We've got these great analysts and we have these great investment bankers." Guess what? The investment bankers believed it, too. And so what did they do? They demanded salary increases and higher bonuses.

And then they said, "Hey, gosh, if you don't give it to me—and I know; you said it right in your annual report: I'm your most valuable asset—I'm just going to walk down the street." And then people were paying them what they thought they were worth. But a curious thing has happened, and this has happened even in GE. Have any of you followed what's happened to a lot of the top-level managers who have left GE? What's happened, Mark?

__: I can't remember their names but, for instance, one took over Home Depot. They've all gone off and become CEOs, in effect.

PROFESSOR MONTGOMERY: A lot of them have left because people said one of the greatest things about GE, one of the critical resources that GE has, is wonderful management training systems. And what I want is I just want to get somebody from GE because they've been trained so well. There are these wonderful managers, and so on, and so on.

What's been very interesting is that if you look at what happened, the grass isn't necessarily greener down the street. The reason—and that's what we're finding in investment banking—is that a lot of these investment bankers, when they leave and they go down the street for their big bucks, they can't reproduce their results. Why can't they reproduce their results? Maybe their goodness and their productivity had something to do with the infrastructure of the firm itself. If it doesn't; if it's just this star player, this star player should be able to appropriate all the money. If it is Michael Eisner; if it's still in 2004, if anybody believes it's still Michael Eisner, he should appropriate the value.

That's why I say you've got to go beyond the people. If you can't go beyond the people to say, "Why is it that this person is more effective here than they would be elsewhere?", then you don't really have a competitive advantage because you can't own the people. So there has to be some infrastructure, something that you're giving to enhance the value of that person. And if you're not, then you shouldn't be appropriating. Your shareholders shouldn't be appropriating the value of those workers.

So that's why I say it's not enough to say—if you want to write in your annual report, great: "Hey, it's our people." But if it's not more than your people, you don't have organizational resources on which you can appropriate returns. So if you look at somebody like Wal-Mart, for example, it turns out that their cashiers are much more productive than other cashiers. So you go to Kmart versus Wal-Mart and, lo and behold, the cashiers are much more effective at Wal-Mart. Why might that be the case? You did that case, right? Why would you be a more effective cashier at Wal-Mart than you might be at Kmart?

__: Incentive.

PROFESSOR MONTGOMERY: Incentive. You get incentives, if you have the right incentives in place. What about a few customers? How about a line of people at the cash register coming through, versus standing there? So it's the whole thing. What do you have that enables that person to be particularly productive?

So here are the characteristics that make resources valuable. It has to meet three tests. It has to be appropriable, so that the firm itself . . . And, no doubt, somebody's already mentioned this: When Warren Buffet came, did they tell you about what he said about why he invested in Disney in the mid '90s? He had just taken a big stock position in Disney, and they said, "Why did you invest in Disney?" And he said, "Because the mouse doesn't have an agent." So what he's saying is that I, the shareholder, can appropriate all the money that Mickey makes.

Leonardo DiCaprio, on the other hand, what about Leonardo? You might get him cheap on the first movie, but the second movie, and so on, you're paying big bucks. He appropriates the value. In an efficient market, he can appropriate the value.

And it's the same with managers. It's the same in joint ventures. If you're in a joint venture, you've got to make sure that you can appropriate the value for the resources that you're putting in. So that's the first thing. That's one of the criteria.

Scarcity
Another is scarcity. So the resources that are in the core of your company—and remember, all of the activities, the kinds of things that you talked about on Tuesday—those can become resources. We'll talk in a minute about how that's so. But if they're not scarce, they can't lead to competitive advantage. So the notion is that if all of you have the same resources, all of you can do what the other ones can do.

So if there's no asymmetry . . . Strategy is about asymmetry. I'm sure you've heard that over and over and over again. If there's no asymmetry in resources, it's unlikely that there are going to be asymmetries in strategy. And where does asymmetry come from? Scarcity is a big part of that. So you need resources that are in scarce supply. Because if they're not scarce, if anybody can duplicate them, then your strategy will be imitated and profits will be driven down.

Demand
And lastly, demand. This is all this stuff about five forces, but there has to be a customer out there. This is external consistency. There has to be a customer out there who values the resource, so that the products that the resources are deployed in have to be able to create sufficient value.

The three tests
So here are the three tests: the test of scarcity, the test of demand, the test of appropriability. And again, think about what you have in your company. You can think about this at a business level; you can think about it at the corporate level: What is it that you have that's really extra special in terms of supporting your competitive advantage?

The test of scarcity demonstrates that a resource is in short supply and that competitors will have difficulty imitating it. So barriers to imitation—what we call isolating mechanisms—make it difficult for competitors to imitate this. And part of it is, if it's a whole system of resources—the kind of thing that Jan was talking about—if you have a lot of individual resources put together into a system and you can't just imitate one of them, you have to imitate the whole system, that increases scarcity value. So we're thinking not only resources valued individually but also taken collectively.

The test of demand demonstrates that a resource produces a good or service for which customers are willing to pay a sufficiently high price. If you are in a perfectly competitive market where there is no differentiation in the products—lots of sellers, lots of buyers—this is the five forces coming in. Are the conditions such that these resources can actually lead to profits?

And the *test of appropriability* demonstrates that the firm can capture the value generated by the resource.

Resource Imitability and Upgrading
So the notion is that resources differ in the likelihood of them being imitated.

Down here, we're all talking about, "Hey, cash is a great thing to have." But look where it is. Generally speaking, cash is very easy to imitate. It's not rare and special, unless there's some unusual circumstance. So the easiest to imitate; up to cannot be imitated: some patents, unique locations, unique assets. But a lot of people, when they think about their resource-based view, they think, "Oh, I want to be hanging around up there on the upper right." But, again, that's not where the action is. There aren't a lot of resources up there on the upper right.

This is a really juicy spot. This is category "difficult to imitate": brand loyalty, employee satisfaction, reputation for fairness. These are these intangible assets and capabilities that are very important to competitive advantage. Other things being equal, not impossible, these are the most difficult kinds of assets to imitate. And again, then, how you use them, by putting them in a system which even trumps that; by having a whole integrated system; if you're going to imitate Gucci or LVMH [Moët Hennessy Louis Vuitton], you have to do the whole system. That's another layer of protection.

But imitability is rarely an either/or question. It's a question of degree: How difficult? How long? How certain? The idea is that most resources, in time, can be imitated. But the question is, can you stave it off longer and longer? And the reason you need to be aware of the competitors who are nipping at your heels is because, once those resources are imitated—if you're a sitting duck and haven't enhanced your resources, you'll be in trouble.

So, when we talk about upgrading resources, continual upgrading of resources is a competitive necessity because your competitors are investing. It's amazing. When we do these strategies, when working with companies, what we find is that they think about themselves in a dynamic way: "Here we are and here we're going, and there they are and there they're sitting." They're going to be moving, too, and changing, and investing. And sources of competitive advantage change over time. And the blunt truth of it is that not everyone has valuable resources. When you go in and look carefully at the resources of companies, in fact, a lot of companies don't have resources that are economically valuable in the kind of way that we're talking about. So that's a reason to upgrade.

Upgrading can occur on several dimensions: competitive superiority of existing resources; by layering on new or unique resources; and deploying them in more attractive industries. So you're saying, "Wait a minute. I really think I've got something here. But if I think about how I can create profit, it's not only what I have but where I'm deploying it." So what you want to do is think about the resources that you have and deploy them in the industries that are going to give you the highest level of return for those resources.

Matching Resources to Markets

We've been talking about entry barriers. And, if you are like me, the first time I read about entry barriers I took it at faith. High-entry-barrier industry: What does that mean? How much entry do you think is going on? Not much, right? In fact, I did a study, a couple of years ago, at the Federal Trade Commission, where we looked at industries and looked at the extent of their entry barriers and looked at entry that occurred in those industries.

Specialized resources

What kinds of industries do you think firms went into that had large established resource bases in R&D? So firms that had great R&D capabilities. Do you think they went into low-entry-barrier industries? No. What about firms that had great marketing know-how: brand-building capabilities; the infrastructure to take a brand from nothing to something important? Do you think they went into low-entry-barrier industries? No. Where do you think they went?

__: More of the same.

PROFESSOR MONTGOMERY: More of the same. They catapulted right over the top. And, in fact, what we found is that high barriers to entry were like magnets, not repellents, to firms that had the resources that it took. So you do the five forces—not all potential entrants are created equal—and you have an industry that has high profits. It can attract firms that have extant resource bases from other industries that can be leveraged to competitive advantage in that market, if those resources are transferable.

So it's very different from what we expected to find. But in fact, those were the two resources that explained the majority of entry into high-entry-barrier industries: extant resource bases in marketing and advertising and in R&D. Just like a beacon, they went right for high-entry-barrier industries. So what you want to do, if you have valuable resources, is to go out there and search for the most valuable industry opportunities to deploy those resources, because that's where you're going to get the maximum value for those resources.

General resources
An example from the complete other end of the continuum. If you look at large conglomerates, where do they tend to be most successful; in what kinds of markets, on average? They tend to be most successful in markets that are characterized by unsophisticated competition. If you take a company like Tyco International and put them up against a lot of Mom-and-Pop players, Tyco tends to trump them every day. Before Dennis Kozlowski [former CEO, Tyco] went away, he used to come down to the School and talk about the kinds of industries that Tyco went into. And what he said is, "We will never go up against Microsoft. We would never choose to go into that kind of industry. And, in fact, the kinds of industries we go into, like fire hydrants and Band-aids—what would you call them, medical patches?—are the kinds of markets where we can't even attract your MBAs to work for us because they're not interesting enough. They're not sexy enough industries. But relative to the players who are in those markets, our resources are really valuable there."

So what we want to do is go to markets where our resources can give us the greatest lift. So successful conglomerates tend to go into unattractive industries where their competitive resource gives them an edge relative to others. So it's this constant match between what resources you have and where you can get the most value from deploying them.

If Tyco deployed its resources vis-à-vis Microsoft, they weren't going to do very well.

Building Resource Stocks
This is the connection between the activities that you were talking about earlier in the week and the resource-based view, because this is where the activities are. So if you think about what you're doing today and why does it matter. These are the current expenditures, and here you have the dollars going in: what you're doing in terms of marketing, distribution, manufacturing, research, and development. These are all of your current activities. And when we looked at Gucci, this is what we were talking about, because they started almost with nothing because they had a very tarnished brand, almost with nothing. And this is where the action was: in the current expenditures.

What you're going for is an internally consistent pattern across all of these functional areas. That's time T. But what we're talking about here in the resource-based view is not only time T, but time $T + 1$, $T + 2$, $T + 3$, $T + 20$; over time, the cumulative value of current expenditures. And that what can happen is that they then become resource stocks. These are what we call resource flows, current expenditures. These are resource stocks. The notion is that if you've been doing R&D in a particular way for quarter after quarter after quarter . . . If it's just one quarter between you and the competitor, that's all the margin of safety you have, right? But if you have a true capability in brand building, if you have a fantastic reputation for safety or for quality, think about how you got that and the amount of time it took.

Disney, for example. We do a case on Disney. We start out with people like you talking about when did you go to your first Disney movie? It turns out, well, let's do it. I'll show you what this is like. Henry? Is it Henri?

__: Henri.

PROFESSOR MONTGOMERY: When did you go to your first Disney movie?

__: Must be five or six.

PROFESSOR MONTGOMERY: Five or six. Whom did you go with?

__: Mom and Dad.

PROFESSOR MONTGOMERY: Mom and Dad. Did you have a nice time?

__: Yes.

PROFESSOR MONTGOMERY: Do you remember it fondly?

__: Yes.

PROFESSOR MONTGOMERY: This has always worked. But you never know, though. Do you have children?

__: Yes.

PROFESSOR MONTGOMERY: Do you take them to Disney movies?

__: Yes.

PROFESSOR MONTGOMERY: Yes. Why?

__: We have a good time together.

PROFESSOR MONTGOMERY: Well, how do you know that you can have a good time together?

__: It's fun.

PROFESSOR MONTGOMERY: How does Henri know that he can have a good time with his children at Disney movies? Five and six years old, he went with his parents. He remembers that fondly, right? How do you replace that? It's not everything you need to compete in the kids' movie business. It's a big chunk of what you need. So if you think about, for you guys, for the Disney brand, where your associations come from, this is where they come from: when you were five and six years old. So that's where we've gone from the right side of the board to the left side of the board. And you've built up an intangible reputation in terms of the brand of Disney.

Now, they were almost taken over twenty years ago, and who knows what will happen now. But they weren't investing in those resources. They weren't investing in new movies. So they had to come back and the current expenditures were very important. But the most valuable kinds of resources are those that have morphed into resource stocks. Activities are important, but it's resource stocks; it's the cumulative effect of those; activities done over and over again become capabilities. That's where your greatest barriers to imitation come. So I encourage each of you to think about it within your own businesses, taking stock of your resource stocks. What do you have, in fact, that really is economically valuable?

Because then what you want to do is to use those resources to leverage them into businesses where they contribute to competitive advantage. If you have a lot of organic growth in your existing market, go with it. But the challenge that we were looking at at Disney is the challenge that Mark was talking about. But this is a positive view of it; not out of desperation: "Hey, we're not doing very well where we are, so let's go buy another company." This is the view that, "Wait a minute. We have some very valuable resources here. How can we grow by leveraging these valuable resources?" So it's more of a proactive way of thinking about managing the growth of the company that goes beyond the limits of a particular single product category.

Economies of Scope and Scale
So the requirements for scope economics. And again, it's very easy to get scope. It's very easy to get scale. You just go out and buy a bunch of companies and you have de facto scope. You have de facto scale. But that's not what you want. To create value, you have to have economies of scale or economies of scope. So it's not just throwing all these businesses together. It's how, because you have both of these businesses together, can you compete in a differential way than you could if they were on their own.

So how is it that if Gucci brings in another brand, that Gucci, managing that brand, can do it in a more effective way than that brand could, sitting out on its own? Because they have a shared cost structure, a shared infrastructure. So if that can drive down their costs on the supply side—so we're talking about relative cost position. If you can do things to enhance your relative cost position, or if you can do things to enhance your relative willingness to pay, those are the kinds of resources you want. Again, this connection constantly between the value of the resources and the application in particular kinds of businesses that need those resources and then can benefit from them.

Requirements for scope economies
So what you need to do is demonstrate, first of all, the value of resources in the way that we've been talking about. But are they competitively superior and are they a critical source of advantage in that market to which you're going?

Now let me give you two examples that relate to competitive superiority. You probably fly a lot. Do you remember going on a plane and getting a little bag of pretzels from Eagle Snacks?

__: Yes.

PROFESSOR MONTGOMERY: What happened to them?

__: Anheuser-Busch.

PROFESSOR MONTGOMERY: Yes. Wasn't that Anheuser-Busch? Yes. So, Anheuser-Busch is a big brewing company, right? And if you're drinking beer, what do you need to go with it?

__: Salty snacks.

PROFESSOR MONTGOMERY: Yes, salty snacks. And so they say, "Well, you know, we have these trucks that go out to all of these outlets. You sell beer and chips and pretzels at the same place. Why not, right? So why don't we go into the salty snack business? It goes with beer, in terms of the products going together and the distribution. We can find some similarities there." So they started out giving away these things on airlines: Eagle Snacks. They put a lot of money into developing their brand. But there's a problem. Isn't there somebody else who does salty snacks?

__: Frito-Lay.

PROFESSOR MONTGOMERY: Right. Frito-Lay. Frito-Lay does salty snacks. How well does Frito-Lay do salty snacks?

__: Extremely well.

PROFESSOR MONTGOMERY: Extremely well. Exactly. What happened to Anheuser-Busch? They couldn't even sell the business. They could only sell the physical plant and equipment. Because what it tells you, this "competitively superior": relative to whom? To the people who are in the industry where you're going. If you're going into the salty snack industry, what does that mean? Relative to Frito-Lay. So what they said is, "Look, we're a big sophisticated consumer marketing company. We sell beer. We know a lot about this. We have cash. We should be able to make this work." Right? Well, competitively superior relative to those that you're going to be facing. They were not competitively superior to Frito-Lay.

A critical source of advantage. The derogatory example we use is paper clips. Just to say that you're going to get economies of scale in purchasing paper clips is not good enough to give you a competitive advantage in a business that you're going into.

Let me give you another example. Union Carbide went into the shoe business. You know why they went into the shoe business? I'm not going to ask Thomas to take off his shoes and look at the bottom of them, but they came up with a better sole. So they decided they wanted to go into the shoe business because they had a better sole. Well, it has to be a critical source of advantage to that, not just that it fits. But does it matter? It's the old "so what?"

So you have this resource. And I can't tell you how many companies I've worked with, diversifying companies that say, "Well, we have these resources we can leverage." Always ask these questions: Is it competitively superior and is it a *critical* source of advantage, not just does it fit and can you leverage it? But what's the "so what" of it? Does it really matter that you have a better sole for your shoe? Doesn't how the upper looks matter? They found out the hard way. It didn't work. You have to demonstrate the transferability of the resources: that you can actually get the resources into the market and that, in fact, they won't be destroyed in the leveraging process.

And you've got to make sure that you have the other resources that are required. Union Carbide didn't know how to make the tops of shoes, didn't know how to do the consumer branding in the shoe industry, and they didn't have the distribution. So they didn't have the other required resources that they needed to be a shoe company, even though they had one element. I bet a lot of you have been in that situation where you've had one element and you say, "Ah, let's go with it. Let's go with it."

But do you have the whole? Because you can't ever get away from the whole strategy wheel. You need to be competitive on the whole strategy wheel, not just on the one sole that you have, because you're Union Carbide. You need all of the functional capacity.

Just to give you an example of one company. This is a fantastic example of economies of scope in the faucet industry. They had automated purchasing and inventory; vertically integrated, high automated production; and they sold through two types of outlets: plumbing wholesalers and do-it-yourself outlets. What they found is that they could go from "good" all the way up to "best" in faucets. Why? Because it took the same critical resources behind it to support competition at good, better, and best product lines because the resources are the same.

This would be like looking at the luxury goods market and saying, Ralph Lauren all the way up to Hermes, and it's the same resources behind it, so go for it. If it's the same resources, great. So this is a wonderful example of economies of scope because it's the same resources supporting competitive advantage at each one of those price points for the product lines.

Similarities versus synergies
This company ran into a problem, though, as they expanded elsewhere. And it has to do with confusing similarities with synergies. They said, "Gee, a good, better, best worked well here, so why don't we run with the good, better, best strategy."

This is a quotation in the annual report from the company president that said, "After all, it is the same customer who buys the faucet in the kitchen who buys the couch in the living room." What do you think they went into? They spent $1.5 billion acquiring furniture companies and another $250 million upgrading facilities. What they wanted to do was to take the good, better, best strategy; go from the low end of the furniture industry to the high end and revolutionize. This is a case that we use for the five forces analysis. And it's a delicious case because you look at it and everybody says, "Oh, I would never go into the furniture industry." You look at this and they say, "Five forces. This is terrible, terrible, terrible, terrible." So then you think, "Well, is it time to go home yet?"

Then you say, "Have you ever heard about a company called Starbucks?" And they say, "Yes." And you say, "How attractive do you think the coffee shop business was?" "Terrible, terrible, terrible." "Bart, do you think you could fix the furniture business?" Maybe so. Then you start talking about it, and it's like, "OK, Willy, what would you do?" And before you know it, you've got three boards filled up with how you're going to change or revolutionize the five forces in the furniture industry, which are rock-bottom awful.

Then we give them the case on this particular company that has $3 billion burning a hole in their back pocket. And they say they only want to enter if they can change the industry. What do you think the students tell them to do? Go for it, go for it!

If you look carefully at the furniture industry, what you find out is that at the low end, the value chain and the activities and resources that are necessary for competing at the low end of the market—this is a whole industry—are radically different from the value chain at the high end of the market, which suggests that the good, better, best strategy is a disastrous fit in this industry.

So what they found is that there are very few shared resources across the segments. And they didn't have resources to overcome the rotten five forces condition of the industry. This was a really, really unattractive industry. And they didn't have a trump card. They had a lot of cash and they had the good, better, best strategy, and they became the largest furniture manufacturer in the United States. They had lots of scale. They didn't have economies of scale. They didn't have a different way of competing because they owned ten rather than one. And going from low to high didn't work because the resources were different.

So the reckoning. The company that had had thirty-two years of consecutive earnings growth until they diversified into the furniture business. Net income fell 30 percent. The operating margin of furniture was 6 percent, compared to 14 percent for the rest of the company—absolutely consistent with what the five forces analysis predicted for the industry—and they weren't able to overcome that with their strategy. After several more years of struggle, the company exited the business at a substantial loss, and said upon sale, "The decision to go into the home furnishing business was the worst decision we've made in thirty-five years."

It has to do with the five forces analysis; that you can't get around the economics of the industry unless you have a strategy supported by resources that brings a differential advantage to that market. Just by getting bigger, just by buying more businesses, that can't trump nasty industry economics. It all gets back to do these resources enable you to do something differently? So this is economies of scope, economies of scale—not just scale and scope.

The sweet spot and multiplier effect

But this is why it's worth thinking about. Because if you look at large sample analyses across thousands of firms, what you find out is that the relationship between the number of businesses and the average firm profitability, ROIC, looks like this. This is the reason why it's worth thinking about scope. Because what this tells you is, if you look in the sweet spot—this is Disney in its sweet days—what you find is that you get a mutually reinforcing system. If you get a platform and you get rare resources embedded in that platform, you can leverage it over and over and over again. You can become a more efficient and more effective producer in those businesses. If you look at Disney, Disney's ability to sell hotel rooms in Orlando is better because they're in the movie business. It's better because they're in the licensing business. It's better because they're in the Disney Channel. All of those things become multiplier effects.

If you're a single business company competing with LVMH, or competing with Gucci, you're not competing with them just head-to-head on one business line. To the extent to which there really is a fit between the resources and the key success factors of those businesses, you're competing with the whole company.

Now, if you're lucky, what you do, if you're a single-business company, is compete with a company that's part of a diversified company, where the resources don't extend and they become a detriment to the business. That's the kind of competitor you want. But otherwise, you're competing with the whole company and those resources. And, if you think about how long it takes to develop intangible resources and capabilities, the value of being able to leverage those across multiple markets can be formidable. That's why this is not a surprising result.

So the notion is that companies that have those valuable resources, if they extend them judiciously to a number of businesses, what you see is that, on average, firm profitability goes up. And that's because of economies of scope that are behind those businesses. It's not just because they've gone out and acquired a bunch of businesses and thrown them together.

Conclusion
So, summing all this up, the appropriate scope of a company is usually more restricted than anticipated. And that the diversification track record, what we find is that a third to a half of acquisitions are later divested because they're not effective within the new environment.

All businesses and effective corporate strategies are related. But look beyond product markets. That's a theme that we've been trying to talk about or underscore over and over again today. That it's not about product relatedness. It's not about "if it's the same industry." If it's the same industry, you're going to get Hermes going together with Prada and with Tommy Hilfiger. That's the same industry. You've got to look deeper. You have to look at the resources that are underlying those businesses, and that it's the goodness of those resources. If those resources are difficult to imitate; if they're scarce; if you can appropriate the value;, and if they're really important to competitive advantage, business unit by business unit, those are trump cards that are very, very valuable. So, it's the goodness of the underlying resources that leads to competitive advantage in a single-business company, and it's the same logic in a multibusiness company.

But if the resources at the core of the company aren't extra special and are, in fact, quite pedestrian, you can imagine that leveraging them over and over and over again, how much is that going to get you? Trouble. So the goodness of this strategy depends on the goodness of the resource, which extends into the likelihood of it creating competitive advantage, business by business by business. And the appropriate scope of a corporation changes over time because of industry evolution and the value and importance of underlying resources. And what you can see in the luxury goods industry through this case is that the single-business companies are going to increasingly be facing challenges. Not because they're less effective than they used to be, in an absolute sense, but, in a relative sense, they're much less effective, as these firms, like LVMH, learn to leverage resources from platforms of multibrand companies.

So this is where it connects back to competitive advantage. Corporate advantage is realized—where the rubber meets the road is, business by business by business. Because what it does, as I said before, it's the wind beneath your wings. It leads to either better products or lower costs; higher willingness to pay or lower total delivery costs, because you're part of this whole.

This is the extension in this case, in LVMH or in Gucci, of the platform. Then that leads to competitive advantage. And that's where you see corporate advantage at work is down here; that you're better off for being part of this corporate family; that it enhances your ability to compete as a manager at this level, business by business by business. So it's the connection between corporate and business strategy.