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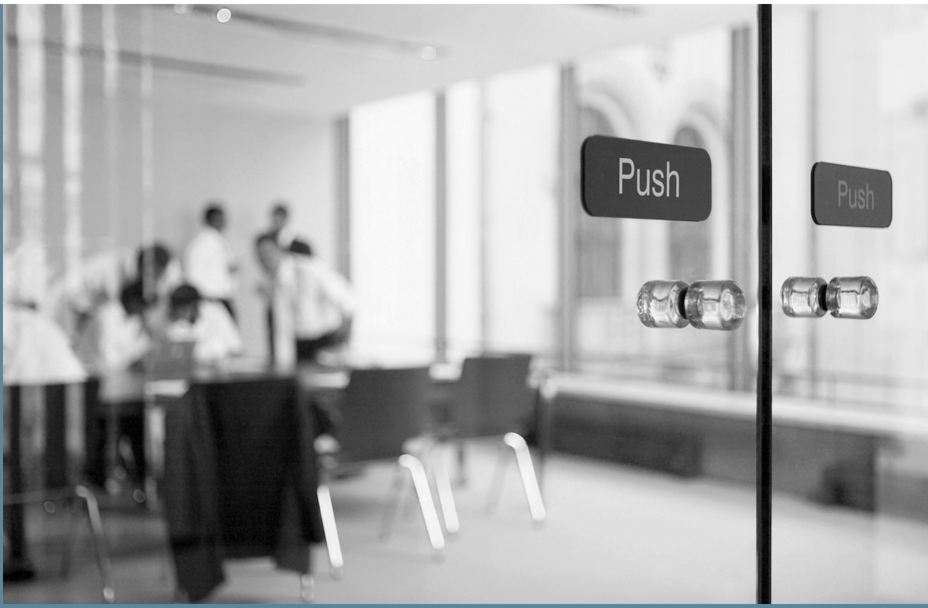

Diversify for Profits, Not Growth

Increase Value and Reduce Risk by Diversifying Your Business the Right Way

Many companies today are struggling to understand how to drive growth in an increasingly challenging marketplace. Developed economies continue to suffer a hangover from the recent economic downturn with slow growth forecasted for the foreseeable future. Even the astronomical growth rates found in emerging economies are showing signs of coming back down to earth.

Diversification has long been the answer to a question that no executive wants to confront: what do we do when our core business starts to slow down? Given the multitude of challenges they face, it's only natural that companies start to ask themselves whether or not they should diversify into new markets. Unfortunately, success does not always follow when companies expand into new markets leading some to question whether diversification is indeed a sound strategy.

We believe that a diversification strategy can create significant value for your business. In fact, our research suggests that companies following a diversification strategy significantly outperform their more focused peers. This leads us to believe that the real question isn't: SHOULD you diversify? We believe the better question is: HOW do you diversify?

Most companies diversify to pursue new growth opportunities in the hopes that profits will follow. Unfortunately, we frequently see this approach failing as the hoped for profits seldom materialize. Our view is that companies should diversify in pursuit of profits, not growth. Diversifying in pursuit of profits focuses on leveraging existing assets and capabilities to decrease the cost of doing business in new markets. And when companies diversify in pursuit of profits, revenue growth almost always follows.

When properly executed, a diversification strategy leads to higher growth, greater profits, and stronger stock price appreciation—all while reducing risk. In this article we'll help you understand why diversification can be such a powerful strategic lever for your business. But most importantly, we'll show you how to properly diversify and avoid the mistakes often made when expanding into new markets.

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What is diversification?

Generally speaking, diversification occurs when you expand your business into new areas. The most common form of diversification is when a company offers new products to their existing customers—such as when McDonald's introduced premium coffee.

As Figure 1 indicates, this approach tends to offer relatively lower risk than other forms of diversification. This is because: (1) companies typically understand their customers well (or at least they should) and (2) investment tends to be limited because companies can leverage their existing infrastructure, channel-to-market, and other capabilities.

Figure 1. Companies that diversify typically start with step 1 (new products to existing customers) and slowly start to move up to riskier approaches as options for growth are exhausted

The next type of diversification is when companies target new customers with their existing products. This approach can also include companies modifying their existing products to target new customers—such as Unilever's attempt to target men with their new Dove® Men+Care® line of products.

Geographic expansion is another form of diversifying your business. However, this type of diversification offers greater risk because the customers are completely new and thus not as well understood. And a greater amount of investment is frequently required in these circumstances to modify existing products and set up operations in a new country.

Companies typically exhaust the methods outlined above before attempting the last form of diversification—entering new markets (i.e. new customers and new products). Because this approach targets new customers and is frequently accompanied by a significant investment, entering new markets is considered the riskiest approach to diversification.

Unfortunately, many companies today are quickly running out of growth options. Most markets are saturated with a plethora of products that more than meet every want or need a customer might have. And even though companies employ exhaustive market research, "big data" analysis, and agile R&D aimed at faster innovation…they are not seeing the corresponding impact on their revenue growth. Additionally, most companies have already expanded across multiple continents, leaving little room for further geographic expansion. Given these circumstances, it is only natural that businesses should consider entering new markets despite the increased risk it brings.

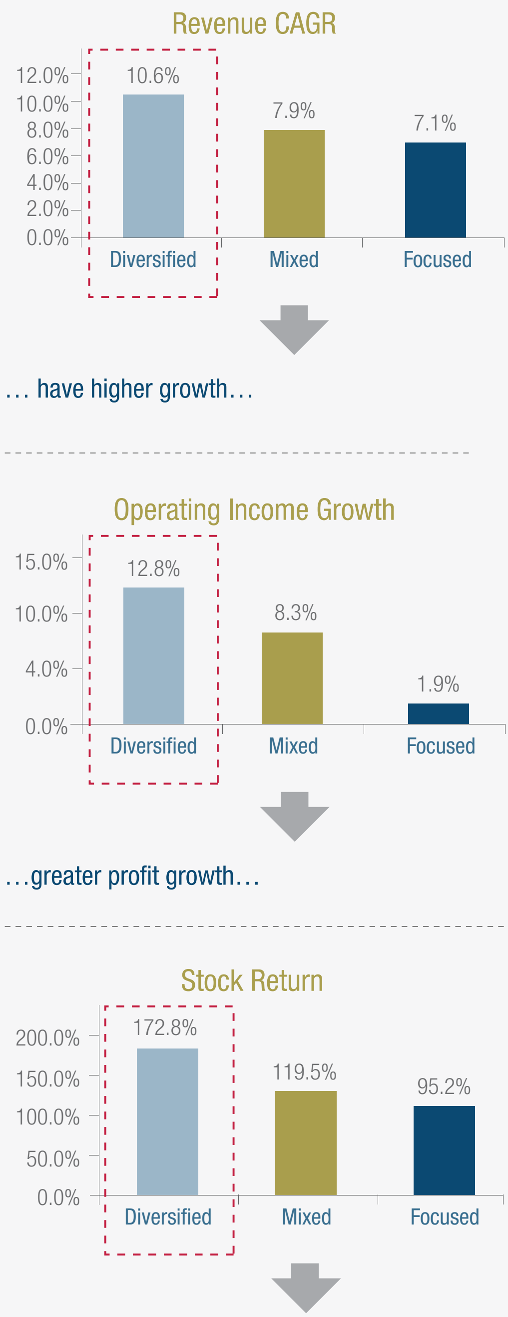
Diversified companies outperform their more focused peers

A diversification strategy brings many benefits. First and foremost, it helps reduce risk. Your company's fortunes won't rise and fall on the whims of one set of customers. And, you're less likely to fall victim to a disruptive innovation that will render your entire business model obsolete (think Netflix's impact on Blockbuster). Diversification also provides more consistent and predictable revenue streams making your business easier to manage and plan for. And as we all know, Wall Street analysts highly value predictability when assigning stock price targets.

Perhaps most importantly, diversification gives companies an opportunity to create value by leveraging their existing assets to serve new customers in a more cost-effective way. Using the example from above, McDonald's is able to offer customers premium coffee by leveraging their existing drive-thru infrastructure instead of having to build a new one from scratch.

In an attempt to quantify the benefits of diversification, we analyzed large public companies across a variety of industries over the time period of 2003 – 2012. Our analysis found that companies pursuing a diversification strategy significantly outperformed with higher revenue growth, greater margin expansion, and superior stock price appreciation (see Figure 2)[1].

Figure 2. Companies that follow diversification strategies…



…and significantly higher stock appreciation

Perhaps the most interesting finding of our analysis is that despite the strong revenue growth of diversified companies (10.6%), they were able to grow their profits by an even greater amount (12.8%). This margin expansion arises from the synergies that diversified companies are able to extract by leveraging their existing capabilities to create value in new markets. On the other end of the spectrum, focused companies (companies that are not diversified) have respectable revenue growth of 7.1%, but only see profit growth of 1.9%. This implies that even though focused companies are growing, they are seeing their margins contract and missing out on important value creation opportunities.

There is good diversification, and bad diversification

Digging deeper into the results of our analysis, we discovered that even though diversified companies outperform focused companies, there is still a wide spread of performance amongst companies that are diversified. We attempted to uncover what separates high-performing diversified companies from their lower-performing peers and discovered that there is a good way to approach diversification…and a bad way.

As we discussed earlier, many companies use a diversification strategy in order to pursue new growth opportunities. However, we believe this is the wrong approach and frequently leads to underperformance. **Our view is that companies should seek to diversify in pursuit of profits, not growth.**

To illustrate the difference between diversifying in pursuit of profits rather than growth, I'll use an example of a company entering a new market via acquisition. A company seeking growth will acquire the target business with the goal of generating revenue synergies such as cross-selling products to the new customer base. The focus is on growing revenue with the hope that profits will follow. All too often however, the hoped-for profits fail to reveal themselves.

Diversifying to seek profits on the other hand, focuses on leveraging existing assets and capabilities to decrease the cost of doing business. Continuing with the acquisition example, a company seeking profits would acquire the target business with the goal of uncovering cost synergies such as consolidating manufacturing facilities or reducing redundant overhead.

Interestingly enough, when companies diversify in pursuit of profits, revenue growth almost always follows. In fact, top performing diversified companies in our analysis generated revenue growth of 15% from 2003 - 2012...significantly higher than other diversified companies. Unfortunately, this relationship does not hold true in reverse—profits do not always follow when your goal is revenue growth.

Diversifying in pursuit of profits is consistently more successful than when seeking growth

Why does diversifying in pursuit of growth yield sub-par results?

- First of all, **chasing revenue is a risky and uncertain proposition.** A business can develop a plan to grow revenue but there are countless factors that can impact success. On the other hand, when you shut-down a facility that is no longer needed, you often know with great certainty how much you will save and when the savings will occur.
- Secondly, **cost savings flow straight to the bottom line whereas new revenue does not.** The cost to deliver the revenue (cost of goods sold, SG&A, etc) must be subtracted before profits can be realized. Assuming 20% profit margins, you would need to generate $500 million in revenue to create the same amount of profit as $100 million in cost savings.
- Finally, **revenue growth creates complexity whereas eliminating cost reduces complexity**. Growing revenue typically entails adding something to your business—new product lines, more manufacturing facilities, and even new processes to manage the growing enterprise. All of these additions serve to increase the complexity of serving your customers resulting in customer confusion, poor service levels, bureaucracy, and declining asset utilization. Even though it may not always be explicit, this increase in complexity adds significant cost to your business. Reducing costs however often go hand-in-hand with reducing complexity. Eliminating an unprofitable product line or consolidating duplicative manufacturing facilities serves to reduce the complexity in your business and free up valuable resources for more profitable endeavors.

To help illustrate these points, consider the following two company examples: one that diversified to seek growth and one that diversified in pursuit of profits. (see Figure 3)[2]

Figure 3. A Tale of Two Companies

DIVERSIFYING FOR GROWTH often leads to underperformance…

Sealed Air acquires Diversify

- **In 2011 Sealed Air Corp,** a $4.5B supplier of packaging and other products, diversified its business by **acquiring Diversify for $4.3 billion**
- At the time of the deal, Sealed Air justified the deal by discussing how the acquisition would drive **growth…with no mention of cost synergies or lowering the cost to serve customers**

Results:

- Just one year after the acquisition, Sealed Air took a **$1.2 billion write-down** on the Diversify acquisition due to lower than expected growth and profits
- Write-downs are an accountants way of saying that the revenue growth that was expected never materialized. This is an unfortunate example of a company seeking growth rather than profits.

…while DIVERSIFYING FOR PROFITS frequently creates lasting success

Stanley acquires Black & Decker

- In 2010, **Stanley Works acquired fellow tool maker Black & Decker for $4.5 billion**
- At the time of the acquisition, Stanley's rationale for the deal was completely related to cost savings—**$350 million in annual cost synergies were expected** from combining the two companies
- Although additional growth was expected, it was not considered as part of the deal rationale

Results:

- Stanley's acquisition of Black & Decker is a perfect example of the benefits of seeking profits over growth
- And the results speak for themselves: by 2013, Stanley had surpassed its cost synergy goal by achieving **$500M in annual savings and gained an additional $300M from revenue synergies**

Conclusion

As other strategic options dwindle, we believe that corporations will increasingly look to diversify into new markets. In fact, our research indicates that this is a sound strategy that on average delivers six times higher profit growth and double the stock price appreciation.

However, success does not always follow when companies expand into new markets. If you want to avoid being another cautionary tale in business literature we believe you must diversify the right way. **Diversifying in pursuit of profits rather than growth helps lead to higher growth, greater profits, and stronger stock price appreciation—all while reducing risk.**

[1] Each company in the analysis was assigned a classification according to their level of diversification. "Diversified" companies were those that participated in multiple markets with different products and customer bases. "Mixed" companies had a more limited form of diversification (e.g. same products but multiple customer bases). "Focused" companies had no significant form of diversification at all. n = 106

[2] Source: company press releases and investor presentations

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About Wilson Perumal & Company:

Wilson Perumal & Company is a premier management consulting firm and the leading advisor on how to manage and capitalize upon the complexity of today's world. To learn more, visit www.wilsonperumal.com.

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