Success or Failure?

CORPORATE DIVERSIFICATION

Diversification by a company may bring benefits or losses to its shareholders. The results are mixed, both in Australia and overseas, but the failures would undoubtedly outweigh the successes. In Australia investors are becoming increasingly aware of the pitfalls of diversification.

Diversification can have a big impact on the price of the diversifying company's shares because:

• earnings can be greatly affected either favourably or adversely;
• the nature of the company's business can be changed, thus affecting the market's valuation of its shares and the risks inherent in its business.

The security analyst cannot afford to overlook the implications of diversification. He must assess whether a company's diversification programme is likely to meet with success. This paper presents five criteria which should assist this assessment.

Successful diversification is obviously difficult to define. From the point of view of the shareholder, diversification could be regarded as successful if as a result:

• earnings per share are higher than they would otherwise have been; and
• the nature of the business is not changed so as to increase the risk of a decline in profits and dividends or to impair the market's valuation of the stock.

The probability of success should be high if the diversification meets the following criteria—

• is the diversification appropriate to the company's resources—particularly competence and finance?
• does the distinctive competence of the company match the distinctive competence required for success in the new area?
• is the diversification part of a broad plan or is it merely an ad hoc move?
• is the diversification consistent with opportunities in the new area?
• is the risk of variations or a decline in per share earnings and dividends reduced by the diversification?

Let us now look at these criteria in a little more detail and examine how they can be used by the security analyst as a basis for assessing diversification moves.

Resources are probably the most critical determinant of success in diversification. Taken together a company's resources represent its capacity to respond to threats or take advantage of opportunities in its environment. In assessing the prospects of a diversification venture, the analyst first has to determine what resources are likely to be needed for profitable operation in the new area. The company's resources then have to be analysed and matched against those required. This demands a critical appraisal of both the company and the environment it is entering. The key resources are usually finance and competence. Facilities, raw materials, brand-names, patents, franchises and a variety of other resources may also be significant in particular cases.

In assessing whether a company's financial resources are appropriate to a particular diversification venture, the analyst needs to satisfy himself on two key points. First, can the company raise the funds needed to finance the diversification economically and without diluting the equity earnings of shareholders?

For example, if a small chemical company contemplated entering the ammonia business, the financing of what is a high capital cost plant could easily place an intolerable burden on its financial resources. Secondly, if the time taken to reach profitable operation is likely to be long, does the company have the cash resources to carry the early losses? In the earlier example of the small chemical company, this might not be possible.

The proportion of financial resources devoted to a diversification venture and the time taken to reach profitability directly affect the risks involved. The higher the proportion and the longer the payoff time, the greater the risk. The impact of failure clearly rises as the proportion of resources committed rises. The chance of failure rises with the payoff time because the chances of unforeseen adverse changes occurring in the environment rises with time. An extreme example is Underwood, an old-established and successful U.S. typewriter company, which attempted to diversify into electronic data processing. Substantial sums were spent on development over a number of years and big losses were incurred. However, these efforts were inadequate and Underwood did not have the resources to push the venture to a successful conclusion. The company was forced to abandon the project and was subsequently taken over by Olivetti, a leading Italian typewriter company.

Diversification can also be too small in relation to a company's financial resources. A relatively small diversification venture, even if it produces a high return on funds invested, may not make a sufficiently significant contribution to total company profits to justify the using up of management time, which is a scarce resource in most
companies. In Australia it is not difficult to find examples of small and medium-sized companies which have diversified too widely. Instead of thinly spreading their limited management resources over a number of fields, these companies may have been more successful had they concentrated their efforts on a few of the more attractive areas.

Competence is usually the key resource in diversification and for the analyst the most difficult to assess. Competence is the aggregation of the skill and talents and experience gathered in the company. It covers expertise in the usual functional areas of marketing, production, finance and technology as well as the deeper core of talents and experience which are often peculiar to individual companies. For example, a margarine company may have technical skills in refining and hydrogenating animal and vegetable oils plus marketing competence in promoting consumer products and operating a wide distribution system covering thousands of outlets. However, it may also have less obvious but nevertheless significant experience developed from learning to live with erratically fluctuating raw material prices and with buying pressure exerted by several dominant supermarket chains who are its major customers.

The degree of competence of a company is not usually uniform across the broad range of skills necessary in its business. Some companies are particularly skilled in certain phases of marketing, while others are especially good in certain technical or financial areas. Comparison of this distinctive competence of a diversifying company with the distinctive competence required for success in the new area gives the security analyst his most important clue in assessing the probable success of the venture. Distinctive competence is most frequently required in the marketing area. Not only must a company be a successful marketer to survive but it is in the marketing area that change is most rapid. The application of distinctive competence in the diversification can be illustrated by the earlier example of the margarine company. Suppose the company had embarked on four diversification ventures:

- refined vegetable oils for the paint industry, utilizing technical competence in refining and skill in commodity buying;
- broiler chickens, utilizing raw material resources (by-product stock feed) and competence in marketing;
- instant and ground coffee, utilizing competence in commodity buying and marketing;
- a fish and chip chain, offering a captive market for a large volume of cooking oil.

Each venture utilizes a resource of the company and none could be regarded as completely unrelated diversification. Analysis of the distinctive skills required for success in each venture might lead to the following conclusions—

- success selling vegetable oils to the paint industry demands special skills in technical service to assist paint manufacturers with formulation problems;
- success in broiler chickens demands special skill in developing chicken strains;
- successful development of a fish and chip chain demands real estate skills in site selection and purchase;
- success in instant coffee demands competence in large scale consumer advertising, the ability to deal effectively with dominant buyer groups and skill in commodity buying.

On the basis of these skills the most successful diversification is likely to be instant coffee. The assessment, however, has to take into account other factors.

If the diversifying company appears to have the necessary resources and distinctive competence, the analyst must then satisfy himself that opportunities in the new environment are such that the diversification venture can be successful and an adequate return can be earned on the funds invested. This calls for analysis of the market and the degree of competition, both domestic and import. The instant coffee market, for example, might be expanding so rapidly that, despite active competition from established suppliers, a new entrant with the necessary resources and critical skills could expect to establish a profitable operation within two or three years. On the other hand it may be that competition, price cutting and excess capacity are so severe that the profit outlook for a new entrant is bleak. In capital intensive industries, the new entrant must start with a plant large enough to allow him to compete on delivered costs with established suppliers. He must then achieve sufficiently high sales volume and selling prices to lift the venture above the break-even point. Competition and market growth may well preclude the new entrant from achieving in the foreseeable future the necessary sales volume and sales realisation net of expenses.

Planned diversification, based on critical corporate self appraisal and penetrating analysis of opportunities, is more likely to succeed than an ad hoc move to close a deal which is superficially attractive in financial terms. Precipitate opportunism is fraught with risk. Time and effort spent by a company on analysing the problems of diversification can reduce the risks, if only by highlighting pitfalls which may not be apparent in an initial appraisal of a proposed venture. Skilful analysis and planning should increase the chances of success. While a successful diversification move of course can be fortuitous, the probability of a company making a series of successful moves should clearly rise with its analytical skills.

Diversification which reduces the risk of fluctuations or, of course,
a decline in per share earnings and dividends must be favourable from the point of view of the stockholder and therefore the security analyst. The risk of declining or fluctuating earnings most frequently has its origins in the marketing side of the business. For example, the company operating in a cyclical industry which diversifies into a market with stable growth or a different cycle is seeking to counter-balance the fluctuations in sales, profit margins and profits which stem from fluctuating demand. Similarly the company with a "mature" product which diversifies into a growth area seeks to offset the risk of declining profits stemming from static or slowly rising demand and the concomitant inability to absorb rising costs or falling selling prices. Technical or financial factors may also underly the risk of declining earnings. New products and processes are being continually developed, making established products and processes obsolescent. The financial and technical resources needed to continue competing effectively and profitably in its established market may be too great for a small company and it may choose to reduce the risk by diversifying into a new area appropriate to its resources.

These five criteria which we have been discussing can be applied to diversification whether it be achieved by internal expansion, by joint venture or by acquisition. However, the question of unrelated diversification by acquisition or joint venture warrants special consideration. This is because unrelated diversification is often justified on the grounds that the diversifying company will obtain the requisite distinctive competence in the new area from the acquired company or the joint venturer. Skills at the operating level can usually be obtained. However, serious problems can and do arise at the policy level, both in the subsidiary and in the diversifying company itself. In the subsidiary the continued retention and motivation of key management personnel is difficult. This applies to both management acquired in a takeover and management on loan from a joint venturer, particularly if domiciled overseas. The diversifying company has to be able to exercise effective policy control over the new subsidiary. This may be difficult or impossible if the diversifying company does not have the experience and competence needed in the new area. For these reasons, unrelated diversification by takeover or joint venture is frequently unsuccessful. Experience indicates that special care should be taken to spot the ad hoc takeover. Opportunism stemming from a desire to "use the share premium" has resulted in numerous ill-conceived acquisitions in recent years.

You may now care to exercise your mind by playing the diversification assessment game. Listed below are twenty Australian companies which have diversified in recent years. Their basic business and diversification are noted briefly. In a column headed "probable success rating", give each company a score of 0 to 5 based on your own assessment of how successful the diversification is likely to be. Add up your scores and you have, in percentage form, your rating of the probable success in diversification of this sample of Australian companies. Anyone for the First Diversification Trust?

<table>
<thead>
<tr>
<th>Company</th>
<th>Original Basic Business</th>
<th>Diversification</th>
</tr>
</thead>
<tbody>
<tr>
<td>A. G. Sims</td>
<td>Scrap metal.</td>
<td>Passenger shipping.</td>
</tr>
<tr>
<td>Australian Chemical</td>
<td>Chemicals, largely for the paint, plastics, rubber, adhesives and paper industries.</td>
<td>Diecasting, metal stamping, plastic moulding, printing, builders' hardware, electrical accessories.</td>
</tr>
<tr>
<td>British Tobacco</td>
<td>Cigarettes and tobacco.</td>
<td>Packaging, soft drinks, pastoral.</td>
</tr>
<tr>
<td>C.S.R.</td>
<td>Sugar growing, milling, refining and marketing.</td>
<td>Building products, chemicals, iron ore.</td>
</tr>
<tr>
<td>Davis Gelatine</td>
<td>Gelatine and glue.</td>
<td>Adhesives, sealants, food stabilizers.</td>
</tr>
<tr>
<td>Concrete Industries</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

©August, 1965

The Australian Security Analysts' Journal