CHAPTER 6

Corporate Strategy

LEARNING OBJECTIVES

Studying this chapter should provide you with the knowledge to:

1. Describe how a corporate strategy differs from a business unit level strategy.
2. Identify the eight ways in which a company may create value through diversification, and the advantages of each source. Be able to evaluate a diversified company's ability to create value using one or more of these sources.
3. Use a portfolio management tool to characterize a company's different business units and to evaluate how well a company manages its portfolio.
4. Explain how a company would choose whether to diversify by greenfield entry or by acquisition. Explain how a company should decide how tightly to integrate an acquisition into its current business portfolio.

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Cisco Systems: Growth through Diversification and Acquisition

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In 1984, Len Bosack managed the computer science department at Stanford University, and his wife, Sandra Lerner, worked with the computer network at the Graduate School of Business, located 500 yards from her husband's building. The two wanted to connect the computer networks of their respective departments and each other. Because the networks used different protocols (commands and languages), the two developed the first multi-protocol router, a device that lets different networks communicate and share data. The husband and wife team decided to commercialize their invention, the AGS router, and, during a drive over San Francisco's Golden Gate Bridge, they chose to name the company Cisco Systems.[1]

Cisco entered the market just as Apple Computer introduced the Macintosh and the personal computer industry began to grow rapidly. Cisco's initial customers were large corporations with multiple, extensive computer networks. By 1989, Cisco had one patent, three products on the market, eleven employees, and $27 million in revenue.[2] The company went public in 1990 (ticker symbol CSCO) with revenue of $69 million, and an initial market capitalization of $224 million. By 1992, sales had grown 550 percent to $381 million and Cisco began to enter new markets for its products and services; Cisco expanded into the market for networked servers and began writing and selling software.[3]

In 1993, the company made its first acquisition, a $94.5 million all-stock deal for Crescendo Communications, a manufacturer of desktop computing workgroup solutions. The acquisition broadened Cisco's product line and expanded its resources and capabilities in the emerging market of networked PCs. CEO John Morgridge touted the acquisitions ability to, "permit us even greater responsiveness" to customer needs.[4] Over the next three years, Cisco would make a dozen acquisitions, each designed to help the company enter new product and customer segments or to expand and solidify its presence in existing markets. In 1997, Cisco entered the training and education market by opening 64 "network academies" to train high school and college students to design, install, and maintain computer networks.[5]

1998 was a watershed year for Cisco. The company, using a mix of acquired and internally developed technology, entered the

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telephone market and introduced Voice over Internet Protocol (VOIP) communications. The fast-growing company realized revenue of $8.5 billion and saw its market capitalization rise to $100 billion. Since going public, revenue had grown almost 1,200 percent and its market cap had grown almost 450 percent! The company's acquisition capabilities grew as well, Cisco completed nine acquisitions that year, averaging one every six weeks. Cisco also expanded its training academies to a total of 580 locations.

Cisco's growth continued over the next two years. The company entered a new market for its products and services in 1999: the home computer and consumer market. By late 1999, 42 percent of American homes had Internet connections, up from almost none five years earlier. The company quickened its acquisition pace, announcing eighteen deals—a deal every three weeks. In 2000, Cisco bought twenty three companies, two a month. The market for Internet connectivity and computer networking continued to evolve, and Cisco's products enabled that growth and evolution. Research and development efforts resulted in patents and products that established Cisco in wireless network technology, a major growth sector of the industry during the early twenty-first century. On March 27, 2000, Cisco became the world's most valuable company, with a market capitalization of $569 billion.[6]

With 46 acquisitions completed since 1993, Cisco had developed a clear and consistent process for bringing acquisitions into the Cisco family.[7] The process began with the identification of attractive targets, typically companies with new and emerging technologies or ones whose products would enhance Cisco's current offerings to customers. The newly acquired company's products would appear in the Cisco catalog—with Cisco part numbers—the day the acquisition closed. This ensured immediate revenue and profit growth from the acquisition. Integration specialists from Cisco worked onsite with the newly acquired company during the first 90 days after the deal closed. These specialists helped the new organization to adapt to and navigate within Cisco's internal systems; they also introduced new members to the Cisco culture. Other integration specialists installed Cisco accounting and purchasing systems.

Cisco fell from its perch as America's most valuable company when the Internet stock bubble burst in 2002. That didn't stop the company from pursuing its strategy of acquisition and diversification to maintain and enhance its status as the backbone of the Internet. At the end of the new century's first decade, Cisco held leading market positions in most router and networking categories, including over 30 percent of the market for routers and switcher.[8] That year, the company shipped its 30 millionth IP phone to customers around the world.[9] Internal growth and acquisitions helped Cisco maintain and extend its lead in cutting edge communication and network markets. Cisco received 913 patents during 2010. The August 2011 purchase of Versly, a software tool for collaboration within Microsoft applications, represented Cisco's 150th acquisition. Over the next five years the company purchased another forty five companies, and sometime in mid-2017 the company would close its 200th deal. Cisco had proven the value of using acquisitions to grow and maintain industry leadership.[10]

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Cisco Systems is a leading business in the tech economy of the twenty-first century. The company uses its intellectual property and brand resources, along with its innovation and acquisition capabilities, to create competitive advantages through the methods you've learned about in previous chapters. The concepts and models discussed in Chapters 2 through 5 presume that a company operates in one definable industry, such as healthcare or home appliances. This chapter discusses how strategy changes when a firm competes in multiple markets.

Corporate Versus Business Unit Strategy

The tools of industry analysis, low cost or differentiation strategies, and innovation help managers devise **business unit strategy**, or an approach for creating competitive advantage within a single industry, market, or line of business. Cisco, when viewed as a collection or portfolio of businesses, competes in a different, but related way than its individual business units. Cisco managers have a clear **corporate strategy**, or an approach for creating value and competitive advantages through participation in several different industries and markets.

Corporate strategy entails competing in a core industry or business and also operating in adjacent businesses or markets. When those adjacent markets can be mapped *along* the value chain, then a firm vertically integrates. For example, when Apple made the decision in the early 1980s to develop its own computer operating system in-house, it vertically integrated backward by producing the inputs to its computers. **Vertical integration** represents such an important and unique form of diversification that Chapter 7 deals specifically with this topic.

When a firm moves to an adjacent business or enters a new industry value chain, it engages in **horizontal diversification**, most commonly referred to simply as *diversification*. The adjacent market may mean selling the firm's existing products to new customer groups, bringing new products and services to existing customers, or selling new products and services to new customers. Managers diversify their firms through one of three methods: greenfield or organic

business unit strategy The search for competitive advantage within a single industry, market, or line of business.

corporate strategy The search for value and competitive advantages through participation in several different industries and markets.

vertical integration Movement into adjacent markets by a firm along its own value chain. Movement in the direction of raw materials is backward integration. Movement in the direction of sales, service, or warranty operations is forward integration.

horizontal diversification The movement into an adjacent market, one that is not along a firm's current value chain.

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existing customers than the firm could without being diversified. Diversification also adds value if the combined businesses reduce the firm's overall cost of producing goods or services.

Value Creation: Exploit and Expand Resources and Capabilities

Diversification adds value when expansion into an adjacent business either *exploits* the firm's valuable resources and capabilities or diversification *enhances* and grows the resource base. To provide more clarity to the notion of exploiting and expanding, you can divide a firm's resources and capabilities into two broad categories: a "front end" or customer-facing resources and capabilities and a technological and operational "back end." Procter & Gamble's resources such as brands, product lines, distribution channels, and its capabilities in uncovering deep customer needs represent the customer-facing part of the business. Walmart's resources in terms of regional distribution centers and information systems and its capabilities in global supply chain management and cost reduction belong in the "back-end" group.

Diversification allows companies to *exploit* their existing customer-facing resources by adding new operational resources and capabilities. General Electric's entry into the finance business in the early part of the twentieth century allowed it to solve a core problem for cities and towns: how to defray the huge upfront costs of electrification. Similarly, a business can exploit its existing technological and operational strengths to reach out to new customer groups. General Electric used its original skills in light bulb and electrical equipment manufacturing to enter a new, high-technology market at the end of the nineteenth century: X-ray machines. GE leveraged its knowledge and skill toward a new set of customers, doctors, hospitals, and patients.

Diversification also creates value when it helps a company *expand* its existing set of resources and capabilities or diversification enables it to prepare for the future. Cisco makes a number of acquisitions designed to expand both its technology platforms and product lines. Cisco introduced its first Internet Protocol (IP) phone in 1998. In 1999, the company made three acquisitions, Sentient Networks, GeoTel Communications, and Amteva Technologies, that brought patents and products that Cisco needed to expand its business.[14] Figure 6.1 illustrates the basic logic of value creation through exploiting or expanding resources and from either front- or back-end resources or capabilities.

The logic of exploiting or expanding resources and capabilities provides you with a deeper understanding of what it means for a firm to enter an adjacent market. Adjacent means "next to," and we might think of adjacent markets as ones with products or services right next to each other. Starbucks sells food and mugs along with its premium coffee, but the company also sells CDs or other products. Food and mugs are naturally adjacent to coffee (people eat food with coffee and drink coffee in mugs), but music isn't. When we speak of an **adjacent market**,

adjacent market A market or industry that is closely related to markets or industries a firm currently competes in.

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		Value Through	
		Exploiting Resources	Expanding Resources
Value From	"Front-end", customer-facing part of the business	• Expand customer base • Better serve existing customers through more, better products	• Gain new market knowledge • Add new brands • Identify new trends earlier
	"Back-end" operational parts of the business	• Create economies of scope or increased scale • Broaden existing production capacity • Adopt new technology platforms	• Improve quality, productivity, or other best practices • Access innovative process or product technologies • Enhance R&D capabilities or outputs

FIGURE 6.1 **Adding Value Through Diversification**

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we mean a closely related market for creating value and utility for customers. Starbucks provides customers with a cup of coffee but also a relaxing place to hang out or meet up with others. Part of that environment entails music to set the mood. Starbucks captures the value of that music by offering CDs and other ambience products to customers.

The notions of expanding and exploiting resources help you understand *why* companies can create sustainable competitive advantages. In the next section, you'll learn *how* companies actually create competitive advantage and business value through diversification.

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