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Porter on corporate strategy

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Introduction

Many companies believe in the virtue of being active in more than one business. These firms have based their strategy of diversification on the assumption that multi-business involvement will lead to synergies that outweigh the extra costs of managing a more complex organization. *Corporate*, or *multi-business*, strategy deals with the identification and realisation of these synergies. Or as Michael Porter puts it, "corporate strategy is what makes the corporate whole add up to more than the sum of its business unit parts."

Most writers, including Porter, agree that strategizing for the corporate whole involves finding answers to two key questions, namely:

1. What businesses should the corporation be in to realize synergies? This issue is also referred to as the *composition* question (De Wit & Meyer, 1994).
2. How should this array of businesses be managed to achieve the anticipated synergies? This issue is also referred to as the *control* question.

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The prevalent view on these issues, before Porter made his main contribution to this topic area in 1987, was the *portfolio approach* (see Haspeslagh, 1980; Henderson, 1979; Hofer & Schendel, 1977). The term portfolio entered the business vocabulary via the financial sector, where it refers to an investor's *collection of shareholdings* in different companies, purchased to spread investment risks. This basic idea was subsequently transferred to corporate strategy. Corporate headquarters was viewed as an investor with financial stakes in a number of stand-alone business units. In this conception of corporate strategy, the multi-business synergies to be realized were seen as mainly financial. Three types of financially-oriented synergies were identified:

a) *Financial Discipline.* By tough financial control at the corporate level, business managers could be instilled with a stronger measure of financial discipline, than if they had been entirely independent;
b) *Optimal Financial Resource Allocation.* By redirecting flows of cash from business units where prospects are dim ("cash cows" or "dogs"), to other business units where higher returns could be expected ("stars" or "question marks"), the corporate level could achieve a higher overall return on investment, than if the businesses had been entirely independent;
c) *Risk Spreading.* By being involved in many different, and preferably counter-cyclical businesses, a corporation could avoid "putting all the company's eggs in one basket", and thus achieve a lower aggregate level of risk, than if the businesses had been entirely independent.

To deal with the question of *composition*, a number of portfolio grids were developed, such as the Boston Consultancy Group matrix, the General Electric business screen and the Arthur D. Little matrix. All portfolio grid techniques had in common that the corporation's businesses were evaluated with regard to their strength and the attractiveness of their industry. Depending on their position on the grid, each business unit could be assigned a financially-oriented strategic mission - grow, hold or milk. Depending on the portfolio balance between mature cash generators and high potential-ROI cash users, revealed by the grid, corporate management could divest or acquire businesses to optimize the corporate composition.

With regard to the issue of *control*, since only financial linkages between the business units were emphasized, in principle each

business unit could be run in isolation from the others. In other words, the complexity of corporate diversity could be managed by *disaggregation* - each business unit could be run independently, with corporate headquarters focusing on resource allocation and financial control. It should be noted that even proponents of the portfolio perspective had to admit that multiple interdependencies between business units often did exist. However, the portfolio approach offered little advice on how to manage these.

Porter's writings on corporate strategy

Porter has not written extensively on the topic of corporate strategy. This is probably because he believes that corporations do not compete, but businesses do. Therefore, he seems more fascinated by the dynamics of competition at the business level, than in the complexities of corporate level strategy. Nevertheless, he has written one article on the topic, entitled "From Competitive Advantage to Corporate Strategy", which was published in the May/June 1987 edition of *Harvard Business Review*. This article, which received the McKinsey Award for the best HBR article of the year, has had a significant impact on both corporate thinking and academic debate.

In this article Michael Porter stages a head on attack against the popular portfolio approach, since he believes that the interdependencies between the business units are the very *raison d'être* of the multi-business firm. He argues that shareholders are better at spreading investment risks than companies are, while capital markets are far better at providing financing and at instilling financial discipline. In his opinion, the value added by the corporate center of a portfolio conglomerate usually does not outweigh the extra costs and constraints, making the corporate whole less than the sum of its business unit parts. Synergy between the parts can only be achieved, Porter argues, if the corporate center strives to create and manage *value adding linkages* between the various business units. In this article he focuses on the transfer of skills and the sharing of activities as the two ways of linking the value chains of different business units.

Transfer of skills. The simplest way for business units to work together is to share knowledge and to increase each others' abilities. Since every activity in the value chain requires certain know-how, all types of skills can be transferred, ranging from logistical to service and human resource management skills. Some of this know-how is

relatively easy to transmit to other units, because it can be formalized and quickly absorbed, but many skills require prolonged co-operation and concerted effort to transfer. If such *learning* creates or strengthens a business unit's competitive advantage, Porter argues that having multiple businesses within one company is justified.

Sharing of activities. Business units can go even one step further in their co-operation by linking some of their value chain activities. By bringing activities together, business units go beyond joint learning, to achieve better economies of scale and a stronger bargaining position. Here, too, Porter emphasizes that all types of value adding activities can be linked, ranging from operations to sales and technology development. Only if such *scale* advantages create or strengthen a business unit's competitive position, does Porter believe that there is value in having more than one business in a company.

So, when confronted with the *composition* question, Porter argues that a corporation should only select those businesses that have good skill transfer and activity sharing potential. Only business units that offer such synergies will make the corporation better off. Porter refers to this argument as the *better-off test* for determining the corporation's composition. It is one of three simple tests that he offers to screen each potential addition to the corporation's array of businesses. According to Porter, to truly create shareholder value, each diversification move should pass:

- *The attractiveness test.* The industries chosen for diversification must be structurally attractive or capable of being made attractive;
- *The cost of entry test.* The cost of entry must not capitalize all future profits.
- *The better-off test.* The new unit must gain competitive advantage from its link with the corporation or vice versa;

Furthermore, Porter suggests that it might be useful for a multi-business company to develop a *corporate theme.* Such a theme, like NEC's emphasis on computers and communication equipment (C&C), focuses a company's diversification efforts and enlarges the possibility that skill transfer and activity sharing can be achieved.

While outspoken on the topic of composition, Porter is almost silent with regard to the issue of control. He recognizes that managing the

chosen array of businesses is a challenging task, yet he does not concern himself with these organizationally-oriented issues. Neither the co-ordination between business units to achieve skill transfer and activity sharing, nor the role of the corporate center are dealt with at any length.

Porter's contribution to corporate strategy thinking

Maybe the best way to evaluate Michael Porter's contribution to the subject of corporate strategy is to apply his ideas to himself. After all, the topic of business strategy has been Porter's "core business" throughout the years, while his writings on corporate strategy could be viewed as a diversification move. The obvious question that should be asked, therefore, is whether Porter's venture into the related field of corporate strategy passes all three diversification tests:

- *The attractiveness test.* It is unnecessary to argue that in a world economy populated by so many multi-business firms, the topic of corporate strategy is extremely important. What made the subject so interesting for Porter was the relatively underdeveloped state of corporate strategy theory at the time he wrote his article in 1987. Although serious doubts had been raised about the portfolio approach, both in theory (e.g. Prahalad & Bettis, 1986) and in practice ("back to the core"), an alternative approach still needed to emerge. Porter's article made a valuable *contribution to this transition* from portfolio thinking to a synergy-oriented view of the multi-business firm.

- *The cost of entry test*: Entering the field of corporate strategy was relatively easy for Porter - no major acquisition was needed, it was all achievable through internal growth. This was because his business strategy philosophy could easily be extended to the corporate level. In Porter's view, competition is rooted within an industry's structure and a business strategy should focus on creating and sustaining a competitive advantage for the business unit within its industry. When applied to the corporate level, this perspective leads to the conclusion that corporate strategy should concern itself with improving each business's competitive position. In other words, the key issue of corporate strategy is not financial control and risk spreading, but increasing business units' long term competitiveness. As such, Porter's article has made a valuable *contribution to defining the focus* of corporate strategy.

- *The better-off test*: Porter's contribution to shifting the emphasis of corporate strategy toward "synergy" and "competitive advantage" has definitely left the field much better off. In this context it should be noted that a part of Porter's strength has been his eagerness to go beyond talking about the general concepts of synergy and competitive advantage, by trying to pin down where these synergies can be realized that enhance competitive advantage. To achieve this, he "transfers a skill" from his business strategy writings - the "value chain" methodology - and applies it within the corporate strategy setting. As such, Porter has made a valuable *contribution to the operationalization* of the concept of synergy.

On the whole, it can be concluded that Michael Porter has made a number of useful contributions to the field of corporate strategy. His article "From Competitive Advantage to Corporate Strategy" is often cited, although his position within the field is not as prominent as it is on the topic of business strategy.

Criticisms of Porter's perspective on corporate strategy
Beside compliments there have also been a number of criticisms of Porter's ideas, either directly or indirectly. It is noteworthy that hardly any of these criticisms are based on a fundamental disagreement with Porter's point of view. Rather, the broad thrust of these critiques is that he does not go far enough, or that his concepts need further clarification. The most important points brought forward are the following:

Premature dismissal of the portfolio approach. Porter brushes aside financially-oriented portfolios, because he believes that they do not create shareholder value - arguing that investors can spread their own risk and capital markets are far better at providing finance. However, there has been one significant defence of the portfolio approach. Goold and Campbell (1987) argue that there are a few circumstances under which a portfolio approach (which they call *financial control style*) can be preferable - when managing an array of relatively simple, mature, stand alone businesses, which require a strict focus on efficiency and low cost (e.g. Hanson and Grand Met). In this type of a situation financial discipline is a key competitive advantage. A "lean and mean" corporate center can often add value by using tough financial control to keep costs down. Therefore, Goold and Campbell argue that the

portfolio approach should remain in view as an alternative to Porter's ideas if certain conditions are met.

Lack of attention for organizational issues. A second comment is that Porter only speaks of potential synergies, but does not concern himself with the question how they can be realized within the organization. In other words, Porter writes about the "why" of diversification, but not about the "how". Yet, determining how to manage the organizational complexity caused by the integration of divers company parts is a central issue within corporate strategy. How can skills be transferred and how can activities be shared are obvious questions, that Porter does not touch on.

Difficulty in operationalizing the better-off test. A third comment on Porter's article is that the better-off test sounds simple in theory, but is extremely difficult to use in practice (Goold & Campbell, 1991). It is an appealing guide-line to only diversify into those businesses that will improve their competitive advantage by their link to the corporation, but in reality it is often difficult to determine in advance which linkages will actually add value. The possible synergies coming from the transfer of skills and the sharing of activities are not something that can be easily estimated up front. Especially in the case of a potential acquisition, it is difficult to judge what the possible synergies are and to forecast whether the possible synergies can be realized or not (Prahalad & Bettis, 1986). This means that more attention must be paid to operationalizing the better-off test - what must management focus on to estimate synergy opportunities? Alternatively, the whole idea of screening diversification moves might need to be dropped, settling instead to evaluate the success of diversification efforts after they have been effectuated. In other words, an ex-post test might make more sense than an ex-ante one.

Need for a "best-off" test. Goold and Campbell further question whether "better-off" is the correct diversification evaluation criterion. They believe that a parent company should not only add value to a new business unit and thus make them better-off, but should add *more* value than any other potential parent. Goold and Campbell argue that parent companies should ask themselves whether they offer the best potential synergies to a subsidiary. The corporation should only retain or acquire a business if they have such a *parenting advantage*.

Unclearly defined concept of corporate theme. A number of writers has commented that Porter's remarks about a "corporate theme" are rather open ended. Porter suggests that a good corporate theme can focus organizational efforts and can enlarge the possibilities for the transfer of skills and the sharing of activities. However, what is a good corporate theme and how can a company create one? Much of the literature on corporate strategy after 1987 has dealt with this topic - how can corporations be built around a common core? The most significant development has been the avalanche of attention for the concepts of *core competences* (Prahalad and Hamel, 1990) and *core capabilities* (Stalk, Evans and Shulman, 1992). These authors believe that Porter's focus on linking the value chains of independent business units does not go far enough. In their perspective, the corporation should not be viewed as a *chain*, with separate business units rings that have been linked together. Rather, the corporation should be compared with a *tree*, where all business unit branches stem from the same trunk and roots, consisting of core competences, core capabilities and/or core products. Such a conception of the corporation has led may researchers to conclude that competition does not only take place at the business level (within industries), but also at the corporate level (across industries). Entire corporations compete against other corporations in their ability to continually learn new capabilities - each industry in which these capabilities are applied is but one battlefield in the much broader war (Prahalad and Hamel, 1990). This is, however, quite a departure from Porter's premises that corporations do not compete, but businesses do.

Conclusion

As stated earlier, Porter has primarily contributed to the topic of corporate strategy by focusing attention on the issue of multi-business synergy and by making concrete where synergies can be realized. Since the publication of his article in 1987, researchers and writers in this field have further explored the origins and forms of corporate synergy. In particular, the organizational processes of creating and sustaining multi-business synergies have become more central. Topics such as developing core competences, managing intracorporate knowledge sharing, post-acquisition integration management and the role of the corporate center are currently high on the research agenda. However, in most of these corporate strategy research fields Porter is not an active participant.

While no longer at the forefront of corporate strategy research, Porter's ideas still find wide-spread acceptance and application in the business world. The fundamental notion that corporations must add more value to businesses than the stock markets can, is currently widely-held. Conglomerates based on the portfolio approach to corporate strategy have largely fallen into disrespect and multi-business firms have increasingly refocused themselves on a core of linked businesses. Porter's recognition, analysis and promotion of this trend has been an important contribution to the restructuring of many diversified companies. And as can be seen in the following chapter by the former co-chairman of Unilever, the transition from conglomerates based on the portfolio approach to focused corporations transferring skills and sharing activities has been a significant step in the evolution of the multi-business firm.

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