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PART I

Foundations

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1

Corporate advantage

Mario had worked hard to become CEO of MoveIt, a large diversified producer of planes, trains, and tractors. Since he took over three years ago, things have gone well: revenues increased every year by at least 15 percent and profits are at an all-time high. But he has this nagging feeling that more is possible. At the same time, he does not know what that is. What should Mario strive for, and how can he know if he is doing a good job as CEO?

Corporate strategy refers to the strategy that multi-business corporations use to compete as a collection of multiple businesses. It is qualitatively different from strategy for a single business firm, or "business strategy." The number of businesses, goals, the nature of competition, and, consequently, the concepts used in analysis, all differ between business and corporate strategy.

Difference 1: Single vs. multi-businesses

Business strategy involves a **single business**, whereas corporate strategy involves **multiple businesses**. For instance, a corporation could have multiple businesses that make appliances, software,

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mining instruments, turbines, jet engines, and healthcare products. Each business has its own business strategy. The corporate strategy of the corporation cuts across and affects all these businesses.

The questions "what is a business?" and "how do we distinguish businesses from each other?" are inescapable if we think of corporate strategy as the strategy of multi-business firms. We find it useful to think of a business as uniquely identified in terms of its ***business model***. A business model comprises the set of choices about customers, products, and value chain activities that every business must make.[1] These choices are also sometimes referred to as the "who/what/how" choices: who are the customers, what are we selling them, and how do we produce what we are selling and get it into the hands of the customers? Two businesses are different if their business models differ from each other on at least one of these dimensions. Thus, a business selling furniture out of local warehouses to customers in the UK is a different business than one selling to customers in India (different "who"). A business offering sushi for lunch from a small restaurant to busy professionals is a different business than one offering hamburgers (different "what"). An online only bank is a different business than one that serves customers exclusively through its branch network (different "how").

Industries, in contrast, are usually distinguished from each other in terms of low cross-price elasticity of demand – a price change within one industry has negligible effects on the demand for goods in the other industry. For example, sushi and hamburgers belong to the same industry if a price increase for hamburgers leads to more sushi being sold. Thus a corporation may have multiple businesses within the same industry. Airlines that operate both a full service and a budget carrier are an instance of this. On the other hand, being in a different industry necessarily means being in a distinct business. To be "in" a business means owning at least some of the assets needed for the activities involved in that business.

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Difference 2: Competitive advantage vs. corporate advantage

The goal of business strategy is to maximize the net present value (NPV) of a business, i.e., its future cash flows appropriately discounted for their timing and riskiness (for a brief explanation of NPV see the appendix to this chapter). At the most basic level, this is achieved by ensuring that your buyers are willing to pay more for the outputs of a business than what your suppliers are willing to sell the inputs to you for. Willingness-to-pay (WTP) is the most that buyers will pay for a firm's product. The actual price (i.e., what the buyers pay the firm) will be equal to or less than the WTP, or a firm will sell nothing. Willingness-to-sell (WTS) is the least price for which suppliers will provide all inputs for a firm's product, including raw materials, capital, and labor. The firm's actual cost (i.e., what the firm pays its suppliers) will be at least as high (see Figure 1.1).

You have a **competitive advantage** over a competitor when your difference between buyers' WTP and suppliers' WTS sell is greater than your competitor's difference (between their buyers' WTP and

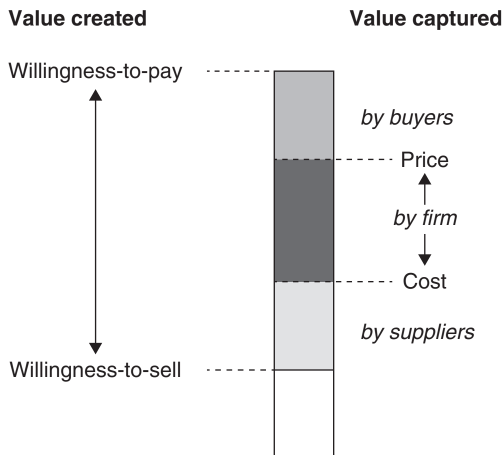

Figure 1.1 Willingness-to-pay and willingness-to-sell

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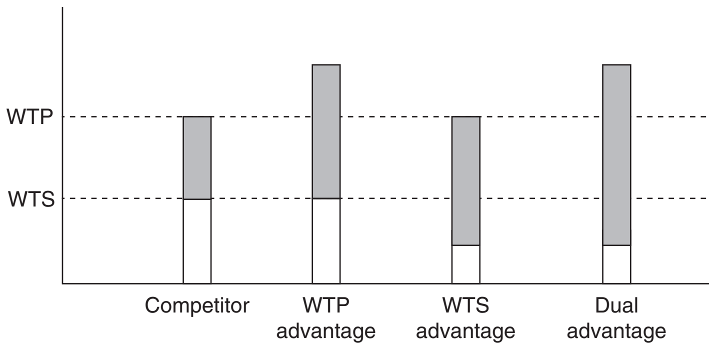

Figure 1.2 Different types of competitive advantage

their suppliers' WTS). There are thus two ways of increasing competitive advantage (see Figure 1.2): by raising the price the customers are willing to pay you (pursuing a differentiation advantage) and/or by lowering the price suppliers are willing to sell to you for (pursuing a cost advantage).[2] It follows that which one you should pursue will depend on the alternatives available to your customers and suppliers (i.e., their bargaining power with you).

One might think that the goal of corporate strategy is to individually maximize the NPV of each of the businesses in the corporation. However, this is incorrect, as it obscures the possible linkages between the businesses when they belong to a corporation. **Corporate advantage** has traditionally been understood as in some sense doing better than the sum of the parts (i.e., individual businesses). Corporate advantage thus exists if the collection of businesses **owned together** is somehow more valuable (i.e., generates higher total NPV) than the sum of values of individual businesses owned in isolation from each other (see Box 1.1).

The goal of maximizing corporate advantage may or may not be consistent with maximizing the competitive advantage of each individual business. To maximize competitive advantage for each business, each business must outdo its rivals in creating a wedge

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Box 1.1 The corporate advantage test

The corporate advantage test can be written as:

$$V[AB] > V(A) + V(B)$$

V(A) is the standalone NPV of business A and V(B) that of business B. This is the value when each is **owned separately**. V[AB] is the NPV of business A and business B when they are **owned jointly**.

between their customers' WTP and their suppliers' WTS. However, some businesses could give up competitive advantage in their business in order to enhance the competitive advantage of other businesses in the portfolio; there may optimally be winners and losers within a portfolio if the winners win more than the losers lose.

Various studies have decomposed the profitability of businesses into factors that arise from the business unit, corporate parent, or industry level. The results show that business unit level factors (such as the management or capabilities underlying the business) explain a big part of the variance in the returns of businesses, but that additionally the corporate level explains a substantial part (ahead of industry level factors). Furthermore, it is also understood that the impact of the business level is at least in part due to decisions taken at the corporate level (such as which businesses to enter).[3] The implication is clear: corporate strategy matters, over and above business strategy, and matters at least as much as the analysis of industry competition. No business within a multi-business corporation can consider its strategic analysis complete without understanding its role within the overall corporate strategy of the parent.

Difference 3: Who is the competition?

The competition for a corporate strategist is different from that for a business strategist. For a business strategist, the competition

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is **anyone who can influence a business' cost or revenues adversely**. This includes direct rivals, but also buyers, suppliers, potential entrants, and companies that sell substitutes (famously captured in Michael Porter's "five forces" framework).[4]

For a corporate strategist, the competition is **anyone who can assemble a similar portfolio of businesses**. We distinguish between two types of such competitors: (1) investors (e.g., mutual funds) and (2) other corporate strategists (e.g., other multi-business corporations, their chief executive officers (CEOs), boards, internal and external advisors, chief strategy officers (CSOs), etc.).

Investors have cash flow rights over returns but typically no decision rights. They have only limited power to tell a corporation what corporate strategy decisions to take. On the other hand, corporate strategists have decision rights in the businesses through the administrative control exercised by corporate headquarters (HQ). Between these two groups is a grey zone. For example, activist shareholders can take a stake in a company and (publicly) pressure a CEO to divest a business. Private equity firms that traditionally focused on financial engineering and operational restructuring are now also engaged in exploiting linkages between businesses. A corporate strategist competes with all of them.

Identifying the competition helps the corporate strategist formulate an appropriate corporate strategy. Because investors have cash flow but no decision rights, their main strategy is **portfolio assembly**. In addition, corporate strategists can also use **business modification**. We discuss these next.

Corporate advantage from portfolio assembly: the "selection" approach

More corporate advantage is better, but how much is necessary? A natural, minimal benchmark for a corporate strategist is a passive

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investor. A corporate strategist should at least be doing better than someone who has no decision power over the individual businesses. But how can an investor create corporate advantage at all, without such power?

The answer lies in the definition of the NPV of a portfolio of businesses A and B: V[AB] = Future cash flows discounted at a discount rate. A discount rate is used to assign a present value (PV) to the cash flows that occur in the future. It follows that value can be created in two ways: influencing cash flows or decreasing the discount rate.

Recall that by our definition an investor cannot influence the cash flows of the businesses. However, an investor may be able to spot bargains: the usual mantra is to "buy low and sell high." In other words, buy a business for less than what it can be resold for later. If successful, an investor may capture value by getting a bargain: more cash comes in than goes out.

Further, an investor can decrease the discount rate. A discount rate depends on three factors. First, a discount rate depends on the timing of the cash flows. Cash flows in the near future are worth more than those in the far future. Getting $1,000 next week is more appealing than getting the same amount ten years from now. Second, a discount rate depends on the riskiness of the cash flows. Secure cash flows are worth more than risky cash flows. A $1,000 payment in ten years promised by the US government is more attractive than the same $1,000 payment in ten years promised by a stranger on a peer-to-peer (P2P) lending site. Third, a discount rate depends on who is the beneficiary of the cash flows. A diversified beneficiary might be willing to take on more risk than an undiversified beneficiary, so that the discount rate would be lower for a diversified than an undiversified beneficiary. For example, you may be unwilling to lend $1,000 to one stranger on a P2P lending site, but you might be willing to lend $100 each to ten different strangers.

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In this last way, an investor can lower a discount rate through diversification. For instance, consider three equally valuable but different businesses, A, B, and C, each owned separately by Alexia, Barbara, and Charlie. Assume further that they have all their wealth invested in their own business and are passive investors (i.e., they don't interfere with their business). For each business, each year there's a 50 percent chance that the owner will get $300 and a 50 percent chance of $0. Thus, on average, each owner will get $150. One day they sit together and discuss combining their businesses into a single corporation ABC, with each obtaining a one-third stake. They are all in favor even though they agree that the businesses will be owned jointly but operated separately (the decision-making for each business is completely independent). The reason is that the risk has been lowered through diversification. Under the new structure, each owner will still get on average $150. But the annual payments are less likely to be as extreme as before (i.e., $300 or $0). In a given year, it is unlikely that all companies do well or all do poorly. Therefore the new investment is less risky than the old one. In other words, the discount rate is lower because the risk is diversified.

This logic underlies the classic investment advice: "don't put all your eggs in one basket." In fact, Alexia, Barbara, and Charlie favor this deal precisely because they had all their wealth tied up in a single business. They probably would not have done this deal had their wealth already been diversified into other assets.

In this example, the condition of corporate advantage is satisfied: $V[ABC] > V(A) + V(B) + V(C)$. This is entirely due to a reduction in discount rates because the cash flows are unaffected. If we take as a benchmark the performance of a passive investor, who can create corporate advantage merely through **selection** of a good portfolio of businesses, then a corporate strategist (with the same portfolio, but who administratively controls her selected portfolio

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