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Research article

Corporate Strategy in Emergence Economics

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Abstract

To be able to manage a large portfolio of unrelated businesses, multinational firms must have appropriate corporate-level strategy as well as the processes and integrating mechanisms to ensure that the corporate parent adds value. The multinational firm's performance will suffer if its corporate managers do not carefully consider their role in managing relationships with and between subsidiaries. The corporate centre needs simultaneously to act as a buffer between and a bridge across the different subsidiaries. To be able to do the latter, it must act as an arbitrator between the different subsidiaries which themselves have varied and sometimes conflicting interests. After reading this paper you should be able to understand major headquarter-level strategic management responsibilities; understand global sourcing strategies; discuss the advantages and disadvantages of vertical integration strategy; discuss the advantages and disadvantages of outsourcing; list and discuss the different diversification strategies; discuss the advantages and disadvantages of the different diversification strategies; develop a global market portfolio matrix.

Keywords: Corporate Strategy, businesses, economics

Introduction

Most successful multinational firms expand into different businesses and regions. The role of the corporate strategy is to develop a well-defined strategy that guides decisions on the scope and types of business to engage competencies to acquire, countries the firm should operate in, as well as allocation of resources into new business opportunities and re-allocation of resources away from undesirable business. The role of the corporate parent is a complex one. 'Corporate parent' refers here to headquarter level. The corporate parent looks for common opportunities to minimize costs and maximize benefits between and within the different subsidiaries. Managers at the centre should possess the expertise and discipline necessary to derive additional value from a portfolio of businesses. For these additional values to be created, however, requires deliberate intervention from the centre. The corporate parent has three key roles. First, the corporate parent must determine the overall strategic direction and structure of the multinational firm. Second, the corporate parent must determine the scope of operations by defining the extent of the firm's involvement across different operations and countries. Third, the management team at the corporate level needs to develop a basis for maintaining an overview of performance across all subsidiaries.

Global Sourcing Strategies

One of the key roles of the corporate parent is developing and managing a global sourcing strategy. The global sourcing strategy must enable the multinational firm to exploit both its own and its suppliers' competitive advantages and the comparative location advantages of various countries in global competition. Multinational firms take advantage of location advantages by sourcing components from foreign markets to take advantage of low production costs in certain countries or regions, or to take advantage of specific skills and technologies located abroad. A multinational firm's global sourcing strategy may include vertical integration, outsourcing, or both. Every time the multinational firm adds another plant to its global network of subsidiaries, it must develop a sourcing strategy to deliver raw materials, and finished and semi-finished goods to and from the new plant to the existing network. This can be done internally through the existing network of subsidiaries on an intra-firm basis or through external, suppliers. The former is commonly referred to as vertical integration. The latter is commonly referred to as outsourcing. Vertical integration represents the expansion of the firm's activities to include activities carried out by suppliers or customers. A vertically integrated firm oversees the flow and processing of raw and finished materials, information, and finances as they move in a process from suppliers to manufacturers to wholesalers to retailers to consumers. Vertical or intra-firm sourcing can be domestic or international. Firms source components in-house domestically when the costs of producing them abroad outweigh the benefits. This is the case when the cost of producing and distributing the components domestically is lower than the cost of producing them in foreign markets, and/or where the quality of the components cannot be guaranteed abroad. When the firm's sourcing strategy cuts across national boundaries, it is referred to as 'global intra-house sourcing strategy'. It involves coordinating and integrating the flow of inputs both within and among subsidiaries in different countries. To be able to source intra-firm from abroad, the firm needs a network of globally Integrated facilities which are able to procure raw materials, transform them into intermediate goods and then final products, and deliver the final products to customers, often in different countries, through an integrated distribution system.

There are several motives for vertical integration. Just after entering a new country, multinationals tend to be vertically integrated because of the lack of suppliers able to produce high-quality inputs. When competencies needed at the different stages of the value chain are similar, vertical integration provides the multinational firm with the opportunity to transfer best practices, and helps it secure access to critical knowledge and resources at different stages of the value chain. Vertical integration enables multinational firms to cross-subsidize one stage of the value chain by another in order to squeeze out competitors. Vertical integration provides multinational firms with the opportunity to retain control over proprietary knowledge, thus preventing leakage of proprietary knowledge to competitors and preventing suppliers from becoming competitors. Vertically integrated multinationals can keep proprietary technology and knowledge within the confines of their corporate system without passing it on to competitors or suppliers. In contrast, multinational firms that are not vertically integrated have to disclose and dissipate knowledge that could compromise their competitive position. Vertical integration enables firms to foreclose or at least raise the cost of input and output markets to competitors. Vertical integration reduces uncertainties in demand and price. Vertical integration enables multinational firms to reduce quality uncertainty by having control over the quality of inputs at all stages of the value chain. Vertical integration enables multinational firms to add value at different stages of the value chain. This is very important in sectors where value has immigrated from one stage of the value chain to another. In some industries value added has migrated downstream in the value chain.

Studies have identified a number of disadvantages of vertical integration. By engaging in several activities, the multinational cannot concentrate on certain core tasks it does best, and as a result more focused competitors may outperform a vertically integrated one. Vertically integrated multinationals often have higher costs relative to multinationals which pursue an outsourcing strategy. This is because vertical integration requires higher investment in plants and equipment than outsourcing firms. In fast-changing global business environments, and particularly in industries where barriers to exit are high, vertical integration increases inflexibility. Outsourcing has become a significant corporate strategy since the 1990s. Organizations large and small, local and global are turning to outsourcing in an attempt to improve their performance. In the 1970s and 1980s multinational firms from Western countries outsourced primarily low-value work and labor-intensive activities to plants in developing countries. Typical of industries that led the way in outsourcing to developing countries were clothing and shoe industries, followed by electronics. Not all activities can be outsourced. To be successful at outsourcing a task in the value chain to a supplier, a firm must meet three conditions. First, it must be able to specify what attributes it needs from the supplier. If the attributes are not specified, the supplier may add, delete, or modify attributes that are key to the final product. Second, the technology and processes to measure those attributes must be reliably and conveniently accessible, so that both the company and the supplier can verify that what is being provided is what is needed. Third, if and when there is a variation in what the

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supplier delivers, the company needs to know what else in the system must be adjusted. That is, the company needs to understand how the supplier's contribution interacts with other elements of the system so that the company can take what it procures and plug it into the value chain with predictable effect.

A multinational firm can outsource its activities domestically or abroad. Firms prefer domestic outsourcing when the disadvantages of producing goods abroad far outweigh the advantages. This is the case when the cost of producing and distributing the components by a domestic supplier is lower than the cost of producing them by foreign suppliers, and where foreign suppliers do not possess the necessary skills and technologies needed to produce the components. In order to reduce production costs under competitive pressure, most multinational firms are increasingly turning to outsourcing of components and finished products from abroad, particularly from newly industrialized countries such as India, China, South Korea, Taiwan, Brazil, and Mexico. The type of relationship with suppliers can be categorized as arm's-length or strategic outsourcing. A firm's decision to pursue arm's-length or strategic outsourcing is often based on the type of component needed and the firm's country of origin. National differences also have an impact on the outsourcing strategy. US firms for instance, tend to manage their suppliers in an arm's-length fashion. In contrast Japanese firms divide their suppliers according to the type of input. Suppliers of core products that are crucial to differentiate the product are managed through exclusive, long-term relationships called keiretsu. Suppliers of standardized, non-core products, however, are managed on an arm's-length basis. Outsourcing has several advantages such as cost saving, Access to proprietary knowledge, Focus on core competence, Flexibility, and Competition. Like all strategies, outsourcing has several disadvantages. Outsourcing may lead to 'hollow firms' offering innovative concepts and designs without investing in physical capital such as manufacturing plants. Outsourcing in general and global outsourcing in particular have high failure rates. Unforeseen operational and cultural problems may arise, primarily when Western firms outsource tasks that require repeated interface with customers in the home market. Outsourcing may damage the multinational firm's ethical image. When multinational firms outsource, parts of their value chain are outside their physical boundaries and difficult to monitor.

Diversification Strategies

Most well-known firms, such as Eastman Kodak and Virgin, began their existence serving a single market in a single country, with a single product or service or a small group of products and services. Several large and successful multinational companies, such as Domino's Pizza and McDonald's, are still pursuing a single-market strategy. This is the concentration strategy. Concentration on a single business entails important advantages as well; dangerous disadvantages. On the one hand, by focusing on a single market the firm is better positioned to obtain in-depth knowledge of the business in which it operates than are firms operating in several markets. Further, by concentrating all its resources and capabilities in a single business, the firm should be in a better position to develop a competitive advantage over firms operating in several businesses. On the other hand, pursuing a concentration strategy is dangerous, especially when risk is substantial; when the product or service the company provides becomes obsolete; or when the industry reaches maturity and starts declining. The rule of thumb is that the firm should stick to its core business unless the risk of operating in that particular business is high; the firm's existing business stagnates or starts to shrink; or the firm acquires or develops unique competencies that are key success factors and valuable competitive assets in other industries.

Industrial Diversification

Industrial diversification is justifiable if it enhances shareholder value. It does so when the new businesses perform better under the parent firm's umbrella than they would perform as stand-alone businesses. The parent can only justify itself if its influence leads to better performance by the businesses than they would otherwise achieve as independent, standalone entities. The parent can do this by carrying out functions that the businesses would be unable to perform as cost-effectively for themselves, or by influencing the businesses to make better decisions than they would have done on their own. Several industrial diversification options are available to the firm. The firm has to choose whether to diversify into closely related business ('related diversification') or into completely unrelated business ('unrelated diversification'). Related diversification measures dispersal of activities across business segments within industries. Unrelated diversification measures the extent to which a firm's activities are dispersed across different industries. A firm diversifies into related business when it enters new businesses that have valuable relationships among the activities constituting their respective value chains. A related diversification involves adding new businesses that are strategically similar to the existing business. Related diversification presents firms with three key opportunities: Economies of scope, Market Power, R&D competencies. Because related business often uses similar production operations, marketing, and administrative activities, related diversification provides firms with the opportunity to reduce manufacturing costs, share distribution activities, rationalize sales and marketing activities, and rationalize managerial and administrative support activities. Related diversification means using common suppliers across the businesses. This gives the firm greater power over its suppliers, and as a result it may secure volume discounts because of the large volume ordered from the same supplier. Related diversification provides firms with the opportunity to transfer valuable know-how from one business to another, and to combine knowledge generated in separate businesses into a single R&D centre. By so doing the firm saves R&D costs, reduces 'new product-to-market' lead time, and is better positioned to develop new products.

Diversification must offer potential for generating synergy between the current business and the new businesses and/or among the new businesses. The transfer of best practices, however, is often hampered by 'stickiness'. General Motors had great difficulty in transferring manufacturing practices between divisions. Barriers to transfer of best practices include inter-divisional jealousy, lack of incentives, inclination to 'reinvent the wheel' by subsidiaries, lack of commitment, and Jack of cap from the recipient to absorb new knowledge. The corporate centre can enhance the transfer between subsidiaries by developing the learning capacities of subsidiaries, systematically analyzing and communicating best practice, and fostering closer relationships between subsidiaries. Further, parent companies should reward their subsidiaries' managers for working together, to make it worthwhile for these managers to cooperate. A firm diversifies into unrelated business when it enters businesses whose value chains are so dissimilar that no real potential exists to transfer technology or management know-how from one business to another, to transfer competencies to reduce costs, to achieve competitively valuable benefits from operating under the same corporate umbrella, or to combine similar activities. Further, unrelated diversification, if not managed properly, may lead to what is known as 'contamination'. Contamination occurs when two businesses with different critical success factors are encouraged to work closely together in the name of synergy, and pollute each other's thinking and strategies.

If the corporate parent cannot benefit from leveraging its core competencies, or sharing its activities across businesses, what motivates a firm to diversify into unrelated businesses? The reason in most cases is the quest for a good profit opportunity. Unlike in related diversification, where the corporate parent adds value by exploring synergies across the different businesses, with unrelated diversification the corporate parent adds value by exploring synergies within the different businesses. The corporate parent does this by using its 'parental advantage'. The 'parental advantage' stems from expertise in, and support from, the centre. The corporate parent, in this case, makes positive contributions to the different businesses by providing them with skills and competencies hard to obtain without the help from the parent, such as expert help (otherwise not available to them or available only at very high cost) on strategic moves, use of brand names, legal processes, divestment and downsizing strategies, and human resource policies. Since corporate managers must divide their time and energy between a numbers of businesses in the portfolio, they will always be less close to the affairs of each business than its own management team. Inevitably, there is a danger that their influence will be less soundly based than the views of the managers running the business. Further, central cost has a tendency to creep upwards, as unproductive central interference goes unchecked.

Diversification may also lead to the use of cross-subsidies which allow poorly performing subsidiaries to drain resources from better-performing ones. That is, diversification enables poorly performing subsidiaries to access free resources as part of a diversified firm, rather than being on their own. This may demotivate highly performing subsidiaries. Another major risk of diversification is corporate parents' interference in the running of subsidiaries. Interference from parents may inhibit the initiative of subsidiary managers and impel them to take on tasks for which they are ill-suited. This is not to suggest that parents should play a hands-off role. On the contrary, the role of the parent is to develop and communicate clear responsibilities to subsidiaries without excessive detail. Absence of the latter will result in confusion about the specific roles and responsibilities of different subsidiaries, and a danger of destructive conflict between subsidiaries.

Diversification in Emerging Economies

While managers in Western developed economies are advised to stick to their core business unless they have good reasons to diversify, managers of large firms in emerging economies are advised to diversify into different lines of businesses unless they have good reasons to follow a focused strategy. This has led to the development of highly diversified companies in emerging economies. Highly diversified businesses in emerging economies include chaebols in Korea, grupos in Latin America, and business houses in India. This is because, in emerging markets, institutions that support key business activities are not yet developed. Further, without strong educational institutions, firms in emerging economies struggle to hire skilled employees. For example, Tata, like many large groups in emerging economies, has its own management training schools to develop the necessary skills needed to manage the company. Also, unpredictable government behavior can stymie any operation in emerging economies. To guard against this risk, firms have to pursue a diversification strategy to spread the risk of government behavior. Furthermore, in emerging economies, because of lack of information and weak law enforcement, it is very hard for customers to verify claims by firms regarding the quality and performance of products. While the cost of building a trusted brand is very high, once the brand becomes credible, the firms can leverage the power of a trusted and well-known quality image to new products and markets across different businesses. Thus, diversification of a large company in emerging economies provides competitive strength in each market it enters, and helps the company deal with market imperfections in these countries. In contrast, as a result of these imperfections, focused firms would find it very hard to survive in emerging markets.

Global Diversification

Recent commentators have often extolled the virtues of global diversification. The main motivations for global diversification include the search for new foreign markets in an effort to exploit unique assets in foreign markets; to gain access to lower-cost, higher-quality input, or both; to build scale economies and other efficiencies; and to pre-empt competitors who may seek similar advantages in strategic markets. On the one hand, increased integration of the global economies and opening of new markets has increased the feasibility of global diversification. On the other, heightened global, competition has forced more firms to focus on their core line of business. That is, while, global diversification has increased over time, industrial diversification has declined over the same period. It must be noted here that global diversification is not replacing industrial diversification. The causes of the recent increase in global diversification are different, and not related to the causes of the decline in industrial diversification. Indeed, research shows that, on average, firms with high global diversification have a higher level of industrial diversification than firms operating in a single country or a very small number of countries. There are two types of global diversification: related global diversification and unrelated global diversification. Related global diversification is the dispersion of a global firm's activities across countries within relatively homogeneous cluster of countries. Unrelated global diversification is the dispersal of the global firm's activities across heterogeneous geographic regions. Buckely and Casson argue that communication cost in multinationals depends on the physical distance between the countries in which the firm operates. This is because of the costs associated with coordinating and controlling a widely dispersed network of subsidiaries. Accordingly, multinationals that operate in countries clustered physically close to each other should have lower costs of managerial coordination, and their managers may benefit from intimate personal contact. It must be pointed out here that, the impact of recent technological advances such as the internet are reducing the importance of physical proximity.

Generally, multinationals that operate in a cluster of countries with similar cultures and a common language may enjoy efficiencies because of reduced complexities in management operations. These complexities may arise because of dissimilarities in the language, culture, and socio-economic environment. Generally, the larger the cultural distance between the centre and the subsidiary the harder the task of transferring technical and managerial knowledge. Intangible assets are generally hard to transfer to certain types of countries. For instance, if a multinational's success is associated to a large extent with intangible assets, which are highly valued in Western countries, it may find it easier to operate in similar Western countries than in developing countries, where customers value tangible assets more than intangible assets. Global diversification can help the multinational firm achieve numerous benefits such as Global diversification enhances shareholder value by exploiting firm-specific assets, by increasing operating flexibility, and by satisfying investor preferences for holding globally diversified portfolios, Global diversification may also enhance value by creating flexibility within the firm to respond to changes in relative prices, differences in tax systems, and other institutional differences, Global diversification gives multinational firms the flexibility to shift production to the country in which production costs are low, or shift distribution to the country in which market demand is highest, Global diversification gives the multinational firm the ability to lower the firm's overall tax liability by exploiting differences in tax systems across countries, and to raise capital in countries in which the costs of doing so are lowest. The benefits of global diversification can raise investors' diversification preferences. This is the case when multinational firms are able to diversify globally at a lower cost than individuals. Global diversification may also benefit corporate managers through increased power and prestige, through compensation arrangements, or through personal risk reduction. Risk-spreading is one general reason for global diversification. Global diversification enables multinationals to spread risks across markets.

Costs associated with global diversification include a globally diversified firm is more complex than a

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purely domestic firm. Global diversification can lead to the inefficient cross-subsidization of less profitable business units. Managers may have the personal incentive to adopt and maintain value-reducing diversification strategies, even if doing so reduces shareholder wealth. It is possible that the costs of coordinating corporate policies in diversified firms, the difficulties in monitoring managerial decision-making in globally diversified firms, increase the likelihood that the costs of global diversification outweigh the benefits.

Managing Global Portfolios

The corporate parent must provide a basis for a continuous review of performance at the different subsidiaries to be able to judge their performance. Further, the continuous review will allow subsidiaries to compare themselves with others and identify aspects for further improvement. It must be pointed out that the quest from the corporate centre to achieve consistency of performance measurement, and to ensure a sufficient degree of rigour and objectivity in measuring and reviewing performance, may create tension between the corporate centre and subsidiaries which want to retain control over their operations, and which seek to 'defend' their performance. The review of the overall performance can be done in many ways. The corporate centre should challenge the way in which products and services are currently provided, and whether they are needed at all. This implies that the corporate centre has a good understanding of the different businesses. The corporate centre should consult with relevant stakeholders (subsidiary managers, employees, and customers) to explore and appraise options for improving performance, developing key performance indicators, and (when appropriate) setting performance-improvement targets. The corporate centre should review and compare performance of the different subsidiaries with competitors on the basis of the agreed key performance targets. Reviews will need to address the key aspects of performance which are important in the context of locally derived priorities. This enables the corporate centre to make an informed judgment about good or poor performance, and hence intervene when necessary to address the problem.

When the headquarter reviews the performance of subsidiaries, it should challenge the way in which products and services are currently provided and whether they are needed at all; consult with relevant stakeholders (subsidiary managers, employees, and customers) to explore and appraise options for improving performance, developing key performance indicators, and when appropriate, setting performance improvement targets; and review and compare performance of the different subsidiaries with competitors on the basis of the agreed key performance targets. Reviews will need to address the key aspects of performance which are important in the context of locally derived priorities. This enables the corporate centre to make an informed judgment about good or poor performance, and hence intervene when necessary to address any problems. Several portfolio models have been proposed over the years to help firms manage their portfolios. However, most of these models were developed for firms operating in a single country, and are not therefore fully adequate to capture the complexity of diversified multinational firms. Diversified multinational firms cover multiple international markets, with multiple related or unrelated product lines. Few writers, however, have attempted to adapt well-known portfolio management tools to incorporate the multidimensional nature of diversified multinational firms. The global market portfolio matrix positions subsidiaries in each country according to country attractiveness and competitive strength.

How attractive is the relevant country in which the firm operates? Country attractiveness is measured by its market size measured according to projected average annual sales in unit’s growth rate of its market, strength and number of competitors, workforce availability, legal business environment, economic indicators, and political risk and stability. The above factors should be weighted according to their relative importance. The weighting of the factors produces a single linear scale composed of the several factors. The weights represent the relative importance of each variable to Ford's strategic planning efforts. The equation uses market size as a benchmark, and weights market growth as twice the weight of market size. That is, the importance of market growth for Ford is doubles that of market size. The weight of price-control regulation is half the weight of market size and compensatory export requirements is one-fourth the weight of market size, and so on. How compatible is the company's strength with each country? The firm's competitive strength is measured by relative market share, product fit, contribution margin, and market support. Ford used the above factors to compute a single linear scale reflecting a firm's competitive strength. As with the country attractiveness, the weights reflect managers' subjective estimates of the relative importance of each variable in defining the competitive strength required to excel in international markets. Markets in the invest/grow position require further commitment and resources by the corporate level to enable them to strengthen their presence and grow. This can involve such tactics as expanding existing plants, opening new plants, or both. In contrast, the firm should harvest and divest from markets with the lowest attractiveness and the weakest strength. This can involve such tactics as closing or downsizing existing plants and selling off assets.

Summary

Most multinationals today have multiple businesses in different countries. The role of the headquarters or parent is to improve, or at least sustain, the value-creation capabilities of the subsidiaries and the multinational firm as a whole. The corporate parent has three key roles. Headquarter-level or corporate parent strategy needs to be based on a clear view of how value can be added by the corporate parent. The rule of thumb is that corporate parents should avoid intervening in businesses unless the specific reasons for believing that their influence will be positive. Effective strategic management at headquarter or corporate level of the multinational firm requires a clear understanding both of the potential for strengthening the competitive position of the multinational through outsourcing and of the threats posed by outsourcing. Understanding the advantages and disadvantages of outsourcing helps corporate managers to decide whether or not to outsource and to determine the optimal extent of outsourcing by the multinational firm. Another fundamental task of the headquarters is to manage the multinational's growth strategy. When the multinational firm follows a diversified strategy, corporate managers at headquarters must be able to identify and create synergies among multiple subsidiaries or businesses. The parent must have sufficient skills and resources to implement strategies which take advantage of potential synergies. It should also play an active role, when required, in promoting, guiding, coordinating, and arbitrating between subsidiaries.

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INSTITUTIONAL PROFILE

Sardar Swaran Singh National Institute of Renewable Energy is an autonomous Institution of the Ministry of New and Renewable Energy, Govt. of India, to conduct state of the art Research, Design and Development activities in all the areas relating to new and renewable energy sources (especially in bio-energy), energy needs in rural areas, including human resources development at all levels, post-doctoral research and research leading to commercialization of the new and renewable energy technology. The campus of the Institute is being developed on about 75 acres of land. The Governing Council under the Chairmanship of Secretary, MNRE manages the affairs of the Institute. It is proposed to fully operationalize the Institute during the 11th Five Year plan period. Accordingly, actions have been taken covering all the activities for establishment of the Institute.