MGO 403
Fundamentals of Strategic Management

Please display your name tents
Put away electronic devices

Sit with your teams!

Professor Youngeun Chu
Week 12 Session 21
Review for Exam #2
April 19, 2017

Exam Information

- Exam on Apr 26, in class
- Format
  - Mix of T/F, multiple choice, and short answer questions
- Sample questions and guidelines will be posted on UBlearns
- Covers weeks 9-12
- ETS Form

Exam rules

- Do not have any papers or electronic devices near you – nothing but a pen
- Stop writing and put your pen down when time is called
- Do not offer help or receive help from others
- Do not look at other students’ exams
- You may not leave the room in the middle of the exam (No restroom breaks)

Exam Tips

- Think before you answer
- We (proctors) won’t be able to answer questions
  - I will help define words that are not directly part of the course

- No dictionaries - I will help define words that do not directly involve course material

Exam Tips

- Questions can come from material from lecture, our class discussions, the book, the slides, or the cases/articles.
- If the lectures/slides disagree in some way with the book, rely on the lecture.
- You may need to know highlights of the cases that we discussed in class

Sections not on exam from textbook

- Chapter 6
  - Value-neutral diversification
  - Value-reducing diversification
  - Strategic leaders
- Chapter 7
  - Restructuring
- Chapter 8
  - Risks in an international environment
  - Strategic competitiveness outcomes
  - The challenge of international strategies
- Chapter 9
  - Sections except strategic alliances as a primary type of cooperative strategy
- Chapter 10
  - International corporate governance
  - Governance mechanisms and ethical behavior

Week 9 & 10 – Corporate strategy

- Concepts
  - What products markets and businesses the firm should be in?
  - Types of diversification: related vs. unrelated
  - Related diversification - logics for value creation
    - Economies of scope
      - Sharing activities
      - Leveraging core competencies
    - Market power
  - Unrelated diversification – logics for value creation
    - Internal capital market allocation
    - Restructuring assets
- Case/Example: Disney/Marvel, P&G, Netflix

Making Diversification Work

- Diversification should create value through *synergy*

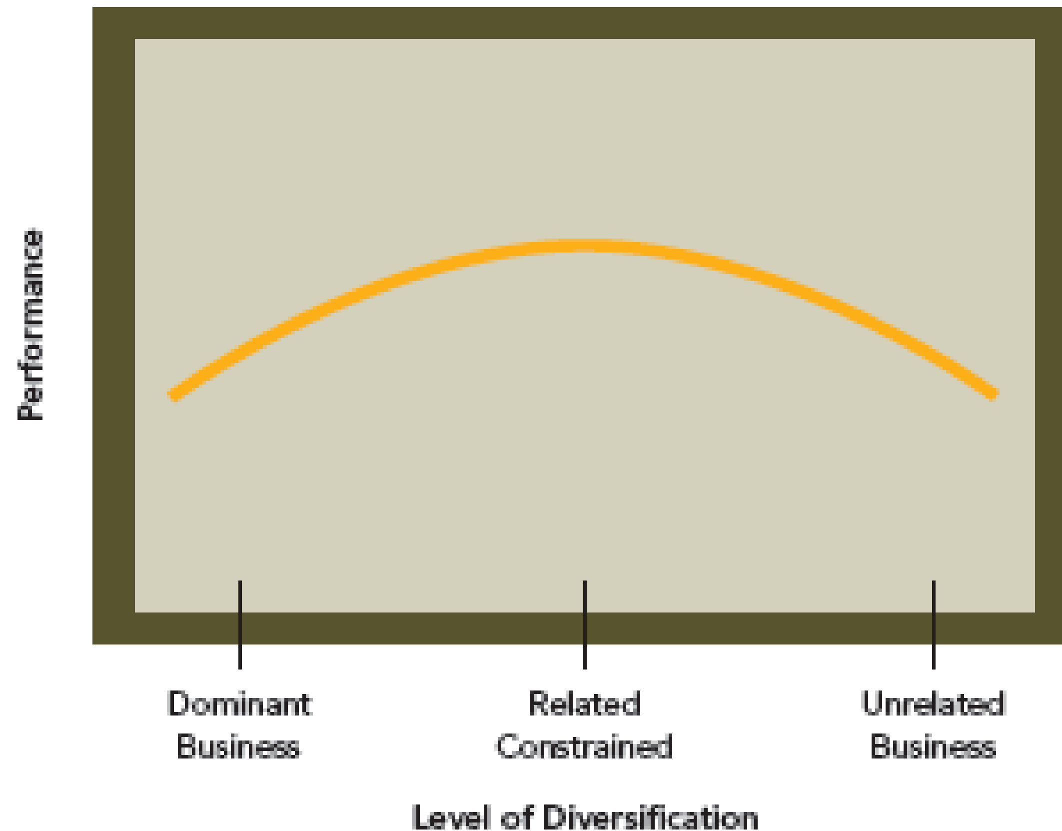
If this equation does not hold, then shareholders are better off investing in each business independently!

- Synergy exists when the value created by business units working together exceeds the value that those same units create working independently

DIVERSIFICATION AND PERFORMANCE

FIGURE 6.3

The Curvilinear Relationship Between Diversification and Performance



Unrelated diversification

- Historically, lower performance than related (‘diversification discount’ or ‘conglomerate discount’)
- It makes it harder for investors to evaluate stocks and therefore to buy, hold & sell them intelligently
- Investors can diversify cheaply on their own

For these reasons, shareholders often prefer that excess cash flows be invested in related businesses, or else returned in the form of dividends or share repurchases

Vertical Integration

- Benefits:
  - Secure source of supply of raw materials
  - Secure distribution channels
  - Protection and control over assets and services
  - Access to new business opportunities and technologies
  - Simplified procurement and administrative procedures
- Risks:
  - Expenses associated with increased overhead and capital expenditures
  - Loss of flexibility resulting from inability to respond quickly to changes in the external environment
  - Problems associated with unbalanced capacities or unfilled demand along the value chain
  - Additional administrative costs

Week 10 – Mergers, acquisitions, alliances

- Means by which to diversify
  - Internal development
  - Mergers and acquisitions
  - Alliances and joint ventures
- Brief note on BCG Matrix
- Case discussion/examples: Disney/Marvel acquisition (revisited), Delta/Northwest, Kindle

Horizontal vs. Vertical

- Horizontal acquisitions/alliances: other firms in the same industry
  - Acquisitions or alliances with similar characteristics result in higher performance than those with dissimilar characteristics
- Vertical acquisitions/alliances: suppliers or distributors of the acquiring firm
  - Increases a firm’s market power by controlling additional parts of the value chain

Merger vs. Acquisition vs. Takeover

- Merger
  - Two firms agree to integrate their operations on a relatively co-equal basis
  - There are few TRUE mergers because one firm usually dominates in terms of market share, size, or asset value

- Acquisition
  - One firm buys a controlling, 100 percent interest in another firm with the intent of making the acquired firm a subsidiary business within its portfolio.
- Takeover
  - Special type of acquisition strategy wherein the target firm did not solicit the acquiring firm's bid
  - Hostile Takeover: Unfriendly takeover that is unexpected and undesired by the target firm

Pitfalls of Acquisitions

- The promise of value creation from synergies must further compensate for:
  - Acquirer's stock price falls on announcement
  - High price - managers often overbid on acquisitions
    - Boston Scientific/Guidant
  - Lack of synergies or difficulty achieving them
    - Costs of coordination
    - Cultural issues that impede integration
      - e.g., P&G and Gillette

Reasons for Acquisitions and Problems in Achieving Success

Effective acquisition strategies

- Greater acquisition success accrues to firms able to:

1. select the "right" target (by buying firms with complementary assets that meet current needs to build competitiveness)
2. avoid paying too high a premium (by doing appropriate due diligence)
3. integrate the operations of the acquiring and target firm effectively
4. retain the target firm's human capital

- Due Diligence: the process of evaluating a target firm for acquisition

Alliances and Joint Ventures

- Strategic alliances – 'cooperative strategy' in which firms combine resources and capabilities to create a competitive advantage

- Three types of strategic alliances
  - Joint Venture – legally independent company
  - Equity alliances (2 or more firms own equity)
  - Non-equity alliances (licensing, distribution contracts, supply contracts, outsourcing)

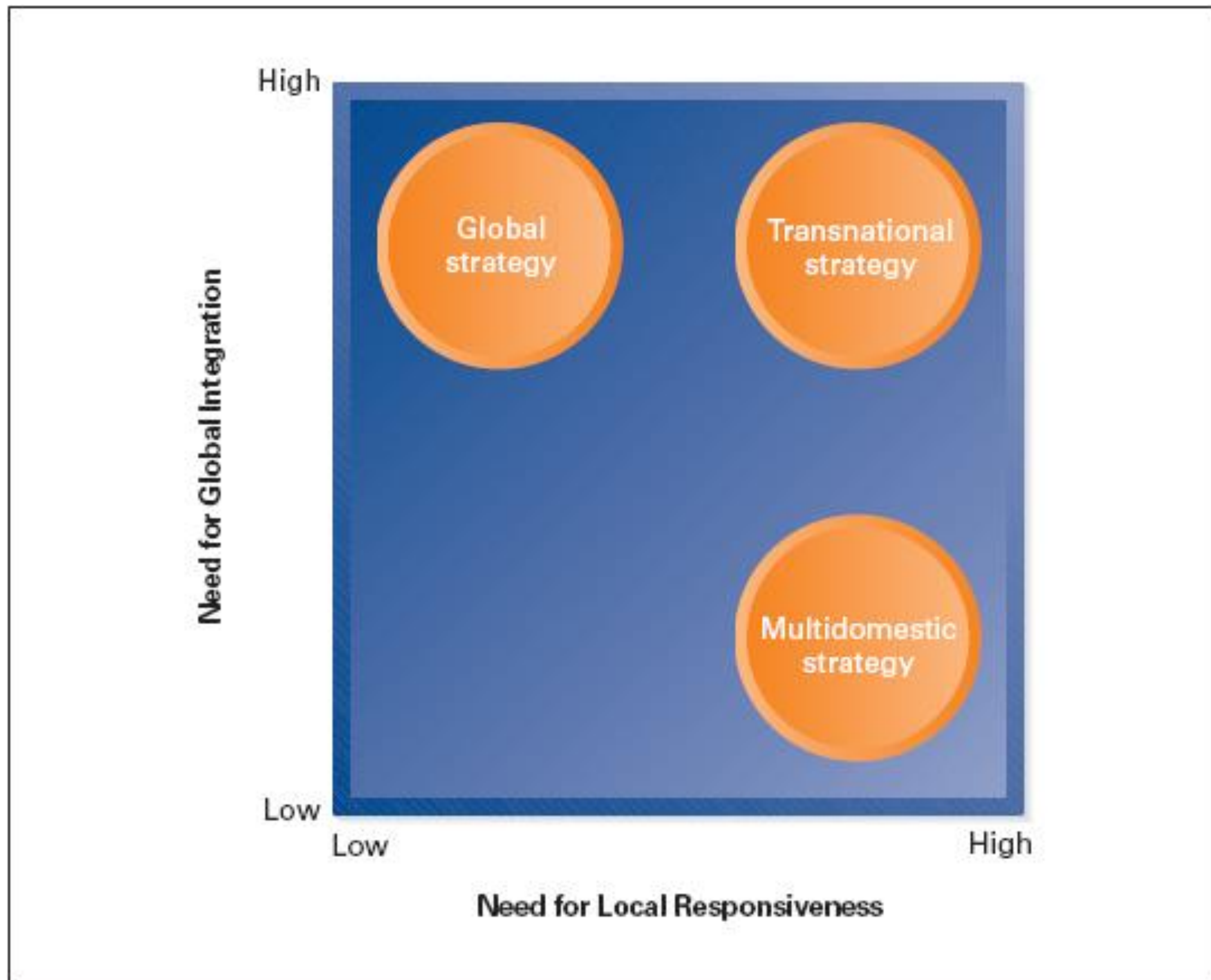
Week 11 – International strategy

- Concepts:
  - Types of international strategies
  - Industry Globalization Potential Framework
    - It's not market size. It's potential for thinking about the industry globally as being one big market vs. lots of individual markets divided by country boundaries.
  - CAGE distance framework
  - Determinants of national advantage (Porter Diamond)
  - Modes of foreign entry
- Cases/examples: Target

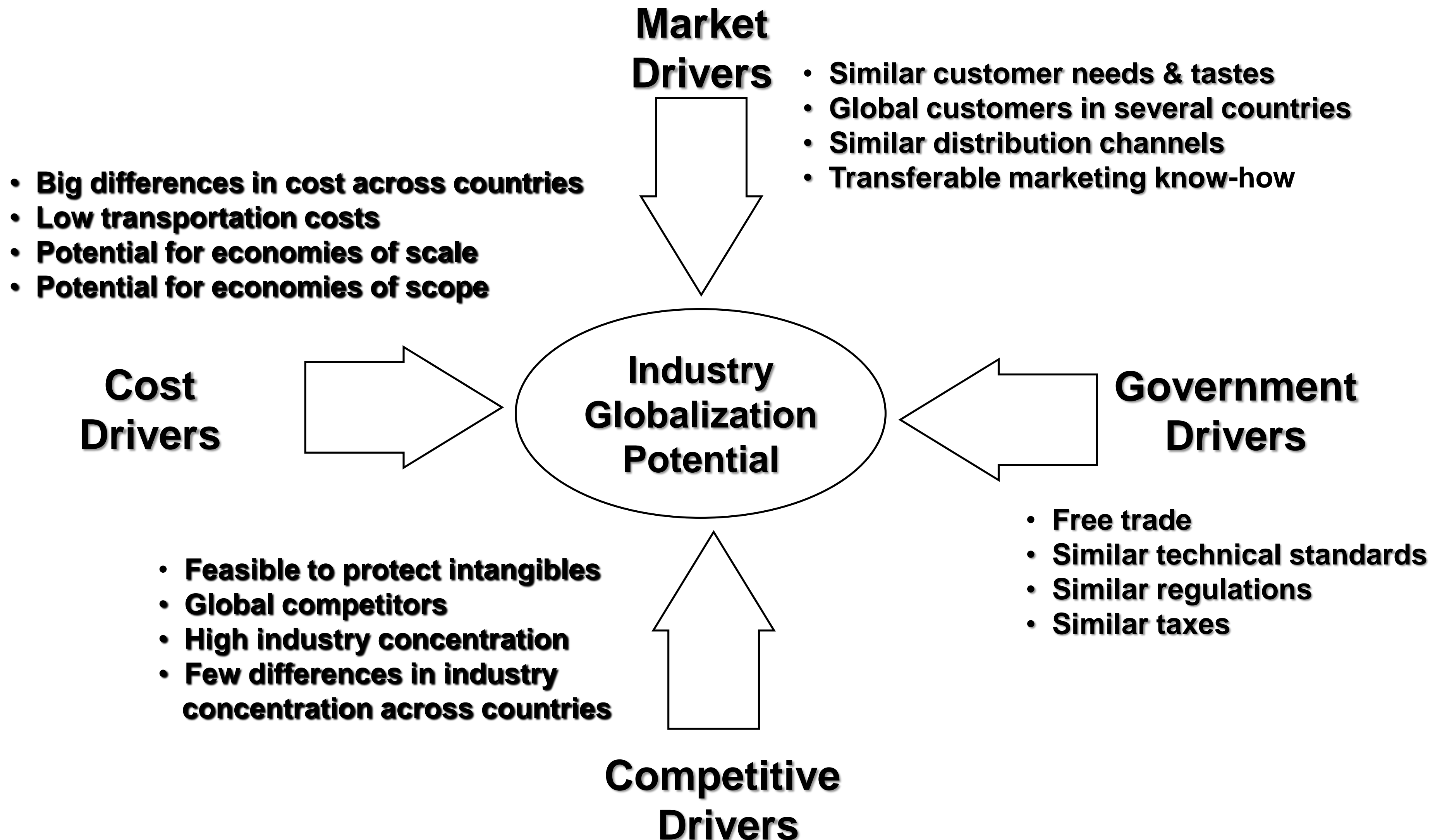
International strategy

- How does value get created when crossing borders?
  - How do firms create value when they expand their geographic scope?
- Three basic benefits
  - Increased market size
    - Domestic market may lack the size to support efficient scale manufacturing facilities
  - Economies of scale & learning
    - Expanding size or scope of markets helps achieve economies of scale in manufacturing as well as marketing, R&D, or distribution
  - Location advantages
    - Certain markets may offer superior access to critical resources, e.g., raw materials, lower-cost labor, energy, suppliers, key customers

International strategy: Two Fundamental Decisions



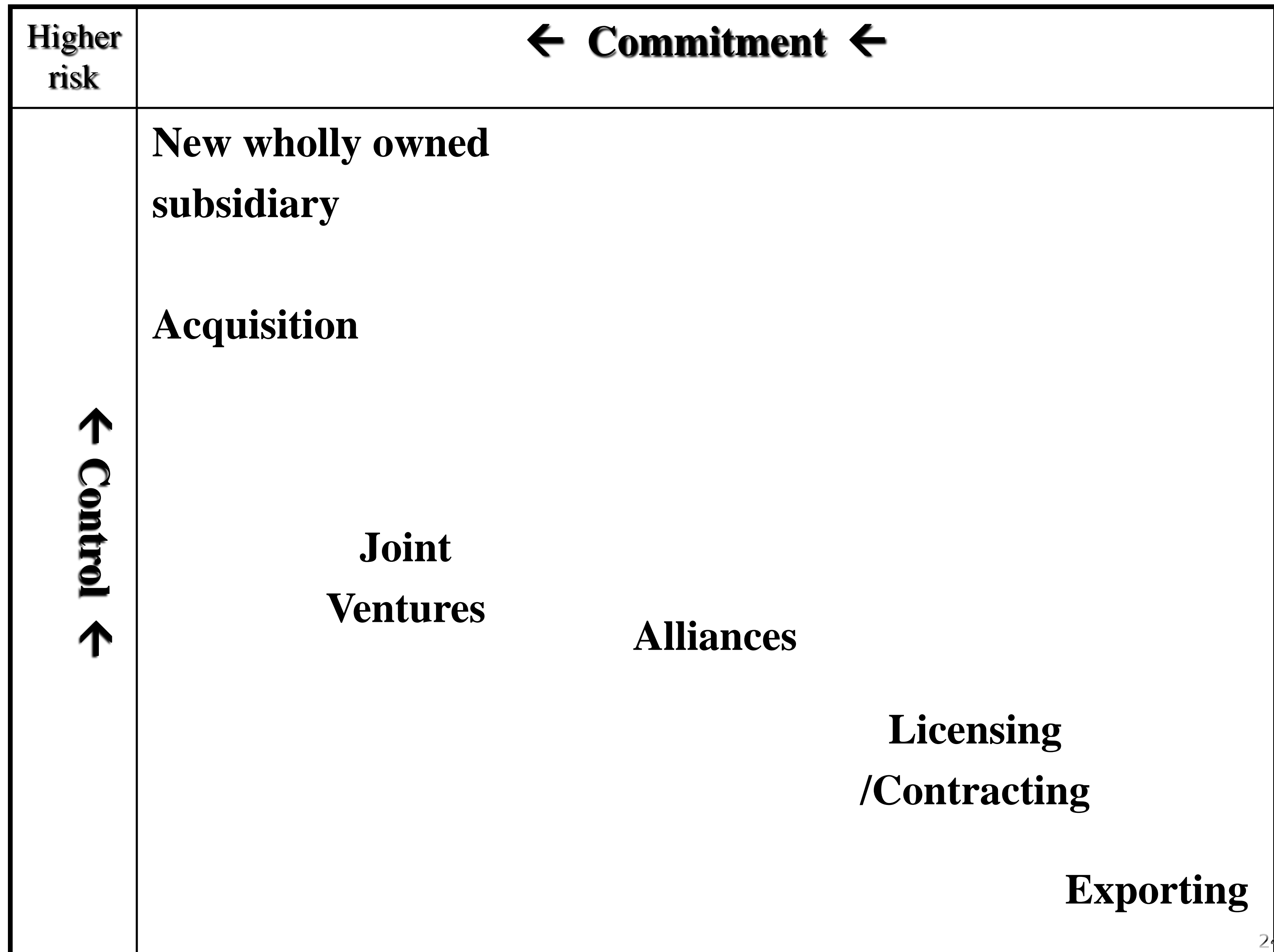
What Contributes to Globalization Potential?



Distance matters (CAGE framework)

- Dimensions:
  - Cultural - common language (42%)
  - Administrative
    - legal system
    - common regional trading block (47%),
    - colony/colonizer (188%)
    - common currency (114%)
  - Geographic (Physical size, physical distance, common land border (125%)
  - Economic – Wealth, income (GDP, GDP per capita)
- All other things equal, firms tend to expand into less “distant” markets first

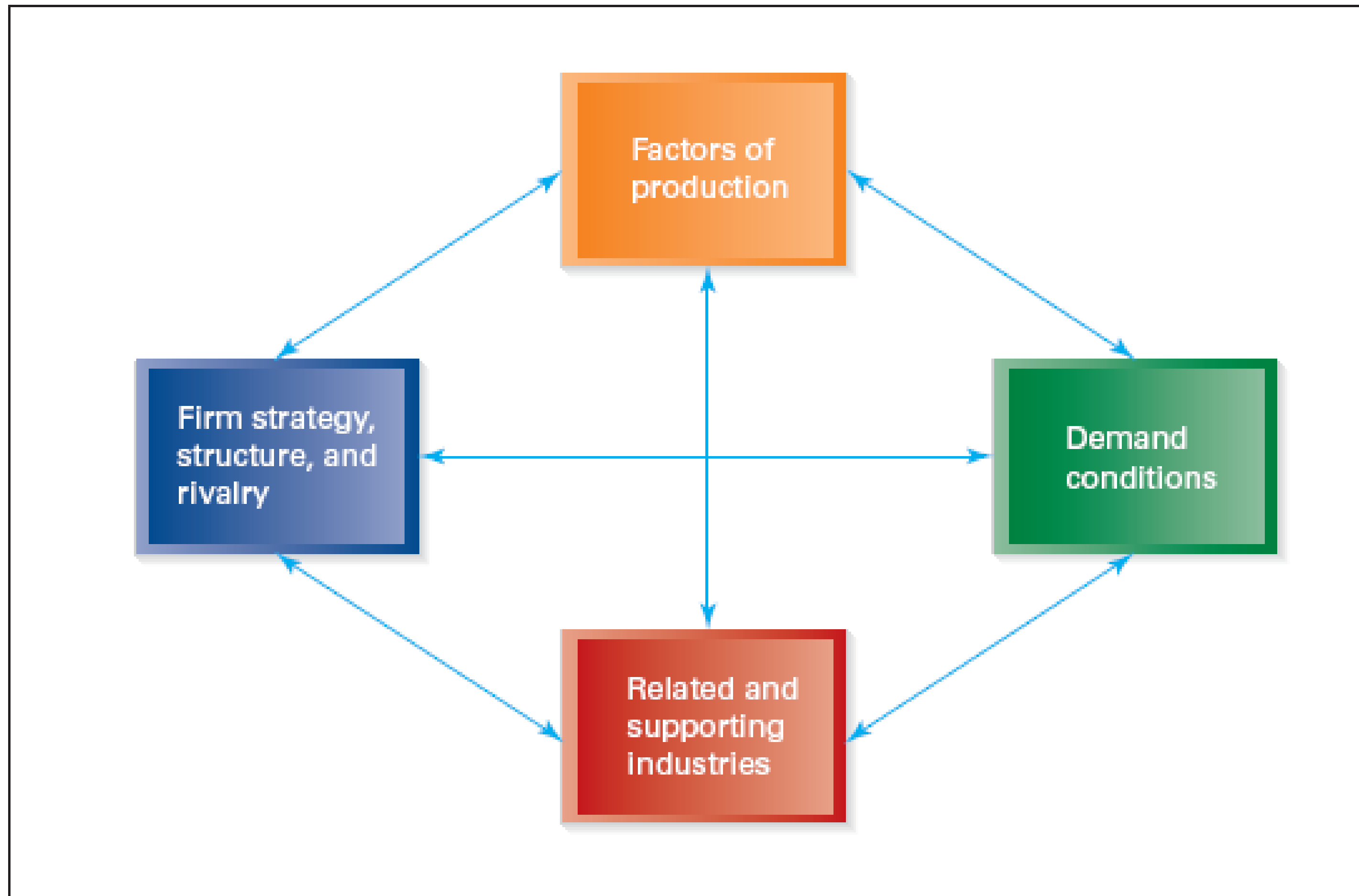
Foreign Entry Modes (costs & benefits)



International Product Cycles

- Products go through a "life cycle": Introduction, growth, maturity, decline.
- Products are frequently introduced for a market opportunity in the local area/home market
- Firm expands internationally following a blueprint developed in home country
- International expansion is incremental, beginning with most similar countries first
- Most mature products are introduced first

Determinants of National Advantage (Porter's Diamond)



Week 12 – Leadership & Governance

- Concepts:
  - Agency relationship and problem
  - Governance mechanisms
  - Board of directors
  - Stakeholders and ethics
- Frameworks
  - Ethical decision rules
- Class discussion
  - Enron
  - Costco
  - Scaffold Plank

Agency problem

- Historically, firms managed by founder-owners and descendants
- Separation of ownership and managerial control allows each group to focus on what it does best
- The separation between owners and managers creates potential conflict of interests between them, leading to managerial opportunism

Governance mechanisms

- Internal
  - Shareholder concentration
    - Relative amounts of stock owned by individual shareholders and institutional investors
  - Board of directors
    - Individuals responsible for representing the firm's owners by monitoring top-level managers' strategic decisions
  - Executive compensation/incentives
    - Use of salary, bonuses, and long-term incentives to align managers' interests with shareholders' interests
- External - Market for corporate control
  - The purchase of a company that is underperforming relative to industry rivals in order to improve the firm's strategic competitiveness

Stakeholders → People who are affected by a firm's performance and who have claims on its performance

Capital Market Stakeholders
- Shareholders
- Major suppliers of capital (e.g., banks)

Product Market Stakeholders
- Primary customers
- Suppliers
- Host communities
- Unions

Organizational Stakeholders
- Employees
- Managers
- Nonmanagers

Ethical Decision Making