Strategy-Train	Small Enterprise Strategic Development Training
Module IV	Formulation of Strategy
Unit 7	Diversification for SMEs
Author	Rumyana Grozeva (REDA)
Training Material online	www.strategy-train.eu

Education and Culture DG
Lifelong Learning Programme

This project has been funded with support from the European Commission. This publication reflects the views only of the author, and the Commission cannot be held responsible for any use which may be made of the information contained therein.

Table of Contents

Module IV. Formulation of Strategy

Unit 7 : Diversification for SMEs

Module IV. Formulation of Strategy

Unit 7 : Diversification for SMEs

Entrance

Keywords
Diversification, type of diversification, advantages and disadvantages of diversification, product life cycle

Learning Objective

This unit focuses on the diversification strategies as a tool for expanding companies' operation by adding markets, products, services, or stages of production to the existing business activities. Its purpose is to present the various types of diversification, their advantages and disadvantages and how SMEs should approach it. It will also indicate how a company portfolio should be planned and managed.

Estimated Time

It should take you around **45 minutes** to complete this unit.

Introduction

The successful management and development of small businesses is a very serious matter involving a great number of responsibilities. Large companies are managed by teams of professionals in different fields, each one in charge of a specific area and presuming that they have been well selected, despite the wide range of activities, a timely response can be expected when required.

However, owner or manager of a small firm is solely responsible for all aspects of a business. They always have to have a backup plan because, if they are not ready to respond to unforeseen circumstances, their company will face the risk of bankruptcy. That is why the companies always look for diversification opportunities to give them a backup plan allowing their survival in critical situations.

Diversification is also a good business development tool for companies. It brings new opportunities through new product lines and services, as well as entering new markets. By means of its successful realization, businesses can establish a reputation on similar markets with their traditional products or services; or they can offer similar or related goods or services; or they can enter completely new markets.

7.1. What is Diversification?

Diversification is a business development strategy allowing a company to enter additional lines of business that are different from the current products, services and markets.

In the current conditions of dynamic markets and strong competition, a successful instrument of risk management is to avoid focusing on a single product, service and/or their distribution to a single limited market. When implemented wisely it contributes to keeping the company stable even in hard times since the economic downturn usually occurs simultaneously in all sectors and all markets.

Diversification of business activities brings competitive advantages allowing companies to reduce business risks. That is why it is a great tool for business development. However, its successful implementation requires profound knowledge and thorough preliminary assessment of the company and its environment. And, although sometimes diversification is difficult for the small companies, it can prove to be inevitable when their original markets become unviable.

7.1.1 Types of Diversification

Diversification is a strategic approach adopting different forms. Depending on the applied criteria, there are different classifications.

Depending on the direction of company diversification, the different types are:

- *Horizontal Diversification* – acquiring or developing new products or offering new services that could appeal to the company's current customer groups. In this case the company relies on sales and technological relations to the existing product lines. For example a dairy, producing cheese adds a new type of cheese to its products.
- *Vertical Diversification* occurs when the company goes back to previous stages of its production cycle or moves forward to subsequent stages of the same cycle – production of raw materials or distribution of the final product. For example, if you have a company that does reconstruction of houses and offices and you start selling paints and other construction materials for use in this business. This kind of diversification may also guarantee a regular supply of materials with better quality and lower prices.
- *Concentric Diversification* – enlarging the production portfolio by adding new products with the aim of fully utilising the potential of the existing technologies and marketing system. The concentric diversification can be a lot more financially efficient as a strategy, since the business may benefit from some synergies in this diversification model. It may enforce some investments related to modernizing or upgrading the existing processes or systems. This type of diversification is often used by small producers of consumer goods, e.g. a bakery starts producing pastries or dough products.

- *Heterogeneous (conglomerate) diversification* is moving to new products or services that have no technological or commercial relation with current products, equipment, distribution channels, but which may appeal to new groups of customers. The major motive behind this kind of diversification is the high return on investments in the new industry. Furthermore, the decision to go for this kind of diversification can lead to additional opportunities indirectly related to further developing the main company business – access to new technologies, opportunities for strategic partnerships, etc.
- *Corporate Diversification* involves production of unrelated but definitely profitable goods. It is often tied to large investments where there may also be high returns.

Related Diversification
Related Diversification is the most popular distinction between the different types of diversification and is made with regard to how close the field of diversification is to the field of the existing business activities.

Related Diversification occurs when the company adds to or expands its existing line of production or markets. In these cases, the company starts manufacturing a new product or penetrates a new market related to its business activity. Under related diversification the company makes easier the consumption of its products by producing complementing goods or offering complementing services. For example, a shoe producer starts a line of purses and other leather accessories; an electronics repair shop adds to its portfolio of services the renting of appliances to the customers for temporary use until their own are repaired.

Experts have formulated two basic fields in relation to:
- Opportunities for sharing resources: when all kinds of tangible and intangible resources can be shared or “copied” and the same trademark can be used.
- Opportunities for strategic integration: when the integration of marketing strategies of two businesses brings benefits and the integrated efforts provide additional competitive advantages.

This type of diversification is used mostly by small businesses because it is less risky. In the majority of cases it does not require big investments and owners feel more secure because they know the opportunities and threats in the field of their main business activities. However, sometimes this diversification does not bring the expected results and profits. Most often the reason for this is the underestimation of accompanying problems and the need of knowledge and skills in the field of change management, cultural differences, human resource management (layoffs, quitting, promoting, hiring) and so on. However, the reason for not meeting the results and expectations of the diversification may be the overestimation of the expected benefits and profits from the synergy, during the preliminary analysis.

Advantages of Related Diversification:
- Spreading the risk by way of producing similar and/or related goods, offering similar or complementing services, or penetrating similar markets;
- In the majority of cases the companies use existing, available resources and experience;

- If the company starts producing part of the raw materials (components) for its main production line, it guarantees better quality, lower prices and regular supplies;
- Strategic goals can be combined and, as a result, opportunities arising throughout the ‘production chain’ can be shared and fully utilized;
- Better usage of opportunities to share technologies, skills and expertise, common distribution channels, similar management techniques and adapting resources;
- Economies of scale can be achieved through the elimination or significant reduction of certain expenses when more than one business activity is developed in a common company and also because of the opportunities to use any internal connections arising along the business chain;
- Synergy effect - when two activities are integrated, the result is greater than the sum of the results of two individual activities.

Unrelated Diversification

Unrelated Diversification is a form of diversification when the business adds new or unrelated product lines and penetrates new markets. For example, if the shoe producer enters the business of clothing manufacturing. In this case there is no direct connection with the company’s existing business - this diversification is classified as unrelated.

The unrelated diversification is based on the concept that any new business or company, which can be acquired under favorable financial conditions and has the potential for high revenues, is suitable for diversification. This is essentially a financial approach; it is implemented when the research determines that this unrelated diversification in a completely new field would bring significantly higher revenues compared to the related diversification on the basis of similar products, services, markets or complementing strategies. A good example of this kind of diversification, that brought high profits for a certain period of time, is that during recent years of growth many companies entered the construction market despite their significantly different field of main business activity. In this case, however, the lack of expertise and experience, and the insufficient knowledge of the market can lead to serious problems.

Sometimes the unrelated diversification is based on the available expertise and experience of the human resources that can be utilized in completely unrelated fields. For example, if the owner of a trade company is competent in the field of computer design, they can open an internet store to sell goods and also expand activity by adding web page design services etc.

In this way the unrelated diversification can be accomplished using one of the following methods:

- Using the existing basic competences of the company and expanding from existing markets into new ones and starting new lines of production.
- Penetrating completely new markets. Usually such opportunity can be identified as a result of the main company business. For example a car dealer may start offering

financial services by developing a car leasing scheme and selling cars through leasing.

- Developing new competences to use new market opportunities.

Advantages of unrelated diversification:

- The unrelated diversification which is carefully developed and undertaken only after thorough analysis of the environment and the company's own resources usually brings very good financial results. However, in all cases it should be a low risk investment with a potential for high returns.
- In some cases of company acquisition, this diversification can secure funds on hand during a seasonal slowdown, adding to the cash flow for the main business activity.
- Spreading the risk through different sectors of the economy. It is very important to identify industries in which the business activity slowdown does not coincide with the slowdowns in the main business of the company.

Disadvantages of unrelated diversification:

- Achieving successful unrelated diversification requires good management skills, closely following each of the business activities and timely identifying and solving even the smallest problems. The greater the number of business activities, the more difficult is the total management task.
- In many instances the overall performance of the unrelated business activities does not exceed the individual ones. Sometimes it is even worse, unless the managers are exceptionally talented and focused.
- As a rule, the implementation of unrelated diversification strategy requires allocation of significant financial and human resources and there is always the risk of harming the main company business.

International Diversification

Although international diversification can be identified as one of the above mentioned forms (related or unrelated) depending on the area of the main business activities, it should be discussed separately because of its specific features and significance for the company development.

Multinational diversification is considered one of the strategic paths to continue diversifying the company activities after the diversification at national level has been completed. It also includes diversification of business and of national markets. This process requires to be developed and executed at different strategies – for the different sectors of the company business on the one side, for the different countries (consistent with their national characteristics) on the other. These strategies have to be developed by high competence managers. Regardless of the great challenges and difficulties of its implementation, multinational diversification attracts companies with big opportunities for long term growth by entering new business sectors and growth in the existing business on the markets of other (new for the company) countries.

At the same time it can increase the competitive advantages of the business in different ways:

- Full use of resources and distribution of costs on the basis of the growing market and product range which leads to economies of scale and accumulated new experience.
- As a result of the larger scale there are opportunities to capitalize savings during the integrated work in the different sectors using the existing expertise along the business chain.
- Valuable resources can be transferred from business to business and from country to country.
- Highly competitive and well-known trademarks can be used jointly.
- Partnership potential can be capitalized in the form of the different business sectors and countries and strategic coordination.
- The different business activities at home and abroad can be funded internally which brings better instruments to fight competition and achieve higher sales.

7.1.2 Why SMEs should diversify their Business?

Diversification, being a strategic approach, is the subject of extensive research aiming to examine its relation to the financial results of the companies. In the majority of studies a comparison is done between results of related and unrelated diversification, although the distinctive line between them is still not clear.

For a long time related diversification has been considered financially more beneficial. However, recently, big multinational companies have challenged this statement with substantial profits that they achieved by diversifying in unrelated industries, like Canon which diversified from cameras to a wide range of office equipment. Walt Disney started as a movie company but later diversified to building entertainment parks, etc.

7.1.3 Where should Diversification be undertaken?

Diversification can be considered a useful business development tool for companies in any sector and location of the economy.

However, you have to keep in mind that there is no recipe for successful diversification. It depends on multiple internal and external factors for each company, which should be carefully studied and taken into consideration when developing a diversification strategy. It is also very important to implement and update this strategy according to the dynamically changing conditions and strong competition under which business usually operates.

7.1.4 How Companies should diversify their Business?

Diversification Strategy of Small Businesses

Successful diversification will ensure competitive advantage to a company in achieving their goals. Using this strategic instrument this will develop their business by entering new production lines and/or markets and reduce the risk by spreading their investments.

However, its implementation also brings risks. It depends on the manager/owner - if they will give a new impetus to your business or turn into a failure.

Steps in the development of the SME diversification strategy:

1. Preliminary assessment of the company and the business environment

First of all, note that successful diversification can be achieved only if you use your company's strengths; do not look for success out of your company. Successful diversification has to rely on a stable basis. Any new initiative involves allocation of part of your time, attention and financial resources that have previously been used in your main business. That is why, although it sounds as a paradox, your first step to diversification, should be to make sure that your main business is highly efficient, productive and profitable. Should you find out this is not so, it is better to postpone diversification of your business and seek other ways to fight competition until you are ready for this challenge.

To start this process you have to be sure that you have enough financial and human resources at your disposal to carry out the preliminary assessment and preparations for diversification. Otherwise it is better to look for other ways to increase your company's market share, for example using subcontractors, joint ventures or informal partnerships.

No matter if the diversification strategy is developed by company experts and managers or outside consultants, the most important thing to do is a thorough assessment of the environment and the company, the nature of its business, its management efficiency, its strengths and weaknesses, to analyze the basic parameters as product features, return on investment, structure of costs, market share, as well as the uniqueness of products and services compared to the other players / competitors in the market, etc. It is also necessary to study market trends, competition, new developments in the industry and other factors and to assess to what extent the company is ready to implement a new project.

2. Choice of industry and ideas for diversification

Ideally the choice of industry sector and/or business activity to diversify is preceded by a serious macroeconomic and sectorial analysis to identify economic fields with expected rapid growth and industries suitable for investment. However, very often, the general economic situation, existing expertise and experience of human resources or business, and the personal contacts of the company owner or manager, predetermine to some extent the field of the future diversification. Of course, the results of the preliminary company assessment should be taken into consideration.

But even if the above statement is true for your company, it is vital to include the next step which will give you an idea if this is truly the right direction to develop your business.

Invite a group of 5 to 7 experts from universities, marketing companies and other professionals in different fields and organize a brainstorming session. It is a good idea to hold the meeting outside of the company office, and to have the group work run by a company representative and an outside facilitator. The goal is to identify the greatest possible number of ideas for diversification. These experts will help your company experts to screen the ideas and estimate their technical and economic viability.

The resulting short list of ideas will be subject to the same procedure several times until you arrive at the one idea which matches to the greatest extent your preliminary criteria. This procedure may seem protracted and time consuming, but if it is avoided and a trial-and-error principle adopted, this can lead to a poor outcome.

3. New business (industry) assessment and process planning

Preparing for diversification is not dissimilar to starting a new business. It is necessary to adequately research the new market, its customers, competition and dynamics which is just what you do for a new business, as well as to develop your marketing plan. Diversification is a big responsibility and commitment and you have to be careful in studying the new business (industry) and planning the diversification process. This will be necessary to develop the correct strategy for project development, as well as your everyday operation.

That is why you have:

- To know the market – make sure you know the new market and your new competitors;
- To update your selling skills – you need to know how to sell efficiently on this new and different market;
- To make sure you have enough capacity left to continue servicing your existing customers without driving them away and loosing key customers after putting your new project into practice;
- To be aware of the necessary investments in new equipment, workers and their training, up-to-date production organization, improved customer service, safe working environment, marketing and advertising. Develop a clear plan for financing the diversification.
- To manage the risk – analyze the opportunities to reduce risk to acceptable levels. Check carefully for all opportunities and adopt these – for example spreading the risk using partnerships or alliances, to make your initial steps into the new market easier.
- To develop clear and measurable indicators for project implementation which will help you trace costs and measure benefits. Create an orderly system to report indicators even if you only have simple processes and give everyone responsibility for achieving the planned results.

Bear in mind your investment criteria, when you make your final decision:

- Is it important for you to remain in your industrial sector or invest in new technologies or products and services. Make sure you have taken into consideration the life cycle of your product or service when planning your diversification strategy.
- Do not give up capital investment just because your competitor has stopped doing so. Follow closely your company's business plan but make sure to keep it updated. And: if you have the resources buy out your competitor's company - do not give up the conglomerate diversification.

- Your requirements towards business, capabilities, operating capital, business strategy and business planning are only part of the determining factors when making decisions to invest in diversification.

Portfolio Planning and Management

The portfolio of a company is the combination of all products and/or services that it offers to its customers. The position and role of each one in the overall company business, as well as their interrelation determine the portfolio structure.

The specific characteristics of SMEs development in the different European countries determine their different approach to setting up their portfolio of products and/or services during the years. In spite of this, a company has to search for balance by adjusting its structure to its own resources and market environment.

EXAMPLE: The development of SMEs in the Eastern European countries during the first years of the transition period was difficult and they had to take of work as long as it brought money into a company. The subsequent rapid growth also offered multiple opportunities and the companies made full use of them. Thus, over 70% of Bulgarian companies, for example, had a portfolio that wasn't related to a defined business strategy and vision for long term development, and its structure reflected the market situation.

However, to stay competitive, small companies in all EU countries have had to re-think and optimize their activities; they have to search for new opportunities for their development. That is why they are being forced to create or update their strategy for the future development of the business, based on the prevailing conditions.

The assessment of the products and services, offered by the company, is very important when defining the vision for the future company development. It is of decisive significance for the correct portfolio building and its successful management.

Part of the questions you have to answer, in order to make a successful selection and build a product portfolio that is stronger compared to the individual products or services and that has long term market advantages, are:

- What stage of their life cycle are you products in?
- Do you produce the necessary products to place your company in the desired position on the market?
- Do you have 'useless' products?
- What do you do when your competitor brings a new product on the market?
- How do you decide whether to take a product off the market or introduce a new one?

The main criteria used to form a company's portfolio are:

- production performance of the existing equipment
- unoccupied market niches
- opportunities for quick profit.

However, you have to be always aware of the role and share of each product in your company's portfolio.

The logical portfolio consistency shows how the products are integrated – production technologies, required knowledge and skills, benefits for customers, methods of marketing and selling. If your portfolio contains products resulting from accidental opportunities that the company did not want to miss, but they do not have direct relation to what you offer to your customers, you have to stop and think. And after that take them out of the portfolio unhesitatingly. This will reduce your costs and optimize processes in your business in a most natural and simple way. When built correctly, the product portfolio is a lot stronger compared to a single product. It involves synergies in production, marketing, distribution and opportunities for market expansion and achieving stable position. It brings serious competitive advantage.

Very often after setting up the initial product portfolio, it remains unchanged for years, despite the end of the life cycle for some products and market changes. This reduces the company's competitive advantage and it has only two alternatives – to meet new market needs and therefore update its portfolio or to fail.

7.1.5 Case Study

When almost 20 years ago one of the largest Bulgarian state-owned companies for manufacturing of disk drives collapsed, 10 engineers left and started their own business. Specialized in the field of telecommunication software, they made a successful start by subcontracting a number of projects for the regional office of the Bulgarian Telecommunication Company (BTC).

A couple of years later, because of BTC restructuring, the number of projects for subcontracting greatly decreased. The owners undertook market research, analysed the external environment and the company resources and expertise and identified another niche – manufacturing different types of poultry-farming incubators.

After working for a long time for the agricultural sector, the company became familiar with it and diversified again its activities by starting dairy production.
Although today the company is better known as one of the producers of high quality dairy products, it still implements telecommunication software projects and manufactures poultry incubators.

Summary of Key Points

It's the old adage of "Don't keep all your eggs in one basket."
Diversification is a strategic approach for small business development. Wisely implemented, it can prove very useful. Diversification helps companies gain competitive advantage diversifying their production, services and/or markets. Successful implementation of the different forms of diversification enhances an SMEs competitiveness in a market, increases its market share and provides opportunities to penetrate new markets where the competition is not so strong or might be completely absent. This is especially useful in times of stagnation when economy downturn affects sales on the company's traditional markets. Diversification helps to use the

non-simultaneous manifestation of unfavourable trends in the various industries and countries. Thus a business can survive during sharp economic downturn because it will sell different products and services on different markets. That is why diversification is already turning into a strong component of many company’s development strategies. However, at the same time diversification brings certain risks and requires investment. The decision to diversify has to be well-considered and planned. Preliminary thorough assessment, in addition to knowledge and experience are necessary when developing and implementing the company’s diversification strategy.

Depending on the business specifics, its human and financial resources, a variety of approaches can be used when diversifying products, services and/or markets.

Advantages of diversification:

- Provides substantial potential for development and profits
- Increases competitiveness on existing markets
- Unveils new market opportunities
- Reduces financial risk by spreading it across multiple investments
- Protects against financial collapse in times of market stagnation
- Offers opportunities for human resource development and attracts competent professionals.

Disadvantages of diversification:

- A lot of time and funds are needed for initial research and development of first-class diversification strategy.
- The implementation of each new project requires investment and human resources which diverts the focus from the main company business.
- Some diversification types need significant capital costs, human resources, technologies, market research, etc.
- Any new project often reduces performance. The company is no longer able to provide its old, loyal customers with its traditional products and services at the same level of quality. This may lead to dissatisfaction and sometimes to loss of key customers.

Diversification is a complicated process involving a lot of responsibility. Its successful implementation provides great competitive advantages and significant business growth. However, its failure can lead to quite unfavourable consequences. That is why a thorough assessment of company features and the market environment is necessary. Successful diversification is based on the company's strengths and the successful selection of the right direction. It should not be done suddenly and hastily.

The portfolio of a company is a combination of products and/or services to be offered to the customers. The place and share of each in the overall company business, as well as the relation between them, define the portfolio structure. Successfully planned and maintained portfolio of products and/or services gives opportunities for synergy in the field of supply, production, marketing, distribution and human resource. This contributes to market expansion, achieving stable positions, penetration of new markets reword.

Bibliography

Books/Articles

"Reengineering: 40 Useful Hints," George J. Miller, APICS XX International Conference Proceedings, APICS, Falls Church, VA.

The Process Reengineering Workbook, Jerry L. Harbour, 1994, Quality Resources, NY.

Chisnall, Peter: Strategic Business Marketing, 1995.

Reengineering Your Business, Morris & Brandon, 1993.

McGraw-Hill, NY Reengineering the Corporation, Hammer & Champy, 1993.

Harper-Collins Publishers, NY, NY Business Process Improvement, James H. Harrington, 1991, McGraw-Hill, NY.

Day, Georges: Strategic Marketing Planning, 1994

Jain, Subhash C.:International Marketing Management, 1993.

Jain, Subhash C.: Marketing Planning & Strategy, 1997.

Lambin, Jean-Jacques: Strategic Marketing Management, 1996.

Murray, Johan & O'Driscoll, Aidan: Strategy and Process in Marketing, 1996.

Weitz, Barton A. & Wensley, Robin: Readings in Strategic Marketing, 1997

Wilson, Richard & Gilligan, Colin: Strategic Marketing Management, 1992.