Cooperative Extension College of Agriculture Washington State University Pullman, Washington 99164

AGR BUSINESS MANAGEMENT

WHY DIVERSIFICATION?

A new term has become firmly entrenched in the vocabulary of American business. "Diversification" is now being discussed, debated, and contemplated by business managers throughout the land. Students of management are uncertain as to the cause and effects of the diversification movement, but all agree it is increasing substantially.

Diversification appears in a variety of forms. Generally it relates to the different types of products or services a business offers. However, no standards have been established by which a business can be categorized as diversified. Within a strict definition, almost every business produces multi-products. Even an apple packing and warehousing operation, for example, offers apples of differing varieties, sizes, grades, and prices. Only if apples of a single variety, size, and grade were sold at a single price at a given time could the firm be classified as undiversified. Therefore, we can only say that some businesses are more diversified than others; not that some are diversified and others are not.

We can also say that most businesses are more diversified than ever. Michael Gort, an economist, has estimated that the rate of diversification among American businesses has doubled since 1950. Obviously this has not been limited to expanded product lines. Businesses are now moving into fields almost totally unrelated to their original function. A firm's product relationship may be nonexistent. We now see businesses processing product combinations such as fertilizer and cotton cloth, chemicals and beef, etc.

Possible Causes

What has caused American business to turn its back on specialization and, with such energy, pursue a diversified path to profits? Chance may have contributed to this, but it is likely that more substantive factors played the major role. In my opinion, it was a combination of several of the following environmental factors.

1. World War II
2. Prestige.
3. Research and development.
4. The aura of bigness.
5. Cash flows.
6. Schools of business administration.
7. Imitation.
8. Foreign competition.
9. The affluent society.

Each shall now be discussed in some detail.

World War II

The seeds of diversification were planted early in the post-depression era when businesses, which had survived, were searching for ways to re-establish themselves. It was not until World War II, however, that the seed began to germinate.

Businesses suddenly found that they were capable of producing a great variety of items. Radiator manufactures produced and assembled wartime vehicles, metal fabricators built airplanes, and general construction firms

suddenly became shipbuilders. With resources and personnel quickly being withdrawn from peacetime pursuits, a business's ultimate survival depended on its ability to shift its production to warfare items.

With the end of the war, these newly acquired talents were not forgotten or abandoned. The lesson learned was that producing new products for new markets could be just as profitable as the prewar routine of supplying a single product to a single market.

Prestige

Post-war businesses prospered and grew at a rapid rate. Cutthroat competition appeared and businesses quickly realized the benefits of product promotion and advertising. They also recognized that the amount of prestige attached to new trade names was in almost direct proportion to the number of different products on which the name appeared. Automobile manufacturers, for example, had by this time merged so that names such as Ford and General Motors were associated with several competing models. The prestige of such businesses as General Foods skyrocketed as their name appeared on an increasing number of consumer items. Management consultants began to discuss "corporate image" and "customer loyalty" as they related to multi-product offerings. The seed of diversification had now broken the crusty topsoil of established business practice.

Research and Development

By the mid 1950's, big businesses were heavily involved in research and development. Preoccupation with R & D soon spread to all corners of the business community. New product development not only accelerated, but the time lag between development and marketing diminished.

Once a firm committed itself to R & D, it had taken an almost irreversible step toward diversification. Unforeseen laboratory discoveries were often too good to pass up, even though they required that the business enter a new field. Research "spin-off" added knowledge to knowledge, often resulting in products totally unrelated to the existing business pursuits.

In addition, businesses could not control the output of their competitor's laboratories. There was always the risk that other's new discoveries would suddenly render an existing product obsolete. The only safety factor was to pursue one's own R & D program with vigor. This entire process contributed greatly towards diversification. To continue with our analogy, this could be described as the seedling growth of the diversification seeds planted and germinated in earlier periods.

The Aura of Bigness

Foreigners often view the United States as a place where everything is big. Americans themselves unconsciously associate things that are big with things that are good. Our attraction to bigness is almost legendary.

A century ago, the lust for business growth was described as ruthless empire building. By the early 1960's however, growth was recognized as a legitimate business goal, as justifiable as profits. Financial analysts became as interested in growth rates as they were in returns on investment.

A single product line rarely provided enough market potential to allow growth at an accelerated rate. Through diversification, however, a business could enhance growth by entering a number of markets, each with its own expansion possibilities. This link between growth and diversification was strengthened by antitrust legislation, which discouraged concentration in a particular area

but only rarely acted against expansion into unrelated fields. The diversification seedling was now growing rapidly.

Cash Flows

American businesses have become massive in size. By the mid 1960's, Fortune Magazine could list more than 25 businesses with total assets in excess of $4 billion. There should be little doubt that $4 billion in assets can create sizeable cash flows in a given year, month, or even day. This huge cash flow enabled businesses to become more flexible and adaptive to attractive opportunities.

Just as a plant absorbs its own bodily substances at maturity, the diversification plant was now feeding on itself. Diversification had created many businesses with large assets. The resulting cash flows then enabled the business to move (quickly if necessary) in different directions where the costs of entry were too great for smaller firms to follow.

Schools of Business Administration

In 1881, the Wharton School of Business was established - the first of its kind in the United States. Harvard followed suit in 1902. By the mid 1960's, every college and university of consequence offered courses in Business Administration.

The B.A. student of the 1960's was somewhat different from his predecessor, however. He was trained to think of business administration more abstractly. He emerged with the concept that a business represents a combination of productive factors. He was confident that he could successfully apply his talents to any kind of business. His training dealt with the adaptation of scientific management practice and was as diverse as it was intense. For persons so trained, there was less product orientation and a greater receptivity to innovation and diversification. Our maturing diversification plant was now about to bring forth its fruit.

Imitation

We cannot forget the effects of imitation. Our diversification plant was about to bring forth its fruit. It would seem only normal that others would wish to profit from this development. There is a business proverb, which states, "As I succeed, so others shall follow." Profit, therefore, encourages others to act in such a way as to increase the probability that they, too, will share in the good fortune.

It would be difficult to say which industries or sectors of our business economy initiate diversification, and which simply follow the successful actions of others. If, for example, ten businesses follow the diversification strategy of their major competitor, we can easily determine that industry trends, in this regard, would be magnified by a factor of ten.

In other words, enclosed within the fruit produced by our successful diversification plant are ten seeds, each capable of exactly duplicating its parent.

Foreign Competition

During earlier periods of American trade isolationism, a few of our major industries maintained control over a large part of the domestic market. Tariffs and other trade barriers protected them from foreign competition.

As the 1960's end, this protectionism no longer exists. The American automobile industry, for example, must now compete face to face with German, Italian, and Japanese counterparts for a foothold in the domestic market. Foreign businesses have increased their efficiency, set their sights on the rich

American market, and designed their output to satisfy American desires.

As a result, the seemingly impregnable position of some domestic businesses has dwindled away. Their survival strategy has been to probe new products and markets to make up for the losses attributable to foreign competition.

The Affluent Society

The term "affluent society", while only recently coined by Professor Kenneth Galbraith, has already become the character-designate for America in the late 1960's. While Kenneth Galbraith may only have been engaging in a game of literary expression, the fact remains that even those below the poverty level are relatively well off by world standards.

The key to an affluent society of 200 million persons lies in the enticements it creates for businesses to tap such a prime market. This comes not only by selling more existing products to persons with rising discretionary incomes, but also involves the development of a larger variety of products with an emphasis on higher quality, novelty, and social prestige. Affluence, therefore, encourages product differentiation, market discrimination, and diversification.

To complete our analogy, affluence enables the propagator of the diversification plant to be more selective in choosing who shall receive the pleasures of consuming its fruit and the charges to be levied.

The Results

One need only consider these environmental pressures to understand the virtual inevitability of diversification. The pertinent question is no longer whether a business should diversify, but how, when, and to what extent. As a result, several basic management philosophies have developed.

Some businesses prefer to maintain a dominant position in a fundamental product field and leave this operation virtually undisturbed as management carefully selects and enters secondary fields of interest.

More recently, some businesses have chosen to view themselves more broadly. This philosophy is often evident in their promotion and advertising. For example, these firms describe themselves as the "science company," the company where "progress is the most important product," the "discovery company," or the company that is "people oriented."

Another management strategy is one of dealing with risk and uncertainty. Most often this can be found in businesses, which rely heavily on federal military contracts. Their first move toward diversification is generally an attempt to develop a civilian version of the military product. Those businesses, which are vulnerable to cyclical influences, look first for new product lines, which are more recession proof.

Finally, some businesses stress diversification through merger and acquisition. Conglomerates fall in the latter category. The conglomerate views itself as a pool of productive resources, which flows in the direction of the most promising return. At a given time its assets may seem non-liquid, but great efforts are made to rectify this situation if a particularly attractive opportunity arises.

Implications

It has been shown that the causes for diversification are no less numerous and complex than are the results thereof. The rather touchy question remaining is the effect diversification has on the general American

public. Its most obvious effect is its impact on competition. Economists do not propose that a business's market power increases in direct proportion to the number of different fields in which it operates. Instead, the critical factor seems to be the proportion of a single product market, which is controlled by that business. Monopoly power, therefore, arises from the degree of concentration in a given industry, not from the absolute size and scope of the business itself.

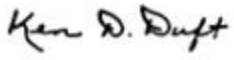
More recently, this theory has been severely questioned. Consideration is now being given to the competitive effect of the huge financial base existent in large diversified businesses. This market influence may arise from the firm's large cash flow or its superior advantage in obtaining financial support. Conglomerates, in particular, have aroused these suspicions. Through continued growth and diversification, could a few conglomerates ultimately gain enough political, economic and social power to exert an unfair influence on markets? This issue is not one sided, as some argue that only one large conglomerate could do battle with another. If competition is to exist in those fields already dominated by a few corporate giants, it can only come from conglomerates of roughly the same size and with resources adequate to absorb the risks of doing battle.

A less obvious effect of diversification concerns the area of labor management relations. Labor unions fear that a business with diversified sources of income will be less apt to feel the pressures of a strike at only one of their many operations. To counteract this, unions are also diversifying by spreading into related industries. Most, however, continue to maintain a centralized industry base.

Union leaders are now attempting to initiate what they refer to as "coalition bargaining." Under coalition bargaining, all the unions in the business act as one solid front to disperse their employer's diversification advantages. Still other union leaders are not satisfied with this strategy and are beginning to propose major changes in union structure, which would enable a union to follow the diversified business in whichever direction it chooses to go.

Conclusions

Anti-conglomerate legislation and union leaders are now actively opposed to continued business diversification. Whatever the outcome, it is my opinion that we will see no halt in the diversification movement itself. American businessmen have tasted the fruit of diversification, responded to a series of environmental factors over the years, and prospered from this firmly established trend.



Ken D. Duft
Extension Marketing Economist