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RETHINKING DIVERSIFICATION

MUCH INK HAS been spilled about the merits of diversification strategies, such as top-line growth, reduced earnings volatility and increased scale. However, the most meaningful measure of the success of any strategy is the Total Shareholder Returns (TSRs) it produces.

Recent divestitures and breakups remind us that greater focus, rather than greater diversification, drives superior TSRs. Among recent announcements, the spinoffs of GE's power business sent shares up 6.7 percent. Similarly, investors cheered Gap's spinoff of Old Navy with an 18 percent jump in share price. And while still in progress, the combination of Dow and DuPont and subsequent spinoff into three separate, focused businesses is expected to unlock significant value.

More diversification simply does not lead to greater value creation. There is no correlation between the number of business segments reported by S&P 500 companies and their TSRs.

In fact, we have found that in the majority of S&P 500 corporations, less than 40 percent of employed capital generates returns above the cost of capital, while 25 percent or more consistently earns returns below the cost of capital. This is primarily the result of undisciplined efforts to diversify into new markets and business segments.

This hidden concentration of economic profit[1] offers significant opportunity to improve the shareholder value of most companies. Informed decisions about where and how to diversify, and how a diversified business is managed are what drive TSR performance relative to peers.

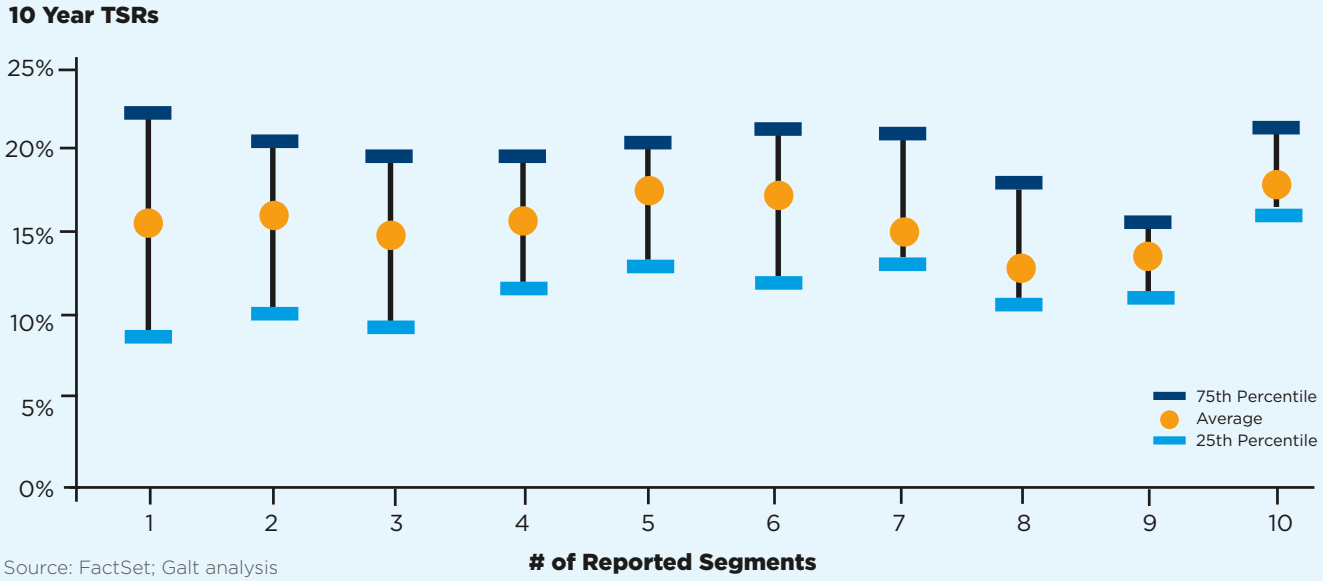
Evaluating New Diversification Opportunities

Market Economics

The first question any leader should ask when considering diversification is whether the market is attractive. For most people, an "attractive" market is one that is "large and growing." But it is the size and growth of the market profit pool, not just revenues, that determine economic attractiveness. This is a starting point that determines whether a new entrant will have a headwind or tailwind in generating returns above its cost of capital and sustaining economic profits over time.

In an all too familiar a story, a business expands into a new market with large and growing demand, only to struggle year after year to generate returns above its cost of capital. General manager after general manager is blamed for "not executing well," until it is recognized that the market is structurally unattractive and most other competitors are also generating returns below their cost of capital. As Warren Buffett cautions, "When management with a reputation for brilliance tackles a business with

S&P 500: 10 Year TSRs vs. # of Reported Segments



Source: FactSet; Galt analysis

[1] Economic profit (EP) is earnings less a charge for the capital required to produce those earnings.

a reputation for bad economics, it is the reputation of the business that remains intact." Businesses should focus on markets that offer attractive economic profit potential (i.e., returns above the cost of capital), not just revenue growth or earnings stability.

Competitive Position

Besides choosing economically attractive markets, companies must also have, or establish, a basis of advantage that results in increasing share of market profits. While product, service or cost advantages all come into play, true competitive advantage is ultimately measured by the sustainable share of economic profits a business is able to generate.

Understanding where a company can leverage its competitive advantages into new adjacencies starts with identifying current sources of competitive advantage. This requires factual understanding of where and why the current business generates economic profits, and how the underlying competitive advantages translate to potential new markets.

As an example, an industrial equipment manufacturer was looking to diversify into smaller, lighter-duty equipment, having identified that as a profitable and growing market. The company entered this new segment relying on its historical sources of competitive advantage: quality, durability and access to repair parts and service. Yet, customers in this segment valued affordability, availability and easy self-service maintenance. To gain share of market profits, the diversification strategy had to be adjusted to do a better job at satisfying these customer needs than competitors and doing so profitably.

Managing a Diverse Business

One of the dangers of diversification is the risk of masking differences in performance across segments. Putting a poor-performing business together with a high-performing one rarely makes a company worth more than the sum of its parts. It can also mask the underlying performance of each business and encourage managing to the averages. The result is that high-performing units are starved for resources, while poor-performing ones are sheltered from pressure to improve. The solution is to maintain clear line of site into the economics of each business segment.

Conclusion

Poorly managed diversification has been one of the primary contributors to shareholder value destruction. However, properly managed diversification offers profitable growth beyond the core that can significantly improve shareholder value. Value creating diversification:

- Starts with having the right objective, which is to increase the company's economic profit growth, not to increase scale or minimize earnings volatility;
- Is achieved by expanding into economically attractive markets with a competitive advantage that enables the business to capture a share of those profits; and
- Is sustained by managing profit growth at a granular level.

Over time, such economically profitable diversification can result in increased cash flow going to a reinvestment advantage that becomes increasingly difficult for competitors to match.

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