Preface

The new forms of mechanization and automation of production enabled, if not imposed, the rise of modern mass production (Chandler et al. 2009). In this setting, firms search productive efficiency to win the competitive struggle. Economies of scale and internationalization are the mirror image of the same phenomenon: firms aim to grow in specialization and foreign markets. Value creation by means of specialization and internationalization proves that they are two winning strategies. Nonetheless, firms may also opt for alternative strategic paths: they diversify into new related or unrelated businesses. Interestingly, theoretical literature and managerial practices assume that the origin of such choice is traceable in the firms' "deep pocket", i.e., the availability of an excess of resources (especially, free cash flow) that specialization and internationalization strategies contribute to provide (Penrose 1959).

Due to the importance of managing diversification strategy, this topic corresponds to one of the most debated in Business Economics and Management (Benito-Osorio et al. 2012). In particular, scholars have dealt with this theme according to a traditional approach based on firm functions:

– strategic management scholars have largely focused on the firms' capabilities to operate in many businesses, the interplay of diversification strategies and business strategies as well as the convenience of related diversification vis-à-vis other growth strategies (Grant 2016);

– the marketing perspective calls attention to diversification as a way to exploit market power (Montgomery 1985), firm reputation, and credibility;

– corporate finance studies have mainly focused on diversification as a way to reduce risk and the emergence of a "diversification discount". They conclude that, in an efficient financial market, conglomerate diversification usually destroys value for shareholders (Martin and Sayrak 2003);

– organization development research assumes that one of the winning traits of diversification strategy is the possibility of leveraging valuable and unique technology competences across businesses (Miller 2006).

While the fertility of functional research on diversification strategies is acknowledged, this book looks at the *processes* of allocation, management and reconfiguration of resources within a diversified firm. Specifically, it focuses attention on the General Electric case, that is an extreme case as both the breath and strategic variety of the business portfolio are overstressed. Interestingly, the overlapping of "conglomerate diversification" (with a special focus on diversification discount) and "strategic leadership", that Pasquale Massimo Picone proposes, appears to be new and even provocative for current state of art on the diversification strategies.

Drawing on the Resource Based View, the Author calls attention to "the central role of the enterprise and *managers* in creating value based on (…) imperfections in the market" (emphasis added; Wan et al. 2011, p. 1339). *In nuce*, this book aims to represent strategic leadership as a "contingent factor" in the relationship between conglomerate diversification and performance, and it discusses the causal links of such relationship.

In order to address this research target, the Author offers an accurate outline of methodological choices required to investigate such phenomena. Then, assuming a constructive approach to realism, he submits a multi-temporal qualitative analysis of Jack Welch's (1981-2001) and Jeffrey Immelt's (2002-2016) strategic leadership in General Electric.

The analysis of General Electric's success allows the Author to bridge corporate finance and strategic management perspectives. He recognizes the dimensions of strategic leadership that need to circumvent the "conglomerate traps" of socialism in resource allocation, overly complex resource management, and inertia in renewing resource configuration. Then he extends prior literature by offering original considerations around the theme of "value", with a special emphasis on the interrelations among diversification strategy, performance and firm value. In this area, this book offers a consistent answer to the question why some conglomerates do not destroy value even when they operate in market conditions characterized by a perfect allocative efficiency.

Bergamo, July 19, 2017

Angelo Renoldi
Professor of Business Economics and Management
University of Bergamo

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Preface

This book aims to understand the fundamental *raison d'être* of abiding conglomerate firm success. In particular, the raising management scholar and promising contributor, Pasquale Massimo Picone, targets to suitably recognize the significance of the value creation processes in conglomerate diversification. This condition is in turn potentially liable to provide practitioners, that is to say managers, consultants, established entrepreneurs, and startuppers, with some of drops of precious and applicable knowledge on the conglomerate traps and how they can overcome them.

To be sure, diversification strategy, intended as a preferential firm growth strategy, has been a constant presence in management inquiry for several decades, virtually starting off with Edith Penrose's foundational volume on the theory of the growth of the firm in the late fifties. Notwithstanding that, while it has traditionally attracted attention from studies in both strategy and finance, there has been little or no trade between the contributions outspreading from the two disciplines.

As often occurs in cookery books, this volume presents four key ingredients that, in my sensitivity, is worth mentioning to its prospective readership. The first ingredient refers to the fact that this is one of the very initial efforts *reconnecting two management literatures* that have been hitherto disconnected: the literature on diversification strategy and the literature on strategic leadership. Actually, while they represent today two chapters of any basic undergraduate course of Business Economics and/or Management, the *space of communication* between them demands to be better clarified and properly unveiled. The book shows that conglomerate traps can be sidestepped by using effective strategic leadership as Ireland and Hitt (2005) reported. In such way, a conglomerate diversification strategy may provide a means to turn superior shareholders' returns and shareholders' value added.

Second, the book sheds further light on the processes of allocation, management, and reconfiguration of resources at the company level by qualitatively delving into the General Electric Company case that it analyzes in-depth over an extensive 36-year period spanning between 1981 and 2016. Actually, Picone proposes an appealing analysis of General Electric strategic leadership under the helm of two of its former CEOs: namely Jack Welch's and Jeffrey Immelt. From a temporal perspective, the evolution of GE is scrutinized in depth extracting and presenting an array of best practices (for instance, Six Sigma, Vitality Curve, and Eco-imagination) that two much-admired GE CEOs, that have been directly involved in implementing a successful conglomerate diversification strategy, have crafted and introduced over time.

Third, from a strategic management perspective, the book is noteworthy because Picone submits an explanation of the apparent "*conglomerate paradox*" (Picone and Dagnino 2016). Drawing on a systematic review of conglomerate diversification literature, the author focuses on three aspects that are usually considered particularly harmful in implementing diversification strategy: (a) misguided resource allocation driven by conglomerate socialism; (b) managerial complexity due to the multiple variety of business where a conglomerate operates; and (c) structural inertia in renewing resource configurations. Then, by examining the ways Jack Welch and Jeffrey Immelt have exerted their role of strategic leaders at GE, Picone is able to illustrate that the enduring and positive performance of the blue-chip American conglomerate stems from these relevant strategic leaderships.

Finally, the book adds to the stream that dedicates increasing attention to the *microfoundations of strategic management* (Foss 2011). This condition occurs since it shows that the effectiveness of conglomerate diversification is reliant on three dimensions of strategic leadership: managerial excellence, intended as pure perception of values that other people do not see, transactional leadership, and transformational leadership. Because such dimensions represent the core of CEO's accountability, the analysis "inevitably has to take place with an eye to the micro-level" (Foss 2011, p. 1417). While the traditional swing of a pendulum in strategic management studies (Hoskisson et al. 1999) has fallen short to properly consider the role of strategic leadership, in the last few decades the interest in studying CEOs' strategic leadership has progressively taken momentum. In such fashion, the book revamps early business policy and strategy reflections (Andrews 1971) on the central role that the CEO takes in ensuring steadfast firm performances with a specific focus on the role of strategic leadership in conglomerate firms.

All in all, for its care and thoughtfulness, it is my feeling that this volume bears the potential to open a novel research space in strategy inquiry, bridging across two significant issues and processes such as diversification and leadership.

Catania, July 27, 2017

Giovanni Battista Dagnino
Professor of Business Economics and Management
University of Catania

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Acknowledgements

Publishing an academic book is an intellectual endeavor that requires an extensive investment of time, energy, and passion. More than two years after the onset of this endeavor, my mind inevitably flashbacks all the single initial steps of this story.

In the last two and half years, I had the fortune to be affiliated to two institutions in both Southern and Northern Italy, the University of Catania and the University of Bergamo. During this period of time, I have developed debts of gratitude to scholars and colleagues of both institutions. Let me report my recognitions below in chronological order.

At the University of Catania, I am greatly indebted to Professor Giovanni Battista Dagnino. My research on conglomerate diversification has started eight years ago when I was a PhD student under his supervision. He has steered all the ladder of my research endeavor from the initial project to the developmental process of this book. I am sure that this book would not have seen light without his tremendous support and enlightening insights. As concerns the University of Catania, I wish to extend my gratitude to the other scholars and colleagues in the Business Economics and Management area for their constant encouragements and informal comments.

At the University of Bergamo, I found a fertile intellectual atmosphere and personal serenity that have jointly made it possible to eventually submit the final version of the book. Generous support, encouragements, and sympathetic comments received from Management scholars have turned extremely helpful.

Besides, I am particularly appreciative to Professor Mike Hitt of Texas A&M University and Professor Caterina Moscheri of IE Business School. During my extended periods of visit at College Station, Texas, in 2011, and at Madrid in 2013, I have immensely benefited from their shrewd advice and sharp comments on my research that are represented in various parts of this volume.

Last but certainly not least, I owe massive appreciation to Anna, my lovely half, and my family of origin. Together they have unremittingly supported my strain to stretch the horizons of my inquiry, while the focus on writing this book has stolen time and care to them.

Bergamo, July 15, 2017

Pasquale Massimo Picone

Chapter 1
Introduction

1.1. Purpose of this book

This book proposes that strategic leadership is an instrumental factor in *conglomerate firms' performance heterogeneity* (Wan et al. 2011; Martin and Sayrak 2003; Villalonga 2004). In this regard, the study clarifies and discusses the role of effective strategic leadership (Hitt et al. 2010; Hitt and Ireland 2002; Ireland and Hitt 2005) in shaping the key processes that characterize a successful conglomerate: the allocation, management, and reconfiguration of resources.

Following the pivotal contributions of Ansoff (1957), Chandler (1962) and Rumelt (1974), the questions of how and to what extent a conglomerate strategy can yield higher levels of performance compared with more focused strategies (such as related diversification and mono-business strategies) have increasingly taken center stage in strategic management research (Datta et al. 1991; Grant et al. 1988; Palich et al. 2000; Wan et al. 2011).

Although earlier scholars recognized the effectiveness of a conglomerate strategy, the mainstream strategy literature (since the 1980s) shows that the economic logic of this strategy is flawed (Goold and Luchs 1993). When financial institutions are relatively underdeveloped, a conglomerate strategy should generate value for shareholders (Fauver et al. 2003; Gopalan et al. 2007; Khanna and Palepu 1997, 2000a, 2000b; Kock and Guillén 2001; He et al. 2013). Vice versa, conglomerate diversification is cheaper for shareholders than it is for firms (Brealey and Myers 2000). Further, various studies corroborate the occurrence of a *diversification discount*, that is, the value of a conglomerate is less than the sum of the values of its individual businesses (Berger and Ofek 1995; Lamont and Polk 2002; Lins and Servaes 1999; Rajan et al. 2000) [1].

Remarkably, strategic management literature has thus far failed to unravel the

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[1] Recognizing that the economic logic of conglomerate strategy is flawed, certain authors maintain that an efficient financial market should deter the implementation of conglomerate strategies (Zuckerman 2000) and over time should steer managers toward a progressive de-conglomeration process (Kay 1992; Liebeskind 2000; Varadarajan et al. 2001).

puzzle of why certain conglomerates generate outstanding performance whereas the majority of conglomerates suffer from a diversification discount (Martin and Sayrak 2003). This question has been referred to as "*the paradox of conglomerate success*." As Kaye and Yuwono (2003) inform, examples of conglomerate success include such firms as the Bidvest Group (South Africa), Onex (Canada), ITC (India), Fimalac (France), General Electric (US), Westfarmers (Australia), and Berkshire Hathaway 'A' (US).

Although Bettis et al. (1978) suggested shifting the research focus from central tendencies to outliers to explore the relationship between diversification and performance, the strategic management literature has continued to overlook the issue of the limited generalizability of empirical analyses of conglomerate firms (Martin and Sayrak 2003). In fact, the conglomerate paradox shows an important conceptual hole in the understanding of how certain firms that operate in various unrelated businesses experience success despite strategic management research that forecasts the opposite outcome (Palich et al. 2000).

Interestingly, although the modest or negative performance of conglomerate firms is not entirely due to strategy per se, the success or failure of conglomerate diversification is shaped by the manner in which the conglomerate strategy is implemented (Dundas and Richardson 1982). In particular, the diversification discount has been attributed to the *antergies* [2] associated with the implementation of conglomerate strategy (also known as "conglomerate traps"), including socialism in resource allocation, overly complex resource management, and inertia in renovating resource configurations (Picone and Dagnino 2016).

Galbraith (1993) suggests that *strategic leadership* may be one of the most relevant and significant factors in the resolution of the conglomerate paradox. However, it remains a theoretical and empirical challenge to evaluate the effectiveness of strategic leadership (Hitt et al. 2010; Hitt and Ireland 2002; Ireland and Hitt 2005) and to connect strategic leadership to the capacity of a firm to overcome the above-mentioned antergies that characterize conglomerate strategy.

This book strives to appraise the role that strategic leadership plays in the ability of conglomerate firms to effectively tackle the conglomerate paradox. The research is grounded in a longitudinal qualitative study; specifically, the General Electric (GE) case from 1981 to 2016. By focusing on the US conglomerate, this book submits an in-depth analysis of two consecutive strategic leaderships at GE: Jack Welch from 1981-2001 and Jeffrey Immelt from 2002-2016. In particular, this book pays attention to the strategic leadership dimensions that may be crucial for avoiding or mitigating the conglomerate antergies. Furthermore, the comparison between Jack Welch and Jeffrey Immelt helps to identify the shared and indi-

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[2] From an etymologic perspective, the word "antergy" derives from ἀντί ("against"), and *ergo* ("act"). Thus, the word antergy evokes "working against." Antergies are indicated when lower results occur as an outcome of the combination of numerous factors.

vidual features of leaderships that are associated with conglomerate success.

By offering a plausible theoretical and empirical explanation of GE's success paradox [3], this research maintains that a relevant source of conglomerate performance heterogeneity is the *implementation of effective strategic leadership* (Galbraith 1993). Effective strategic leadership may explain the paradox of conglomerate performance by incorporating *transactional leadership* (Bass 1985; Dienesch and Liden 1986; Northouse 2004), *managerial excellence* (Finkelstein et al. 2009; Hambrick and Finkelstein 1987), and *transformational leadership* (Bass 1999; Bass and Riggio 2006; Bass and Steidlmeier 1999). Effective strategic leadership in conglomerate firms is characterized by a clear awareness of the sources of firm value, the ability to create the internal conditions needed to increase the impact of firm resources, the capacity to broaden the resource base of the firm, and the recognition of the cleavage between existing resources and the future ambitions of the organization.

1.2. Value added of this book

A structured analysis of the GE case from 1981 to 2016 as an example of the successful conglomerate strategy advanced in this book yields intriguing and relevant insights into the intersection of diversification strategy research, strategic leadership literature, and business practices. In particular, this book contributes to strategic management research in five respects. First, by exploring the impacts of the strategic leadership of Jack Welch (from 1981 to 2001) and Jeffrey Immelt (from 2002 to 2016) on GE success, this book advances diversification literature by illustrating how the conglomerate strategy can be successfully guided and implemented by effective strategic leadership.

Second, the book contributes to the resource-based approach to diversification strategy (Benito-Osorio et al. 2012; Hauschild and Zu Knyphausen-Aufseß 2013; Wan et al. 2011). In particular, this book maintains that *effective strategic leadership* can be a valuable, rare, inimitable, and non-substitutable resource and thus can help the diversified firm to mitigate conglomerate antergies and achieve good performance. However, drawing on Ketchen et al. (2007), strategic leadership is considered to have only a *potential value*; complementarity with other firm resources is essential.

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[3] While Jack Welch's period at General Electric is unanimously considered a case of successful diversification (Martin and Sayrak 2003), there exists an open debate about the effectiveness of GE performance under Immelt's strategic leadership. In this book, we will explain why humble performance of GE are, at least partially, explained by economic conjuncture (Hitt et al. 2011) and how Immelt reconfigured GE's resources "to generate a new style of «GE premium» in the stock price" (Le Guyader 2016, p. 29).

Third, this book contributes to the strategic leadership literature by applying the general concept (Hitt et al. 2010; Ireland and Hitt 2005) to a specific context, namely, the conglomerate firm. The explorative nature of the research helps to identify several important dimensions of strategic leadership (i.e., managerial excellence, transactional leadership, and transformational leadership) that may be indispensable for avoiding or mitigating conglomerate antergies and thus could lead to heterogeneous (positive) conglomerate performance.

Fourth, this research bridges a gap existing among the strategic leadership literature, the resource-based view, and the dynamic managerial capabilities perspective (Kor and Mesko 2013; Helfat and Martin 2014) as concerns to conglomerate firms. According to the resource-based view, the disposition of unexploited or excess resources, such as human know-how and managerial expertise, may drive diversification (Hoskisson and Hitt 1990; Mahoney and Pandian 1992; Ramanujam and Varadarajan 1989). The dynamic capabilities perspective provides a complementary view on diversification strategy by taking into account how dynamic capabilities support the continuing engagement of essential staff and managers and the advancement of human resources (Døving and Gooderham 2008; Kor and Leblebici 2005; Makadok 2001). In this vein, the present study evokes the dynamic capabilities contention that the development of strategic leadership requires that the manager's role be considered "analogous to an *architect*" (Makadok 2001, p. 389, emphasis added). This archetype dates back to Andrews (1971) and encompasses managerial excellence, as well as transformational and transactional leadership.

Fifth, because there is a lack of understanding of how conglomerates allocate, manage, and reconfigure their resources to generate value for shareholders (Picone and Dagnino 2016), this book contributes to the previous literature by juxtaposing conglomerate strategy research with an empirical inquiry of a relevant and important business case. In this manner, it is possible to extract insights that may guide executives in the deployment of resources and the development of capabilities that epitomize successful conglomerates.

Table 1.1. – Overview of the book

Aim	This book investigates whether strategic leadership is an instrumental factor in conglomerate firms' performance heterogeneity.
Research question	Can strategic leadership shape (the direction or intensity of) the relationship between conglomerate strategy and performance?
Method	Longitudinal qualitative study adopting a constructive realism approach.
Methodological choices	Selection of GE as a purposeful example, nested approach, data collection and triangulation of facts, and temporal bracketing strategy.
Sample	GE's story over a period from 1981 to 2016. It covers the analysis of two different strategic leaderships: Jack Welch (1981-2001) and Jeffrey Immelt (2002-2016).
Contributions / Originality	1. It illustrates how the conglomerate strategy can be successfully guided by effective strategic leadership. 2. Drawing on the resource-based view, it shows the potential value of strategic leadership within a conglomerate. 3. It contributes to the strategic leadership literature by applying this general concept to conglomerate firms. 4. It bridges a gap that exists between the strategic leadership literature, the resource-based view, and the dynamic managerial capabilities perspective as they relate to conglomerate firms. 5. It juxtaposes extant research on conglomerate firms with a significant business case.

1.3. Structure of this book

The remainder of this book is organized as follows. Chapter 2 aims to provide a systematic interpretation of previous strategic management research on conglomerate diversification. Additionally, the literature review shows and takes advantages of the dynamic exchange between strategic management and corporate finance studies. At first, Chapter 2 offers a multi-level map of the antecedents of conglomerate diversification. It considers: contextual-level antecedents (i.e., seeking legitimacy for the institutional framework and overcoming the weaknesses of external financial institutions), firm-level antecedents (i.e., enhancing market power; orchestrating rare, valuable, and imperfectly imitable resources; acquiring, sharing, and synthesizing unrelated knowledge; and opening strategic windows to new businesses), and management-level antecedents. Then, it illustrates the main antergies of conglomeration: (a) "conglomerate socialism" in resource allocation; (b) overly complex resource management; and (c) inertia in renovating resource configurations. Finally, this Chapter summarizes previous studies on conglomerate firm performance, examining the conditions that lead to the emergence of a diversification discount and considering evidence collected across time and countries.

Chapter 3 posits that one of the main sources of heterogeneous firm performance is "unique managerial talent that is inimitable" (Penrose 1959, p. 35). This perspective offers a resource-based framework that links strategic leadership to performance. Specifically, Chapter 3 summarizes the responsibilities of strategic leadership according to the model developed by Ireland and Hitt (2005) and Hitt et al. (2010). It includes: (a) developing and communicating the firm vision; (b) exploiting and enhancing core capabilities; (c) forming and enriching human capital; (d) sustaining an effective firm culture and the promotion of ethical practices; and (e) exercising a balanced control of the firm. Drawing on this background, the role of strategic leadership in the deployment of resources within the boundaries of a conglomerate firm is abstractly detailed.

Chapter 4 describes the methodological features of this research. Whereas the bulk of the literature on conglomerate diversification utilizes econometric analyses, this book focuses on outlier values (i.e., conglomerate successes) that are commonly neglected by econometric analyses. Further, introducing strategic leadership into the relationship between conglomerate diversification and performance implies a fine-grained scrutiny that large samples do not always permit (Golden-Biddle and Locke 1993). Drawing on these arguments, Chapter 4 justifies the choice of a longitudinal case study by adopting a constructivist realism approach (Cupchik 2001). Consequently, Chapter 4 explains how the research adheres to the scientific criteria of qualitative research (through, for example, criteria for case selection, triangulation of data, data analysis, the temporal bracketing strategy, and an inter-temporal comparison).

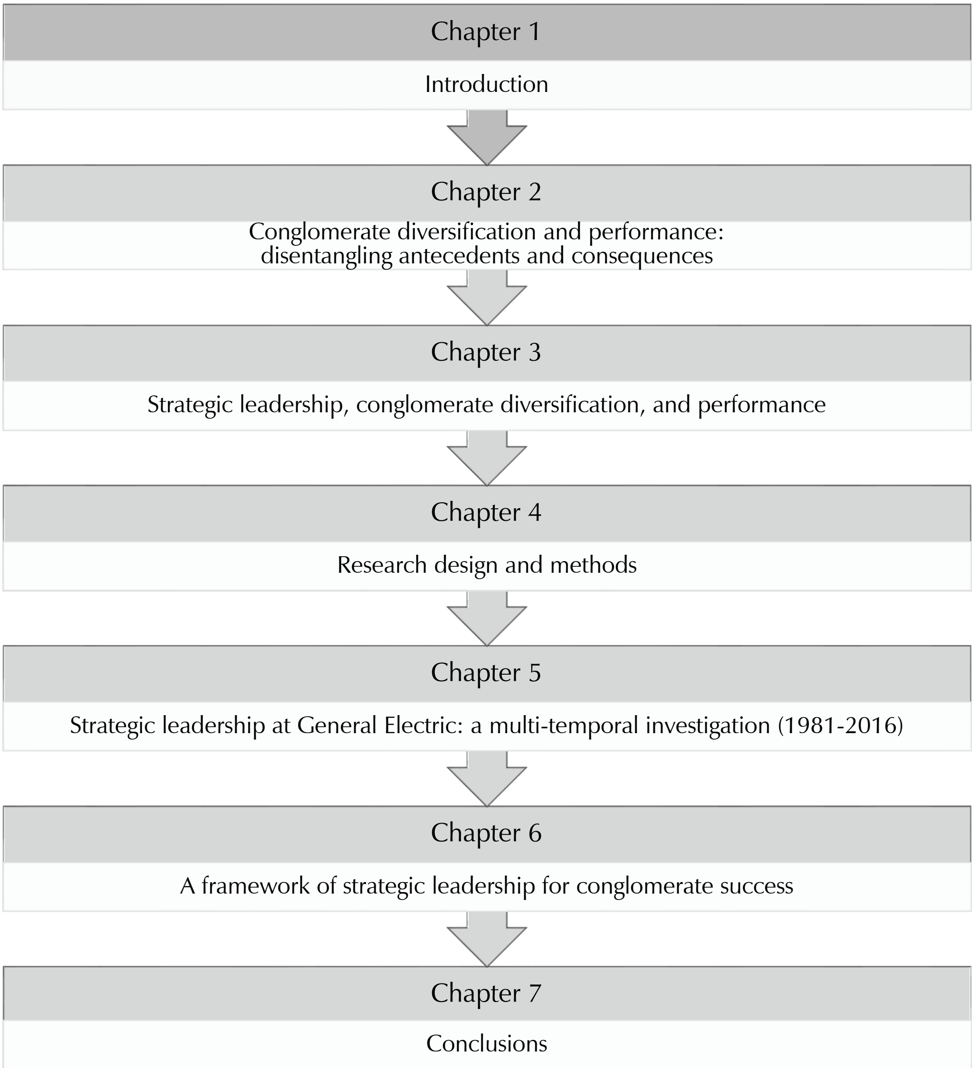
Applying a temporal bracketing approach, Chapter 5 defines the key sequential stages in the evolution of the strategic leaderships of Jack Welch (1981-2001) and Jeffrey Immelt (2002-2016) at GE. This Chapter aims to elucidate how effective strategic leadership can transform a chain of events or pre-existing conglomerate conditions that usually lead to failure into something positive. Specifically, the evolution of Jack Welch's strategic leadership at General Electric considers three phases: (a) phase I: new corporate portfolio management practices and extreme organizational change (1981-1985); (b) phase II: strong firm identity and the development of human resources as a strategic stimulus to achieve the GE vision (1986-1995); and (c) phase III: new challenges: expanding the operating plan (1996-2001). The evolution of Jeffrey Immelt's strategic leadership at General Electric (2002-2016) reflects two phases: (a) phase I: understanding General Electric fit to the market and society (2002-2007); and (b) phase II: becoming a catalyst for change (2008-2016).

Drawing on the multi-temporal investigation of the strategic leaderships of Jack Welch (1981-2001) and Jeffrey Immelt (2002-2016) at GE, Chapter 6 discusses the role of strategic leadership in the success of GE as a conglomerate firm and advances a framework of strategic leadership for conglomerate success. Blending three straightforward constructs (i.e., transactional leadership, managerial excellence, and transformational leadership) that are reciprocally non-exclusive and complementary (Bass 1985; Bass and Avolio 1993a, 1993b), this Chapter assesses the role of effective strategic leadership in conglomerate firms.

In conclusion, Chapter 7 highlights the original contributions made by this book to diversification strategy literature. The book inductively advocates a fascinating role for strategic leadership in resolving the antergies of conglomerate strategy. Specifically, the strategic leadership role appears to lie at the basis of the firm's capacity to effectively implement conglomerate strategy. Chapter 7 also notes the novelty of the approach taken in this book, which converges corporate strategy and strategic leadership research. Furthermore, the key managerial lessons are summarized. Finally, Chapter 7 discusses the capacity of this book to illuminate new paths of research.

A map of the book is offered in Figure 1.1.

Figure 1.1. – Map of the book



Source: Author's elaboration.

Chapter 2

Conglomerate diversification and performance: disentangling antecedents and consequences

Chapter 2 offers an organized and systematic interpretation of the existing literature on conglomerate diversification strategy. First, the Chapter offers a brief overview of diversification strategy, including definition, patterns, how corporate strategy makes a difference, and modes of entry into a new business. Then, Chapter 2 defines conglomerate strategy and justifies the focus of the book on this specific corporate strategy. By leveraging multiple theoretical angles and two disciplinary traditions (i.e., corporate strategy and financial management), this Chapter disentangles conglomerate strategy antecedents by distinguishing among contextual-level antecedents, firm-level, and management-level antecedents. Furthermore, Chapter 2 focuses its attention on the antergies that emerge as a result of implementing conglomerate strategy. Finally, Chapter 2 discusses the relationships between conglomerate diversification and corporate performance.

2.1. Diversification strategy: definition and core concepts

A diversification strategy is a means for generating firm growth by entering into a new business [1] (Ansoff 1957; Chandler 1962; Rumelt 1974, 1982). The firm implements "a simultaneous departure from the present product line and the present market structure" (Ansoff 1957, p. 114) [2]. Ideally, the aim of a diversification

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[1] According to the Ansoff (1957) product-market strategies matrix, it is possible to identify three other growth strategies that complement diversification: (a) market penetration; (b) product development; and (c) market development.

[2] The difference between business and industry is not always clear. *Business* identifies a precise combination of products, target customers, and technology (Abell 1980). *Industry* comprises a set of firms that use the same technology but aim to satisfy distinct target customers and offer different products (Abell 1980). Generally, diversification strategy refers to entering into a new business. When firms entering a new business exploit the same technology, it is called "intra-industry diversification" (Hashai 2014; Zahavi and Lavie 2013).

strategy is to gain competitive, economic and financial advantages from a wide-ranging base of resources that are invested in more than one business (Hoskisson and Hitt 1990; Martin and Sayrak 2003; Wan et al. 2011). Diversification extends the breadth of a firm's businesses portfolio in order to perform as well as, if not better than, firms operating in a single business (Grant et al. 1988).

Choosing the right business is one of the most important factors in the economic and financial outcomes of diversification (Porter 1996) and represents the conclusion of a time-consuming managerial process involving estimations and judgments (Detrie and Ramanantsoa 1986; Grant 2010; Porter 1996). Porter (1987) recommends three main tests to support the choice of an effective diversification strategy. The first test assesses the *attractiveness of a specific industry* in terms of the expected profitability and potential growth[3] (Porter 1987). Generally speaking, Porter's five forces model (1979) is the most common schema for this test because it analyzes the competitive forces of suppliers, customers, competitors, potential entrants, and substitutable products (or services). Despite the fact that Porter's model (1979) is an essentially static or comparative static schema (Grundy 2006), it enables a firm to "understand the structure of its industry and stake out a position that is more profitable and less vulnerable to attack" (Porter 2008a, p. 78).

The second test weighs the *cost of entry into the new business* vis-à-vis profit opportunities (Porter 1987). The result of this test relates to the level of the entry barriers (Caves and Porter 1977) that the firm must overcome to compete in the new business (e.g., patents, licensing requirements, and so on). Entry barriers largely favor incumbents over potential entrants (Pehrsson 2009; Porter 1980), so their existence negatively affects the profit opportunities for a potential new entrant (Caves and Porter 1977).

The final test involves estimating the *potential synergies* between the firm's old business(es) and the business the firm may enter[4] (Porter 1987). This test is also recognized as the "better-off test." Leavy (2003, p. 32) summarizes the content of this test in a question: "Will the new business gain competitive advantage from its link with existing businesses or vice versa?".

Porter's tests offer a preliminary evaluation of the potential value created by a diversification strategy. However, firms pursuing a diversification strategy should

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[3] We should note that a focus on industry attractiveness may be inadequate. Wernerfelt and Montgomery (1986) criticize the attention on profitability and other characteristics linked with industry attractiveness and show that the same drivers of industry attractiveness "may cause its inefficient participants to earn lower profits" (Wernerfelt and Montgomery 1986, p. 1223).

[4] The etymology of the word "synergy" is particularly illuminating. It originates from the Greek term *synergía* or *synérgeia*. Both root words recall the concept of *synergo*, i.e., *syn* ("with, together") and *ergo* ("act"). Generally, synergies emerge when superior results occur as an outcome of the combination of many factors. The "combination and recombination effect" implies that the outcome differs from the sum of the factors. The etymology analysis was extracted from http://www.treccani.it/, Accessed: September 30, 2017.

answer the following three questions (Furrer 2010). First, what are the means by which a business generates value for shareholders within the boundaries of a diversified firm? Second, "if business value derives from the revenues generated by the relationship between the business units and their consumers, how is corporate value created?" (Furrer 2010, p. 50). Third, how do firms select the "right" entry mode into the new business?

To respond to these questions, this section offers a three-part synthesis of the diversification literature. Subsection 2.1.1 illustrates diversification strategy patterns, describes the similarities and differences between related and unrelated diversification, and clarifies how both strategic choices may contribute to firm value creation (Rumelt 1974, 1982). Subsection 2.1.2 sheds light on how corporate strategy affects the performance of a diversified firm (Bowman and Helfat 2001). Finally, Subsection 2.1.3 examines the modes of entry into a new business (Busija et al. 1997; Yip 1982).

2.1.1. Diversification strategy patterns

The strategic management literature contains many taxonomies of diversification strategies [5]. However, the most important distinction is between related and unrelated diversification patterns (Rumelt 1974), which are strictly "tied to the characteristics of the resources controlled by the existing businesses of the firm" (Kochhar and Hitt 1998, p. 602). More explicitly, in searching for strategic alternatives to grow market share, firms may (or may not) leverage the sharing of marketing or technological resources and knowledge (Hoskisson and Hitt 1990) [6].

A *related diversification* strategy aims to exploit the "strategic fit" between the value chains of the old and new businesses (Venkatraman and Camillus 1984). In related diversification, the Porterian value chain between and among related businesses is clearly analogous or complementary (Luchs 1996). A popular example of related diversification occurs when a firm operating in the footwear business decides to offer bags and accessories. In this case, there are many potential marketing and technological synergies. The firm is entering an adjacent market and thus will exploit the same technology. We see exchanges in operating activities, for instance, the modes of cutting leather. Additionally, this strategy increases the market power to leather suppliers. Finally, it also supports the sharing of intangible resources (such as brands) and reduces the costs of advertising and communication to customers.

Frequently, related diversification does not encompass both market and technological commonalities but rather only one of the two. Figure 2.1 shows how the patterns

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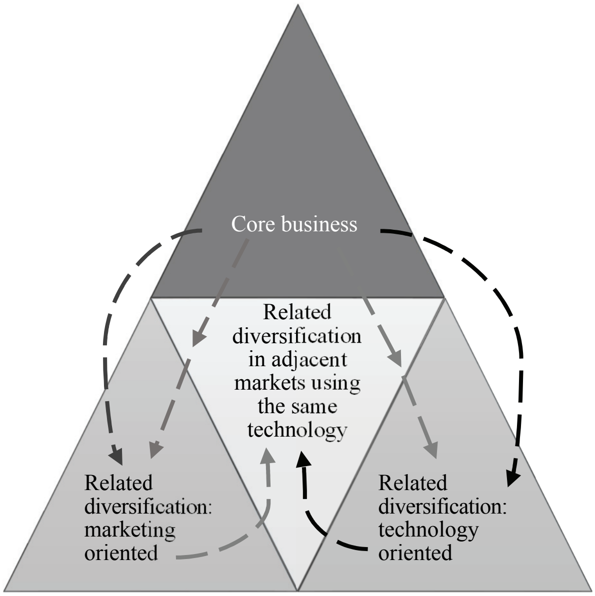
[5] For instance, Rumelt (1982) considers the following categories of multi-business firms: dominant vertical, dominant constrained, dominant linked-unrelated, related constrained, related linked, and unrelated business.

[6] This book generally refers to marketing-related diversification and technology-related diversification as related diversification.

of related diversification may vary. In one pattern, a firm diversifies into adjacent markets using the same technology. A second pattern emerges when a firm diversifies directly into an adjacent market to exploit a brand advantage by investing in a new technology (*related diversification market oriented*). A third pattern explores the possibility of offering products in different markets using the same technology (*related diversification technology oriented*). Figure 2.1 also shows that over time, the firm may shift between technology – and market-related synergies and vice versa.

Figure 2.1. – Main paths from a single-business strategy to related diversification strategies



Source: Author's elaboration.

A method to determine the extent and proper for related diversification is to map Porter's value chains for both businesses (Furrer 2010; Thompson et al. 2008). Corporate strategy should converge, synchronize, and recombine resources in the value chain and stimulate and enable the development of synergies between them (Collis and Montgomery 2005; Holcomb et al. 2006). In this context, we also recognize the role of managerial perceptions. In effect, CEOs will "select, interpret, and discuss information relevant to business relatedness in the course of making its assessments, and all of this relies on managerial perceptions" (Pehrsson 2006, p. 268) [7].

[7] As Pehrsson (2006) argues, managerial perceptions influence the assessment of relatedness