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Turning the conglomerate discount into a premium
A framework for corporate centers of multi-business firms

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Turning the conglomerate discount into a premium

A framework for corporate centers of multi-business firms

Group managers of multi-business firms need to be able to convince their stakeholders that they will be able to realize a corporate premium or surplus in the long run. They have to provide convincing evidence that they are the clear best owners for the businesses in its corporate portfolio. But paradoxically, the majority of diversified multi-business firms stand for the opposite: they destroy value because the costs of the group level are higher than the value added. But how might a corporate center turn such a conglomerate discount into a premium.

Some companies have responded to these external and internal pressures by changing their (stock) ownership structure. Specifically, some companies tried to "recruit" an anchor investor to ensure greater continuity and less divergence of interests. Some companies have even considered taking their company private to escape the quarterly earnings race and the scrutiny of financial analysts.

Other companies have attempted to pacify capital markets by drastically reducing the size of their corporate centers which, in some cases, led to a close down of entire strategy departments leaving the company's corporate development in the hands of corporate finance units. Although all these responses may potentially have positive short-term effects, they seem unlikely to be an adequate response in the long term.

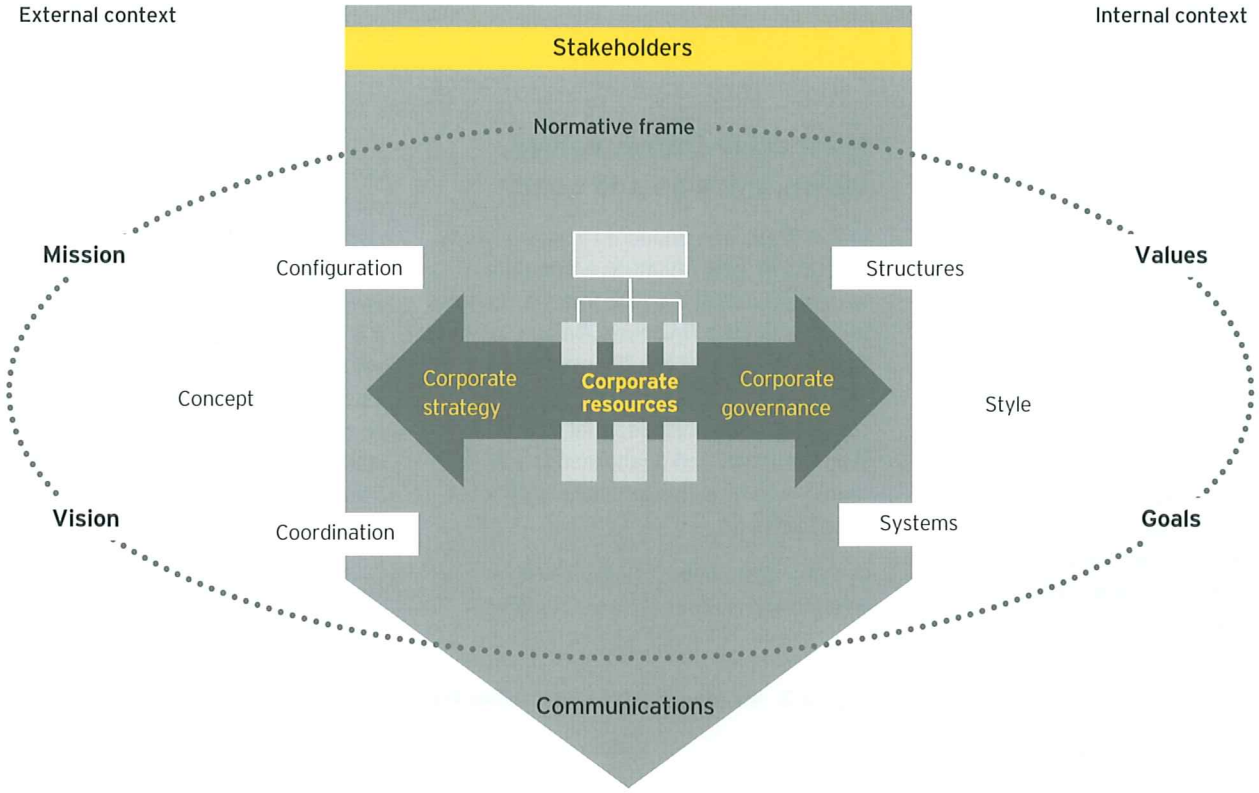
For almost six years, we have considered this question using a multitude of quantitative and qualitative research methods, but also by engaging in a very active dialogue with corporate executives in the process of our everyday teaching and consulting activities. Based on our theoretical and empirical insights, we derived a corporate management framework that depicts the 10 key levers for adding value at the corporate level (see Figure 1).

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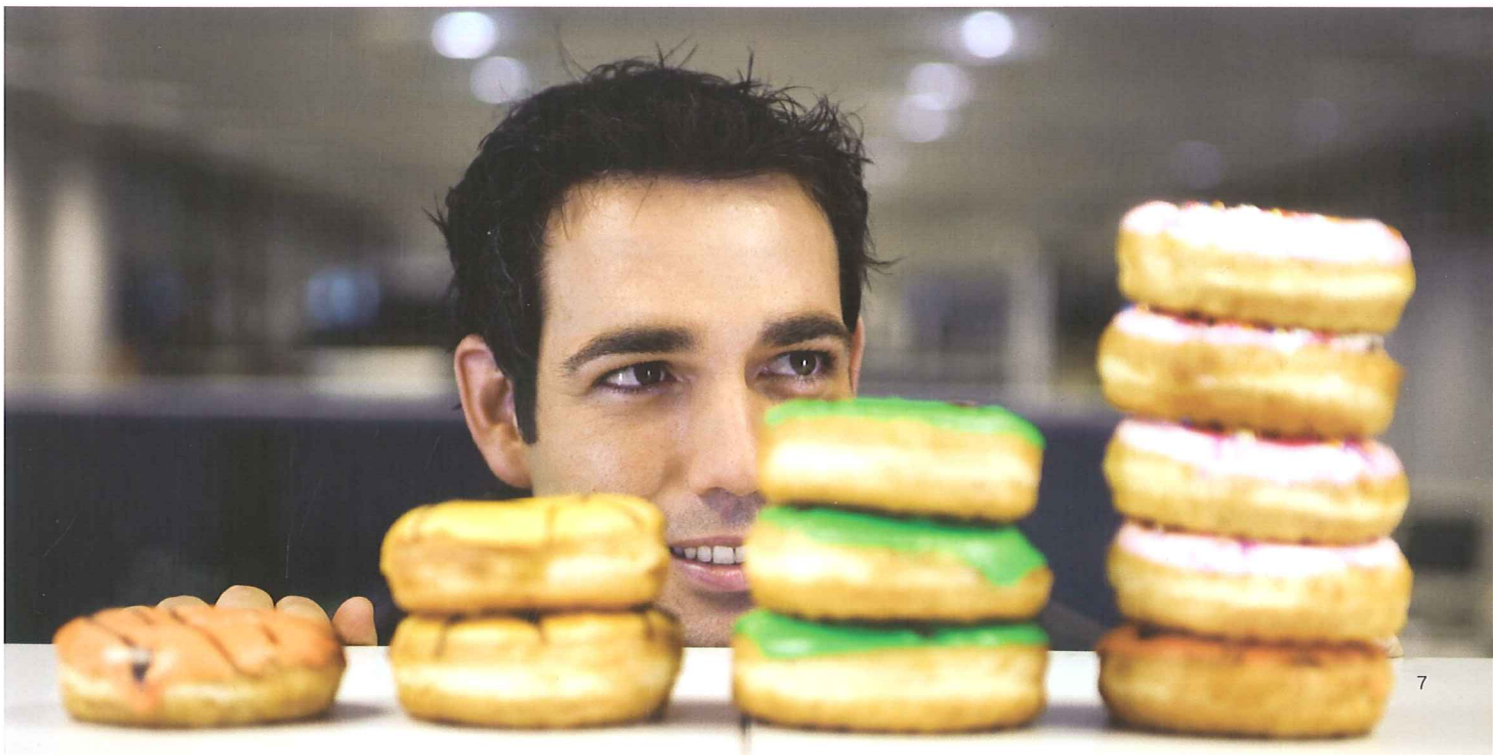
Prof. Dr. Günter Müller-Stewens, Director, Institute of Management, University of St. Gallen, Switzerland

Figure 1. St. Gallen Corporate Management Model



Sustainable competitive advantage in accordance with society and the environment

Source: Müller-Stewens/Brauer, 2009



The major task of group managers is to add value to the company and to the businesses they manage

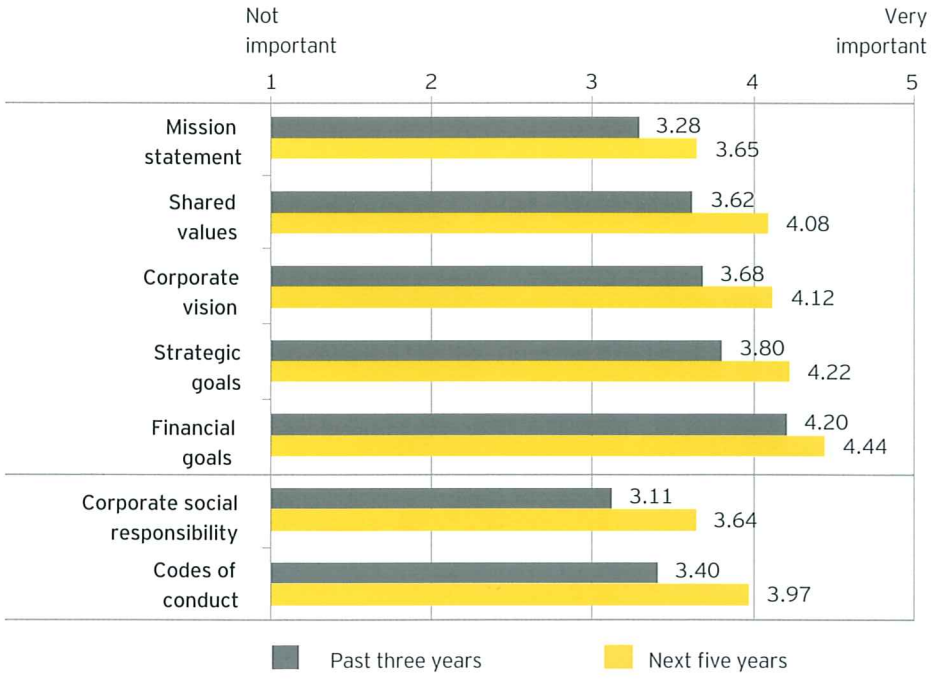
Our framework consists of three complementary components that need to be closely aligned in order to unlock their full value creation potential. The three levers – concept, configuration and coordination – together make up the corporate strategy of a company. The three levers – structure, system and style – form the (internal) corporate governance body of the company. We contend that both corporate strategy and (internal) corporate governance should not be considered as independent of each other. Instead, the proper functioning of the company requires that the corporate center aligns each of these six levers so that they are complementary and mutually supportive. For instance, a well thought out corporate strategy will never be implemented if the organizational structure, incentive systems or the leadership style of the corporate center contradict its intent. Similarly, we found that, although a company's ability to develop a coherent and distinctive corporate strategy and design an internal corporate governance body would generate a temporary competitive advantage, both components did not supersede the need for a strong normative dimension. This normative frame, as we call it, consists of the values, vision, mission and goals of a company. The importance of the normative frame has been increasingly recognized, not only in the face of past corporate governance scandals, but also in the face of the recent financial crisis that sparked a heated debate on the insufficient institutionalization of responsible corporate management in many companies.

Normative frame: values, vision, mission and goals

In 2009-10, we conducted a survey study in terms of total revenues among the largest private and public Swiss companies in terms of total revenues. Results indicate that, in the face of the financial crisis and growing societal pressures, many companies have realized that values, vision, mission and goals need to play a more prominent role in business conduct (see Figure 2).

In many companies, values, vision, mission and goals, however, continue to be loosely connected concepts that are nicely presented on websites and in corporate citizenship reports, but are not institutionalized in the companies' strategic and operative everyday routines and doings. For instance, in many cases, it is impossible to mentally connect the value statement of the company with its corporate strategy. We contend that companies that are able to design and institutionalize a coherent normative frame will be able to realize a competitive advantage because the normative frame then functions as an important source of strategic direction, but also a source of motivation for the company's employees.

Figure 2. Relevance of the normative frame



Source: Müller-Stewens/Menz/Lochbrunner 2010

The normative frame renders answers to the following set of questions:

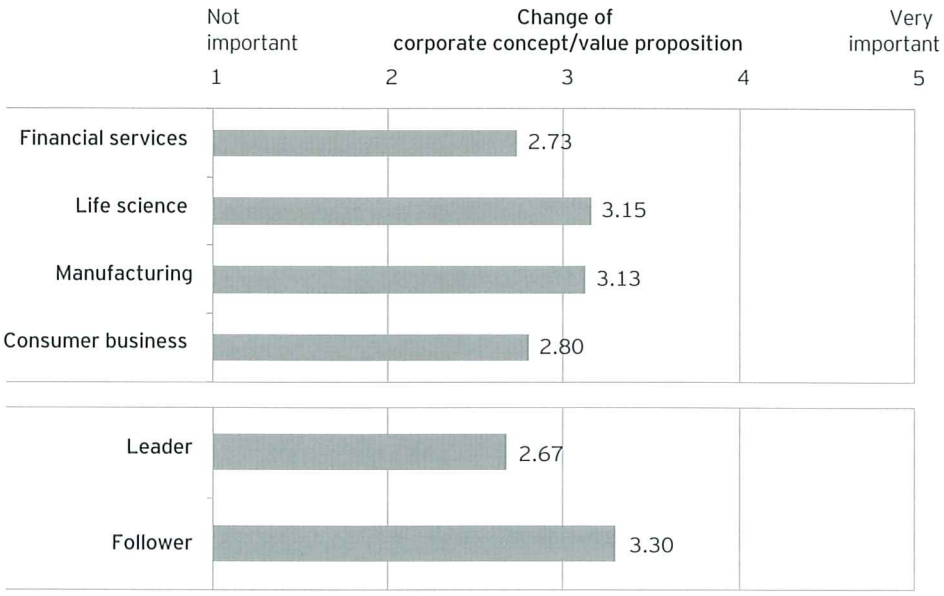
- What ethical values form the baseline for our business conduct with our stakeholders?
- Which values do we want to instill, share and live?
- What is the main value proposition of the company towards our key stakeholders (mission)?
- Where do we want to take the company in the longterm (vision)?
- What are our qualitative and quantitative short-term and medium-term strategic objectives to realize our mission and vision (objectives)?

Clear and consistent answers to these questions, however, are only meaningful if they find their way in a company's everyday activities. Otherwise, these elements often breed frustration and cynicism. Consequently, mission and vision, for instance, should serve as a foundation when thinking about the overall concept of the company (the group business model), or when making decisions about the configuration of the company's business portfolio. Similarly, corporate values need to play a key role not only in the recruitment, development and remuneration of employees, but should also be reflected in the strategic guidelines of a company. Companies such as BASF, Credit Suisse, or Novo Nordisk, for instance, derive their strategic guidelines based on their core set of corporate values.

Corporate strategy: concept, configuration and coordination

A company's corporate strategy should describe how it creates value through the configuration and coordination of its multi-market activities. Using our terminology, the corporate concept provides the roadmap for the strategic development of a multi-business company. The corporate concept is a description of the corporate business model (e.g., one-firm approach), and should provide both employees and investors with a clear sense of the core logic that ties the different multi-market activities together and what drives their development. The more diversified a company, the more difficult it is to find and clearly and concisely articulate this logic. Many diversified companies have lost their clear corporate identities, not only in the eyes of investors, but – more importantly – also in the eyes of their own employees. A well-defined corporate concept helps the company to position itself better, give it a clearer stock-market identity, and distinguish its business activities from competitors – three aspects which are positively perceived by capital markets. Given these positive effects of a corporate concept, it is not surprising to see that our empirical results highlight that "followers" – companies that try to compete with market leaders – try particularly hard to rework their corporate value proposition in order to catch up (see Figure 3).

Figure 3. Relevance of redefining the corporate concept



Source: Müller-Stewens/Menz/Lochbrunner 2010



For employees, an explicit corporate concept helps to create a common understanding and foster a sense of belonging. Employees will feel more committed to a company whose identity and overall strategic thrust is clear, and helps them to see the connection between their own work and the overall positioning of the company. Many companies have begun to grasp the value of defining an explicit corporate concept. Siemens AG, for example, which to outsiders has been a long-standing example of incomprehensible group diversification, has now started to subscribe to a corporate concept that relies on a one-firm strategy approach. The business portfolio composition is meant to position Siemens among the few companies that are able to carry out big infrastructure projects such as airports or hospitals in a one-stop-shop manner. Other companies have begun to reshape their overarching corporate concepts. Nestlé, for instance, no longer sees itself as only a food company, but defines itself as a nutrition, health and wellness company. This has wide implications for its competitive positioning and future business development.

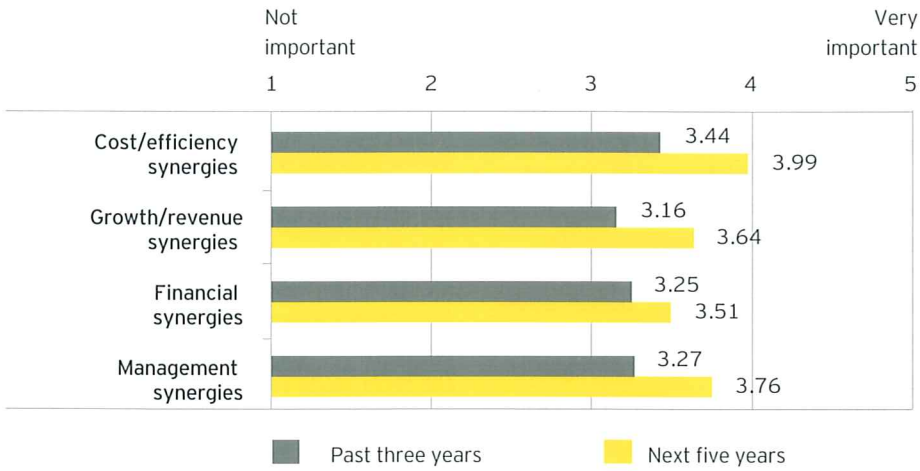
A corporate concept therefore provides a general roadmap for both the configuration of the business portfolio and the degree of coordination between the businesses in the portfolio. Configuration refers to the composition and development of the business portfolio. Coordination refers to the extent to which the different business units of a company are interlinked in terms of resource transfer, sharing and recombination (e.g., joint product development).

In many companies, a business portfolio's composition is not the result of a carefully crafted strategy in line with the corporate concept or the normative frame of the company. Instead, the business portfolio seems to be a product of a historical, partly path-dependent process, or simply the outcome of an opportunistically driven portfolio strategy. Given the prominence and attention given to portfolio development activities such as acquisitions, alliances and divestitures in the investment community, it is further surprising to see that few corporate centers actively manage their portfolios.

Active portfolio management requires that the company composes its business portfolio according to a consistent logic. For instance, this can be to create a balanced portfolio of businesses – some with high cash inflows, and others with high growth prospects initially requiring extensive cash outflows – to invest in businesses which meet certain financial hurdle rates only (i.e., return on investment), or to have a set of different businesses that maximize complementarities between the businesses and corporate center's core capabilities and knowledge reservoirs. Independent of the nature of the business portfolio configuration logic, they assist corporate managers to reduce resource allocation inefficiencies by clarifying the roles and expectations for each individual business unit. Greater role specification and comparability of the different units along the same measures and guidelines also allow for more targeted mergers and acquisition activity.

A firm's corporate concept and configuration of the business portfolio are also closely interrelated with the extent that a corporate center decides to coordinate activities across business units. At the heart of coordination lies the notion of synergy realization. By transferring, sharing and recombining resources across units, a company strives to benefit from economies of scope, scale and learning. Facilitating inter-unit collaboration is thus obviously an important function of corporate centers. However, corporate centers should not only think about horizontal synergy realization between business units, but also aim for vertical synergy realization by using its group-level capabilities to support individual business units. Our survey results suggest that management synergies may be a promising way of realizing such vertical synergies (see Figure 4).

Figure 4. Synergy types and their present and future relevance



Source: Müller-Stewens/Menz/Lochbrunner 2010

Corporate governance: structure, style and systems

The quality and smoothness of corporate strategy execution, to a large extent, hinges on the company's internal corporate governance mechanisms. It is thus a major task of the corporate center to ensure that the company's organizational structures (e.g., the group functions), the style with which group-level management interacts with the business units, as well as the management systems (e.g., corporate planning and controlling systems, incentive systems, IT systems) are well aligned with the corporate strategy and the normative frame of the company. For instance, a corporate center that pursues a one-firm concept, as such, stressing horizontal and vertical collaboration between its business (and relatedness and complementariness in its business portfolio configuration), needs to think carefully about centralizing and de-centralizing its organizational structures. It may decide to establish centralized shared service centers to leverage skills across units, and to generate efficiency gains. It may also want to think about setting up new collaborative organizational structures such as communities of practice that enhance inter-unit knowledge transfer.

Moreover, the corporate center also needs to define its leadership style toward the business units clearly. How much autonomy and guidance should be given to the business units? Within this corporate-business relationship, a mind shift on the part of many corporate centers is often needed; instead of asking what can the business units do for us, corporate centers should ask what they can do for the business units? Again, different corporate concepts and business portfolio logics require different degrees of involvement of the corporate center in the operative activities of the business units. The quality of the company's management systems will determine the need for direct intervention in business unit affairs. For instance, implementing the aforementioned one-firm concept requires that incentive systems shift from rewarding individual business unit performance to account for cross business unit collaborative efforts.

Turning a conglomerate discount into a conglomerate premium will require a tremendous effort by corporate centers. Given the unpredictable nature and moods of capital markets, corporate centers may want to set their sights on a more achievable (and maybe even more desirable) objective: proving they are adding value to their own business units. We hope that the corporate management framework will assist corporate centers in this quest.

The quality and smoothness of corporate strategy execution, to a large extent, hinges on the company's internal corporate governance mechanisms

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