3. Reasons of Diversification (Internal)

Any business firm has a prime objective i.e. profitable growth. This growth can be achieved internally or externally. Internal growth can be achieved either through the process of introducing or developing new products or by expanding or enlarging the capacity of existing products. External growth can be achieved externally by acquisitions of existing business firm.

Diversification of risk

When a company produce single product then the company's profits and cash flows fluctuate widely. This increase the risk of a firm. Diversification reduces the risk of the firm. So a company whose earnings are of different nature. The merger of companies whose earnings are
negatively correlated will bring stability in the earnings of the combined firm. So diversification reduces the risk of the firm.

Growth

This is possible in two ways— external and internal. Mergers and acquisition help company to grow quickly without any gestation period.

Reduction in Tax Liability

Under Income-tax act there is a provision for set off and carry forward of losses. A sick company may not be in a position to earn sufficient profits in future to take advantage of the carry forward position. So a sick company with accumulated losses may like some profitable company to merger with it to take advantage of tax benefits. Even the sick company with accumulated losses may be merged with a profitable company and take advantage of income tax benefits with the approval of Government.

To Increase Market Power and to Kill Competition

Merger help the company to reduce competition in the market. It also help to increase the market power.
Financial synergy

The following are financial synergy available in case of mergers:

➢ Better credit worthiness: This helps the company to purchase the goods on credit, obtain bank loan and raise capital in the market easily.

➢ Reduces the cost of capital: The investors consider big firms as safe and hence they expect lower rate of return for the capital supplied by them. So the cost of capital reduces after the merger.

➢ Increases the debt capacity: After the merger the earnings and cash flows become more stable than before. This increases the capacity of the company to borrow more funds.

➢ Increases the P/E ratio and value per share: The liquidity and marketability of the security increases after the merger. The growth rate as well as earnings of the firm will also increase due to various economies after the merged company. All these factors help the company to enjoy higher P/E in the market.
- Low floatation cost: Small companies have to spend higher percentage of the issued capital as floatation cost when compared to a big firm.

- Rising of capital: After the merger due to increase in the size of the company and better credit worthiness and reputation, the company can easily raise the capital at any time.

Diversification means dividing your investment among a variety of assets. Diversification helps to reduce risk because different investments will rise and fall independent of each other. The combinations of these assets more often than not will cancel out each other's fluctuation, therefore reducing risk.

**Why companies diversify?**

- When the objectives of the firm cannot be accomplished with the present portfolio of the firm.

- Diversification promise more profitability than business expansions.
> When firm's cash reservoirs contain more cash than that required for present expansions.

> When companies have strong and powerful brands that could be transferred to the products of other businesses.

> When diversifying into a closely related business opens new avenues for reducing costs.

> When companies suffer from the "other side of the grass is greener" syndrome..

<table>
<thead>
<tr>
<th>Market</th>
<th>Present</th>
<th>New</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Withdrawal</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Consolidations</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Market Penetration</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Market Development</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Diversification</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Product Development</td>
</tr>
</tbody>
</table>

Diversification can be achieved mainly in two different ways: -

1. Related diversification

Related diversification strategy involves building the company around businesses whose value chains possess competitively valuable strategic fits. Related diversification is preferred for various reasons: -
➢ For transferring skills and capabilities from one business to another.

➢ Gaining control on supplies with respect to quality (tea processor going for own plantation), quantity (auto components manufacturer), or price (printing facility can be cheaper, if in house).

➢ Building on core competencies and technologies (precision engineering company entering into another product market with similar technical requirement).

➢ Spreading risk and resource utilization - example: ITC, Wipro, Tata

➢ Cost savings (a fully integrated business).

➢ Control of markets - companies like LG, Samsung, Liberty (shoes), etc., own retail outlets.

Related diversification is achieved in three possible formats:

➢ Backward integration: backward integration is achieved by a firm by getting into operations involving manufacturing and/or supplies of raw material, components, or processing machineries.
Backward integration also involves a firm getting into logistics operations (transportation) and financing.

- Horizontal integration: for achieving horizontal integration a firm acts on its product offerings by introducing complementary products, competitive products and making better utilization of the by-products.

- Forward integration: firms usually achieve forward integration by extending their control over distribution operations such as company owned showrooms, obtaining better market information, developing in house service and repair operations which may have been outsourced earlier, and logistics (transportation).

One of the best examples of a completely vertically integrated company Indian business scenario is Reliance Petrochemicals. Reliance's petroleum business starts from back end operations of oil exploration, further continuing it with oil refining at the horizontal level and finally distributing the oil through company owned petrol pumps at the forward end.
In foreign context a good example of a related diversification is that of Gillette, which has diversified from its main business of razors and blades to related businesses like toiletries, tooth brushes etc. Various other examples of related diversification are Johnson & Johnson, PepsiCo.

One of the potential threats of related diversification is that failure at any particular stage (backward, horizontal or forward) or in cases of recession or slow down in the industry the entire business is affected and such risk or losses are shared by other business as all are related.

2. Unrelated diversification

Common characteristics of an unrelated businesses diversification are:

1) Unrelated diversification involves NO

a) Common linkage of strategic fit among a diversified firm's lines of business

b) Meaningful value chain interrelationships

2) Corporate strategy approach
a) Venture into "any industry & any business in which we think we can make a profit."

3) Firms pursuing unrelated diversification are referred to as conglomerates.

a) no unifying strategic theme

Some of key advantages of diversifying into unrelated businesses are:

- Business risk is scattered over a set of truly diverse industry: as compared to related businesses, an unrelated business more closely approximates pure diversification of financial and business risks.

- The company's financial resources can be employed to maximum advantage by investing in whatever industries offer best profit prospects. Cash rich companies can buy out distressed businesses at low prices and turn-around those businesses with infusion of cash and its managerial know-how.
Profitability may prove somewhat more stable over the course of economic upswing and downswing in case of a company diversified in unrelated businesses.

In some cases companies can make better utilization of underutilized resources or competencies.

One of the best examples in field of unrelated business diversification in Indian context is ITC. Company from its main business of cigarette has diversified into various other businesses like FMCG (Sun feast, Ashirwad atta, matchboxes and agarbattis), Lifestyle Retailing (Willis life style), Stationeries (expression greeting cards), Hotels, Paper businesses, and Agriculture products.

For the Quarter ended 30th September 2005, company registered a net turnover at Rs. 2183 crores with a robust growth of 22.2% driven by Cigarette sales, ramp up of the Foods business, higher agri exports and improved performance of the Hotels and Paperboards, Paper & Packaging segments. The non-cigarette topline, which now accounts for 44% of the Company’s Net Turnover, grew by 39% during the quarter.
Various other examples of unrelated diversifications are Wipro (IT, FMCG, Illumination), Tata (vehicles, steel, finance, and telecom), Kingfisher (liquor, airlines), and Reliance Industries (chemicals, petroleum, and telecom).

Whether a company is going for related or unrelated business diversification, a company should check the following:

a) The industry attractiveness

b) The cost of entry

c) The competencies required

d) The cross business strategic fit

External Diversification

External diversification occurs when a firm looks outside of its current operations and buys access to new products or markets. Mergers are one common form of external diversification. Mergers occur when two or more firms combine operations to form one corporation, perhaps with a new name. These firms are usually of similar size. One goal of a
merger is to achieve management synergy by creating a stronger management team. This can be achieved in a merger by combining the management teams from the merged firms.

Acquisitions, a second form of external growth, occur when the purchased corporation loses its identity. The acquiring company absorbs it. The acquired company and its assets may be absorbed into an existing business unit or remain intact as an independent subsidiary within the parent company. Acquisitions usually occur when a larger firm purchases a smaller company. Acquisitions are called friendly if the firm being purchased is receptive to the acquisition. (Mergers are usually "friendly.") Unfriendly mergers or hostile takeovers occur when the management of the firm targeted for acquisition resists being purchased.

Diversification in the Context of Growth Strategies

Diversification is a form of growth strategy. Growth strategies involve a significant increase in performance objectives (usually sales or market share) beyond past levels of performance. Many organizations pursue one or more types of growth strategies. One of the primary reasons is the view held by many investors and executives that "bigger is
better." Growth in sales is often used as a measure of performance. Even if profits remain stable or decline, an increase in sales satisfies many people. The assumption is often made that if sales increase, profits will eventually follow.

Rewards for managers are usually greater when a firm is pursuing a growth strategy. Managers are often paid a commission based on sales. The higher the sales level, the larger the compensation received. Recognition and power also accrue to managers of growing companies. They are more frequently invited to speak to professional groups and are more often interviewed and written about by the press than are managers of companies with greater rates of return but slower rates of growth. Thus, growth companies also become better known and may be better able, to attract quality managers.

Growth may also improve the effectiveness of the organization. Larger companies have a number of advantages over smaller firms operating in more limited markets.
Large size or large market share can lead to economies of scale. Marketing or production synergies may result from more efficient use of sales calls, reduced travel time, reduced changeover time, and longer production runs.

Learning and experience curve effects may produce lower costs as the firm gains experience in producing and distributing its product or service. Experience and large size may also lead to improved layout, gains in labor efficiency, redesign of products or production processes, or larger and more qualified staff departments (e.g., marketing research or research and development).

Lower average unit costs may result from a firm's ability to spread administrative expenses and other overhead costs over a larger unit volume. The more capital intensive a business is, the more important its ability to spread costs across a large volume becomes.

Improved linkages with other stages of production can also result from large size. Better links with suppliers may be attained through large orders, which may produce lower costs (quantity discounts), improved
delivery, or custom-made products that would be unaffordable for smaller operations. Links with distribution channels may lower costs by better location of warehouses, more efficient advertising, and shipping efficiencies. The size of the organization relative to its customers or suppliers influences its bargaining power and its ability to influence price and services provided.

Taking advantage of geographic differences is possible for large firms. Especially for multinational firms, differences in wage rates, taxes, energy costs, shipping and freight charges, and trade restrictions influence the costs of business. A large firm can sometimes lower its cost of business by placing multiple plants in locations providing the lowest cost. Smaller firms with only one location must operate within the strengths and weaknesses of its single location.

b. Rival's Business Strategy

Tyre makers MRF Ltd and CEAT Ltd both reported a sharp rise in quarterly net profit, helped by stable raw material prices and increased sales in the replacement market.
MRF reported a 79% jump in net profit to Rs517.5 million and Ceat’s profit rose 63% to Rs192 million on a 9% and 5% rise in sales respectively.

Officials at both companies said sales in the higher margin after-sales markets made up for weaker demand from auto makers. MRF’s secondary market sales rose by 5%, Koshy Verghese, executive vice president, said.

“We had a better product mix suited for after-sales in the wake of a not so buoyant demand from OEMs (original equipment makers),” K.J. Rao chief financial officer at Ceat said.

Auto sales in India nearly slid 2.5% between April and December, with the fall led by two-wheelers and commercial vehicles, hit by interest rates ruling near a six-year high.

Ceat also gained from pre-booking rubber at prices it perceived attractive to hedge against volatility, helping core operating margins rise in the quarter to 8.9% in the quarter from 7.8% a year ago, Rao said.
On Tuesday rival JK Tyre & Industries Ltd said its quarterly net profit more than doubled to Rs217.4 million.

MRF shares ended 0.5% up at Rs4,861.10. Ceat shares have been suspended from trading to effect a spinoff of its investment unit into a separate firm and will resume trading on Friday, Rao said.

When Paras Chowdhary took over as the managing director of CEAT in 2001, he was thrilled to hear Chairman Harsh Goenka's assurance that he would get a free hand in running the company. But the caveat came swiftly: Chowdhary can ask for anything except money for additional investments.

It certainly wasn't music to his ears then, but the tyre industry veteran (Chowdhary was the CEO of Apollo Tyres for 11 out of the 22 years he spent there before joining the RPG Group) says he later understood Goenka's compulsions at that stage. CEAT was for all practical purposes a sick company in 2001.

The Rs 14-crore (Rs 140-million) loss in that year was a lesser evil; what was particularly worrying was that the company was paying Rs 115
crore (Rs 1.15 billion)towards interest and depreciation. For a company with gross sales of just Rs 900 crore (Rs 9 billion), it was bad enough. Worse, both the loss as well as the interest amount were actually much more. Here’s why. CEAT then used to lend money to other group firms and charge interest on it which was considered as income.

But the interest never came and the entire amount had to be ultimately written off.

Analysts estimated the actual loss in 2000-01 at not less than Rs 60 crore (Rs 600 million) and the interest and depreciation at Rs 140 crore (Rs 1.4 billion).

Chowdhary admits CEAT’s identity was blurred at that stage -- was it a tyre company or was it an investment company? "We were postponing our problems to the future. There were too many problems that were not immediately visible on the balance sheet," he says, sitting in his modest second-floor office at the RPG Group headquarters in Worli, Mumbai.
So, in 2001, the problem looked quite complicated: CEAT was over-leveraged, it had no money to spend, no financial institution was willing to support it, and raising money through the equity route was just not possible as the share price at that time was too low.

There was more. No supplier was willing to give material unless the company cleared the dues of over Rs 150 crore (Rs 1.5 billion). And it was getting increasingly difficult to explain to the investing community and the board the reasons for the worsening profit margin vis-a-vis its competitors.

Then there were legacy issues. Both its plants were in Maharashtra -- one in Bhandup, a Mumbai suburb where the cost of operation was very high, and the other at Nasik.

To ship its produce outside the state, the company had to pay huge octroi -- a cost which its competitors who were well spread out weren't incurring. The factories were very old with practically no modernisation efforts. And since it was not a leader in the business, CEAT had to price its products 2 to 3 per cent lower than rivals.
Analysts say CEAT's margins were hence around 5 per cent lower than competition. "In an industry where the profit margin has been traditionally low at 6 to 7 per cent, you had it if your margin is 5 per cent lower than competition," admits Chowdhary. The company's relatively smaller size only added to the problems. Analysts estimated the actual loss in 2000-01 at not less than Rs 60 crore (Rs 600 million) and the interest and depreciation at Rs 140 crore (Rs 1.4 billion).

Chowdhary admits CEAT's identity was blurred at that stage -- was it a tyre company or was it an investment company? "We were postponing our problems to the future. There were too many problems that were not immediately visible on the balance sheet," he says, sitting in his modest second-floor office at the RPG Group headquarters in Worli, Mumbai.

So, in 2001, the problem looked quite complicated: CEAT was over-leveraged, it had no money to spend, no financial institution was willing to support it, and raising money through the equity route was just not possible as the share price at that time was too low.
There was more. No supplier was willing to give material unless the company cleared the dues of over Rs 150 crore (Rs 1.5 billion). And it was getting increasingly difficult to explain to the investing community and the board the reasons for the worsening profit margin vis-à-vis its competitors. Then there were legacy issues. Both its plants were in Maharashtra -- one in Bhandup, a Mumbai suburb where the cost of operation was very high, and the other at Nasik.

To ship its produce outside the state, the company had to pay huge octroi -- a cost which its competitors who were well spread out weren't incurring. The factories were very old with practically no modernisation efforts. And since it was not a leader in the business, CEAT had to price its products 2 to 3 per cent lower than rivals.

Analysts say CEAT's margins were hence around 5 per cent lower than competition. "In an industry where the profit margin has been traditionally low at 6 to 7 per cent, you had it if your margin is 5 per cent lower than competition," admits Chowdhary. The company's relatively smaller size only added to the problems.
The Fight back

Chowdhary had joined the RPG Group in 1997 but was heading the IT and telecom business for a peculiar reason: He had worked for Apollo long enough and didn’t want to work for a rival tyre company. But in 2001, Goenka told him that CEAT ‘was in a difficult spot’ and it would be great if he could take charge.

Chowdhary knew that there were no easy answers to the problems that CEAT faced: He couldn’t change the location of the factories, he didn’t have the power to abolish octroi, he couldn’t change the fact that Mumbai was a high cost city, he didn’t have control over the fact that CEAT was an old company of 1960 vintage and hence carried a lot of baggage, and, most important, he couldn’t find any money to ride out of the crisis.

Despite these handicaps, CEAT’s transformation is an eye-opener. Consider the numbers first. The company’s interest burden in 2008-09 was Rs 91 crore (Rs 910 million) -- less than 4 per cent of its net sales of Rs 2,500 crore. (Rs 25 billion)
In 2001, when he took charge, it was 13 per cent of a relatively smaller base of net sales. Chowdhary is now aiming to bring that number down to 3 per cent, despite higher capital expenditure.

CEAT's operating profit before tax as a percentage of net sales has gone up to 13.5 per cent in the first quarter of 2009-10 from (-) 1.7 per cent in the year-ago period. Compare this with the corresponding figures of market leaders Apollo (12.1 per cent from 6.9 per cent) and JK (from 4 per cent to 6.9 per cent) and one starts getting a sense of the dramatic transformation. Productivity in CEAT's two factories has gone up by nearly 50 per cent since 2001 without much reduction in manpower.

Chowdhary is candid enough to admit that all this has been possible partly due to luck but mostly because of some 'real hard work' put in by his team members to implement a seven-fold turnaround strategy.

The Turnaround

The first part of the strategy of course was to reduce the debt burden and thereby cut the interest payout. CEAT stopped all fresh
investments as it was desperate to clean up its books. Result: CEAT has been repaying Rs 80 crore (Rs 800 million) debt every year. Its total debt, including working capital loans, is now just Rs 398 crore (Rs 3.98 billion).

Two, it decided to get into high-margin segments (90 per cent of its products are now in that category) with a vengeance. That explains Chowdhary's drive to focus on the replacement market where the company's share in its total sales was just 50 per cent. That figure went up to 75 per cent in the first quarter of 2009-10 -- something Chowdhary says was a dream fulfilled. The replacement market is important for tyre manufacturers as the consumers here don't mind paying extra for a quality product.

But the fact is CEAT is the smallest player in radial tyres now with a monthly capacity of just 60,000 tyres against an average 200,000 of a couple of its competitors. To correct this, CEAT is setting up a grassroots radial plant at Halol in Gujarat at an investment of Rs 500 crore or Rs 5 billion (half of that money will come from internal accruals).
The plant, which will start production from August next year three months ahead of schedule, will have a monthly capacity to produce 180,000 tyres, taking its monthly production of radial tyres to 240,000. Three, the company will start another plant at Ambarnath in Maharashtra by 2012, for which it has already been allotted 50 acres of land. Four, it decided to get higher output from the two existing factories without making much investment. It was a difficult strategy to implement, but Chowdhary managed it by signing a long-term wage settlement with workers that was linked to productivity.

A few anxious moments later, the Bhandup plant production went up almost 50 per cent. In the Nasik plant, production went up as much as 70 per cent. "The extent of the productivity increase surprised me. Money is a great motivator and the capacity of human beings to deliver is infinite," Chowdhary says. The workers made sure that plants were open even on Sundays.

Five, the company put its might behind ensuring the quality of the products. Earlier, the quality of its products was acceptable, but not something that would create a customer pull.
This was even more so as CEAT started targeting 20 per cent of its revenues from the export market where profitability was good.

Six, Chowdhary made cost-cutting a religion for CEAT. So things such as better working capital management, manpower rationalisation, reduction of administrative cost, cutting the commissions of the cost & forwarding agents became the new buzzwords.

"For a Rs 2,500-crore company, we were even willing to question practices that could save us just Rs 25,000 annually," Chowdhary says. The cost of manpower will come down further once the Halol plant goes on stream because the salary of an industrial worker in Gujarat is at least 40 per cent lower than his counterpart in Maharashtra where CEAT's two plants are now located.

And seven, Chowdhary's top team resorted to some smart buying of raw materials. For example, it imported 20,000 tonnes of natural buyer valued at Rs 200 crore (Rs 2 billion) in February/March on a staggered shipment basis. That gave it a 20 per cent cost advantage. Throughout the first and second quarter of this financial year, CEAT
consumed natural rubber that was bought at Rs 75-80 at a time when
the ruling market price of the raw material has been hovering around Rs
90-108 for the last three-four months.

Eye on the Future

Chowdhary says CEAT now wants to grow at 20 per cent per
annum against the industry average of 13-14 per cent. And he is hopeful
that the market share, which is at 14 per cent now, will increase to 20
per cent even on an expanded market in five to six years. If that
happens, CEAT hopes to improve its position to become the third largest
tyre company in India from fourth now.

He also expects turnover to hit Rs 5,000 crore (Rs 50 billion) in FY
12 compared to an expected Rs 3,000 crore in this financial year. That's
easily achievable as the Gujarat plant alone is expected to contribute
over Rs 1,000 crore (Rs 10 billion) in 2011-12.

Competitors however are not losing any sleep. Say the chief
executive of a rival tyre company: "CEAT is doing better now, but that's
just not enough." He adds the size of the company is too small compared to MRF, Apollo and even JK.

Besides, CEAT, he says, has lacked a killer instinct and has been traditionally slow in responding to market requirements. The problems of the past are also difficult to correct, he says. Chowdhary is aware of the problems. "It's true all the problems have not been corrected, but we have made good progress," he says. That is reason enough for him to leave office at 6 pm every day as he has put together a capable team that can steer the company even in his absence.

**Conclusion**

Diversification becomes an attractive strategy when a company runs out of profitable growth opportunities in its original business and diversification can be in form of acquisition, internal startup, or joint ventures/strategic partnership.

Sharing of information between units of a large firm allows knowledge gained in one business unit to be applied to problems being experienced in another unit. Especially for companies relying heavily on technology, the reduction of R&D costs and the time needed to develop
new technology may give larger firms an advantage over smaller, more specialized firms. The more similar the activities are among units, the easier the transfer of information becomes.

Tyre makers also benefited from the easing in rubber prices to an average of about Rs95 a kg, compared to Rs100 in the year-ago quarter, helping margins. Raw material, mainly rubber, make up about 70% of the cost of a tyre.