THE DCA ADVISOR

JUNE 2014

Newsletter Spotlight: Product Diversification

- **Reap the Benefits of Diversification**
- **Dell's Diversification Difficulties: *Don't Let Them Happen to Your Business***
- **Diversification on Steroids: AMAZON**
- **2 Critical Traits of a Successful Diversification Plan**

What is Diversification?

The best way to illustrate the concept of a diversification strategy is to show it in relationship to other growth strategies a company may adopt. Igor Ansoff in his Product/ Marketing Matrix (shown to the right) illustrates the 4 general growth strategies businesses employ. Selling a *new* product or service into a *new* market is known as a diversification strategy.

Products

Markets	Current	New
Current	Market Penetration	Product Development
New	Market Development	Diversification

Igor Ansoff's Product/Market Matrix

The Benefits of Diversification

At some point in their development, many companies make the decision to adopt a diversification strategy. Diversifying the products or services that a company offers can benefit a business in two ways: First, it can generate incremental revenue and add several percentage points of organic revenue growth to the business. Second, it can help to mitigate a decline in total revenue when conditions develop that reduce sales of the original products or services. Some companies enjoy both of these benefits as a result of a diversification strategy.

Diversification Difficulites

As common as diversification strategies are, you would think that they would often produce great results for the businesses that adopt them. The reality is just the opposite, though. Several times a year we read stories in the business journals about very well known and previously successful companies that achieve disappointing results through their efforts to diversify their business.

One good example of a diversification strategy yielding disappointing results comes from the computermaker Dell. Dell was the #1 manufacturer of personal computers from 1999 through the mid 2000's. By the mid 2000's, sales growth declined dramatically as more and more users bought laptops as their sole computer. Then came the advent of the iPad tablet, and the sales decline in desktop PCs accelerated.

When it became clear that the decline in growth in the desktop PC market wasn't going to reverse itself, Dell adopted a diversification strategy. They diversified in a number of ways, adding televisions, servers, printers, and tablets to their product lines as well as mall-based retail stores to their distribution channels.[1] Their initial entry to the tablet market was called the Dell Streak. Ever hear of it? Don't feel bad, neither have I!

The Dell Streak, targeted at consumers, was a dismal failure compared to the success of the Apple iPad. Dell's response? Refocus their tablet sales from consumers to another one of their core customer groups, large-company IT organizations. When it was apparent that this strategy wasn't winning in the market, they significantly downplayed the importance of the tablet. Their VP of Commercial Sales Operations was quoted as saying that tablets were not good enough for "real work."[2] Meanwhile,as Dell was distracted trying to make the new products and channels a success, their market share in desktop PCs dropped from first to third.[1]

When are Diversification Strategies Successful?

Ken Favaro, a partner at the consulting firm Strategy& (formerly Booz & Co.), has done extensive research about what he refers to as the strategy of "Adjacencies." His conclusion is that firms that are successful with a diversification strategy usually share 2 traits: The first is that the adjacency improves the value of the original product or service offering to the customer. The second is that the competencies that make the firm successful in their original endeavor are important to success with the new endeavor(3)

Consider the example of diversification at Dell with this insight from Ken Favaro. What made Dell incredibly successful in the desktop PC market was its extraordinarily lean and effective supply chain model. They could deliver a custom configured PC made to an exact user specification in a matter of a few days and at a lower cost than an off-the-shelf model from a retail store. At the height of their success their operating margins were a full 11% higher (absolute) than those of their next closest competitor Hewlett Packard.[1]

Let's apply Ken Favaro's two success criteria to the Dell experience with diversification into tablets. Is a customer for a desktop PC more likely to buy from Dell because they also offer tablets? Probably not. Are the things that made Dell hugely successful in desktop PC sales important to tablet customers? Tablet customers generally value a sleek form factor, an easy-to-use hardware and operating system, the breadth of applications that run on the device, and the "coolness factor." Does Dell invoke images of any of those purchase criteria? Probably not.

Diversification on Steroids

amazon

Many people forget that Amazon actually started life as "just" an online bookseller. Shortly after their launch in the US in 1995, they added Internet book sales channels in the UK and Germany (called a "Market Development" strategy in the Ansoff Product/Market growth matrix). They then diversified their product offering to include music CDs and movies in videotape and DVD format. They then added various categories of electronic devices and began experimenting with the sale of specialty clothing, tools, and other home improvement items. Most recently they have moved into Internet-based sales and same day delivery of groceries after testing this concept in the Seattle area for more than a year.[4]

Do all of these diversification moves meet the two criteria identified by Ken Favaro? In many cases when individuals shop on Amazon, they are looking to buy multiple products. Their ever-expanding list of product offerings has increased the likelihood of consumers shopping there over time. ✓ Do the things that made Amazon a successful online bookseller help them to be a great online seller of CD's and DVD's? ✓ Consumer electronics? ✓ Groceries? My jury is still out on this last one, but time will tell. My inside sources tell me that Amazon learned from the failure of Webvan and their competitors in the early 2000's as well as from their own pilot in the Seattle area. Personally, I wouldn't want to bet against Amazon on this one.

A Personal Experience With Diversification

Early in my career I was VP of Operations for what was at the time the largest manufacturer of computer touchscreens. These are the computer input devices that today are used on almost every cell phone and tablet computer. Our company was the technology leader for this input device. We had invented the technology and advanced the state-of-the art technology every few years. We had world-class engineers and an exceptional manufacturing facility. Our products were the highest quality, best performing, and longest lasting that the industry had to offer. Our average touchscreen and electronic controller sold for approximately $200 each.

The year before I joined the company, the leaders had decided to diversify downstream in the value chain and started to produce and sell computer displays with touchscreens already incorporated. Called touchmonitors, this new product drove a dramatic increase in revenue growth as we in many instances replaced the sale of a $200 touchscreen with the sale of a $500 - $700 touchmonitor.

We loved our organic revenue growth rate that increased by more than 50% as a result of this diversification strategy. Midway through my tenure our sales of touchmonitors came to be significant. To better manage our growing business, we decided to change our organization design from a functional to a product line structure. I was chosen to be the first GM of our touchscreen business, my first job as a GM.

One of the first tasks in the months after we made the organizational change was to create product line P&L's, one for our touchscreen business and the other for our touchmonitor business. After a month of arguing about how to allocate sales, marketing, R&D, and G&A expenses between the two product lines, we finally had 2 separate P&L's. We quickly learned two things:

1. Our touchmonitor business was driving about 75% of our organic revenue growth

2. Our touchmonitor business was operating at close to break-even profitability

The implication was clear. As our touchmonitor revenues continued to grow, we would see our profitability at the company level decline sharply. We had already seen hints of this, but the impact had been small as our touchmonitor revenue was still a small fraction of total revenue.

What went wrong with our diversification strategy? Some of our customers valued the fact that we now offered both touchscreens as well as touchmonitors, so we got that part right. Unfortunately, the things that made us the world leader in touchscreens didn't help us to be the most successful supplier of touchmonitors. It turns out that many touchmonitor suppliers operated out of their garages (literally) and had no engineering staff. They purchased monitors at only a slightly higher price than we got, but their labor and overhead costs were dramatically lower than ours were. We built our touchmonitors in our state-of-the-art factory, using highly paid technicians and hired a dedicated engineering staff to test, agency certify, and eventually design our own custom line of monitors. Trouble was, customers would only pay a small premium for our monitors as compared to those provided by our garage shop competitors.

What did we do? We realized that we couldn't continue to operate the same way in the future. We changed our organization back to a functional design, outsourced most of our touchmonitor manufacturing to our Asian monitor suppliers, and took other dramatic actions to reduce our touchmonitor costs. We didn't abandon that diversification strategy altogether, but we substantially changed how we implemented it.

Key Takeaways

Diversification can be a successful part of a business strategy, but it can have very negative consequences if done incorrectly. Here are the three main points of this month's newsletter:

1. A diversification strategy is most successful if customers find you more appealing to do business with as a result of the diversification. You also should look for opportunities where the factors that have made you successful in your current activities are important success factors in the diversified business.

2. Recognize ahead of time that the new product or service can have a very different level of profitability than the current products or services have. Try to figure this out ahead of time, and if this is not feasible, at least monitor your profitability closely after the launch of the new product or service.

3. Finally, don't allow your infatuation with the new product to cause you to "take your eye off of the ball" of your current products.

A Strategy for Your Business

FOCUSED EXECUTION
DCA ADVISORS

The DCA Advisors Focused Execution Service is designed to help you select the best strategy for your business, think through the implementation details, execute the strategy, and achieve the business results you deserve. If a diversification strategy makes sense for your business, we'll help you ensure that the new products or services are a good fit for the capabilities on which your company was built. Contact us today to find out how Focused Execution can benefit your business.

Citations

(1) Wikipedia contributors. "Dell." *Wikipedia. The Free Encyclopedia,* June 2, 2014.

(2) Spoonauer, Mark. "*Dell VP: Tablets Not Good Enough For 'Real Work'*", http://blog.laptopmag.com/future-of-dell, January 22, 2014.

(3) Favaro, Ken. "How IKEA, Disney, and Berkshire Hathaway Succeed with Adjacencies", www.strategy-business.com, March 11, 2014.

(4) Wikipedia contributors. "Amazon.com." *Wikipedia, The Free Encyclopedia*, June 6, 2014.

Allen Pierce
Managing Director

p: 916.960.0629 **m:** 510.501.6675
email: apierce@dcaadvisors.com
site: www.dcapartners.com

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