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Expansion Options for Safeguard Fire Security
Acquisitions, Mergers, or Product Diversification as an Alternative?

By

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TO WHOM IT MAY CONCERN

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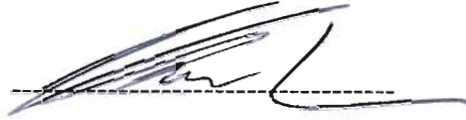
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Declaration

This research has not been previously accepted for any degree and is not being currently submitted in candidature for any degree.

Signed

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Date

15.9.2003

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I would like to thank my wife Lillian and my two children Mieke and Julius for their continuous support, as well as my supervisor Professor Elza Thomson, my father-in-law Julius Moolman, and my good friend Sally Hines for the many hours spent on reviewing this text.

Abstract

The purpose of this research is to provide the members of Safeguard Fire Security with the knowledge and tools to make an informed decision as to whether the business should be enlarged by extension into new geographical areas through acquisitions and mergers, or by diversification into other product-markets. In order to optimise the company's growth objectives, strategic decisions must be made and the reasons why firms diversify or expand is discussed. Different types of diversification strategies are contemplated and considered. It is noted that expansion offers a strong transfer of technology and or marketing competence, while in diversification novel products are acquired and previously unexplored markets are entered. Since diversification is costly and risky, attention is given to the question of whether the firm can solve its problems without diversifying (internal assessment). The discussion on the internal assessment of the firm is done through an 'internal assessment diagram' that steers the assessment through several steps.

In order to analyse the product-market opportunities that are available to the firm outside its present scope and thus produce the final decision whether the firm should diversify, an external appraisal of the firm is done. The analysis is done through an 'external assessment diagram' that puts the firm in the position to make a diversification decision. The firm can now make a choice to pursue expansion, diversification, or both. The particular course of action chosen and its timing depends on the risk philosophy of the firm's management. After the firm has applied the procedure for developing product-market alternatives the stage is set for a major decision point at which the firm commits itself to a particular product-market scope and growth vector.

Instead of seeking remedies in operational improvements (such as cost reduction, new managers or reorganising of the company), the members of Safeguard Fire Security decided to revamp the entire product-market position. It is pointed out that more diversification and expansion options should have been considered and several recommendations are made with the aim of guiding the members in their new venture. It was concluded that the product diversification opportunity to manufacture fire appliance equipment for the fire industry was attractive enough to sacrifice expansion moves and even to relinquish some parts of the firm's present business.

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CHAPTER 1

Introduction

'... The strategic aim of a business is to earn a return on capital, and if in any particular case the return in the long run is not satisfactory, then the deficiency should be corrected or the activity abandoned for a more favourable one.'

Alfred P. Sloan Jr

1.1 Introduction

This chapter commences by giving a brief background of the company Safeguard Fire Security. The members of the company will be introduced as well as the current situation the company finds itself in. Growth opportunities through expansion and different diversification methods will be considered.

The motivation for this research is the current saturation of the market in KwaZulu-Natal as well as the potential and lucrative benefits it might hold for the company to expand in other provinces or different product-markets. The value of the study lies in the fact that an informed decision will be able to be made as to whether the business should be enlarged by extension into new geographical areas through acquisitions and mergers or by diversification into other product-markets. It will be postulated that the client base of the company will be broadened due to a bigger share of the market and that a competitive advantage will be gained by economies of scale and through the marketing of other product lines.

The problem statement comprising of methods of expansion and product diversification will be followed by the objectives of the study. The chapter will further explain that the research methodology is qualitative in nature and will conclude by mentioning the limitations of the project.

1.2 Background of the research

Safeguard Fire Security (PMB) cc is a security company that specialises in safety services and more particularly in the design and maintenance of fire suppression systems, fire detection and alarm systems as well as the sale and service of general fire equipment for both marine and land use in KwaZulu-Natal. The company was registered as a closed corporation in 1992 and is one of the oldest fire companies in the province. The company is in possession of all relevant accreditations and certifications to undertake specialised work on international ocean-going vessels as well as on land. The leased workshop and offices are situated in Livingstone Road, Pinetown, Durban.

The company has four members, namely Marnus van der Westhuizen, Neville de Swardt, Glennis Davidson and Mahommed Kader. All of the members have had extensive experience in the sale and servicing of fire equipment as well as the design, installation and maintenance of fixed fire suppression systems. All members are actively involved in the day-to-day running of the company and duties include managing the servicing team, customer liaisons and the active ongoing marketing of the company.

Since the registration of the company in 1992 no work or contracts have been carried out outside the province of KwaZulu-Natal and since the mid-1990s the turnover has decreased dramatically. The focus of this study is thus to explore expansion and diversification options for the company in order to either establish a company presence in major industrial areas in other provinces or to diversify into other product-markets.

The main strategic growth alternatives are limited growth and substantive growth. Limited growth strategies can be divided into market penetration, market development, and product development. Market penetration and product and market development in a single business concept are shown as limited growth strategies as they mainly affect competitive strategies rather than imply major corporate change. Invariably these strategies involve innovation (Lynch, 2000).

The members of Safeguard Fire Security will concentrate on substantive growth strategies that are divided into horizontal integration, related diversification, vertical integration, and unrelated diversification. These strategies imply a more ambitious and higher risk expansion, which is likely to alter the corporate perspective because these growth strategies are frequently implemented through acquisitions and mergers (Lynch, 2000).

External growth can involve the purchase of, or an arrangement with, firms that are behind or ahead of a business in the added value channel, which spans raw material to ultimate consumption. Similarly, it can involve firms or activities that are indirectly related businesses or industries. The key objectives are additional market share and the search for opportunities that can create synergy. The outcome from this will be larger size and hopefully increased power, and ideally, improved profitability.

Horizontal integration occurs when a firm acquires or merges with a major competitor, or at least another firm that operates on the same level in the added value chain. The two organisations may well appeal to different market segments rather than competing directly. Market share will increase, and pooled skills and capabilities should generate synergy. Horizontal integration is therefore concerned with issues of critical mass, which are discussed in Chapter 2 (Marren, 1993).

Vertical integration is the term used to describe the acquisition of a company that supplies a firm with inputs of raw materials or components, or serves as a customer for the firm's product or services. When a fire company like Safeguard Fire Security acquires a fire appliance manufacturer, this will be known as backward vertical integration. This type of integration aims to secure supplies at lower cost than competitors, but after the merger or acquisition it becomes crucial to keep pace with technological developments and innovation on the supply side, or competitive advantage may be lost (Marren, 1993).

If a fire appliance manufacturer were to buy Safeguard Fire Security, it would constitute forward vertical integration. This type of integration secures customers or outlets, guarantees product preference and gives a firm much greater control over its total marketing effort. Firms will reduce the extent to which they are vertically integrated if they fail to obtain the appropriate benefits and synergy from the fusion of two sets of skills and capabilities (Marren, 1993).

Any form of diversification involves a departure from existing products and markets. The new products or services involved may relate to existing products or services through either technology or marketing and where this is the case, the diversification is known as related (or concentric) diversification. An example of this would be a specialist manufacturer of ski clothing who diversifies into summer leisurewear to offset seasonal sales. Potential consumers may or may not be the same; distribution may or may not change; but the existing production expertise should prove beneficial. Any organisation seeking concentric diversification will look for companies or opportunities where there are clearly related products, markets, distribution channels, technologies or resource requirements. The related benefits should be clear and genuinely capable of generating synergy (Gaughan, 1996).

If Safeguard Fire Security were to venture into conglomerate or unrelated diversification there would be no discernible relationship between existing and new products, services and markets. The diversification, however, is justified as a promising investment opportunity. The strategy is regarded as high-risk because the new technologies, new skills and new markets involved constitute unknowns and uncertainties. Because the change is uncertain and challenging, it may be tempting to switch resources and efforts away from existing business and areas of strength, and this compounds the element of risk involved (Gaughan, 1996).

Conglomerate diversification is often linked to portfolio analysis, and sometimes the search for businesses that might remedy any perceived strategic weaknesses. If Safeguard Fire Security had reserves of cash to invest, it might

seek to buy businesses with growth potential in new industries. Acquisitive and financially orientated companies diversify in this way with a view to rationalise the businesses that they buy. Parts can be retained if the company feels that it can add value and benefit accordingly; other parts can be divested (Gaughan, 1996).

The critical issue for the company should be the opportunity cost of the money involved. In other words the long-term return on capital employed should exceed alternative uses for the money. The real issue regarding unrelated diversification is whether strategic leadership can deliver value for all key stakeholders.

One of the most important reasons to expand through acquisitions is the particular asset of the company that is bought. Patents, core competencies, brands, market share or special technologies may be the motivation that leads to acquisitions. When buying a company with valuable assets, a disadvantage could be that a substantial premium would have to be paid for the company. Besides the asset that is being bought, an acquisition may also be made for competitive reasons (Galpin, 2000).

There are four principle questions to address in reaching an informed judgement on a possible acquisition venture:

1. Cost: what will the acquisition cost?
2. Market value: what is the fair market value of the target?
3. Return: what is the target worth to the prospective buyer or what is the maximum price that the acquirer can pay and still achieve the desired rate of return on its investment?
4. Risk: what is the probability of achieving the expected return? (Galpin and Herndon, 2000)

In the sense of two companies combining, mergers are similar to acquisitions. This option would normally be considered when neither of the two companies is able to acquire the other one on its own. The potential benefit of a merger is that it could be seen as a more friendly action than an acquisition. In other

aspects it is similar to an acquisition in terms of the main strategy issues (Lynch, 2000).

1.3 Motivation for the research

Competition in this industry is segmented between land and marine work. Due to fierce competition on the land side in KwaZulu-Natal, Safeguard Fire Security has reached a stage where its market has become saturated. The company is in direct competition with five other companies on the marine side in KwaZulu-Natal. The scope for growth in this province on the marine side is reasonably good as the competition is limited. A further reason for limited competition on the marine side is the accreditation (and cost of it) that fire companies must have in order to work on international marine vessels. Although there are various accreditations that a company could have, Safeguard Fire Security is in possession of the most relevant accreditations and certifications.

Competition on the land side is ferocious. Land work needs a different approach and prices are more often than not cheaper than on the marine side because of the nature of the competition. The potential, however, of land work is far greater than that of marine work because there are far more customers and relationships are more long lasting between the customer and the company. Dealing with shipowners or agents can be tiresome and difficult as a result of language barriers and different safety standards and national regulations.

By law and for insurance purposes every company is compelled to have hand-held fire equipment and hose reels. It is also required by law that this fire equipment has to be serviced at least once a year by an accredited fire company in possession of at least the SABS (South African Bureau of Standards) and SAQCC (South African Qualifying Council Committee) certification. With the new OSHACT and stringent ISO 9001 requirements, companies are even more pressurised to maintain and service their fire equipment to specified standards.

Thus, motivation for this research in strategic expansion options is the saturation of the market on the land side in KwaZulu-Natal as well as the potential and lucrative benefits it might hold for the company to expand to other provinces or into different product-markets. A further motivation is the fact that every company is required by law to have fire protection on their premises.

1.4 Value of the project

This study will serve as a basis for the company to make a decision between extending the business into new geographical areas through acquisitions and mergers, or extending the business through diversification into other product-markets. It will broaden the client base of the company through bigger market share and size and create competitive advantage through economies of scale and other product lines.

1.5 Problem statement

What strategic option(s) is the company going to implement and how is it going to implement it in order to either expand its operations throughout South Africa or to diversify into another product-market?

1.6 Objectives of the study

The desired end result of this study is to enable the company to make an informed choice between a structured and systematic process of company expansion on the one hand and product diversification on the other. This will be done through exploring different environment-based expansion options, which the company and its members can implement in order to establish a presence in major industrial areas in South Africa.

The study will also evaluate the different means of expansion and product-market diversification in order to select the most appropriate method to be implemented by the company and its members to achieve such expansion or product-market diversification. Evaluation of the strategic options will be done through scenario settings and the identification of the advantages and disadvantages of each expansion and diversification option.

Through evaluation of the different expansion and diversification options this study will determine the best possible option to implement in order to achieve the desired outcome of a company with a presence in other provinces or in a new product-market.

1.7 Research methodology

The methodology of this study is qualitative of nature and the work is both descriptive and analytical. The conceptual framework for this study is the examination of the organisation presented as a case study of a larger phenomenon. The study illuminates a wider set of issues and/or theories that require a wider debate. The research design and method flows logically from the central research questions and the conceptual framework surrounding those questions.

1.8 Limitations of the project

This research only includes acquisition and diversification strategies as expansion options. It does not consider expansion options such as franchising, mergers, licensing and joint ventures. It further does not divulge any strategic financial information about Safeguard Fire Security except for general financial information.

1.9 Summary

In this chapter the reader has become acquainted with the company Safeguard Fire Security, its members, and a brief introduction as to when it was established. It has also been stated that as a result of the dramatic decrease in turnover the members decided that an in-depth study be undertaken regarding ways and means of diversifying into other products, or expanding the company by means of acquisition.

Different growth strategies were introduced and it was emphasised that the company's main objective was to concentrate on strategies that would result in substantial growth. These strategies included diversification alternatives which, it was realised, were more ambitious and risky because they would

entail a departure from the company's existing products and markets. Varying means of diversification strategies were presented and discussed. The strategy of expansion was expounded and the reasons for a firm adopting such a strategy were elaborated on. The fact that acquisitions could be a competitive strategy was mentioned, as were several important questions, which the company had to address if an informed decision was to be arrived at.

The motivation for this research was stated to be the saturation of the market on the land side in KwaZulu-Natal, the potentially lucrative benefits the research might hold for the company, as well as the fact that every company was required by law to have fire protection on their premises. The anticipated value of the project was that the members would, on the basis of the research, be in a position where they could arrive at an informed conclusion regarding the available strategic expansion options. The problem statement and objectives of the study are also discussed and the expansion mission of the company reiterated. The chapter further explains that the research methodology is qualitative in nature and concludes by stating the limitations of the project.

CHAPTER 2

Strategy in Context

2.1 Introduction

This chapter will outline the theory that any given firm should follow in order to make strategic decisions that will lead to orderly and profitable growth. In order to optimise the achievement of the objectives of any given firm, different types of decisions need to be made. The decision, which this chapter will mainly be concerned with, will be strategic in nature and will discuss questions such as what business the firm is in and what kind of business it should seek to enter. Although strategic decisions appear to be deceptively simple, it will be pointed out that they deserve careful consideration. A checklist for the development of strategic decisions will guide the firm to achieve change.

Firms can broaden their product-market for many reasons. It may well be a trigger signal such as market saturation or obsolescence of a product. Consideration will be given to two types of market expansion, namely diversification and expansion strategies. The underlying reasons why firms would want to diversify as well as the different types of diversification strategies will be discussed and considered.

This chapter will illustrate that expansion offers strong transfer of technology and or marketing competence, whilst in diversification novel products are acquired and previously unexplored markets are entered. Therefore, given the two opportunities, synergy will be higher in expansion than in diversification. Since diversification is costly and risky, attention will be given to the question of whether the firm can solve its problems without diversifying (internal assessment). The discussion on the internal assessment of the firm will be done through an 'internal assessment diagram' that will steer the assessment through several steps.

In order to analyse the product-market opportunities that are available to the firm outside its present scope and thus produce the final decision whether the firm should diversify, an external appraisal of the firm will be done. The analysis will be done through an 'external assessment diagram' that will eventually put the firm in the position to make a diversification decision. A choice will have to be made by the firm to pursue expansion, diversification, or both. The particular course of action chosen and its timing will depend on the risk philosophy of the firm's management.

Synergy and structure of the firm's organisation are dependent on each other. Whether synergy will follow structure or vice-versa is a major management decision. This decision must be made at this point rather than delayed until an actual acquisition is at hand because it affects strategy and hence the search for, and evaluation of, opportunities. The 'synergy structure decision diagram' will illustrate the effect of synergy on strategy and will result in a consolidated list of industries ranked on each of the major objectives.

After the firm has applied the procedure for developing product-market alternatives the stage will be set for a major decision point at which the firm commits itself to a particular product-market scope and growth vector. A helpful feature of strategy formulation is the process of narrowing the field of alternatives, which reduces the final list of portfolio scopes to a small number and sometimes even to a single acceptable alternative. It would be to the firm's advantage to identify opportunities within the scope, which offer a definite competitive advantage. Although some straightforward steps can be taken to select the competitive advantage, really successful results require uncommon skills in anticipating trends in markets and technology.

The decision whether the firm should make or buy new product-markets must be made before strategy can be implemented. Two primary variables influence the choice between the major alternatives, namely the start-up cost and the timing. The pros and cons of acquisitions versus internal development can be related to the components of synergy as shown in an 'internal development versus acquisition table'.

2.2 The decision-making process

Managers have to make numerous decisions on a daily basis. On a single day a manager might be called upon to decide on a future course of the firm's business, to reconcile an organisational conflict between two executives, and to resolve a host of day-to-day operating problems.

From a decision viewpoint the overall problem of the firm is to direct the conversion process in such a way as to optimise the achievement of the objectives. This calls for many different decisions. The decision process can be divided into strategic, administrative and operating decisions. Strategic decisions are primarily concerned with external, rather than internal, problems of the firm and specifically with selection of the product-mix which the firm will produce and the markets to which it will sell. Strategic decisions are concerned with what business the firm is in and what kinds of business it will seek to enter. Questions addressed in the strategic problem are: what are the firm's objectives and goals; should the firm seek to diversify, in what areas, how vigorously; and how should the firm develop and exploit its present product-market position (Galpin and Herndon, 2000)?

A very important feature of the overall business decision process becomes accentuated in the strategic problem. This is due to the fact that a large majority of decisions must be made within the framework of a limited total resource. Strategic decisions deal with a choice of resource commitments: emphasis on current business will hinder diversification; and over-emphasis on diversification will lead to neglect of present products. The objective is to produce a resource-allocation pattern, which will offer the best potential for meeting the firms objectives (Galpin and Herndon, 2000).

Operating decisions consume the bulk of the company's energy. The aim is to maximise the firm's profitability from current operations. The key decisions here involve pricing, marketing strategy, setting production schedules and

inventory levels, and deciding on relative expenditures in support of research and development (Galpin and Herndon, 2000).

An administrative decision concerns the structuring of the firm's resources in such a way as to create maximum performance potential. This involves structuring of authority and responsibility, work flows, distribution channels and location of facilities. It is also concerned with acquisition and development of resources, for example, the development of raw material sources, personnel training and development and acquisition of facilities and equipment (Galpin and Herndon, 2000).

Unless actively pursued, strategic decisions may remain hidden behind the operations problems. Generally firms are very slow in recognising conditions under which concern with the operating problem must give way to a concern with the strategic. And usually when such conditions occur, operating problems neither cease nor slacken. On the contrary, they appear to intensify. The last promotional campaign has failed to increase sales. Could the advertising approach be wrong? The last cost reduction effort has failed to bring cost in line with prices. Have we taken the proper approach towards increased efficiency? Competition has cut prices to a point below our costs. Should we meet them and go into the red, or should we hold the line (Galpin and Herndon, 2000)?

The immediate demand on management time and effort raised by these operating problems can readily obscure the fact that the basic ills lie not in the firm but in its environment. Even when a continuous downward trend in profitability or obvious signs of market saturation points to the need to revamp the entire product-market position, a natural tendency is to seek remedies in operational improvements such as cost reduction, consolidation, a new advertising manager and even re-organisation of the company. And yet the main problem facing the company might be the decline in the demand for the firm's products.

Because strategic problems are harder to pinpoint they need special attention. Unless specific provisions are made for addressing strategy, the firm might misplace its efforts in pursuit of operational efficiency at times when attention to strategic opportunities or threats can produce a more radical and immediate improvement in the firm's performance. Two kinds of provisions are required. One is to provide an administrative environment in which a proper balance of management attention can be maintained. The other is to provide management with a method of analysis, which is focused on the search for strategic decision needs, and opportunities (Burkhart and Reuss, 1993).

2.3 A model for strategic decisions

The end product for a strategic decision is deceptively simple: a combination of products and markets is selected for the firm through the addition of new product-markets, divestment of some old ones, and expansion of the present position. The change from the previous posture requires a redistribution of the firm's resources, a pattern of divestment and investments in company acquisitions, product development, marketing outlets, advertising, etc.

A checklist in the development of a strategic decision methodology can be constructed as follows:

1. Perception of decision need or opportunity: This is a major issue in strategic decision-making. A method which fails to provide for the choice between continuing concern with the operating problem as opposed to attention to the strategic, leaves a key part of the problem to intuition and judgement.
2. Formulation of alternative courses of action: In a strategic problem it is a rare situation that all of the alternatives are known at decision time. Only a few of the alternatives are normally known at the beginning of the planning period. Usually these will include the firm's traditional product-markets, current research and development projects, and perhaps some names of firms that are interested in mergers. Other alternatives will present themselves throughout the planning period: new market opportunities, firms available for acquisition and joint venture opportunities. Under these conditions of partial ignorance a firm is

confronted with two problems. The first is how to conduct an active search for attractive opportunities. The second is to allocate the firm's limited resources among the opportunities which have been uncovered and the possibly more attractive ones which are just around the corner. This is the classic 'bird in hand versus two in the bush' dilemma which is common to many decision situations in practice.

3. Project evaluation: Long term profitability over the lifetime of the project cannot be the only yardstick for evaluation. Efforts to apply such a single yardstick to the strategic problem run into theoretical as well as practical difficulties. Profit is not the sole objective of a company but rather one of a vector of objectives, only one of whose components is profit. Such a vector is usually composed of conflicting objectives: when the firm's performance is optimised on one, it is degraded on others. For example, if one of the objectives is a high degree of worker satisfaction, this can usually only be attained at the expense of profit to the stockholders.
4. Choice of one or more alternatives for implementation.
5. The ability to handle the allocation of the firm's resources between opportunities at hand and probable future opportunities under conditions of partial ignorance.
6. Evaluate synergy resulting from addition of new product-markets to the firm.
7. Single out opportunities with outstanding competitive advantages.
8. Handle a vector of potentially antagonistic objectives.
9. Evaluate the long-term potential of projects even though cash flow projections are unreliable (Burkhart and Reuss, 1993).

2.4 Concept of strategy

Every firm needs a well-defined scope and growth direction which acquires additional decision rules if the firm is to have orderly and profitable growth. Such decision rules and guidelines can broadly be defined as strategy (Whittington, 2001).

Objectives set the performance levels that the firm seeks to achieve, but they do not describe the business of the firm unless statements are constructed to

provide the description. A definite description of the firm's role in the environment is a requisite for growth and success. Such description should encompass a great scope of natural extensions of the firm's product-market position, derived from some core characteristics of the present business (Whittington, 2001).

Thus, railways would find themselves in the 'transportation business' and petroleum companies in the 'energy business'. Does it then follow from this concept that railways should be in the long-haul trucking industry? The answer would seem to be yes. But what about the taxi or rental car business? These are also transportation industries, but at first glance would seem to have little in common with railways. It is hard to see where the skills, facilities and experience of railway companies have anything to contribute to the latter areas. Consider the energy business for petroleum companies. Does it follow that they should diversify into fabrication of uranium fuel for atomic plants, build the plants or retail electricity? The respective management, technical, production and marketing skills are all different. Where is the common core capability?

The weakness with concepts such as 'transportation business' or 'energy business' is that they are too broad and do not provide what is called a 'common thread' – a relationship between present and future product-markets which would enable outsiders to perceive where the firm is heading, and enable the inside management to give it guidance.

In seeking to answer these questions it is useful to review how firms usually identify the nature of their business. Some firms are identified by the nature of their product line. Thus there are 'transistor companies', 'machine tool companies' and 'fire companies'. Others are described by the technology which underlies the product line, such as 'steel companies', 'aluminium companies', and 'glass companies'. Each may sell a range of different products to different users, but a manufacturing and/or engineering technology provide a common thread.

Firms are also described in terms of their markets. Here it is useful to make a distinction between customers and missions. A mission is an existing product need; a customer is the actual buyer of the product. The usefulness of this distinction lies in the fact that sometimes the customer is incorrectly identified as the common thread of a firm's business. In reality a given customer will frequently have a range of unrelated product missions or needs. He would not always satisfy them through the same purchasing channels, nor use the same approach to buying. Thus, the individual consumer fills his food needs at the supermarket and his entertainment needs at a television dealer. Since the product technology, the distribution channels, and the customer motivation are different, no strong common thread is available to a firm which would attempt to sell both food and television sets (Whittington, 2001).

In selecting a useful range of missions of a particular customer, a firm needs to find a common thread either in product characteristics, technology, or similarity of needs (Manning, 2001). Thus agricultural machinery firms supply a range of needs to the farmer. All of these are related parts of his overall mission of tilling and harvesting the soil. Similarly, a home appliance manufacturer offers effort-saving products for the home, which may range from washing machines to electric irons.

To the extent that the respective objectives and goals are consistent with actual performance, they do provide an indirect description of a common thread. Thus, a firm that has shown a consistent rate of high growth is usually recognised by the investment community as a 'growth firm', and a well diversified one as a 'broadly-based' firm. Management as guidance in selecting new product-market areas can constructively use both of these descriptions. However, this guidance is very weak and assures no common thread in the firm. Thus, a 'growth' firm might simultaneously be in pharmaceuticals, banking and industrial controls-areas, which have no relationships to one another, except that they all may have attractive growth prospects (Manning, 2001).

A useful specification of the common thread is through the means of the growth vector, which indicates the direction in which the firm is moving with respect to its current product-market posture. Market penetration denotes a growth direction through the increase of market share for the present product-markets. In market development new missions are sought for the firm's products. Product development creates new products to replace current ones. Finally, diversification is distinctive due to the fact that both products and missions are new to the firm. The common thread is clearly indicated, in the first three alternatives, to be either the marketing skills or product technology or both. In diversification the common thread is less apparent and is certainly weaker (Manning, 2001).

2.5 Is strategy necessary?

To define strategy is not to prove that it is necessary for each firm. The question of the usefulness of strategy as a management tool must, therefore, be examined. This will be done by firstly examining the alternative to strategy. This alternative is to have no rules beyond the simple decision to look for profitable prospects. Under these conditions the firm does not select formal objectives, performs no appraisals, and formulates no search and evaluation rules. Instead, it would inform the business world of its interest in 'good' profitable opportunities; it would evaluate each new opportunity on the merits of its individual profitability (Whittington, 2001).

Several reasons can be given in favour of this approach:

1. The firm would save the time, money, and executive talent, which are required for thorough strategic analyses.
2. The field of potential opportunities will be in no way restricted. Objectives and strategy limit the field of its search. Since strategy is based on uncertain and incomplete knowledge, there is a chance that some attractive opportunities will be missed. An opportunistic firm takes no such chances.
3. The firm reaps the full advantage of the 'delay principle'. By delaying commitment until an opportunity is at hand, it is able to act on the basis of the best possible information (Whittington, 2001).

Counterpoised to these are some weighty disadvantages:

1. In the absence of strategy, there are no rules to guide the search for new opportunities, both inside and outside the firm. Internally, the research and development department has no guidelines for its contribution to diversification. The external acquisition department similarly lacks focus. Thus the firm as a whole either passively waits for opportunities, or pursues a 'buck-shot' search technique.
2. Project decisions will be of poorer quality than those of firms with a strategy. Without a focus for its efforts, the staff will lack the depth of knowledge in any particular area needed for competent analysis. Without strategy criteria, it will lack tools for recognising outstanding opportunities. As a result, managers acting on such results will be forced into extreme forms of behaviour. Conservatives will refuse to take reasonable risks; entrepreneurs will take the plunge without appreciation of potential costs or dangers.
3. No yardstick will be available to judge whether a particular opportunity is a rare one, or whether much better ones are likely to develop in the future. Thus there will be a danger of either premature over-commitment of resources or of failure to fully utilise the resources available within a budget period.
4. Without the benefit of a periodic assessment, the firm would have no assurance that its overall resource allocation pattern is efficient and that some product lines are obsolete.
5. The firm will lack an internal ability to anticipate change. Without strategy, managers will either do nothing or risk the danger of acting at cross-purposes (Whittington, 2001).

It would seem that for most firms the advantages of strategy would outweigh those of total flexibility. However, strategy requirements will differ from one type of firm to another.

2.6 Why diversify?

A firm's concern with the strategic problem is not automatic and in the absence of a trigger signal, most managers will focus their attention on administrative and operating decisions. Attention to strategy is either assured on a continual basis through special organisational arrangements, or it remains dormant until triggered through a traumatic experience, such as a drastic drop in sales or earnings, a product breakthrough by competition or continued failure to meet profit objectives. The unfortunate fact about this route is that the challenge often comes at a time when the firm is ill-prepared to cope with it (Stimpert and Duhaime, 1997).

Firms cannot treat strategic change as a once-off response. Strategic change is so rapid that firms must continually survey the product-market environment in search for diversification opportunities. This would then suggest the following:

1. In the present business environment no firm can consider itself immune to threats of product obsolescence and saturation of demand.
2. In some industries, surveillance of the environment for strategic threats and opportunities needs to be a continuous process.
3. As a minimum, firms in all industries need to make regular periodic reviews of product-market strategy (Stimpert and Duhaime, 1997).

The key question, therefore, is not whether to direct management's attention to strategy, but rather how and to what extent. For a firm that faces it for the first time, the question has a chicken and egg quality; a definite answer cannot be given until a complete analysis has been carried out. However, certain preliminary guidelines for decisions can be set down:

1. Clearly, the resources of the firm will limit the intensiveness of the analysis. A one-man top management will of necessity be forced into a highly condensed review of strategy; a large multi-divisional firm can afford a thorough study.
2. The characteristics of the firm's product-market environment will have a dominant influence. If the industry is highly dynamic, if change in technology is rapid, and if the market structure is unstable, the firm will

need to put strategic change on a permanent basis. If, on the other hand, the industry is one of the few remaining ones, which have enjoyed relative stability in the past, it is best to wait until the first results are in before deciding on administrative changes.

3. The magnitude of the needed product-market realignment will influence the decision. If the problem appears as a minor 'soft spot' in an otherwise healthy product-market position, temporary *ad hoc* arrangements for correcting it may suffice. If a wholesale revision of the position appears necessary, a major allocation of resources on a long-term semi-permanent basis is indicated (Stimpert and Duhaime, 1997).

If the final conclusion is that a major effort is required on the strategic problem, far-reaching organisational changes will have to follow. The cost and the risk attendant on strategic change require that top executive talent be given full-time responsibility for the effort and that it be supported with adequate staff resources and budgets. This issue becomes particularly acute in a small firm where all kinds of indirect staff expenses have traditionally been reviewed as wasteful and should be avoided at all costs. If the firm is in a highly dynamic environment, it will attain better growth and profitability if part of the total budget is used to support a small staff created for the purpose of searching out new products and markets, performing exploratory market research, and evaluating opportunities (Thompson and Strickland, 2003).

Strategic change has been defined as a realignment of the firm's product-market environment. This does not necessarily mean diversification as shown in the revised growth vector matrix below. The growth is now in two parts: expansion and diversification. The latter consists of market penetration, market development, and product development. In this respect, it would be incorrect to say that most firms neglect the strategic problem between two major crises. On the contrary, a majority seeks to improve its product and process technology, expand sales territory, and increase share of the market. In most cases there are natural and routine extensions of the present product-market position brought about by extrapolation of trends in R & D, perceived changes in customer demand, and availability of new materials. It would

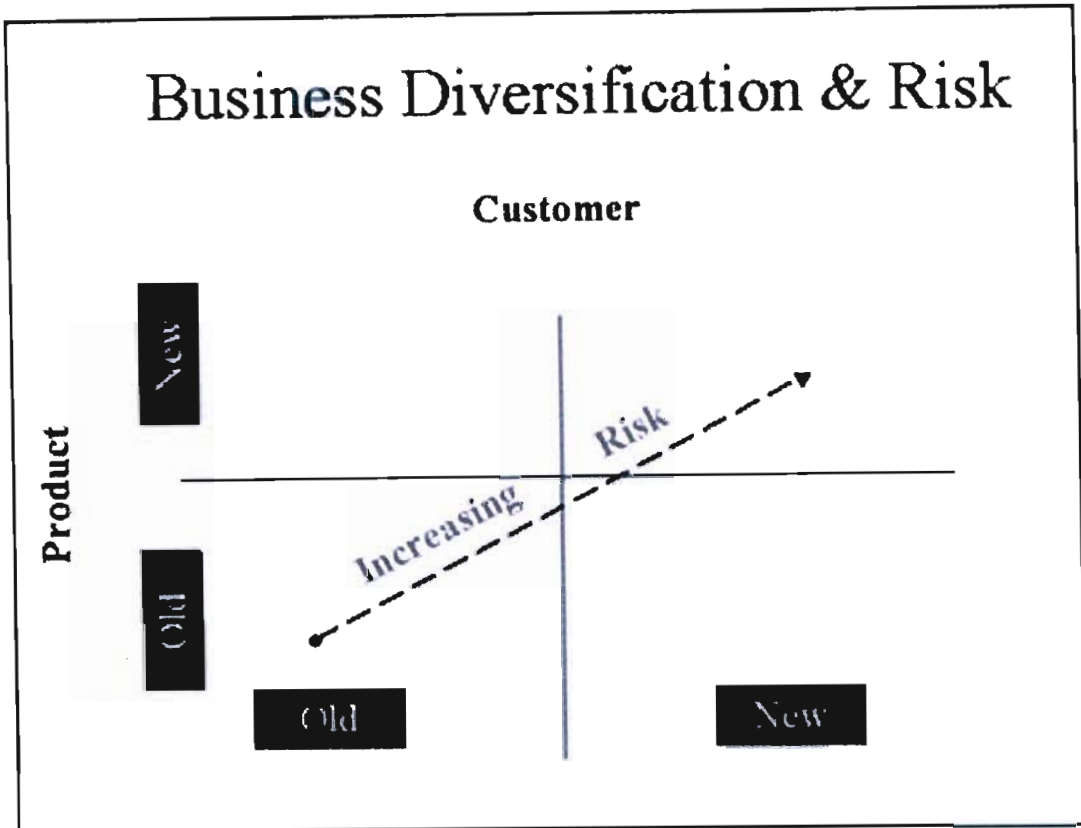
therefore be fair to say that in most firms strategy does not remain static but evolves, however slowly, in response to changes in environment (Thompson and Strickland, 2003).

Table 2.1 Growth direction matrix

Mission Product	Present	New
	Present	New
Present	Expansion	
New		Diversification

As the preceding matrix suggests, changes in the product-market orientation can be brought about through a major revision in the expansion strategy and/or through diversification. By its very definition diversification is the more drastic and risky of the two strategies, since it involves a simultaneous departure from familiar products and markets. One classic way of looking at the degree of risk is shown in the matrix below. Typically, the least risky effort is offering a new product to one's current customers, followed by expanding with existing product to a new market. The most risk is incurred in introducing a new product to a new market (Internet 1).

Table 2.2 Business diversification and risk matrix



The decision on whether or not to diversify represents a major milestone in a firm's development. The underlying reasons why a firm would want to diversify can be summarised as follows:

1. Firms diversify when their objectives can no longer be met within the product-market scope defined by expansion. In the area of proximate and long-term profitability objectives, the cause may be market saturation, general decline in demand, competitive pressures, or product-line obsolescence. A typical symptom is a drop in the rate of return on reinvestments into the present business; another is a 'drying up' of the stream of new opportunities. In the area of the flexibility objective, the cause may be a disproportionately large fraction of sales to a single customer, a generally narrow market or technological base, or influx of new technologies into the firm's product-market scope.

2. Even if attractive expansion opportunities are still available and past objectives are being met, a firm may diversify because the retained cash exceeds the total expansion needs. The rate of return available on liquid resources is generally lower than that from operations. The pressure may be on the firm to invest the money more profitably.
3. Even if current objectives are being met, a firm may diversify when diversification opportunities promise greater profitability than expansion opportunities. This may occur under several conditions:
 - a) When diversification opportunities are sufficiently attractive to offset their inherently lower synergy.
 - b) When the firm's research and development organisation produces outstanding diversification by-products.
 - c) When synergy is not an important consideration and hence the synergy advantages of expansion over diversification are not important (for example in an investment firm, which deals in securities).
4. Firms may continue to explore diversification when the available information is not reliable enough to permit a conclusive comparison between expansion and diversification. This situation occurs quite frequently, since a firm normally has a great deal more information about expansion prospects than about the vast outside field of diversification (Hilton, 1970).

The above list points to some significant conclusions. The goals of the firm are not absolute, but are closely related to opportunities. Under reasons 2 and 3 above (diversify when retained cash exceeds the total expansion needs/diversify when diversification opportunities promise greater profitability than expansion opportunities), firms would pursue diversification when an opportunity to revise the goals upwards presents itself. Under reason 1, if analysis of opportunities shows that diversification cannot improve the firm's position, the goals will have to be revised downwards.

This absence of an absolute proper set of goals for a firm gives the management great latitude in exercising its risk preferences. Conservative managers would be content to limit interest in diversification to reason 1.

Thus, if the firm meets its current objective, diversification would not be pursued. On the other hand, entrepreneurial orientated managers would view the firm as a pattern of investments to be amended and changed when better opportunities arise. They would see all four reasons as appropriate to diversification activity.

2.7 Diversification alternatives

In the preceding section the growth direction matrix was divided into an expansion and diversification component. Each can be further expanded in terms of characteristics of products and customers in relation to the present product-market position. Such expansion is shown in the matrix below for the diversification component. The product alternatives are divided into those that are related to the present technology base, and those that are technologically new to the firm. The missions are sub-divided according to types of customers.

An important characteristic of horizontal diversification is that it consists of moves within the economic environment of the diversifying firm. Therefore, those industries that happen to contribute horizontal opportunities will usually rank low on flexibility, and will contribute little towards improvement to the stability of the firm. The strong common thread in this type of diversification is found in marketing synergy, since the firm continues to sell through established marketing channels (Gaughan, 1996).

Table 2.3 Diversification options

		New Products	
		Related	Unrelated
		Technology	Technology
NEW MISSIONS	Same Type	Horizontal Diversification	
	Firm Its own Customer	Vertical Integration	
	Similar Type	(1)*	(2)*
	Concentric Diversification		
	New Type	(3)*	Conglomerate Diversification

*(1) Marketing and technology related

*(2) Marketing related

*(3) Technology related

Vertical integration is even more sensitive to instabilities and will offer less assurance of flexibility. In fact, by putting more eggs into the same end-product basket, vertical integration increases the firm's dependence on a particular segment of economic demand. Synergy will be strong if technology is related, but may actually be quite weak, and even negative, in the case of unrelated technology. This occurs because the management practices and technology in producing parts or materials for the present products are often very different from those of the firm. If the new operation is closely controlled by the parent and integrated by the parent organisation, dis-economies may occur, and inappropriate management decisions may be made (Gaughan, 1996).

Thus, both vertical and horizontal diversification vectors offer only a limited potential for objectives. They make a limited contribution to stability and flexibility and they will contribute to the other objectives only if the present economic environment of the firm is healthy and growing.

The remaining two directions – concentric and conglomerate diversification – differ in the degree of synergy with the firm's present position. Although more tenuous than in other vectors, concentric diversification has a measure of common thread with the firm either through marketing or technology or both. Conglomerate diversification, by definition, has none. Both have the potential of meeting all of the objectives of the firm. However, a concentric strategy, which matches a conglomerate strategy on economic prospects and on flexibility, will usually be more profitable and less risky due to synergy (Hilton, 1970).

Thus, at first glance one would expect the concentric strategy to be preferred by an overwhelming majority of firms. In point of fact, however, the record shows the opposite; a great many appear to follow the conglomerate path. Several reasons can be offered for this:

1. There are many cases where firms have no strategy beyond a desire for profitable opportunities. Seen from the outside they appear to follow a conglomerate strategy, whereas in fact they are 'marching in all directions'.
2. The capabilities of some firms are too highly specialised or too obsolete to have synergy with other kinds of business. The former appears to be the case in the search by missile companies for compatible diversification opportunities outside the defence industry.
3. In some firms the depth of competence is too shallow to offer opportunities for synergy, so that all diversification moves are conglomerate in nature.
4. In some firms the management's preference and training structure dispose it toward conglomerate growth (Hilton, 1970).

One could be critical of the absence of an apparent common thread in conglomerate diversification. In addition to a lack of joint advantage, the objection could be that an outside investor has no sense of the direction in which the firm is heading and hence would feel insecure about the future of his investment. This is certainly true of firms with no strategy at all. It should, however, be recognised that a well-formulated conglomerate strategy does have a sense of direction expressed through a competitive advantage, product-market scope, and objectives, albeit less definite than in the concentric case, and that many firms have been successful in building up an impressive record of performance via the conglomerate route.

Since many firms will continue to use the conglomerate path and particularly since the distinction between concentric and conglomerate diversification is one of degree, it is useful to set forth the advantages and limitations of a purely conglomerate diversification strategy:

1. Conglomerate strategy can improve the overall profitability and flexibility of the firm through acquisitions in industries that have better economic characteristics than those of the acquiring firm.
2. Although the consolidated performance may improve the firm's position, firms that pursue a conglomerate strategy into growth fields frequently dilute the earnings of their stockholders. Since the firm has no trading advantage it will generally pay the same discount for future earnings as the individual investors.
3. In the absence of synergy, the combined operating performance of a conglomerate firm will in general be no better than it would have been if the division operated as the independent firms did. The conglomerate firm will therefore have no operating competitive advantage over independents.
4. A conglomerate firm has a potential advantage of better access to capital markets and better stability of earnings under normal conditions.
5. The inherent economic potential of a new industry must not be the sole criterion for conglomerate acquisitions. In addition, the acquiring firm must insist on a record of successful operation and evidence of competent management.

6. Organisational strategy is of great importance in conglomerate acquisitions. If internally well-managed and left to themselves, divisions of a holding company should operate no worse than their independent competitors. However, if central management begins to assert decision prerogative other than financial, there is a strong danger of negative synergy (Hilton, 1970).

2.8 The assessment

As mentioned above, the expansion component of strategy offers strong transfer of product technology, or marketing competence, or both. In diversification, novel products are acquired and previously unexplored markets are entered. Therefore, given two otherwise equal opportunities, synergy will be higher in expansion than in diversification. Consequently, the firm can expect higher profitability and lower risk from the former. This would suggest that if a firm could meet all of its objectives by measures short of diversification, it should do so. Since diversification is costly and risky, one should first consider whether the firm can solve its problems without diversifying (internal appraisal). If the firm cannot solve its problems within the limit of the present product-market position, presumption is strong that the firm has to diversify. If the conclusion is that the problem can be solved internally, the firm may or may not terminate the analysis, depending on the risk preferences of the management.

A decision to continue will call for a survey of opportunities outside the firm's present product-market scope (external appraisal). Comparison of the result with that of the internal appraisal leads to a final decision to diversify or not and an allocation of the firm's resources between diversification on the one hand and expansion on the other.

Decisions to diversify raise the question of whether the new acquisition will be integrated into the firm's present organisational structure, or whether the structure will be varied so as to take advantage of the synergy potential. The choice of the synergy structure relationship is a key management decision, which affects the final product-market strategy of the firm.

The flow of decisions leading to strategy formulation can be very expensive, complex and time-consuming. Many smaller firms may not be in a position to make such commitments.

2.8.1 Internal assessment

The discussion on the internal appraisal will be done according to the 'internal assessment diagram'. In order to relate the diagram to the discussion, numbers in brackets will be marked to correspond to appropriate boxes in the diagram.

As discussed earlier, strategic analysis may be triggered off by a signal of serious trouble or by a change in top management. Forward-looking management may anticipate changes in the environment of the firm and act before difficulties arise. Aggressive management will make strategic change a way of life and periodically review its strategy regardless of performance.

The first order of business will be preparation of tentative objectives (1). A firm new to strategic analysis may be faced with the problem of making its objectives explicit for the first time. Other firms will conduct a review of current objectives in the light of past performance and make a tentative revision in the priorities and the goals (De Kare-Silver, 1997).

Concurrently, a current forecast (2) of future performance will be made. This is constructed to predict the firm's performance on its high-priority objectives. If a long-range plan had been previously developed for the firm, it will serve as the foundation for the current forecast. The difference between the two will be in the attributes for which the forecasts are made. Since long-range plans are usually confined to proximate profitability forecasts, additional information will have to be developed for the long-range and flexibility objectives (De Kare-Silver, 1997).

A comparison can now be made between the objectives and the current forecast to measure the total gap (3) – the discrepancy between aspirations and anticipations. For example, a firm whose tentative objectives in the order of

If such a gap exists, revised objectives (4) are prepared. If expectations exceed aspirations (a negative gap), objectives are adjusted upwards. If the gap is positive, a different order of priority assignment to objectives may become apparent. In the above example, increased priority is indicated for the flexibility objective. On other occasions the gap may be generally judged to be too great in the light of the trends and the limitations of the firm, and goal-threshold values are adjusted to lower acceptable values (Ambrosini, 1998).

If, after these adjustments, a significant gap remains, the analysis moves to the next phase. If there is no gap, conservatively inclined management may choose to terminate analysis at this point until the next review date. Entrepreneurial management will choose to proceed with the purpose of discovering whether the firm can do even better than indicated by the current forecast. This optional management decision is indicated by an arrow and by the word 'Stop', appearing on the 'internal appraisal diagram' (De Kare-Silver, 1997).

Revision of objectives is followed by two concurrent analyses. The first, strengths and weaknesses, and opportunities and threats (5), involves constructing a competence profile for the firm and comparing it with profiles of successful competitors to develop a pattern of the firm's strengths and weaknesses relative to its present product-market strategy (Ambrosini, 1998).

The other concurrent analysis is of the industry potential (6). Its purpose is to determine the growth potential available within the industry to a firm which is willing and able to make an all-out effort to capitalise on it. Industry potential explores the economic and competitive prospects for the industry as a whole. Trends in growth, profitability, and market shares are projected. The competitive environment is analysed from the viewpoint of the trend in demand to capacity and the cost of entry and exit from the industry. The

technological trends and potential impact of new technologies are identified (Ambrosini, 1998).

By combining the analyses of strengths and weaknesses with the industry potential and by referring to the current forecast, it is now possible to construct a new revised forecast (7) for the firm. Assuming that, rather than continue on its present groove, the firm will make an all-out effort to take advantage of its opportunities, short of embarking on diversification. The analysis may show, for example, that the current forecast of return on investment is below the maximum expected potential. Further investigation may show this to be due primarily to the firm's traditional reluctance to shift from distributors to direct sales. If this shift is feasible, an assumption can be made that the firm can raise its return on investment to or near the maximum possible. On the other hand, it may appear that the lag in profitability is to be ascribed to an unfortunate distribution of the firm's manufacturing plants and attendant distribution cost. Although some improvements can be made, the basic pattern cannot be changed short of costly relocations. In a case like this the conclusion might be reached that the industry maximum is not attainable. The revised forecast will reflect this decision.

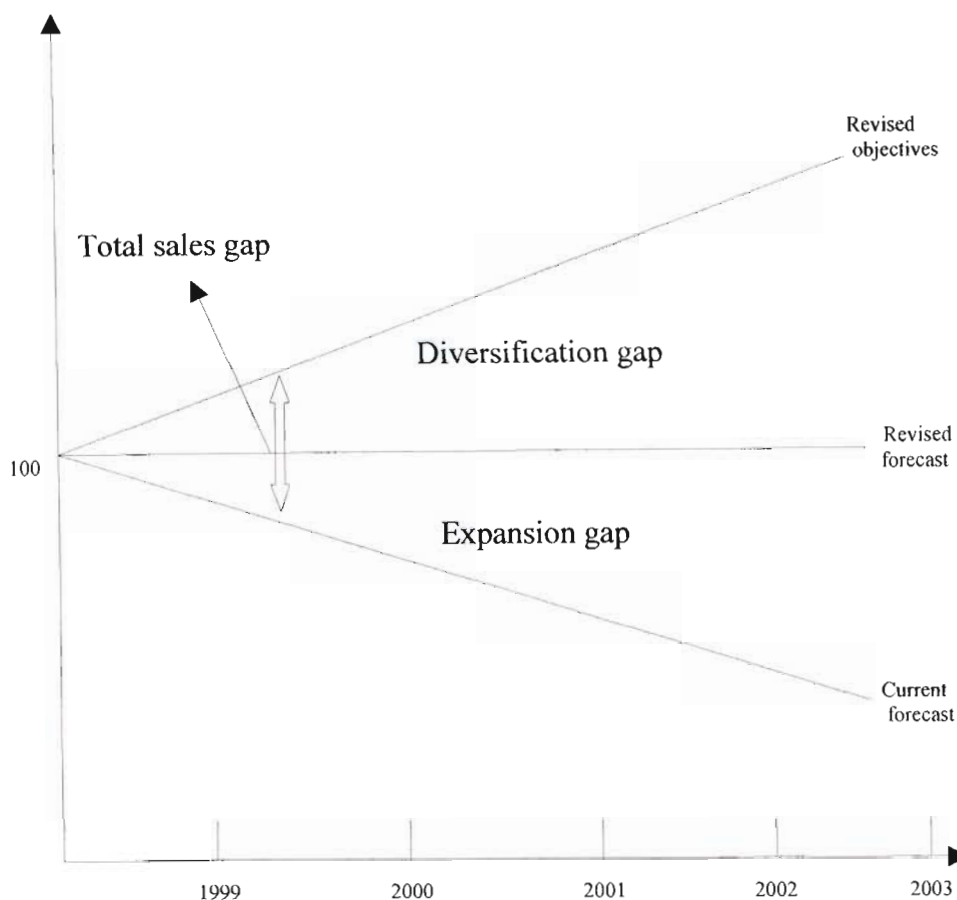
Preparation of the revised forecast will single out areas of strength that the firm needs to exploit, as well as measures to be remedied. These may be in the form of increased operating efficiency, changes in administrative arrangements (as in the example above), or in the product-market strategy, such as a shift of emphasis from seeking a large share of the market to intensified product development.

It will be recalled that the total gap (3) was determined on the basis of tentative objectives (1) and that a new set of objectives was established (4) (Ambrosini, 1998). Therefore, the total gap needs to be revised. This is shown in box (9) – revised total gap – in which the current forecast is compared with the revised objectives. Next the revised forecast (7) is compared with the revised objectives to determine the diversification gap (10) which will remain

after all internal steps have been implemented. The difference between this and the total gap is the expansion gap (11), which will be closed.

To illustrate this still further, the figure below shows how the respective gaps may look for the firm's sales potential. The two gaps thus show the respective contributions to be made from pursuing expansion and internal changes on the one hand, and diversification on the other. Analyses of the gaps lead to another major management decision point. If the internal expansion measures promise to close the diversification gap, many firms will decide against diversification at this point in time (Internet 1). Again, management risk preferences play an important role, but in a somewhat different way from the preceding decision point. As discussed earlier, a move from expansion to diversification entails for some firms not only greatly increased risk, but also very high transfer costs. Such firms are usually highly integrated, with large fixed investments in physical assets and specialised business and technological know-how. They welcome the opportunity to redress imbalances in the present position without diversifying (Internet 5).

Figure 2.2 Gap analysis



On the other hand, firms with highly fluid and negotiable resources and without specialised know-how, such as an investment trust, would have no particular incentive to stop the analysis at this point. The incentive is rather to survey the broadest possible field of opportunities before selecting the product-market posture.

If the decision is to continue the analysis, the next step is to determine the resources available to the firm for implementation of the respective changes. The revised forecast (7) provides a basis for estimating the resources that will be generated (resources available [8]) for growth and expansion. The primary dimension of this is the net cash flow that will be available for acquisition activity. The latter is based on the present ownership patterns, the acceptable dilution of present ownership, and the acceptable dilution (if any) of earnings to present stockholders. The result is an estimate of the rand value of equity available for trading (Ghemawat, 2001). The usability of the equity for trading

will depend on the firm's price/earnings position in relation to potential acquisitions. Resource analysis should single out the particular resources that may become limiting factors (8) in strategic activity. Quite frequently this will be competent general management, but it may also be a limited availability of raw materials, of skilled labour, or of middle management.

Since the intent is to fully implement the expansion forecast before diverting resources to diversification, the next step is to make an estimate of expansion requirements (12). These are costs in terms of rands, manpower and other resources, over and above the operating costs, which are required to bring about expansion. They include expenditures on new and modernised facilities, administrative changes, and increases in advanced research activities (Larsen et al., 1998–1999).

The diversification resources (13) estimate is now obtained by comparing the total available resources (8) with the expansion requirement (12). It has to be recognised that diversification resources are self-regenerative, i.e. use of equity to acquire a firm may be a rich supply of ready cash for further expansion. Therefore, the diversification resource is an estimate of capabilities for the first phase of the programme. Nevertheless, even with this reservation, these resources may or may not be judged adequate for the diversification effort required by the gap (Lawrence and Glueck, 1988).

The last step in internal appraisal is another major decision point. The diversification gap is examined in relation to the diversification resources to determine whether the objectives need another revision (14) and whether the firm should decide against diversification. It is possible that diversification may not substantially narrow the gap. In this case, the objectives may be revised downward to the level made possible by expansion only and a decision made not to diversify.

2.8.2 External assessment

The purpose of external appraisal is to analyse the product-market opportunities which are available to the firm outside its present scope and thus

produce the final decision on whether the firm shall diversify. In the external appraisal diagram (page 39) the appraisal is triggered either by a need (existence of a diversification gap), or a management decision to find out whether there are outside opportunities which are more attractive than internal ones.

The analysis commences with economic (1), cost of entry (2), and synergy (3) criteria denoted by the respective boxes in the external appraisal diagram. A comprehensive list of economic, cost of entry and synergy criteria are listed in Table 2.4, Table 2.5 and Table 2.6.

In actual practice the list of criteria below for a particular firm could be much shorter. For example, the firm that seeks a cash rich acquisition for the first step in the programme would reduce its list of economic criteria virtually to the single item 'internal flexibility' – cash reserves (Gordon, 1985). Most firms would end up with a longer list, depending on the nature of objectives sought through diversification. Together these three lists of criteria depicted below constitute the master list (4).

The second step in the external appraisal analysis is to develop lists of candidate industries. This is done by compiling a comprehensive industry list (5) and then removing obvious misfits from it to obtain a preliminary industry list (6). This is accomplished through use of the master list and the diversification resource limitations (Gordon, 1985).

Data is now collected for each industry along the dimensions indicated by the criteria. These are grouped into three categories: economic potential (7), competitive characteristics (8), and competitive profiles (9). The procedure for constructing competitor profiles is a time-consuming phase of the analysis, but the data for it is generally available in government publications, trade literature and business periodicals (Gordon, 1985).

Table 2.4 Sample list of economic criteria for external assessment

Objective	Criterion	Yardstick	Example: Firm's threshold goals
Proximate	Return on investment	ROI data Historical Current Trend Variability	1. 10–20% return on equity 2. 20–30 % return on equity
Long term	Growth Stability	Trend in sales Trend in return on sales R & D as % of sales Life cycle position Technology prospects Dependence on single customer Seasonal stability Stability over business cycle	1. 8–10% per annum sales growth 2. 5–10% per annum sales growth 1. \pm 15% of sales over business cycle 2. \pm 20% of sales over season
Contributes to proximate and long-term objectives	Competitive pressures	Status and trends in: Demand capacity Control of market shares Price stability Earnings stability Mobility of competition	
Flexibility	External Internal	Diversity of technology Diversity of demand Liquidity Cash reserves	1. Less than 30% of sales from single technology 2. 50/50 Defense and industry sales 1. Current ratio 4:1 2. Cash and securities ratio to current liabilities 1:1

Table 2.5 Sample list of cost of entry criteria

Criterion	Yardstick	Example: Firm's constraints
Cost of Entry	Price/Earnings: a) History b) Current c) Trends Price/book Critical size of entry Typical project payback period	1. No dilution of earnings/share 2. Maximum five-year payback
Availability entries	Number and size distribution of firms Willing merger candidates Room for product-market new entries (demand/capacities)	

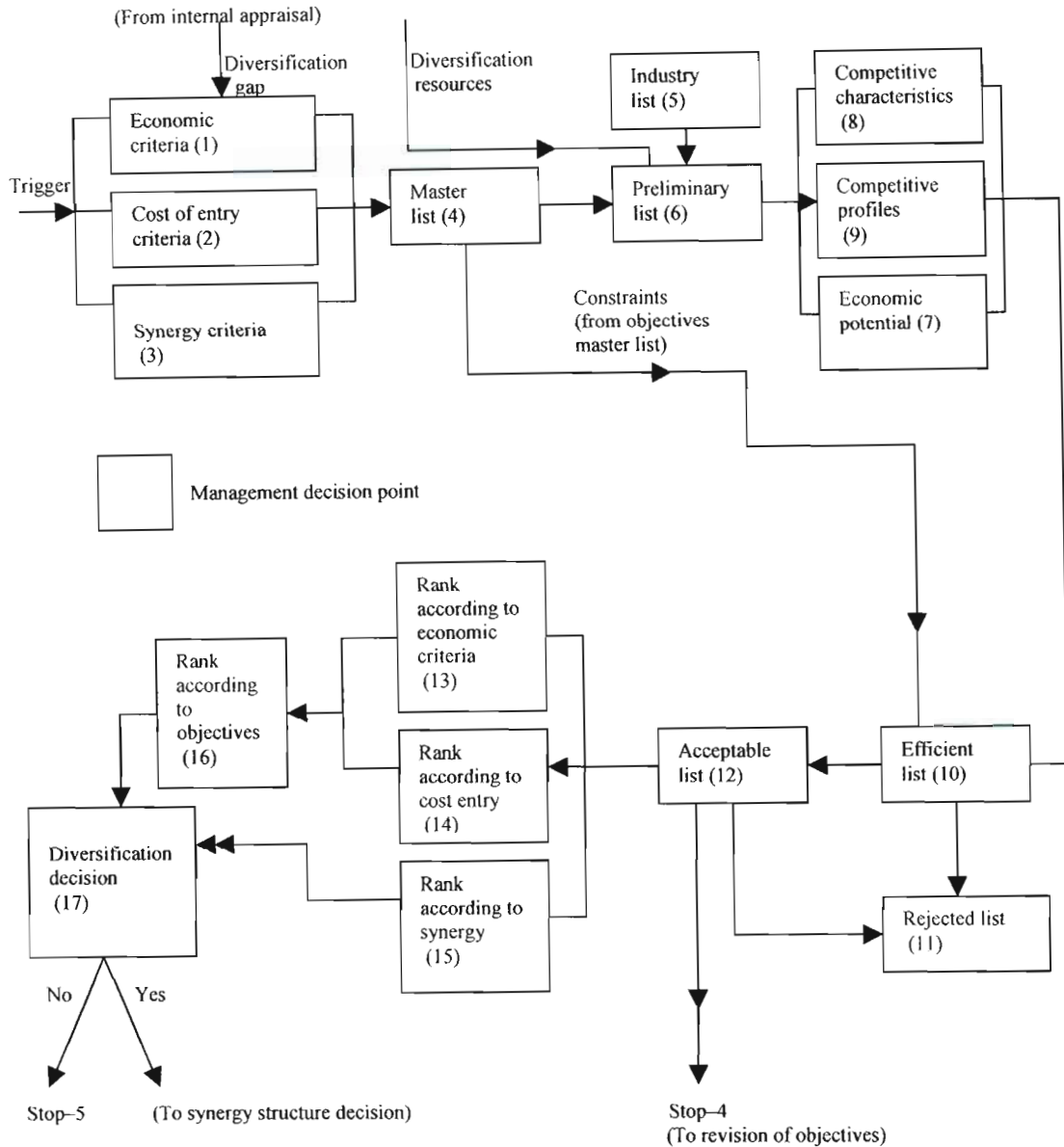
Table 2.6 Sample list of synergy criteria

Criterion	Yardstick
Start-up synergy	Skills critical to success Common management skills Common organisational capacities Common equipment and factory Timing advantages
Operating synergy	Potential for new joint product market Sharing of facilities Sharing of overhead Economics of scale in direct costs Sharing of R & D and management

Next, the master list of criteria is applied to the above sets of industry characteristics to produce relative ratings of the industries. In the process some industries will be disqualified by threshold-goal criteria; some will pass, but will be demonstrably inferior on all accounts to some other industries. Both of these sets are placed on the rejected list (11), the rest on the efficient list (10). An important characteristic of this list is that no industry is demonstrably superior to all others. While one industry might be outstanding on one criterion, there are others which are outstanding on different criteria.

While all industries on the efficient list are promising from the viewpoint of the objectives, not all of them will be acceptable because of either internal or external constraints. Internal constraints are policy limitations self-imposed by the firm (Miller, 1996). Thus, as shown in the sample list of cost of entry criteria (Table 2.6), the firm's management may decide that diversification must not dilute the earnings/share of the present stockholders. Another internal constraint may be to avoid acquisitions in industries that have unions hostile to the unions of the firm. In this matter the firm avoids becoming a pawn in a jurisdictional struggle. A further internal constraint may be to avoid acquisitions in areas in which salary and wage scales are sharply out of line with those of the firm.

Figure 2.3 External assessment diagram



After the constraints have been used to reduce the efficient list, the remainder is the acceptable list of industries (12). It is possible that the analysis will be terminated at this point if the acceptable list is empty or if it contains very few suitable potential entries. If a decision to stop is made at this point, returning to (7) in the internal appraisal will need another revision of objectives (Gordon, 1985).

When the acceptable list is not empty, the next step is to rank entries in each list. Rankings can be constructed and consolidated in several steps. First, the

multitude of economic yardsticks should be reduced to a threefold rank according to economic criteria (13). Second, a list is produced which ranks industries according to cost of entry (14). The economic criteria (13) and cost of entry (14) lists are consolidated into rank according to objectives (16) with the cost of entry being used to adjust the economic criteria ranks. Next a two-column rank according to synergy criteria (15) is constructed. A start-up synergy column measures the effect on near-term profitability of new entries, and the operating synergy column on the long-term profitability (Gordon, 1985).

We are now in a position where a definite diversification decision can be made. The expansion opportunities analysed in the internal appraisal can now be compared with the list produced in the external appraisal. A choice must be made to pursue expansion, diversification, or both. The following variants of the decision to diversify are possible:

1. In rare cases, when internal assessment forecasts a decline in the firm's present business in spite of all possible measures taken to reverse it, the indicated decision is to liquidate the firm as it now exists and to reinvest the proceeds into diversification, thus creating a new type of firm (Power, 1994).
2. When the expansion forecast shows level sales or slow growth, a somewhat less drastic decision is to keep the present business, but to devote most of available resources to diversification (Bridge and Dodds, 1978).
3. When both expansion and diversification opportunities are only moderately promising, but upon comparison, no diversification opportunity is sufficiently superior to justify the added risks and the loss in synergy, the previous commitment of resources to expansion would be maintained. Diversification would be limited to the use of the residual resources (Colenso, 1998).
4. When diversification opportunities are attractive enough to sacrifice expansion moves and even relinquish some parts of present business, the revised forecast, the expansion, and the expansion resources on the internal appraisal diagram (Figure 2.1) are adjusted downward and the

diversification gap and resources for diversification are correspondingly increased (Colenso, 1998).

- 5 When the information obtained through the external assessment is judged to be inadequate to commit the firm either way, several courses may be pursued:
 - a) A decision to develop more information may be made. If so, appropriate parts of the external assessment (particularly parts 5 to 9) are pursued on a continuing basis until enough information is developed.
 - b) Another, not infrequent decision is that information about diversification is inherently less reliable than information about expansion and that the advantages of diversification are not worth the risk. The firm will in this case pursue the expansion strategy (Stimpert and Duhaime, 1997).
 - c) A third is a decision by default. An attempt to formulate strategy will lead nowhere, but the firm ought to look around for individual attractive opportunities (Stimpert and Durhaime, 1997).

The particular course of action chosen and its timing will again depend on the risk philosophy of the firm's management. Thus, management with aversion to high risks would probably avoid facing decision 1. – liquidation of present business – until the last moment in the hope that 'things will straighten out'. They would also not be inclined to follow decision 4. – curtailment of expansion and possible divestment from some products in favour of diversification.

2.9 Synergy and structure

Synergy and structure of the firm's organisation are dependent on each other. This relation can be resolved by making structure follow synergy. In such a case the post-diversification organisation is adjusted so as to maximise synergy. When strong synergy exists at all levels of the firm, a tightly integrated organisation would be used. Top management would be made responsible not only for strategic but also for key operating decisions, such as pricing, production and respective inventory levels. The acquisition would be

absorbed into the respective functional departments of the firm and profit and loss responsibility would be centralised. When synergy is strong only in general management, but not in functional areas, a decentralised organisation is indicated. The acquisition would be set up as a division and assigned profit and loss responsibility (Eisenhardt and Galunic, 2000).

Finally, when synergy potential is weak up and down the organisation, a holding company structure is indicated. This would occur, for example, when the diversified firm finds itself in shipping, electronics and chemicals at the same time. To avoid negative synergy it will be advisable that management delegates the strategic as well as the operating decisions, reserving for itself only the area of corporate finance (Eisenhardt and Galunic, 2000).

If structure is to follow synergy, the acquiring management should have both the desire and the flexibility to change with the occasion. Quite frequently this will not be the case. Top managers who were brought up in internally oriented skills, such as engineering or manufacturing, often feel uncomfortable in the loosely structured environment of a holding company; but managers from marketing, and particularly finance, frequently prefer it. Furthermore, the respective groups perform better in a familiar environment.

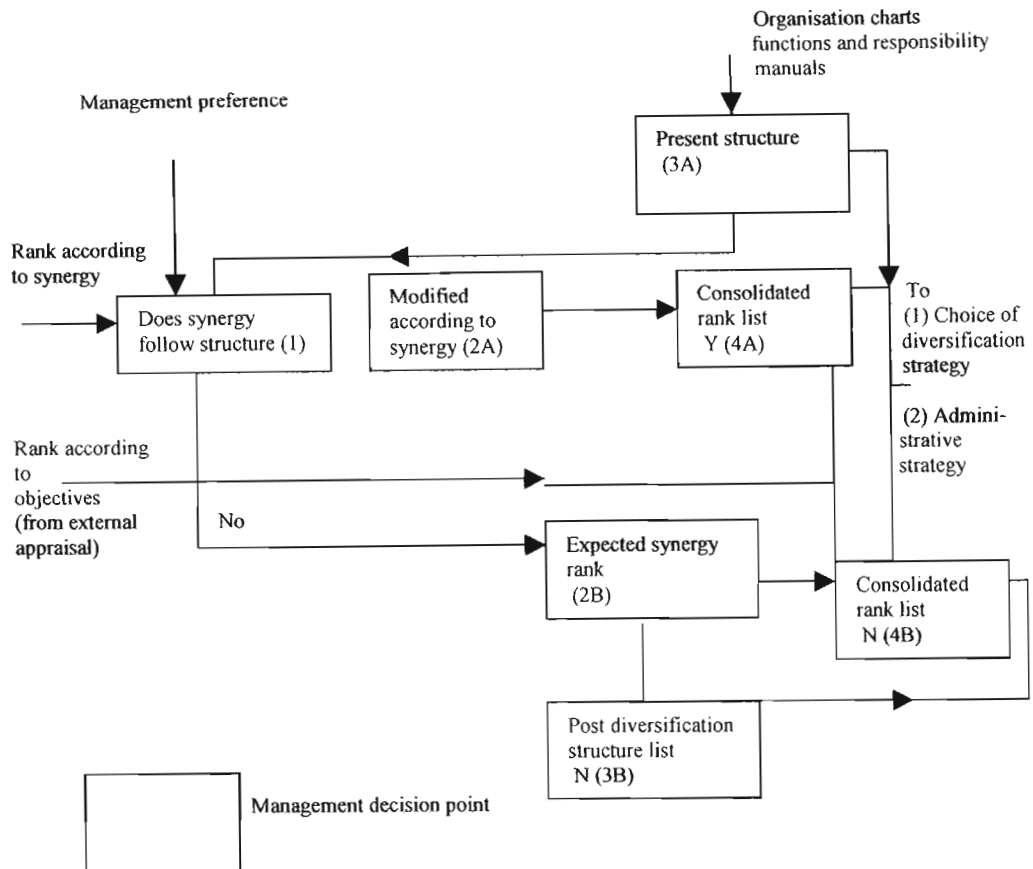
Aside from management preferences, firms do not usually have the flexibility of structure to follow the vagaries of synergy. Nor would the synergistic advantages always offset the resulting cost and inefficiencies of structural change. This would be true, for example, when the acquisition is relatively small but very different from the parent. Rather than revise the overall organisational concept, the firm will usually force the acquisition to fit into the already existing structure and not worry about synergistic effects. This is sometimes called 'loving your acquisition to death' – rather than being left alone it frequently is enveloped by well-meaning, voluminous, and poorly informed advice from the corporate headquarters (Eisenhardt and Galunic, 2000).

Whether synergy should follow structure or vice-versa is a major top management decision. This decision needs to be made at this point, rather than delayed until an actual acquisition is in hand because it affects strategy and hence the search and evaluation of opportunities (Eisenhardt and Galunic, 2000). Its effect on strategy formulation is illustrated in the 'synergy structure decision' diagram (Figure 2.4).

The first step is management's answer to the question whether synergy follows structure (1). If the answer is yes, a new modified rank according to synergy (2A) is produced by modifying the rankings on synergy produced in external appraisal to take account of organisational mistakes. If the decision is to change the organisation in order to maximise synergy, the expected synergy list (2B) will be the same as the list in the external appraisal. However, to each industry an appropriate post-diversification organisational structure (3B) is assigned. For example, a firm in railway signals and brakes, which diversifies into military wear should give the new subsidiary almost full freedom of action. The same firm acquiring a company in diesel locomotives should use either a functional or a closely integrated divisional structure (Eisenhardt and Galunic, 2000).

In either case (2A) or (2B) the next step can now be taken. This would be consolidating the synergy ranking with the ranking according to objectives. In each case a final consolidated rank (4A) or (4B) is produced for the industries on the acceptable list.

Figure 2.4 Synergy structure decision diagram.



2.10 Choice of strategy

The synergy-structure decision results in a consolidated list of industries ranked on each of the major objectives. This list is the basis for selection of the diversification product-market scope. Except in unusual circumstances, no single industry will be preferable to all others for all of the firm's objectives. If the unusual does occur, the choice is clear and the analysis can proceed to selection of other components of strategy. More often, industries that are preferable for proximate profitability will be inferior to others on long-term objectives. Industries that would contribute most to flexibility will generally be deficient on near-term profitability because of lower synergy with the firm (Eisenhardt and Galunic, 2000).

To provide the firm with an attractive overall product-market posture it is necessary to consider alternative portfolios of industries. This can be done by

constructing all possible combinations of industries from a consolidated rank list and to measure them against objectives and other relevant constraints.

The flexibility objective is obtained through a diversity of different entries: it therefore requires a large number of entries in the portfolio. The other two major objectives exert an influence towards a small number of entries. The reasons are:

1. A large number of different entries entail an accumulation of entry costs that will depress profitability. The cost of an entry is relatively independent of its size, since the same minimum learning costs have to be incurred for a R500 000 entry as for a R10 million entry. This applies to all types of firms, but the restriction is less stringent for non-integrated ones.
2. Once acquired, many distinct and different entries will cost more to operate because of a lack of synergy and dilution of management attention. For a given entry a minimum management commitment is required, regardless of its size.
3. For many types of entry there is a minimum critical mass below which the changes of success drop off quickly. This applies primarily to firms that acquire to create whole operating units, such as divisions or companies. It does not apply to firms that acquire a part of the equity in an operating unit.

Critical mass is the market share that a firm must obtain in order to become fully competitive on price and cost. The firm must be able to attain the critical mass within a reasonable span of time, comparable to the normal product development lead-time for the industry. Failure to do so creates strong pressure to abandon the venture. In small firms, failure to build up quickly to the critical mass may lead to bankruptcy (Butler, 2001).

While critical mass is the minimum size of entry needed in order to be competitive, entries which are larger than critical mass are to the firm's advantage because of larger volume and a consequent stronger competitive position. Since the total resources available for diversification limit the overall

size of the portfolio, the most attractive portfolios will be the result of a compromise between sizes of individual entries and their total number, subject to the critical mass constraint (Butler, 2001).

A procedure for developing portfolios of product-market alternatives could be summarised as follow:

1. Several provisional product-market scope alternatives or portfolios are selected by judgement. At this point an alternative scope may be as narrow as an industry or part of an industry, or it may be a combination of two or three industries selected and matched on their respective contribution to objectives.
2. Next, each entry in the portfolio is assigned a critical mass and a tentative size of entry. The assignments are based on competitive profiles data previously developed in the external appraisal.
3. The total resource requirement generated by a product-market portfolio is now tested for feasibility by comparing it with the resources available, as determined in the internal appraisal. If the scope is not feasible, it is reduced and again tested for critical mass.
- 4 Alternatives that pass the feasibility test are now classified for their growth vector properties. This serves three purposes:
 - a) Within an industry a sub-division into several related product-mission combinations helps sharpen the choice of product-market scope. Thus, a firm that originally had electronics as a diversification alternative may split this into several distinct alternatives, such as military and space systems, conventional components, exotic components, materials and consumer products.
 - b) Within a portfolio, the growth vector matrix relates different industries to each other with respect to their economic and technological foundations. This makes it possible to rank portfolios on the economic and cost of entry objectives.
 - c) The common thread delineated by the matrix permits synergy estimates for each portfolio.
- 3 The set of portfolios defined and measured against objectives with the assistance of the growth vector is now ranked on each major objective.

The result is a list similar to the consolidated list, but containing portfolios for its entries, rather for industries (Colenso, 1998).

The stage is set for a major decision point at which the firm commits itself to a particular product-market scope and growth vector. This would appear to be quite simple; the portfolio that offers the best performance for the firm's objectives is the one to choose. In practice it is not that easy. Each portfolio is measured by three ratings, one each in proximate, long-term, and flexible objectives. These are in the nature of apples, pears and oranges. Each contributes to a different aspect of the firm's performance; a different yardstick measures each aspect; and an increase in one normally means a decrease in another. There is no obvious way in which they can be combined to produce a single figure of merit for each scope.

This dilemma of reconciling non-commensurate and non-collinear objectives is not an issue in the behavioural theory of the firm. There it is asserted that real-life firms do not deal with multiple alternatives, but rather search for one alternative at a time. When an alternative is found that satisfies the firm's aspirations on all of the dimensions of the objective, the search stops and the alternative is adopted. Thus, no combined figure of merit is needed. While some conservative firms behave this way, some progressive firms would not. Firms should take advantage of all opportunities to select from multiple alternatives for the simple reason that in the absence of some absolute standard the value of a course of action can be more clearly perceived if it is viewed against the background of alternatives (Colenso, 1998).

A helpful feature of strategy formulation is the process of narrowing the field of alternatives, which reduces the final list of portfolio scopes to a small number and sometimes even to a single acceptable alternative. Another feature is the assignment of priorities to the respective objectives since these can be used as 'weights' to compute an overall weighted rank for each of the remaining alternatives. Different numerical weights, however, may lead to different choices and therefore several weighting schemes should be tried. The result of these evaluations may be a dominant choice that is not sensitive to

reasonable weighting schemes. More frequently several alternative optimal choices will emerge depending on the weights (Colenso, 1998).

These weighting procedures do not resolve a problem that has a major influence on final choice, namely the problem of risk. Risk enters the problem in different ways. First, it has to be recognised that our ability to foresee the future in any detail is limited to only certain foreseeable events and that we have every reason to believe that other unforeseeable events will occur. Even the foreseeable events contain several elements of risk for the expectations of the firm's success in any given industry and are at best probability judgements. Even projections of business conditions, on which these expectations are based, are themselves estimates of probable events. It is also conceivable that the activities contemplated by the firm will impinge on those of other firms that may react through competition and try to minimise the effectiveness of one's actions (Colenso, 1998).

Thus the expectations from respective diversification prospects depends on four sources of uncertainty: uncertainties in estimation of results; uncertainties in projecting the results; uncertainties in projecting the environment; and uncertainties in competitive reaction (Colenso, 1998).

2.11 Competitive advantage

Beyond specifying the scope and the growth vector, it is to the firm's advantage to be on the lookout for individual opportunities within the scope, which are unusually promising. There are two ways in which such opportunities can be identified:

1. In relation to characteristics of other products and markets.
2. Through the general characteristics of the competitive environment.

Turning to the latter first, some environmental characteristics that may make a new entry attractive to a firm have already been identified. One of these is the cost of entry for a new competitor. A large firm backed by substantial resources would prefer the cost of entry and exit to be relatively high. Once the entry is made, the firm can feel secure from entry by new 'fly-by-night'

competition. A small firm, on the other hand, may prefer the advantages of low cost and flexible response (De Kare-Silver, 1997).

Another characteristic that a firm may consciously seek is a favourable demand to capacity relationship. If the total capacity equals or exceeds demand, the competitive environment is due for a shakeout, even if the demand is growing. A third characteristic that a firm may require in its entries is competitive dominance. This may be attained by means of patent protection, cost of entry, or a dominant share of the market (De Kare-Silver, 1997).

The search for a competitive advantage can be helped by a classification of product-market opportunities. Thus competing products can be classified into one of the three following categories:

1. A breakthrough product that offers either a radical performance advantage over competition, a drastically lower price, or, in a highly desirable but unlikely situation, it may offer both. Usually such products incorporate a technology that is novel to the particular customer need. The automobile was a breakthrough product in the 1890s, radio in the 1920s, television in the 1940s, transistors in the 1950s, etc.
2. A competitive product is one that shows no clear-cut advantage over other products. It is competitive in the sense that it represents a particular compromise of cost and performance characteristics. Some of these are superior to competition, others are at a disadvantage. A typical example of competitive products is the group of synthetic fibres available: Dacron, Nylon, Kodel and Orlon.
3. An improved product that lies between the above two, while not radically different, can be shown to be clearly superior to others (usually better performance at competitive price, or lower price for same performance). It will usually be the result of incorporation of recent advances in the technology which had previously been applied to the particular market need (De Kare-Silver, 1997).

The characteristics of the demand for products can be similarly classified:

1. Established demand exists when current products have previously serviced a particular customer need.
2. Under latent demand a group of potential customers is identified. The customers are aware of their needs, but no product has so far been offered to fill them.
3. Under incipient demand there is no awareness of need on the part of prospective customers, however a trend can be recognised which points toward emergence of a future need (Green and Carrol, 2000).

The important difference between types of demand lies in the cost of gaining acceptance for a new product. Under existing demand, acceptance is gained by proving superiority of the new product over others available. When this superiority appears self-evident, as with a breakthrough product, the cost is relatively low and competitive potential correspondingly high. Under latent demand, the customers need to be sold, not on a relative asset, but on the idea of the product. They will want to have its performance capabilities demonstrated, they will want to be assured of reliability, and they will want to be convinced that it really fills the need. Above all, they will need to be sold on the price (Green and Carrol, 2000).

Incipient demand requires the highest cost for customer acceptance. Two additional elements of cost must be considered. One is the cost of 'educating' the customer; the other is the cost of finding the customer. This cost has to be incurred on the embarrassingly frequent occasions when the engineering department of a firm invents what has been aptly called 'a solution in search of a problem' – a product for which no specific group of customers has been identified. The confidence level in whatever estimates are arrived at for incipient demand is the lowest of the three cases. The uncertainty in the estimates of market size must now be compounded with the uncertainty of existence of the market in the first place (Green, 2000).

The grouping of products and markets offers a mean for examining the product-market scope for trends and directions which are competitively attractive and which also contribute to the objectives. From this examination

the firm can select an additional strategy component, namely competitive advantage. The table below is helpful in this analysis.

Table 2.7 Competitive advantage as a strategy

Demand Product	Existing	Latent	Incipient
Breakthrough	Flexibility		
Improved Competitive	Proximate	Proximate and long term	Long term

The table offers a rough classification that matches product-market types to the objectives they can best meet. The breakthrough product is seen to contribute to the firm's flexibility. The timing of the contribution will depend on the type of demand to which the product is addressed. The improved and competitive products may contribute to either the proximate or long-term objectives, or to both, depending on the nature of the demand.

In seeking breakthrough products, the firm pursues the strongest possible competitive advantage. However, the estimate of the advantage must be tempered by the higher cost of opening latent and particularly incipient markets. Pursuit of these calls for a strategy of gradual resource commitment in order to take advantage of timing on the one hand and the natural evolution of markets on the other. In this manner the firm avoids the extra burden of being a single-handed trailblazer. In some ways, anticipation of latent markets with existing or improved products appears to be the most attractive of all, since it takes advantage of astute timing and may not require major financial exposure. An attempt to open up incipient markets with improved or competitive products is the riskiest and potentially the most expensive course. A firm that follows this undertakes the thankless task of blazing a trail for other firms without any particular advantage over them (De Kare-Silver, 1997).

Competitive advantage thus adds a dimension to strategy, both in search and in evaluation of opportunities. Although some straightforward steps can be taken to select the competitive advantage, really successful results require uncommon skills in anticipating trends in markets and in technology. The ability to anticipate is greatly enhanced by knowledge of the industry and its environment. This is one reason why concentric diversification to related areas offers better opportunities for a competitive advantage than is offered by conglomerate diversification (De Kare-Silver, 1997).

2.12 Synergy component of strategy

A natural companion to the competitive advantage is the synergy component of strategy. This requires that opportunities within the scope possess characteristics that will enhance synergy. The process for determining the synergy component was described earlier. To recapitulate briefly, the firm's competence profile is superimposed upon the competitive profile of the product-market scope. Reinforcement shows areas of potential synergy described in terms of individual skills, specialised facilities, organisational or management skills. The items with the strongest potential are selected for the synergy component of strategy (Eisenhardt and Galunic, 2000).

The synergy component and competitive advantage need to be made compatible – ideally, one should be an extension of the other. Unless this is done they may cancel each other out. For example, the selected competitive advantage may call for opportunities which utilise a geographic shift in the demand pattern, while the synergy component may require that the opportunities fit into the current marketing and distribution facilities.

2.13 Acquisition versus internal growth: the make or buy decision

The decision as to whether the firm will make or buy new product-markets must be made before strategy can be implemented. Both acquisition and internal development assume many forms. The former varies from licensing to purchase of developed products, to mergers with another firm; the latter varies

from addition of new products to major organisational changes to make room for new skills and competencies (Internet 4).

Two primary variables influence the choice between the major alternatives. These are the start-up cost and the timing. In internal development the cost is incurred by product development and introduction, and by acquisition of new facilities and organisations. Acquisitions pay for these costs too, but over and above them is a premium that frequently has to be paid as a compensation for the risks that have been taken by the seller to develop the property and the competence being sold (Hovers, 1972).

Because of this premium, it can be argued that internal development is cheaper. This is not necessarily the case, because, in risky undertakings, budgeting for internal development has to include a risk allowance to provide for the variances in the estimates and the uncertainties of the results. There will be cases where the premium paid on acquisition will not be an accurate reflection of the risks that have been taken. Thus, a firm that seeks to diversify into a currently glamorous growth industry is forced to pay a premium that may be excessive (Internet 2).

In some cases, the choice between acquisition and internal development is weighted in favour of the latter. This will occur when the current price/earnings ratio in the new industry is much higher than that of the firm itself. A desire to avoid large dilutions in earnings per share may militate against acquisition. The choice may also be forced by lack of attractive acquisition opportunities in the new industry. The choice may be forced the other way when the competitive structure in the new industry leaves no room for a significant new entry (Hovers, 1972).

In internal development the timing of entry consist of two elements:

1. The normal product development cycle. This may vary from a few months to several years depending on the technological and marketing complexity of the product.

2. The time span required for gaining new skills and competence. The total time span will depend on the degree of synergy between the new product-market and the firm.

In acquisition of a firm, the delay is theoretically only as long as the time to consummate the transaction. In practice, a time delay is added during which the acquisition is introduced into the parent organisation. However, even after this provision it generally takes much longer to develop than to acquire a firm. If a product, rather than a firm is being acquired, the time span may vary from the time it takes to tool and market, when synergy is strong, to several years, when a complete range of supporting competencies has to be developed. The pros and cons of acquisition versus internal development can be related to the components of synergy as shown in Table 2.8 (Jones, 1982).

As the second entry in the table indicates, internal development is indicated when the start-up synergy is strong, even if operating synergy is weak. Although there may not be operating economies, the firm's competence pattern assures a fast start and low risk. Exceptions in favour of acquisitions may occur in the following circumstances:

1. When the needs of the firm or the instability of the market make a quick entry important.
2. When the firm needs or is offered opportunity to acquire competent management.
3. When the firm will have to enlarge some of its capacities anyway.
4. When a product developed outside the firm costs less than it would to develop internally.
5. When the market shares in the new industry are stabilised, making it very difficult for a newcomer to take away business from established competitors (Jones, 1982).

Weak start-up synergy makes an acquisition preferable. However, if opening synergy is strong – indicating applicable unused capacities – a combination of acquisition and internal development is indicated. Absence of synergy points to acquisition in most cases. An exception is a situation when the premium on

timing is low. This may occur, for example, when the move is being made in support of a very long-term objective and when the competitive advantage is focused on incipient demand (Eisenhardt and Galunic, 2000).

The middle column in the table relates the method of expansion to the growth vector. The high synergy strategies will usually be pursued through internal development. Synergy can vary in horizontal and vertical diversification and so will the appropriate growth methods. Conglomerate diversification normally calls for acquisition.

Table 2.8 Components of synergy: internal development versus acquisition

Synergy		Preferred method	Applicable diversification growth vectors	Exceptions
Start-up	Operating			
Strong	Strong	Internal development	Market development, product development; technology related horizontal and vertical diversification	<ol style="list-style-type: none"> 1. Timing is of essence 2. Acquisition of good management 3. Acquisition of needed capacity 4. Low-cost product acquisition 5. Stable market shares; no room for new entry
Strong	Weak	Internal development	Unrelated horizontal and vertical diversification	
Weak	Strong	Combination of acquisition and internal development		
Weak	Weak	Acquisition	Concentric diversification	<ol style="list-style-type: none"> 1. Timing of importance 2. Incipient demand 3. No competent firms available 4. High price/earnings
None	None	Acquisition	Conglomerate diversification	

2.14 Summary

This chapter revolved around the theory of any given company's decision to expand through either acquisition and/or diversification. It started off by discussing the decision-making process with consideration primarily being given to the strategic decision-making process. It was accentuated that every firm has to give special attention to strategic problems because they are very

hard to pinpoint and because attention to strategic problems can lead to improvement in the firm's performance.

The importance of strategy as a business tool was explained and it was concluded that the alternative, namely the 'no rules approach', posed some weighty disadvantages that resulted in management being forced into extreme forms of behaviour. The theory with examples that were discussed indicated that for most firms the advantages of strategy would outweigh that of total flexibility.

The underlying reasons why firms would want to diversify as well as the different diversification alternatives were covered and explained in detail. Advantages, disadvantages and limitations of different diversification options were also dealt with and diversification alternatives were compared with each other. This led the discussion to the internal and external assessment of the firm, which was done with the help of various figures and tables. This was followed by an important discussion on synergy and structure with the help of a 'synergy structure decision diagram', which resulted in a consolidated list of possible industries, which the company could either acquire or use as a basis for diversification.

Beyond specifying the scope and the growth vector, it was noted that the firm had to look for opportunities within the scope that had the promise of competitive advantage. This was followed by a discussion on competitive advantage and it was reiterated that competitive advantage added a dimension to strategy, both in search and in evaluation of opportunities.

The theory finally arrived at the decision to either make or buy – acquisition versus internal growth. The primary variables that influenced the choice between these two alternatives were given and discussed, namely the start-up cost and the timing. Arguments that internal development is cheaper were investigated and proved not necessarily to be the case. The theory section then concluded with a table that can be applied or used as a tool in the choice

between internal development and acquisition, depending on the synergy structure of the company.

CHAPTER 3

Case Study

3.1 Introduction

This chapter will introduce Mr Hewings, the founder of Safeguard Security in 1962. The company's principle business and its history will be described in detail as well as the problems and decisions that faced its members during the past two years. Difficulties such as an ever-decreasing workload, which forced the members to investigate opportunities outside their present product-market scope, will be pointed out. This chapter will reveal which options were identified and contemplated by the current members and the process they followed in order to arrive at a decision, which could rescue the company from the dilemma confronting it.

3.2. History of the company

Although Safeguard Fire Security (PMB) cc has only been registered as a closed corporation since 1992, a Mr Hewings founded the original company, Safeguard Security, in 1962. As the company name suggests, the organisation's main business was the hiring of guards on a permanent and temporary basis to businesses. The company's head office (and only office for that matter) was situated in Pinetown, Natal. Mr Hewings was an astute businessman and quickly made a name for himself and his business in the Durban area.

By the late 1960s Safeguard Security had become a threat to established security companies. Coin Security subsequently made an offer to purchase Mr Hewing's business for an undisclosed amount. The offer was accepted and Safeguard Security was taken over by the Coin Security group.

The entrepreneurial Mr Hewings, however, could not remain idle for long and in the early 1970s established Safeguard Fire Security, a company which supplied and serviced new fire extinguishers and fire hose reels. The company's factory and workshop were situated in Pinetown. At that time only a few companies offered these services to the business community and because competition was extremely limited the company was fairly prosperous. Mr Hewings's background as a senior fireman employed by the Durban Corporation made him ideally suited for the business in which he operated. Initially the business was principally involved in the supply of new fire extinguishers and hoses and the recharging and servicing of extinguishers, as well as the servicing of hose reels.

Before long Mr Hewings was looking at other possibilities for expanding his business. At that time only one type of fire hose reel frame, manufactured in Johannesburg, was available on the local market. Mr Hewings recognised the gap in the market and saw the opportunity for expanding his business from within. After six months of research and many hours of labour in his factory the 'Fire Fyter' hose reel frame was born. This new type of frame was an improved design and substantially cheaper than its competitor and therefore easy to market. An added bonus was the fact that the company did not have to seek new clients but could immediately sell the product to its existing clients.

With the success of the new type of fire hose reel Mr Hewings realised that a large market existed for reasonably priced new fire equipment. Mr Hewings investigated the possibility of importing a cheaper fire extinguisher than those available in the South African market. The company located a reputable source in Asia that had been exporting fire equipment to Europe and Northern Africa for years. The fire extinguisher that Mr Hewings was interested in would introduce brand new technology to the South African market.

Until 1977 the only type of powder-based fire extinguisher in South Africa was a cartridge type extinguisher. This type of extinguisher was not only outdated in international terms but also dangerous to use under certain conditions. The extinguisher that Mr Hewings wanted to import was a 'stored

pressure' extinguisher and differed from a cartridge type in the sense that a cartridge extinguisher had a CO² gas cartridge on the inside of the cylinder that expelled the powder in the cylinder when triggered by an outside mechanism. The stored pressure extinguisher was pressurised in total (the whole cylinder) with nitrogen and had a pressure gauge on the outside of the cylinder that indicated pressure levels of the unit. Presently this is the only type of powder-based fire extinguisher allowed in South Africa.

The company started importing the powder-based stored pressure extinguishers in 1978 and marketed them under the by now well known 'Fire Fyter' name. The safety aspects appealed to many mining groups and before long they were the company's major clients as many mine groups phased out their existing powder-based cartridge extinguishers for the new powder-based stored pressure extinguisher. Mines were excellent clients as one mineshaft in the many shafts of one mine needs about 2 500 extinguishers for safety precautions.

By the mid 1980s most of the South African fire extinguisher manufacturing companies realised that in order to survive they would have to start manufacturing stored pressure type extinguishers. Natex and Chubb, to name but a few companies, started manufacturing powder-based stored pressure type extinguishers and slowly but surely regained market share. In a very unfortunate incident Mr Hewings lost nearly R2 million in an import/export deal that went sour and the company filed for liquidation in 1988.

In 1989, after all the creditors had been paid, a Mr Neville de Swardt, who had worked for Mr Hewings for ten years, purchased the company from the liquidators for R1 000 00 and changed the name to Safeguard Fire Security (PMB) cc. The company was at the time registered as a closed corporation with Mr De Swardt and his brother, David de Swardt, as the only members. They then decided to stop manufacturing the 'Fire Fyter' hose reel frame (the design of which had already been copied and is still being sold by a prominent fire company in KwaZulu-Natal) as well as the import and distribution of powder-based stored pressure extinguishers.

From 1970 to the mid-1990s the number of fire companies operating in KwaZulu-Natal increased dramatically. In order to regulate the industry all fire companies' workshops were required to acquire SABS registration before their technicians could service fire equipment. The company's workload had decreased drastically since the time of liquidation and the new owners had to rethink their strategy to ensure survival. At that time only one company, Chubb Fire, was servicing and supplying fire equipment to South African and foreign marine vessels in the Durban harbour. This situation had arisen because of the difficulty and expense of obtaining the necessary accreditation to carry out safety work on marine vessels, and especially work on foreign ships.

For the next several years the company's members tried without success to acquire the required accreditation in order to undertake fire safety work on marine vessels. Invariably difficulties arose with the voluminous paperwork needed or with new specifications of which the members had not taken cognisance or had failed to keep track.

In 1999 Mr Marnus van der Westhuizen, who until then had been practising as a lawyer in Pretoria, joined the company after buying the 50% member's interest of Mr David de Swardt who had decided to emigrate. Because of his experience in dealing with corporate clients in his previous profession it was mutually decided that Mr van der Westhuizen would handle the involved process of acquiring the necessary accreditation's required before the company could be registered as a service provider to international marine vessels.

In order to be allowed to work on local marine vessels in Durban and Richards Bay harbours Mr van der Westhuizen initially acquired the SAMSA (South African Marine Safety Association) certification. Within the ensuing six months the Bureau Veritas, det Norske Veritas and American Bureau of Shipping certification and accreditation was secured which enabled the company to undertake work on European and American marine vessels.

By this time the company had approximately 600 clients whose business was spread fairly evenly over the calendar year. Some of the major clients included:

- Sappi Stanger Paper Mill
- Tongaat Hulett's
- Various shipping lines
- Denim Textiles
- Durban Country Club
- Natcos
- SAPREF
- Engen Refineries
- P&O Grindrod Logistix
- Various state and private hospitals
- Lubrizol Oils
- Various transport companies

In 2001 one of the employees, Mohammed Abdul Kader, bought a 5% interest in the company and became a member, followed in 2002 by another employee, Glennis Davidson, who also bought a 5% member interest.

By the middle of 2002 the four members had come to the realisation that drastic steps would have to be taken to ensure the survival of the company. Monthly turnover was down and competition became fiercer by the day as rival firms cut prices to the bone to secure tenders. Although competition in the marine sector was not so intense, the land side was struggling and called for action. One of many problems was the fact that the land market was rapidly becoming saturated. There were simply too many fire companies in KwaZulu-Natal and the so-called 'fly-by-night' companies were taking their toll. Safeguard Fire Security was bound to deliver a standard of service as stipulated by the SABS and other certifications and could not, and would not, compromise on service standards. All the members were in agreement that something had to be done, and done quickly. The question was: what should be done?

3.3 The decision to move forward

Vitally important decisions had to be made which would influence the future course of the company's business. The decisions to be made would be strategic in nature and would have to address questions such as 'what business is the firm in?' and/or 'what business would it like to enter?' At a brainstorming session the members wrote down what questions, in their opinion, ought to be addressed to ensure the continued survival of the company. All were in agreement that a re-evaluation of the goals and objectives was necessary. Another question asked was whether the firm should diversify and if so into what areas and how vigorously? And, how should the firm set about developing and then exploiting its current market position?

Instead of making a decision as to whether the firm should diversify, the members decided to look into the whole spectrum of diversification options. Questions such as into what areas should the firm diversify and whether they had the necessary personnel and skills to diversify successfully needed to be addressed. If the diversification option was deemed not to be practicable would the decision be taken to close down or expand to other areas through mergers or even acquisitions? And if this route was chosen would the firm be able to afford such an expansion?

3.4 Strategic decision model

At first a decision to diversify or expand did not appear too difficult a task. Simply buy a fire company in Johannesburg or Cape Town which has a high monthly turnover. If product diversification is decided upon, simply develop a new type of fire extinguisher and promote it through an advertising campaign!

It was not that simple though. After some deliberation the members realised that to make these decisions they would need a method of analysis which was focused on the search for strategic decision needs and opportunities. Next, alternative courses for the company had to be plotted. If product diversification was eventually decided upon, was expansion to be totally ignored and vice-versa? Because this was a new and unfamiliar situation for

the members, they were not aware of a lot of alternatives. How to seek alternative opportunities still eluded the firm and this had to be fully explored to be understood.

The newly decided project, whether expansion or product diversification, would have to be evaluated before commencement. The members decided that profit should not be the only evaluation tool because profitability was not the firm's only objective. Other evaluation criteria would be to weigh the opportunities against the funds available in the bank, as well as the synergy existing between the firm and the acquired firm and the new products. Equally important, the members decided that the venture that was to be attempted should have an obvious competitive advantage factor potential in the long term.

The members realised that for the company to succeed and for their business to grow the firm needed to be described/defined within its environment. To describe the firm as a fire company was too broad and did not provide a common thread that would enable outsiders to perceive in which direction the firm was going or allow inside management to guide it. The increased penetration in the design and installation of fire suppression systems on marine vessels indicated a direction for growth and was also seen as a useful specification of the common thread. The members decided that the company would be known as a firm that designs, installs and services fire suppression systems and hand-held fire equipment.

3.5 The necessity of strategy

Some members of the firm reasoned that a strategy was not a necessity and that in the long run the only objective should be good and profitable opportunities. They argued that the firm could save time and money and the executive talent required for thorough strategic analyses. After further consideration it was pointed out by one of the members that the many advantages of following a strategy far outweighed the one or two advantages accruing from not formulating a strategy. He made further valid points in pointing out that in the absence of a strategy there are no rules to guide the

search for new opportunities, both within and outside the firm. The result being that the firm as a whole will either passively await the advent of an opportunity or follow a 'shot in the dark' search technique. He also pointed out that without any strategy criteria the firm would lack the necessary equipment to recognise a genuine opportunity. He also argued that without a strategy the firm would either do nothing or risk the danger of acting at cross-purposes.

3.6 Why should the company diversify?

It was decided by the members to explore two alternatives, namely diversification and expansion of the firm. After having given themselves the option of diversification or expansion it was decided that both options should be thoroughly investigated in order that the most suitable option be adopted. To this end it was decided that Mr van der Westhuizen would investigate the two options and report back to the members in two weeks.

In his report Mr van der Westhuizen firstly pointed out that of the two alternatives diversification was definitely the more risky option. He suggested that diversification would entail the simultaneous departure from not only the well-known products of the firm but possibly also from its existing markets. A decision to diversify would therefore represent a major decision for the firm. He informed the members that there are a great many reasons why firms diversify but in his investigation he had concentrated solely on the reasons why Safeguard Fire Security should adopt this course of action. He summarised the situation as follows:

1. Decline in demand through competitive pressures: In the past three years companies that serviced fire equipment had sprung up like mushrooms. The barriers of entry to this line of business were minimal if a firm opted to operate without certifications and inferior workshops.
2. A disproportionately large fraction of sales to a single customer: For the past several years the company's biggest client had been the Sappi Stanger Mill. If this client were to switch its custom to another service provider the future of Safeguard Fire Security would hang in the balance.

Mr van der Westhuizen also explained that different diversification alternatives were available to the company. He advised the members that if diversification was adopted as a strategy, they should opt for the alternative which involved the minimum risk. He explained that this could be achieved by either backward or forward vertical integration. The acquisition of a fire equipment manufacturing company such as Adriel Fire would foot the bill.

The members argued correctly that diversification entailed entering previously unknown markets and would thus be an expensive and risky exercise. They speculated that there would be a higher level of synergy if the expansion route was followed rather than diversification and that expansion would be less risky and more profitable. The consensus of opinion was that if the firm's objectives could be met through expansion, this would be the route to follow. If the members found that they could not solve the firm's problems within the limits of their present product, they would opt for diversification into another product field. The decision was taken that their firm would firstly be assessed from within, with the aid of an internal assessment chart, in order to establish the way forward.

3.7 Internal assessment

The internal assessment of the firm was initiated by setting out tentative objectives for the firm. It was agreed that the firm's objectives should be long-term profitability, continuous growth with a presence in at least four or more provinces in South Africa within a period of two years, and to be a market leader in the design and installation of fire suppression systems. At the same time, a current forecast of future performance was made based on a long-range plan which had been formulated by Mr de Swardt and Mr van der Westhuizen in 1999. Mr de Swardt pointed out that they had resolved to expand the company to at least three other provinces in 1999 but that due to a lack of finance, human resources and possibly determination, this never materialised. It was decided that the company's current forecast would be broadened to include the expansion into three other provinces either by diversification into another field or through an acquisition or merger. A comparison between the objectives and the current forecast indicates that the current forecast may hold

the promise of achieving the goal of market leader in a specific field but would not meet the goal of expansion into so many provinces.

The discrepancy between the aspirations and the anticipations illustrated the total gap and the members concluded that a revision of their objectives was necessary. In a general meeting it was agreed that the company's objectives would be lowered by aiming to expand into one other province only, but to do so in a shorter time span.

The next aspect to be considered by the members required of them to enter, for them, uncharted territory. Every member was required to compile a list of what they considered to be the internal strengths and weaknesses of the firm, as well as external opportunities and threats. The strengths of Safeguard Fire Security were summarised as follows:

1. Expertise in providing consistently good customer service
2. Collective knowledge embedded in the firm built up over many years
3. Good company reputation
4. Strong partnership with key suppliers
5. Good promotional talents of its members

A similar exercise was carried out in respect of internal weaknesses of the firm, with less pleasing results:

1. The company had no clear strategic direction and was lagging key rivals in putting strategy in place
2. The workshops were outdated and too small and some tools needed to be replaced
3. Overheads, and in some cases salaries, were too high
4. Higher overall unit cost in supplying new equipment compared to some key rivals
5. Different management styles of members resulting in confusion amongst employees
6. Shortage of financial resources to fund possible strategic options
7. Not attracting new customers as often as rivals do
8. Ongoing rivalry and antagonism within the workforce

9. Products not differentiated

At this stage most of the members were not talking to each other and the programme appeared to be stalled. The debate had agitated some members who felt that some of the weaknesses listed were attempts by other members to discredit them. Eventually, the members agreed to continue with the exercise and to discuss the external opportunities and threats resulting in the following:

Opportunities:

1. Serving additional customers in new geographic areas
2. Utilising existing company skills to recruit new businesses
3. Integrating forward or backward
4. Acquisition of rival firms
5. Using the Internet to pursue new sales growth

Threats:

1. Likely entry to the market of potent new competitors
2. Loss of sales to competitor companies
3. Increasing intensity of competition among industry rivals resulting in a squeeze on profit margins
4. A slowdown in market growth in KwaZulu-Natal
5. Increased pressure from customers for lower prices

The next analysis examined the potential of the market in which the company was operating. To establish this, the following questions numbered A–F were answered:

A. What are the industry's dominant economic features?

1. The market size in KwaZulu-Natal is small, i.e. between R2 million and R3 million per month.
2. The scope of competitive rivalry is national.
3. There are numerous rivals with a few big companies and the rest divided into smaller companies.
4. Products and services of rival firms are basically identical.

5. Capital requirements are not big, making it easy to enter or exit the market.
6. Industry profitability is below par.

B. What is the competition like and how strong are each of the competitive forces?

1. Rivalry amongst competing sellers: The members concluded that rivalry in this industry is centred on price competition. Occasionally the competition is so fierce that the company is compelled to sell new equipment below cost in order to retain a client. Cut-throat competition is common in the fire industry and is intensifying as the number of competitors increases. Another aspect fuelling rivalry is the fact that there is virtually no cost to the customer when switching from one service provider to another.
2. Potential entry of new competitors: To enter the fire industry does not require a large capital investment. A firm can set up a workshop with tools for less than R50 000. The members appreciated that this was the reason why there are so many competitors within the industry and some had previously questioned the advisability of remaining in the industry. Although it is a requirement for all companies that supply and service fire equipment to be SABS approved, it has been the member's experience that there is no watchdog to monitor this regulation and it would appear that of the approximately 100 fire companies in KwaZulu-Natal only 37 have been SABS approved.
3. Competitive pressures from substitute products: The members agreed that the one advantage that they have in the fire industry is that there are no substitute products for the servicing and supply of fire equipment. A service as such cannot be substituted and a fire extinguisher is a fire extinguisher. At worst, a fire extinguisher can be substituted with a bucket of sand or water, but no fire company sells buckets of sand or water to customers.
4. Competitive pressures from buyer bargaining power and seller-buyer collaboration: The members agreed that because the client can switch to a competing brand at very low cost, the client can negotiate extensively on

price with the company. It frequently happens that the anxious company members seek business by making concessions to customers. Because there are so many fire companies the prospects of losing customers is very real and this pressurises the company into making concessions in one way or another.

The members realised that the industry analysis clearly indicated that up to now the market conditions were so tough that the firm could suffer prolonged sub par profitability and even suffer losses. The competitive structure within the fire industry is clearly not in favour of profitability as is the case as far as Safeguard Fire Security is concerned because of strong rivalry, low entry barriers allowing new entrants to gain a foothold and customers who are able to exercise considerable buying leverage.

C. What driving forces are causing the industry's competitive structure and business environment to change?

At this stage the members realised that industry conditions and competitive conditions change because forces are in motion that create incentives or pressures for change and that these forces are known as driving forces. The members debated the driving forces in the fire industry and came to the following conclusions:

1. Changes in the industry long-term growth rate: The members argued that a shift in the industry growth rate must be a driving force for change in the industry. Because of the many new entrants in the past few years the market has become smaller. This resulted in heightened competitive pressures and some fire companies were forced to retrench employees.
2. Entry of a major firm: In the opinion of the members the entry in 2001 of Tyco Fire, the world's biggest fire company, shook up competitive conditions.

D. What strategic moves are rivals likely to make next?

The company was in the 'fortunate' position that one of its members, Glennis Davidson, had been in the employ of a major opposition company in the same industry for almost ten years before she joined Safeguard Fire

Security. She had been a manager at Fire Check, and possessed accurate intelligence regarding their strategies, latest moves and resource strengths and weaknesses.

This intelligence, the members realised, could help the company determine whether it needed to defend itself against specific moves made by rivals. The members came to the realisation that information about the strategy of major rivals like Chubb Fire and Eagle Fire could be gathered by observing what they were doing in the marketplace, looking at their geographic market arena, and establishing whether recent moves were offensive or defensive.

E. What are the key factors for competitive success?

The members comprehended that the industry's key success factors were those things that most affect their firm's ability to prosper in the marketplace. After some consideration it was decided that the only key factors for success in the fire industry could be summarised as follows:

1. Courteous customer service: As there are very few or possibly no aspects that differentiate one fire company from another, customer service is of paramount importance and could be the deciding factor in client retention.
2. Overall low cost: The members fully agreed that although this would be vehemently denied, many big companies were consistently cutting their safety budgets year after year. Mr van der Westhuizen gave an example and noted that when he joined the company in 1999 the firm provided 9 kg stored pressure powder-based extinguishers for R260 at a cost of R135. At present the company's asking price for the same product is R280 at a cost of R210. Overall low cost was therefore definitely a key factor for success.

F. Is the industry attractive and what are the prospects for above average profitability?

The members were beginning to realise that the industry in which they found themselves was not very attractive. In their opinion the growth potential in KwaZulu-Natal is much weaker than in Gauteng for example,

because there are very few new developments or big companies entering the marketplace as potential clients in the province.

Another factor is the fierce competition that is driving prices per extinguisher down to levels that Safeguard Fire Security was charging in the mid-1980s. The members also noted that the driving forces which they had identified would most definitely affect the profitability of the industry unfavourably and they were facing the probability that their company's competitive position would grow weaker. The entrance of the international security giant Tyco, which had recently bought out ADT Security, has made the firm's prospects even gloomier. Tyco Security has the resources to endure extended periods of below par profitability. Safeguard Fire Security has not.

Although there are weaker and more vulnerable companies than Safeguard Fire Security it would be pointless to capitalise on these smaller companies' vulnerabilities by luring their clients because all of these companies are trading at lower rates than Safeguard Fire Security does.

Now that the members knew what the firm's strengths and weaknesses were, and also the potential within the industry, they could progress with the internal assessment of the firm by formulating a final forecast for Safeguard Fire Security.

When the members looked back at the strengths that they had listed for the firm they felt that they would be able to exploit at least some of these. Their good customer service, the expertise of the members in the field of design and installation of fire suppression systems and their promotional abilities could be used to become a market leader in a specific field and to expand into another province.

The members determined that if this forecast were to materialise the firm's internal weaknesses would have to be remedied. Immediate attention would have to be given to outdated workshops and the replacement of

obsolete tools. When consideration was given as to where the funds would come from Mr de Swardt proposed that every member should take a cut in salary and that company expenses would have to be cut to the bone.

However, the question still uppermost in everyone's mind was where the company was going to find sufficient resources to achieve its objectives. A cut in salaries and cutting cost could only go that far: no member was drawing more than R15 000 per month. A R2 000 to R3 000 cut, for example, would not remotely provide the resources for an acquisition.

Since none of the members had any idea as to the purchase price of an established fire company they decided to engage the services of a business broker and also scanned newspapers in search of a fire company that was for sale. It was established that fire companies were available at costs ranging from R200 000 to R5 million and that the latter had a monthly turnover of R400 000. The members were somewhat surprised by these prices and some openly contemplated whether the firm should not be sold or perhaps that they should sell their member interest.

The existing client base of approximately 600 customers had generated an average monthly income of R109 000 over the past four years with the annual turnover for fiscal 2001/02 just topping R1.5 million. Comparing these figures with the for sale companies, the members estimated that the company could be sold for at least R1.5 million.

Thus, to buy a company with at least the same turnover as Safeguard Fire Security a layout of R1.5 million was required. This figure did not include the cost of manpower, operating costs, new and modernised facilities or administrative changes. The members realised that they would not be able to raise the capital on their own and that they would have to approach several financial institutions with a well drafted business plan if they wished to expand through acquisition. The resources available would, therefore, depend on what overdraft facility the financial institution would grant the firm. The members decided that if the approved loan amount was

insufficient to acquire a worthwhile firm, they would rather consider diversification alternatives into different product lines.

3.8 External assessment

The members now moved on to the analysis of the opportunities that existed outside its present activities in order to arrive at a decision regarding diversification. It was decided that the external assessment would start with a list of the economic, cost of entry and synergy criteria for diversification.

The members concluded that the economic criteria for diversification through acquisition and through product diversification would be long-term growth and stability for the firm. The cost of entry criteria would be based on the history, size and the price of the acquired company in the case of an acquisition and upon the trends in the market in the case of product diversification. The synergy criteria in the case of an acquisition would be common management skills, and in the case of product diversification the criteria would be factory and equipment commonality.

The members felt that the assessments that they had done so far provided sufficient information to shortlist certain companies for acquisition and also to identify certain diversification opportunities into other products. There were two Johannesburg companies for sale which looked promising, namely Domestic and Industrial Fire Services and Delta Fire Engineering. Both companies had been in business for more than ten years and had consistently exceeded a R2 million annual turnover. The asking price was R1.5 million and R1.7 million respectively.

For a while now some of the members had entertained the idea of diversification through backward vertical integration and to acquire or establish a fire equipment manufacturing company. The reasoning behind this was the fact that there were only two fire appliance manufacturers in KwaZulu-Natal. These two companies, NATEX and CENTA, were not only supplying all of the province's fire companies with a range of fire appliances

and equipment but were also supplying many customers outside of the province, as well as exporting to parts of Africa.

This type of integration would not only secure supplies of fire equipment at lower cost than competitors, but the company could also continue with its current type of work, namely the servicing of fire equipment and instalment of fire suppression systems. The members felt that a definite competitive advantage would be achieved as no other fire company in South Africa services and manufactures fire equipment to sell wholesale to the industry.

Even if these two manufacturing companies were for sale, Safeguard Fire Security would not have been able to purchase them because the asking price would most certainly be in the range of R20 million. Preliminary calculations showed that to extend Safeguard Fire Security's existing workshops and to acquire the necessary manufacturing equipment would cost in the region of R1.2 million. This was cheaper than the two Johannesburg companies that were for sale.

In deciding which route to follow, the members realised that they would have to compare the option of product diversification with the expansion option. The first criterion applied was the economic potential of the above options. The members reasoned that the economic potential for a fire company in Johannesburg would be similar to that of one in KwaZulu-Natal.

The economic potential of Safeguard Fire Security is very bleak as strong competition is driving prices down to levels that are not sustainable. On the other hand, there are only two fire appliance manufacturers in KwaZulu-Natal which cater not only for all fire companies in the province but also to fire companies as far afield as Cape Town. The members debated that the economic potential of a fire appliance manufacturing company certainly appears to be more favourable than that of a service provider inasmuch as the market is big enough to accommodate three fire appliance manufacturers.

The second and third criteria respectively used to resolve the question of product diversification or expansion were competitive characteristics and competitive profiles. As pointed out, the competition amongst fire companies is tremendous, as there are more companies than the market can accommodate. At present no, or at most very limited, competition exists between the two fire appliance manufacturers because there is more than sufficient work for both companies.

The members were also aware from previous experience that the two companies were sometimes so busy that they had a backlog of orders for up to three weeks. This could be extremely frustrating for customers and sheds a poor light on the company. The members realised that if they were to start up a manufacturing side that they would always have sufficient and cheaper product at hand, and fill a gap that exists in the marketplace.

Although enthusiastic, the members decided that they still needed to investigate some limitation factors. One of the aspects discussed was management for the new venture. Would the company appoint new managers for the venture or would the members manage it themselves? It was resolved that if Safeguard Fire Security were to go ahead with the product diversification Mr de Swardt and Mr van der Westhuizen would manage the new venture whilst the remaining members would manage Safeguard Fire Security.

The members understood that another limiting factor would be the funds required for the new venture. If the venture were to be undertaken, Mr van der Westhuizen was nominated to draw up a business plan and submit it to the other members for approval before submitting it to several financial institutions. It was also decided that if product diversification was undertaken it should not dilute present earnings in any way. Aspects such as the number of workers and their wages were discussed and it was decided that the firm's workforce was already too big so the excess workers could be transferred to the new manufacturing side if diversification took place.

The members felt that they were finally in a position to make a choice between expansion, product diversification, or both. It was decided that they would base their decision on a list of diversification variants which was to be drawn up. Because the internal assessment had forecast a decline in the firm's present business, the first option was to liquidate the business as it now exists and reinvest the proceeds into diversification and thereby create a new firm. Another option would be to keep the firm as it is, but to devote most of the available resources or financed resources to diversification.

In a general meeting the members finally decided that the product diversification opportunity to manufacture fire appliance equipment for the fire industry was attractive enough to sacrifice expansion moves and even to relinquish some parts of the firm's present business.

3.9 Summary

This chapter has revolved around the case study of Safeguard Fire Security. The history of the company has been presented and the acumen of the founding member accentuated. The reasons why the company members felt that expansion through acquisition and/or diversification was necessary have been given, i.e. market saturation, fierce competition, and below par profitability. Various diversification and expansion options have been investigated.

However, before making a final decision on the route forward, the members decided that an internal and external assessment of the company should be carried out. The assessments included an in-depth study of the company's strengths, weaknesses, opportunities and threats. An industry analysis was done which made it clear to the members that the industry in which they find themselves is not a very attractive one.

The option of expanding through the purchase of either one of the two Johannesburg companies was discarded as the members realised that there was insufficient potential within the industry. The members therefore decided that the route to follow would be product diversification by entering the field of

fire appliance manufacturing which offers big scope for growth and profitability for their company.

CHAPTER 4

Evaluation of the situation

4.1. Introduction

In the previous chapter it was pointed out that the basic ills of the company lie not in the firm but in its environment. Instead of seeking remedies in operational improvements such as cost reduction, new managers or reorganising of the company, the members of Safeguard Fire Security decided to revamp the entire product-market position. The aim of this chapter will be to analyse the manner in which the members proceeded in making their strategic decision to either expand or to diversify into another product-market. This chapter will also attempt to indicate what the company has done well, or not done well, in order to be a successful company.

4.2 Trigger signals

It was stated in Chapter 2 that strategic problems are more difficult to pinpoint and therefore require special attention. Continuing downward trends in profitability and obvious signs of market saturation clearly indicated that the company needed to urgently address strategic problems that had arisen.

The management realised that if the trigger signals emanating from decreased sales and lower profits were ignored, the existence of the company was under threat. Although these signals were recognised and a decision made that special attention should be given to them, the fact remains that these trigger signals should have been identified in the mid-1990s when the company's workload and profits reduced appreciably.

4.3 The move forward

The members correctly decided that they had to move forward and re-evaluate their market position. They realised that in order to change from their current

position, firm resources would have to be redistributed and expansion through acquisitions or product diversification had to be considered. In Chapter 2 a checklist for the search for a strategic opportunity was listed. The methods adopted by the members in their search were more or less in conformity with the checklist.

An important aspect that the members concentrated on in their search for a strategic opportunity was the thorough evaluation of expansion and product diversification factors before commencing with the task. Two aspects that could have been more closely examined at this stage were the evaluation of synergy resulting from the addition of new product-markets, and the evaluation of the long-term potential of product diversification and expansion.

4.4 The use of strategy

In the search for opportunities the members correctly emphasised the advantages of using strategy to meet their objectives. Without strategy there would be no rules to guide the search for expansion or product diversification opportunities in and outside the firm. Members would not have been able to identify a genuine opportunity without the use of strategy because no objectives would have been formalised, no assessments would have been done, and no search and evaluation rules would have been formulated.

The emphasis that was placed from the beginning on the required use of strategy created a competitive advantage for the company as it had an advantage over other fire companies that blindly aimed for various ways of expanding. It seemed the emphasis that the firm placed on strategy contributed in the internal and external assessments that were done on the firm and consequently contributed in identifying the way forward.

4.5 Caught off guard

It is definitely true (as stated in Chapter 2) that when a company waits for a trigger signal before any strategic decisions are made (as the members of Safeguard Fire Security did), the challenge often arises when the company is ill-prepared for it. Safeguard Fire Security treated strategic change as a one-off

response and failed to survey the environment for strategic threats and opportunities.

When the members were suddenly confronted with the strategic problem of declining profits and market saturation, they had to appoint one of the members to investigate product diversification and expansion opportunities, as they had never given these options any thought. This time-consuming exercise could have been avoided if the company policy was to make regular periodic reviews of current and future product-market strategies, as the theory suggests.

4.6 Strategic change on a permanent basis

The members correctly argued that the magnitude of the required product-market realignment had a big influence on the way the company was going to move forward. The problem that the company faced, namely losing an even bigger share of the market than it already had, could not be described as a minor soft spot in an otherwise healthy product-market position. The members therefore correctly decided that temporary ad hoc arrangements for realigning the company's precarious position would not be sufficient.

In Chapter 2 theory suggested that the firm would have to put strategic change on a permanent basis if the company finds itself in an unstable market – and this is exactly what the members decided to do. The members prudently decided that the company would have a better chance of growth and profitability if part of the total budget was used to support a small staff (one member in this case) to do market research and explore permanent opportunities for product diversification and expansion.

4.7 Reasons to diversify

Theory suggests that diversification involves the departure from familiar products and markets. The member who was mandated to investigate expansion and diversification opportunities therefore correctly informed the other members that diversification was the more drastic and risky of the two strategies.

Several reasons why a firm should diversify are discussed in Chapter 2 and the member delegated to investigate these mentioned correctly why he thought that the company should diversify, namely a decline in demand through competitive pressures and a disproportionately large fraction of sales to a single customer. His suggestion to diversify into a related field would eventually create opportunities that had never before been contemplated by the members.

4.8 A drawn out exercise

The members argued that synergy would be higher in an expansion opportunity than in product diversification. The decision, therefore, by the members to only opt for the product diversification strategy, if the company problems could not be solved through expansion, proved to be a prolonged exercise. The case study shows that expansion was eventually not going to be the appropriate decision.

It could be argued that the members with their extensive experience in the market should have realised this from the start and should have opted for a product diversification strategy from the moment that they realised that drastic changes had to be made. On the other hand, it could be argued that the internal and external assessments of the company by the members was a crucial exercise in strategy implementation.

4.9 Tentative objectives

In the attempt to internally assess the company, the members prepared some tentative objectives. As they were new to the concept of strategic analysis, this process was not easy. What the members should have done in their attempt to prepare these objectives was to conduct a review of current objectives in the light of past performance and then make a tentative revision in priorities and goals. If the members had done it in this way they probably would not have decided to pursue the idea of expansion in other provinces but would rather have opted for product diversification as the founder of the company had successfully done in the 1970s.

4.10. Current forecast of future performance

The next step was to make a current forecast of future performance for the company. In retrospect the members should have based this forecast on the long-term plans for the company that were made by Mr Hewings in the 1970s and not on the plans made for the company by two of the members in the 1990s, namely expansion.

If a comparison had been made between the objectives and the current forecast it would have been clear from the beginning that the members should have steered the company into another product-market field. There would not have been a discrepancy between the aspirations and anticipations and the members would have pursued the idea of product diversification sooner than they eventually did.

4.11. SWOT and industry analysis

In order to further internally assess the company the members rightly decided to do an exercise where they listed the company's strengths, weaknesses, opportunities and threats. The result was that the weaknesses and threats far outweighed the strengths and opportunities.

An industry analysis was also performed in order to investigate the potential of the industry the firm found itself in. At this stage, the management of Safeguard Fire Security started to realise that the industry that the company found itself in was not very attractive. Members correctly pointed out aspects such as the small market in KwaZulu-Natal, numerous rivals, no differentiation of products, the ease of entry and exit into the market and sub par profitability, to name but a few.

Instead of investigating product diversification options at this stage, the members still busied themselves with problems such as where the funds would come from to acquire other fire companies and even spent money on the services of a business broker.

4.12 External assessment

Fortunately the members made the correct decision assessing the company externally in order to find out if there were more attractive opportunities outside the present scope of the firm. In deciding what the economic criteria for product diversification would be, the members opted for long-term growth and stability. Although there is nothing wrong with long-term growth and stability, it could be argued that return on investment, as well as competitive pressures, could have been economic criteria influencing Safeguard Fire Security towards investing in product diversification.

The same could be said for the cost of entry criteria that the members decided upon for diversification, namely trends in the marketplace. Additional cost of entry criteria that should have been considered for product diversification are the size of the planned entry, the room for new entries, and the product demand. In the case of synergy criteria for product diversification, the members thought that common factory and common equipment would be sufficient criteria. Synergy criteria such as skills critical for success, common management skills, common organisational capacities, sharing of overheads and timing advantages that should have been considered, were neglected.

4.13 Measuring of options

The members did well in keeping their options open and could at this stage start to compare options that were presented to them through their research. The options that presented themselves, namely the two Johannesburg companies that were for sale and the backward vertical integration strategy, were correctly measured against each other by making use of criteria such as economic potential, competitive characteristics, and competitive profiles. The members used the industry analysis, which they had compiled when they considered the economic potential of the two fire companies in Johannesburg. They came to the correct conclusion, i.e. the economic potential for any fire company is indeed very bleak.

4.14 Another industry analysis?

It is true that the economic potential of a fire appliance manufacturing company does indeed look brighter than that of a service company, but that is purely on face value. A proper industry analysis should have been done of this industry in order for the members to be absolutely certain that they were making the correct choice.

It is also true that there are only two fire appliance manufacturing companies in KwaZulu-Natal – but the question should also be asked, why? Perhaps two companies are enough to accommodate the demand. The members should also have spent some time determining if any other company had previously contemplated establishing a fire appliance manufacturing company, but did not proceed with it.

4.15 Limitation factors

One of the limitation factors that was considered by the members was the funds required for the manufacturing venture. Although this limitation factor is important, few financial institutions will refuse funds where the potential of the industry is grasped, a proper track record is exhibited and a suitable management structure is proposed. More attention should rather have been given to internal constraints, such as the managers who were going to be appointed to manage the manufacturing side.

The members decided that Mr van der Westhuizen and Mr de Swardt would run the manufacturing side of the new venture. It is clear that not a lot of thought went into this decision as neither of them have any experience in the manufacturing of fire appliances. A more rational decision would have been to appoint a manager with extensive experience in the field of fire appliance manufacturing and to appoint one or two existing members of Safeguard Fire Security to work closely with the new management.

4.16 To liquidate or not?

After the members decided that they were going to invest in backward vertical integration, they were still faced with the option to proceed with the servicing side of the company. The company could have been liquidated and the proceeds used in the product diversification venture. One could argue that the decision not to go the latter route was the correct one.

The decision not to liquidate would mean that the company could still retain their clients on the service side and could also use them as a starting point to sell their new products. Although the industry has many competitors, liquidation of a company would not pass unnoticed and would lead to a mad rush by companies trying to acquire Safeguard Fire Security's clients.

4.17 Synergy and structure

It could be argued that not enough thought was given to the important aspect of synergy. Synergy and the organisation's structure are dependent on each other and therefore the members should have contemplated adjusting the post-diversified company so as to maximise synergy. Because the synergy in Safeguard Fire Security was only strong in general management and not in functional areas, it could be argued that the members should have opted for a decentralised organisation. This would imply that the backward vertical integration into the manufacturing side should be set up as a separate division and assigned profit and loss responsibility.

4.18 Synergy and cost

The members never considered whether synergistic advantages would offset cost and inefficiencies of structural change. When an acquisition or product diversification is relatively small and different from the parent (as in the case of Safeguard Fire Security) synergistic advantages normally do not offset the cost of structural change.

Instead of forcing manufacturing to fit into the already existing structure (and ignoring synergistic effects), members should have contemplated revising the

overall organisational concept into a separate entity. If not, the new manufacturing side would probably be bombarded with poorly informed advice from headquarters.

4.19 Critical mass

Another important aspect that was not considered by the members was critical mass. The newly formed manufacturing division would have to obtain enough market share in order to become fully competitive on price and cost. Sufficient market share must further be obtained within a relatively rapid time span compared to the normal product development lead-time for the industry. Failure to do so would create pressure to abandon the newly formed venture and would nullify the reasons for entering the new venture, namely saturation on the servicing side of the market. In a small firm, such as Safeguard Fire Security, failure to build up quickly to the critical mass could lead to bankruptcy.

4.20 Other diversification options

When the members became interested in product diversification, and specifically backward vertical integration, they only investigated one route of backward integration, namely fire appliance manufacturing. Further investigation should have led the members to various other forms of backward integration. Acquiring a company or starting a company that manufactures powder for fire extinguishers is but one example.

Instead of starting up a company that manufactures a complete fire extinguisher, the members could have investigated options to manufacture only certain parts of fire appliances. Gauges, stem-checks and, in some cases, powder are but a few of the spare parts that are currently imported by the two manufacturers of fire appliances in KwaZulu-Natal. This option would have definitely cost the company less and if their prices were right the company would have had two big buyers, namely NATEX and CENTA, right from the start.

4.21 Competitive advantage

Although there was some emphasis placed on competitive advantage, the concept is so important to strategy that one can argue that the members did not emphasise it enough in their search for expansion options. It would have been to the firm's advantage if the members identified more opportunities within the scope that offered a definite competitive advantage.

In the search for competitive advantage the members could have classified product-market opportunities into different categories. For example, the members could have investigated import opportunities from Asia where they might have found fire appliances at very reasonable prices. Although these imported products would have had no clear-cut advantage over other products, it would have been competitive in the sense that it represents a particular compromise of cost and performance characteristics that could have been superior to competition.

Competitive advantage adds a dimension to strategy in the search for and evaluation of opportunities. It is true that straightforward steps can be taken to select competitive advantage, but a really successful formula requires skills in predicting trends in markets and technology. The fact that the members know the industry and its environment fairly well greatly enhances their ability to anticipate market trends.

4.22 Product demand

None of the members looked at a favourable demand to capacity relationship. If the total capacity equalled or exceeded demand, the competitive environment would be due for a shakeout. This would be the case even if the demand was growing. Although the members established that there was an existing demand for the product, the cost of gaining acceptance for the new product was never considered. This would imply that the members would have to gain acceptance for their products by proving superiority of the new product over other available products.

It was doubtful if superiority of the product would be self-evident and therefore the customers would have to be sold on the performance capabilities, reliability and most of all, the price of the product. Other costs that were never considered was the cost of finding the customers and educating them.

4.23 The choice between acquisition and product diversification

It is apparent that two primary variables influenced the choice between product diversification and acquisition, namely the start-up cost and the timing. In internal development, the cost is incurred by product development and introduction, and by acquiring new facilities. Acquisitions pay for these costs too, but over and above them is a premium that frequently has to be paid as a compensation for the risks that have been taken by the seller to develop the property, as well as the competence being sold.

Because of this premium, the members would argue that they went for the cheaper option. This is not necessarily the case, because, in risky undertakings, budgeting for internal development has to include a risk allowance to provide for the variances in the estimates and the uncertainties of the results. There will be cases where the premium paid on acquisition will not be an accurate reflection of the risks that have been taken. Thus, a company like Safeguard Fire Security, that seeks to diversify into a currently glamorous growth industry, is forced to pay a premium that may be excessive.

4.23 Summary

This chapter aimed to analyse the manner in which the members proceeded in making their strategic decision to either expand or to diversify into another product-market. In considering the options between expansion and diversification, this chapter pointed out several aspects where the members did fairly well, as well as aspects where they could have done better. The recognition of trigger signals and the decision to move forward were just some of the aspects where the members did fairly well. It was argued that they should have recognised these signals at an earlier stage because when they

realised that they had to move on they were actually caught off guard and ill-prepared.

The chapter also emphasised the exercise of the internal and external assessments where the members did really well in accentuating the problems facing the company. It was stressed that although the members did well in assessing their own industry, they should also have properly assessed the fire appliance manufacturing industry.

It was further stated that not nearly enough attention, if any at all, was given to aspects like synergy, internal constraints, critical mass, other diversification options, competitive advantage, and the relationship between favourable demand and capacity relationship. The chapter ends with a warning that although the members might have thought that they went for the cheaper expansion option, the premiums that they might have to pay could be excessive.

CHAPTER 5

Recommendations and Conclusion

5.1 Introduction

The aim of this chapter is to make certain recommendations to guide the members in setting up and starting the new company. The first aspect that will be considered is the trading status of the company. Limited liability as a trading status will be considered against other trading options and certain suggestions will be made. The importance of a name change as well as a mission statement is accentuated.

Management skills and capabilities within the business will be dealt with and it will be recommended that the members seriously consider appointing management with experience in fire appliance manufacturing. Aspects like skilled staff and staff recruitment will also be dealt with. Consideration will be given to current policies and the fact that they should initially concentrate on maximising sales and revenue and subsequently improve the profit margins within the sales revenue. It is also recommended that the decision-making process must be proactive rather than reactive.

Recommendations will be made regarding aspects such as stakeholders, financial resources, financial system and control procedures, location and premises, customers, competitive advantage, as well as the important aspect of advertising.

5.2 Trading status, re-naming and mission statement

Safeguard Fire Security is currently trading as a closed corporation. The question arises as to whether this type of trading status is sufficient for the present business and whether it will suffice for the future? It is suggested that the new venture should be run as a separate entity and also be renamed. The

new name could be similar to the existing one but with a subtle difference. Something like Safeguard Fire Manufacturing would suffice.

It appears that the members wish to expand substantially and that the company will in its pursuit of market share probably increase the number of credit customers. This will leave the members vulnerable due to an extensive exposure to the risk of bad debt. Furthermore, if the members are to open more branches in the near future, it is recommended that a limited liability status, which reduces the exposure, be considered. Although the borrowing capacity of the members may be affected, it is suggested that a limited company be formed. It would also be a good idea for the status of the current company to be changed to one with limited liability (Marino, 2002).

The company must have a mission statement, which clearly specifies the key objectives of the organisation. The mission statement should serve as a proud emblem proclaiming the customer focus of the organisation and also serve to inspire its employees. If the members intend to summarise their primary objectives, there must be a practical and measurable purpose behind it, and it must be realistic and achievable.

5.3 Management skills within the business

Expansion can be inhibited by deficits in management skills, such as staff management, leadership, financial planning and control, operations management and information management (Marino, 2002). It is recommended that before the members commence with their expansion process they need to be aware of the current position in terms of management capabilities. The current knowledge and management capabilities within the firm must first be identified. It is also recommended that the company's members take cognisance of the following aspects:

1. Are management skills and capabilities being used to the full?
2. Are these capabilities and skills sufficient for the current needs of the business?

3. Are the management skills and capabilities likely to prove adequate for the future needs of the business or will other skills have to be imported or developed?
4. What are the particular skills that are lacking?
5. Are there any staff members within the current business that could be trained in these skills?
6. What would be the cost of training in terms of money and productive time lost from the business?
7. Is suitable training available?
8. Is training viable or should the company rather try to recruit skilled staff or buy in the necessary skills from an external provider?
9. Can the company afford to buy in these skills?
10. What would the cost and operational implications be of not having the necessary skills, i.e. can we afford not to have them?

The members decided at a general meeting that Mr van der Westhuizen and Mr de Swardt would manage the new venture whilst the remaining members would manage Safeguard Fire Security. It is suggested that this is not the way forward. The case study pointed out that none of the members had any production experience and therefore it is suggested that the members' current skills and capabilities are not sufficient for the needs of the new venture. New skills and capabilities need to be imported and these skills must preferably come from someone who has been in the production of fire equipment for some time. The manager must be in charge of production as that is where the members' skills are lacking.

It is further suggested that at least half of the new staff must be skilled and recruited from existing manufacturing companies and that the other half should be recruited from within. The skilled staff should train some of the existing staff members who are recruited for the new venture. This way money would be saved on training as in-house training could be provided. In a manufacturing environment the company cannot afford to have staff without the necessary skills and it is thus strongly recommend that the members follow this route.

5.4 Current policies and the decision-making process

The current policies of the firm are not specified or even written down. As with many firms they evolved as the business established itself and started to grow. Although the policies of the new company would initially be influenced by the simple need to survive and to reach break-even level before the working capital is exhausted, it is suggested that the members should immediately make an attempt to specify current policies. Initially these policies must relate to maximising sales and revenue in order to improve the profit margins within the sales revenue.

The decision-making process must be proactive rather than reactive and therefore we recommend the members explore the following aspects:

1. To decide what they want from this new venture (objectives) and when they are going to achieve that.
2. Key decisions must be made that will help the members achieve their objectives.
3. Will they involve any outsiders in the process when important decisions are to be made?
4. Have they made any bad decisions in the other company that could be used as a learning experience?

This reflective process will probably be uncomfortable or even painful to face, but it will be invaluable in planning for the future.

5.5 Stakeholder's interests and objectives

The most obvious stakeholders in the business will be the owners who will most probably risk their personal assets, as well as the providers of loan capital whose repayments will depend on the company's success. The employees will also be dependent on the company for continued work and their families for their income, the suppliers for continued custom, and the customers for a reliable source of goods. The stakeholders must be satisfied

with the company's performance and the company should meet their expectations.

The member's own family members and dependants are also stakeholders – what do they think of the enterprise, and has it met with their expectations, both in terms of the business and you as a person? Direct families of owner-managers can easily become the most neglected of stakeholders as business demands take priority over the needs of the family.

5.6 The financial resources, capitalisation, working capital and cost structure

It is recommended that the members first examine the capitalisation. They should decide if the business is going to be funded by equity, long-term borrowing, from reserves generated by the previous year's profits or a combination of these. The members should find out what the current borrowing capacity is of the business and if adequate security is available to support further borrowing. If the members do not want to incur further debt, they could consider selling shares in the business to raise more capital.

The aspect of working capital must also be addressed. The working capital must be sufficient for the company's needs and it is recommend that if possible the members should not rely on overdraft facilities and credit from their suppliers. Working capital must also be adequate to allow for planned growth without further borrowing.

Operating costs will have to be compared with those of rivals in terms of higher or lower overheads, variable production cost and profit margins. Components must be bought at a cheaper price than rivals. This could possibly be accomplished if the members can pay their creditors either on a current basis or quicker than 30 days. Operating costs should be acceptable as well as sustainable in the long term.

5.7 The financial system

The controls and record systems that is to be used within the business must be designed specifically for the operational requirements of the new venture. The

members must guard against the situation that applied in Safeguard Fire Security, namely that the financial system evolved on a need basis, with extra bits being bolted on as the business changed or expanded, or as more demand for financial information was requested by lenders or the company auditors. Financial records, as a start, should at least include sales, purchases, nominal ledgers, sales invoicing, customer statements and accounts, payroll and PAYE returns, VAT records and petty cash payments and receipts. The most important aspect of the financial system is that it must operate efficiently and expeditiously. It must also give the members information on the spot when they need it.

In terms of financial controls, the members must look at the monitoring of cash flow, collecting debts on time, paying suppliers on time, and controlling and reconciling cash and bank figures with the ledger system. The members must manage their cash flow efficiently from the start and not lose valuable time chasing debts in order to pay bills, as in the case of Safeguard Fire Security. It is recommended that the members persuade their customers to keep within the agreed credit terms and that these credit terms should not exceed payment 30 days from invoice. If it does not affect the relationship with the suppliers, supplier's credit should be stretched to the absolute limit.

It is recommended that in terms of financial planning, the members should regularly monitor their new venture's sales and expenditure figures against planned budgets in order to identify variances and potential problems. If not, the members are, as in the case of Safeguard Fire Security, only going to react when the crisis hits them.

5.8 Past financial performance and profitability

Accounting records will be the tangible evidence that the business and its managers are showing a trend of progressive growth and profitability to justify the interest of a potential lender or investor. The other importance of accounting records is that it would show why the business is not making a profit.

The members are advised to continually ask themselves whether the business is trading profitably or if it will trade profitably and continue to do so in the future. Members must establish which activities generate the most profit and which generate the least. Even low-profit sales contribute towards overhead cost and therefore members should ask themselves whether they could justify any change to these activities, or if they should rather concentrate on high-profit activities.

Members must establish whether the company's profit margins are above or below the industry average or those of their competitors and why that is the case. If they are lower than average, the question should be asked if these profit levels are acceptable to the members and/or the stakeholders in the business. It is suggested that because the company will be started from scratch, that the members, at least for the first year, rate long-term stability and survival above short-term profits. For at least the first year, the company will be gaining a foothold in the market and would be working on reduced margins. The emphasis here should be on understanding the reasons behind past performance to help plan future policies.

5.9 Monitoring and control systems

The above systems are determined by the nature of the products or services which the business is going to provide. It is suggested that in the new venture's manufacturing output they must relate to control of material usage, standard costs, production outputs and product quality. On the retail side of the new venture, it should involve stock ordering, meeting delivery deadlines and achieving sales volumes. The monitoring and control systems that were used in Safeguard Fire Security cannot be applied in the new venture as the original company is in the servicing industry where more emphasis is placed on customer care, retention and minimising complaints.

It is recommended that the members supervise their control systems continuously in order to establish whether it is functioning optimally and if any changes could be made to make the system more efficient and cost-

effective. Information that is generated by the control system should be of practical use for the members as well as up-to-date.

5.10 Physical location and premises

The nature of the market will have fundamental implications for the location and vice-versa. The business needs to reflect the community it serves and therefore its location within that community must be selected to match the needs of that community. As the company will be manufacturing and selling fire extinguishers, fire hoses, fire reels and frames, as well as fire fittings, it would be recommended that the premises should be situated in an industrial area where its commercial clients can call and park easily.

Equally, it is recommended that the location of competitors should be considered. As the market is fairly large it should not be a problem if the members decide to locate the business close to one of the rival companies. It would in fact be a good idea to locate the new company as close as possible to the rivals so that the members could keep track of any occurrences that they should know about. Location should also match the image of the product offered.

The factory space that Safeguard Fire Security has available at present will not be sufficient to accommodate a manufacturing component. The members will have to choose other premises, and for logistical reasons, preferably as close to the current workshops as possible. Start-up firms normally begin by selecting premises that match their immediate needs at the lowest affordable cost. It is suggested that the members look into the future to ascertain what space or premises they require. This should not be problematic if the members complete a strategic analysis of their new venture that will identify the direction of the company's growth, along with some realistic and quantified objectives.

It is suggested that the chosen site must be large enough to accommodate plant and equipment for a number of years and should ideally have sufficient surrounding area to accommodate further expansion at a later date, otherwise

the company's surplus profits and reserves will be swallowed up by repeated relocations. This may mean that the company will be paying for space that is not being fully utilised in the early stages, but it could always be sub-let until the company needs it for its own use.

5.11 Physical resources, equipment and stockholding policies

Because the new venture is a manufacturing business, it is suggested that notwithstanding the cost, the members should acquire the ideal equipment from the start. A full inventory of plant and equipment covering all items that will be used on a regular basis must be drawn up. The members will have to have an active policy of maintenance and replacement and cannot just buy new items when the old ones are beyond repair. Full productive use must be made of the inventory otherwise machinery will sit idle, costing the company money for the space it occupies and the interest on the loan that paid for it.

As a manufacturing concern, the new venture will hold stock of raw materials and finished goods. Average value of stock that the company holds in terms of days must be compared with sales revenue, i.e. is the stock being turned over at an acceptable rate, and how does it compare with the industry average? The company will have to adopt a realistic stock management policy in order not to run out of stock or to hold too much. It is very important that stock will have to be monitored for theft and/or wastage. It is suggested that the members design a stockholding system that links in with the company's financial accounts. If not organised and maintained properly, stock control can be a major headache.

5.12 Changes within the organisation

Managing change is always a problem for any business and even more so if the change has resulted from a reactive rather than a proactive decision, as in the case of Safeguard Fire Security. Diversification into manufacturing is a major change, especially as these changes were not planned well in advance and were the result of problems the company was facing. It is suggested that the members should establish if these changes would have an adverse effect on customers and staff.

5.13 Who are the customers?

It is suggested that the members learn as much as they possibly can about their customers. For example, do they fit into stereotype groups, or do they share common characteristics in terms of their size and types of organisation? How many customers of each type does the company have, and which type generates the most profits? The members will have to study the customers' buying patterns in order to establish the products they select, the volume of purchases and the frequency or regularity of orders. Changes in clients buying patterns will have to be monitored – are these changes positive or negative? The key criteria why the customer is buying from you and not another supplier will have to be established, for example, low price, quality products or reliable service. It is also very important to have a continuous line of communication between the members and their customers.

5.14 Quality standards and policies

Quality management is supposed to be a continuous and ongoing process, but with the numerous demands and pressures which face managers of small firms it is hardly surprising that those standards are often allowed to slip. Once this has happened the members will find it very hard to re-establish themselves. The bottom line is that the members will have to have written quality standards and policies that should be reviewed on a regular basis. Employees as well as customers should be aware of these quality standards.

Systems must be put in place to get feedback from the customers about the quality of the products. If negative feedback is received, the members should respond rapidly to rectify the problem.

5.15 Advertising and promotion

Advertising and promotion can be a very expensive and time-consuming business. Once the members find an advertising medium that works reasonably well they should guard against using it without subsequent review, as advertising can become outdated and ineffective without the company realising it immediately. In order to keep ahead of the competition, sales and

promotion activities should be continuously monitored. It would be particularly important for the members to monitor their advertising expenditure against the results it generates.

The members must also guard against regarding advertising as an expense that should not encroach too much on profits. It would be a good idea to compare the company's rivals' advertising methods in order to decide if the company should compete head on with it.

5.16 Competitive advantage

It is recommended the members identify the competitive advantages their new venture has over their rivals and how these can be sustained. What is it about their products that make them stand out from the competition? What unique features do the company's products have that makes customers want to buy them as opposed to the alternatives and how can the members ensure that this uniqueness persists? The answers to these questions will start to form the options for the strategic marketing plan.

5.17 Conclusion

Drastic steps needed to be taken to ensure the survival of Safeguard Fire Security. There were simply too many fire companies in KwaZulu-Natal and the so-called 'fly-by-night' companies were taking their toll. The members were beginning to realise that the industry in which they found themselves had below par profitability and was thus not very attractive. Fierce competition was driving prices down to levels that Safeguard Fire Security was charging in the mid-1980s. The members also noted that the driving forces, which they had identified, would most definitely affect the profitability of the industry unfavourably and they were facing the reality that their company's competitive position was growing weaker. The entrance of the international security giant Tyco made the firm's prospects even gloomier. It was, therefore, imperative that vitally important strategic decisions had to be made to influence the future course of the company's business. Questions such as 'what business is the firm in?' and/or 'what business would it like to enter?' were addressed.

Internal and external assessments provided sufficient information to shortlist certain companies for acquisition and also to identify certain diversification opportunities into other products.

The members entertained the idea of diversification through backward vertical integration and of acquiring or establishing a fire equipment manufacturing company. This type of integration would not only secure supplies of fire equipment at lower cost than competitors, but the company could also continue with its current type of work, namely the servicing of fire equipment and instalment of fire suppression systems. The members felt that a definite competitive advantage would be achieved as no other fire company in South Africa services and manufactures fire equipment in order to sell wholesale to the industry.

There are only two fire appliance manufacturers in KwaZulu-Natal that cater not only for all fire companies in the province but also to fire companies as far afield as Cape Town. It will be concluded then that the product diversification opportunity to manufacture fire appliance equipment for the fire industry was attractive enough to sacrifice expansion moves and even to relinquish some parts of the firm's present business.

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