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THE ESSENCE OF  
**STRATEGY**

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# WHAT IS STRATEGY?

In very general terms, strategy is a plan for achieving goals. "Strategy" was first used in military circles, as set forth by General Sun Tzu in Asia and General C. von Clausewitz in the West. The term migrated into business management during the 1960s, primarily because of the American economic historian and economist A. D. Chandler and his book *Strategy and Structure: Chapters in the History of the Industrial Enterprise*.

The economic interpretation of strategy can be broken down as follows:

- A goal is set. For example, the financial goal for a business division is defined by a company's owners or management. The strategy describes how this goal is to be met.
- Strategy is an abstract plan. The practical implementation of strategic actions, although important, does not form part of the strategy.
- Strategy focuses purely on the main aspects of meeting a goal.

Strategic planning in a company can address different areas: the entire company, a business unit, or a specific function. In this case, we are interested in business-unit strategy. A business unit is generally active in a limited market environment

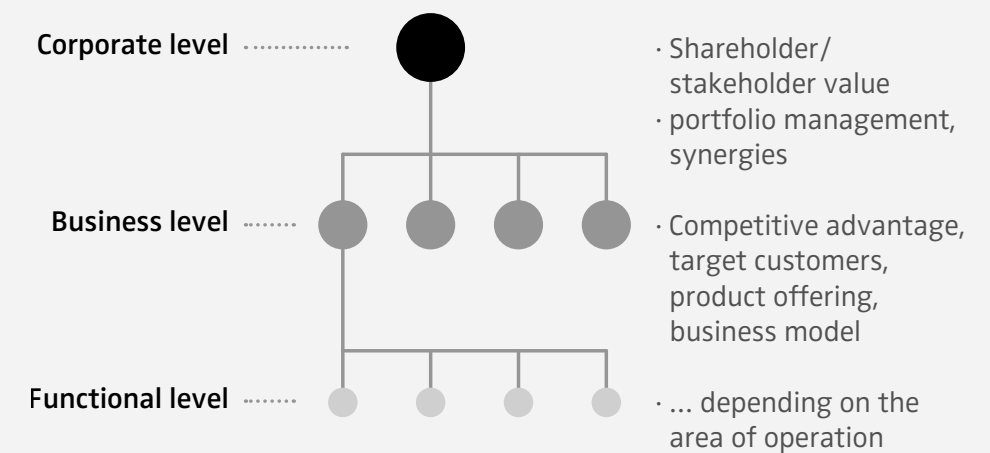
and is responsible for its own profits and losses. Nonetheless, the different business divisions and their respective strategies are interdependent (see Figure 1). Its goals are set by those higher up in the organization.

A difference also exists between strategic and operational planning. Roughly speaking, strategic planning asks, "Are we doing the right thing?," whereas operational planning asks, "Are we doing it right?" In practice, we find that the answers are not always clearly distinguishable.

The main reason for devising a strategy is to provide direction for a company's stakeholders. The employees need this for orientation and to give their work meaning, whereas the owners perceive it as an investment incentive. If a strategy is made public (which is not standard, because not everyone wishes to reveal their plan for outperforming the competition), it can also inform suppliers, customers, and political representatives about the direction that the company or division is following.

In a continuously changing environment, a strategy is also indispensable; the changes may merely affect its duration and how frequently it needs to be adapted. General Clausewitz had to contend with the unpredictability of battle. Lacking advanced intelligence, he had to prepare for all available outcomes. The same applies to current-day economic strategies.

Figure 1: Strategic hierarchy in a company



## 1. BUSINESS STRATEGY

The aim of business strategy is to secure a strategic business unit's economic success. The key requirement for this is competitive advantage.

### 1.1 COMPETITIVE ADVANTAGE

For business to take place, the supplier and the customer must stand to benefit. Both parties give and receive something while assuming that they will receive more than they have given. This can be represented using an image of two sets of scales (see Figure 2). Before deciding to sell or purchase, the supplier and customer both assume that the benefits gained from the transaction will be greater than the costs incurred, thereby tipping the scale in their favor.

However, it is not enough simply to offer the customers something for which the benefits outweigh their costs. In the customers' eyes, the offer must also beat those of any competition. If this is the case, then the supplier enjoys a customer advantage.

One way for suppliers to achieve a customer advantage is to keep their prices lower than those of the competition. However, the question then arises as to the size of their benefit and how long they will remain on the market if they can no longer cover their costs. Thus, it is necessary to offer customers a lasting benefit as well as remain profitable. If this is the case, then suppliers enjoy a competitive advantage.

This competitive advantage must fulfill three criteria:

- It must be important for the customer.
- It must be profitable for the supplier.
- It must be difficult for the competition to replicate.

The economist M. Porter defined three competitive strategies in this respect. He maintains that, first, a business division can achieve a competitive advantage based on the quality of its products, calling this approach a "differentiation strategy." Second, the firm can try to achieve low unit costs via large sales volumes, thus offering customers lower prices than other competitors. This is a "cost leadership strategy." The third possibility is to use a "niche strategy" by focusing exclusively on one specific customer segment.

Strategy professors X. Gilbert and P. Strebel then expanded these three competitive strategies by adding a dynamic component. They believe that competitive pressure forces companies to improve themselves over the long term – regarding both costs and customer benefits – leading them to always stay one step ahead of the competition. Porter then ascertained that improvements in costs and quality cannot be continued indefinitely and that eventually companies reach the "productivity frontier" (see Figure 3).

Figure 2:  
The cost-benefit scale for  
the supplier and customer

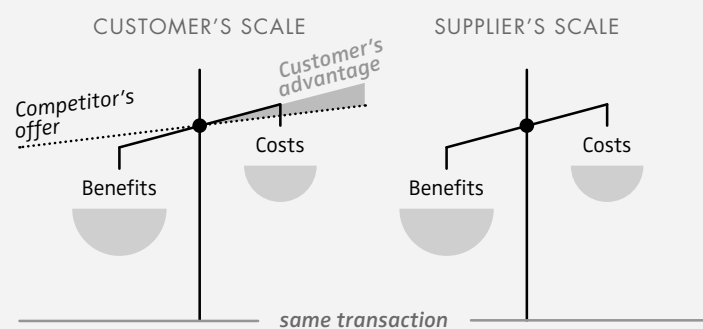


Figure 3:  
Competitive strategies  
according to Porter



These strategies were further developed by Professors W. Chan Kim and R. Mauborgne under the heading "Blue Ocean Strategy." They maintain that in order to generate new demand, a company must continuously strive for product and process innovations as a means of breaking through the productivity frontier. In their opinion, this renders the interaction between costs and quality obsolete – a tactic they refer to as a "Red Ocean Strategy."

Yet, the question also arises as to how suppliers define the market for which they are designing a strategy. Consider Porsche: The success of this brand can be viewed as evidence of a successfully implemented differentiation strategy. In this case, we would consider the automotive market as the baseline and Porsche as the quality leader, compared to other mid-range cars. Or we can view Porsche as an example of a successfully implemented cost leadership strategy. In this case, we would be positioning Porsche on the luxury car market, where Porsche demonstrates higher production volumes than Ferrari and Lotus. It can therefore offer lower prices than the competition, making it the "cost leader." This example shows that defining a business segment's competitive advantage raises further key questions, which need answering. The three most important of these are discussed below.

### 1.2 WHICH DEMAND DO WE ADDRESS?

A supplier must determine which customer demand has to be addressed. In the B2B space, where products are often also described as a solution to a problem, a further question exists: What fundamental problem has generated demand for a solution? Potential customers might be seeking to bond two materials, transport goods from A to B, or procure certain chassis parts to manufacture a car. The question of how to define a strategy can thus focus more sharply on the solution: What function does a product or service have to fulfill to meet a customer's needs?<sup>1</sup> A problem such as transporting goods can then be broken down into its constituent components by asking: What distance needs to be covered? How quickly must the goods arrive? What safety regulations need to be followed?

Apart from that, different expectations will affect customers' priorities as they evaluate offers. Those customers with similar preference profiles can be grouped together in segments, one of which is what customers are willing to pay. The more accurately a supplier identifies and responds to the needs of a segment, the greater the customer benefit and the supplier's customer advantage. The supplier makes a strategic decision to address one, several, (and if so, which ones), or all of a market's customer segments.

Closely related to customer segmentation is the supplier's regional focus. This is important because customer purchasing behavior in some markets can differ significantly between countries, for example as the result of national legislation. In most markets, however, the key segmentation criteria diverge

across national boundaries. Even then, significant resources are required to develop foreign markets. As a result, suppliers must know precisely which customers in which specific world regions they are addressing and which ones they are not. That is why strategic planning should also include fundamental decisions on regional focus.

### 1.3 WHAT DO WE SELL?

After defining a customer's demand, strategic planning must be applied to determine the means required to solve a customer's problem. This might be to bond two materials using adhesive or screws, to transport goods via rail or truck, or to manufacture car chassis parts from steel, plastic, or aluminum. At the same time, strategic planning must address how broad the product offering spectrum should be. For example, a truck manufacturer must decide whether to offer just a few standard versions of a vehicle or a wide range of models; whether to also include chassis enhancements in the portfolio; and whether financing options should be offered or not. After all, the term "product" covers both material and non-material components (i.e., goods and services alike).

In their quest to fulfill their customers' every wish (i.e., leave no sales potential untapped), some companies are tempted to make their sales portfolios as broad as possible. However, this can lead to suppliers overlooking the fact that a wide range of offerings can become very costly due to the complexities involved. In addition, the supplier can also lose out to competing product specialists in certain areas by offering a broad range of products. To maintain the appropriate focus, strategic planning must also consider which services are not included in the product portfolio.

### 1.4 WHICH BUSINESS MODEL DO WE APPLY?

Finally, defining a business strategy should also set the parameters of the commercial framework in which the supplier wishes to do business. In this context, we speak of the business model. This model defines which inputs and outputs are attributed to the supplier and the customer in a transaction, or how the rewards and burdens of the value-creation chain are divided between the two parties.<sup>2</sup> Related issues might include who owns which usage and property rights (i.e., whether a product is sold, rented, or leased). Nowadays, the question of who owns the data created during the value-creation process also plays a role.

<sup>1</sup> The notion of "served functions" is put forward by D. Abell in his textbook *Defining the Business*.

<sup>2</sup> The term "business model" can be interpreted in very different ways. A good overview is provided by T. Bieger and S. Reinhold. It should be noted that here we interpret the term more narrowly than the now relatively popular definitions forwarded by A. Osterwalder or D. Teece, who understand a "business model" as basically covering all elements of what we think of as business strategy.

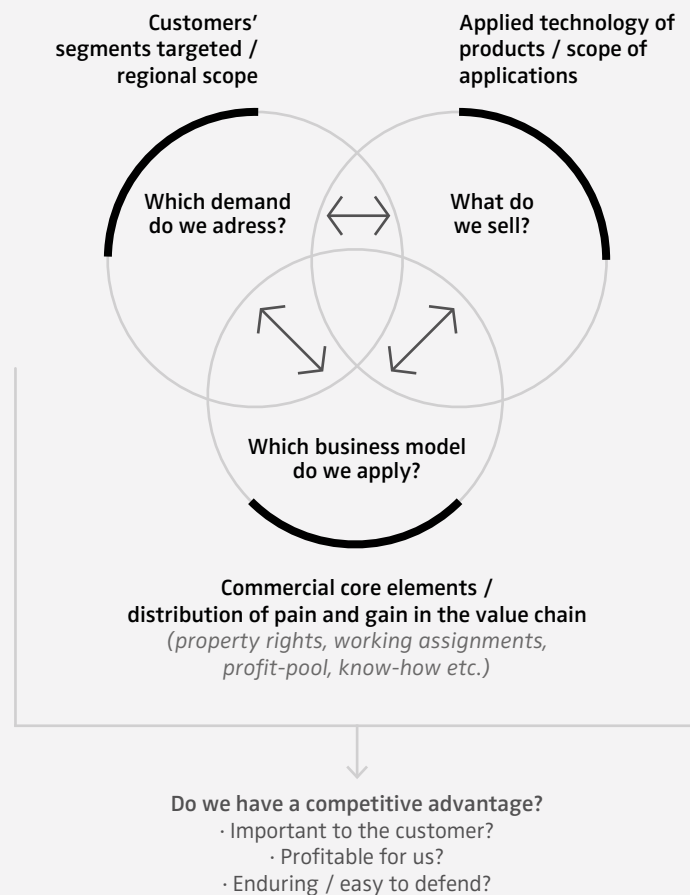


Figure 4:  
3 + 1 key questions for  
devising business strategy

Both parties have to decide how they want to share created value between themselves. For example, the aircraft turbine manufacturer Rolls-Royce links its earnings to those of its customers, that is, airlines use Rolls-Royce products and pay based on “power by the hour.” This also means spreading the risk. In this case, Rolls-Royce shares the sales-loss risk with its customers, for example if an airline’s workers go on strike.

The core elements of a business model can also determine which work processes in the value-creation chain are to be performed by the supplier, the customer, or third parties. For instance, IKEA rose to fame partly due to its decision to leave responsibility for furniture assembly to the customers in exchange for price savings.

In summary, the 3 + 1 key questions depicted in Figure 4 provide a useful guideline for devising a business strategy.

### 1.5 STARTING POSITION

When it comes to analyzing a supplier’s starting position, the “core competencies” concept devised by economists C. K. Prahalad and G. Hamel has become popular. They recommend deriving strategic decisions from the existing competencies that give companies an economic advantage. A practical example of this are Yamaha’s key competencies in developing and manufacturing small combustion engines, which helped the company penetrate the market for motorcycles, lawnmowers, and boat engines.

In addition, a company’s financial resources are a variable that has to be considered in determining its starting point. These values can also be related to the specific aims of the analysis (e.g., focus on cash flow). In the past, profit levels were also viewed in context with a company’s level of capitalization, such as the return on capital employed, which compares the pre-tax operating result with its operating assets. These indicators are not compiled just to ascertain the company’s current situation. They are also used to help estimate a firm’s potential for raising the necessary funds to implement a specific business strategy.

Of course, how a company invests its competencies and resources is also a key factor. A wide range of approaches are used to structure these elements, the best-known being the value-chain model devised by Porter. Porter’s model divides the services performed throughout the process of transforming basic materials into a product ready for end-use into (i) the primary activities directly related to the service provision (e.g., customer service), and (ii) the support activities used in performing the primary processes (e.g., human resources). This approach involves analyzing the costs and effects of the company’s activities so as to identify their contribution toward creating competitive advantages. This, in turn, helps pinpoint a company’s or business segment’s strengths and weaknesses.

### 1.6 MARKET-SPECIFIC DEVELOPMENTS

Numerous institutions and associations conduct studies to ascertain the current situation and predict future developments in a sector. This information is supplemented by many companies’ own marketing research activities. Porter’s “Five Forces Framework” analysis tool, which was originally designed to explain the differences in profitability in individual sectors, has proven to be a very practical tool for classifying and understanding these information sets. As the name suggests, he identified five related factors:

- Competitive rivalry
- Suppliers’ and customers’ power
- Threat of new entrants and substitutes

Suppliers’ and customers’ power depends on their reliance upon one another. The supplier therefore considers the following questions: Could the customer manage without the planned products? Can they produce them alone? Are customers committed to long-term purchasing agreements with different suppliers? If not, do other suppliers offer similar products in their portfolios? In the case of alternative suppliers, the customer’s costs for switching to a new supplier must be considered. The amount that a company would stand to lose if a customer or supplier were to end the business relationship – or the cost of finding a new partner – also plays a role. The more power that customers or suppliers have, the lower the company’s profitability.

The threat presented by new competitors and substitute products is determined mainly by the costs associated with their market entry. This depends, among other things, on the new market entrant’s capital requirements and existing competitors’ economies of scale. In addition, a business sector’s upside profit potential plays a role, because low industry profits can serve as a barrier to market entry.

### 1.7 CROSS-MARKET DEVELOPMENTS

The number of people living in urban environments worldwide exceeded the number of those in rural regions for the first time in 2008. This global trend toward urbanization is having a significant impact on business. PEST (political, economic, socio-demographic, and technical) analysis can be used to classify these developments. Out of the many criteria that this kind of analysis can address, we highlight the four most significant ones for industrial companies.

1. The world’s population is growing at an accelerated rate. From an economic perspective, this growth is initially positive, because it is driving purchasing requirements. However, because most of the population live in the emerging economies of developing countries, the main demand increase is centered around customer segments with a low ability to pay. Although rising levels of prosperity

in the emerging economies and developing countries boost the demand for products in higher price bands, the upward sales potential is actually in the lower price bands over the medium term.

2. The customer segments with a low ability to pay are not as interesting for international corporations as they are for regional suppliers, whose lower-quality but more affordable products meet their requirements. Although most of these suppliers will not be able to sustain long-term success and will disappear from the market again at some point, some will nonetheless continue to grow. These companies, in turn, will reach a level that leads them to look for new business opportunities. It is these market players that have the chance to improve product quality and to also address customer segments with a higher ability to pay. In this way, they can start to compete with the established premium companies. In the process, they transform the competitive landscape in their markets.
3. The rapid developments in state-of-the-art information and communication technologies are changing many customers’ requirements, while the exchange of information between objects such as machines and products is becoming increasingly important. These new communication options are coupled with analysis and evaluation systems, which are able to capture, analyze, and use big data for the purpose of boosting the efficiency of processes and offerings.
4. As data management and software play an increasing role in fulfilling customers’ wishes, many companies in the IT sector feel empowered to move into markets that were previously dominated by industrial companies. Moving forward, information technology developments will drive future change in the conventional competitive landscape.

### 1.8 STRATEGIC GROWTH OPTIONS

Managers identify economic growth opportunities – this is one of their most important business objectives. The American mathematician and economist I. Ansoff already developed generic strategy options for reaching this goal during the 1960s in the form of a product-market matrix. According to this matrix, a company can grow by improving its market penetration and winning competitor market share. A second option is to win new customers, whereas a third is to expand the product range offered to existing ones. Fourth, it is possible to appeal to new customers with new products, which Ansoff calls “diversification.”

In the late 1990s, business scientist P. Kotler expanded the matrix to include the further development of existing products. He viewed entry into new regional markets purely as a precursor for winning new customer segments. To these approaches by Ansoff and Kotler, we add the strategic growth options generated by introducing new business models.



In light of current market developments, companies specifically consider the following business strategy questions:

- What spectrum of services should we offer, in particular in terms of innovative data-based services?
- How should we develop our business model, with particular regard to ownership rights and pricing?
- To what extent should we address high-price segments? (This particularly applies to companies in emerging markets.)
- To what extent should we address low-price segments? (This particularly applies to companies in industrialized countries.)
- Where should we offer which services, and how do we distribute our value creation around the world?
- To what extent must we change our organizational structure, processes, and leadership culture if we introduce cutting-edge technologies?
- We now consider three counter-strategies that are closely related to these questions.

#### Counter-strategy 1: No-frills products

The aforementioned global developments were said to generate the greatest growth potential in customer groups with a low ability to pay. It therefore makes sense to develop low-price, cost-effective offerings for these segments – simple “no-frills” products. Because these customer groups are located in emerging economies and developing countries, so are most of the suppliers. Many of them use a no-frills approach as their strategy for entering the market. Large industrial companies, which traditionally sell sophisticated premium products, find it difficult to adapt to this strategy. They frequently resort to offering no-frills customers the less costly, older product types from their portfolios. Large industrial companies that want to go beyond their premium target groups and reach customers with a low ability to pay must answer the following questions:

- How much should the prices and products differ from the premium band?
- To what extent can existing sales channels and resources be used for no-frills offerings?
- Should a separate brand be created for no-frills offerings, or can an established brand be used?
- Which staff in which region are to be given the task of developing no-frills products?
- What new supplier networks are necessary?

#### Counter-strategy 2: Advanced premium goods

“Premium” means that this strategy is aimed at customers who are willing to pay high prices. “Advanced” indicates that state-of-the-art technologies are used to create these products. In this context, the marketing focus on “goods” refers not only to objects but also to product-related services such as maintenance and repair. Although the traditional markets for such products are found in industrialized nations, the emerging economies and developing countries are slowly gaining ground in this area. The producers of advanced premium goods are generally large industrial companies, although medium-sized companies have also been successful in this market. Business consultant H. Simon coined the term “hidden champions” for these companies and identified the following common characteristics:

- leading technological competence, including above-average investment in R&D and patent registrations;
- high prices (10–15 percent above the industry average);
- close relations with customers (25–50 percent of the workforce has direct contact with customers);
- global orientation (subsidiaries in many countries);
- high degree of vertical integration (individual control over value creation is valued more highly than cost benefits achieved by sub-contracting to suppliers or outsourcing).

#### Counter-strategy 3: Complex service solutions

In recent decades, the economic circulation of services has increased worldwide compared with that of industrial goods. It is rare to find an industrial company nowadays that is not looking to increase the amount of services that it offers. Above all, this relates to the kind of “complex service solutions” that other suppliers are unable to copy. The industrial companies most interested in complex service solutions are those subject to increasing pressures in their traditional product lines caused by imitators and falling price levels.

However, complex service solutions place high demands on managers. In this context, we return to the concept of “power by the hour” from Rolls-Royce, whose sales managers’ expertise must stretch beyond turbine engineering to incorporate state-of-the-art data-processing technologies. Not only that, but they must be familiar with the customer’s circumstances to be able to negotiate the price for a service. For example, they have to know which destinations the customer will be flying to in the future. After all, turbines wear more heavily than average in desert regions, for instance, because of the sand in the air. As a result, many companies wishing to market complex service solutions will encounter the greatest challenge in finding the right staff.

### 1.9 FROM PAPER TO PRACTICE

Answering the 3+1 key questions and choosing a particular growth option leads to a strategy plan, which in turn calls for an action plan. This should at least involve defining the key measures and risks, estimating the resources required, and setting a schedule. Measures, costs, and scheduling can be refined as things progress.

Successful implementation also calls for harmonizing all the conditions within the organization. Organizational theorist D. A. Nadler, and M. L. Tushman, a professor in business administration, were particularly involved in examining this congruence. They divide organizations into “employees, organizational culture, organizational structure, and tasks,” which must always be checked for the right “fit” prior to any strategic change. For example, the complex service solutions referred to above, which call for close customer relations, creativity, and flexibility, are not suitable for highly function-focused organizations.

However, a failure to achieve strategic aims does not always stem from poor implementation. It can also occur if the underlying conditions change. As a result, they must be constantly monitored. Have new competitors succeeded in copying the company’s offerings? Have technical innovations placed the need for the offering in doubt? Have authorities introduced new regulations that hinder access to foreign markets? This repeatedly brings us full circle in strategic planning and forces us to analyze the conditions in which the company operates. As the last diagram in this section shows, the strategic planning and implementation process is a continuous loop (see Figure 5).

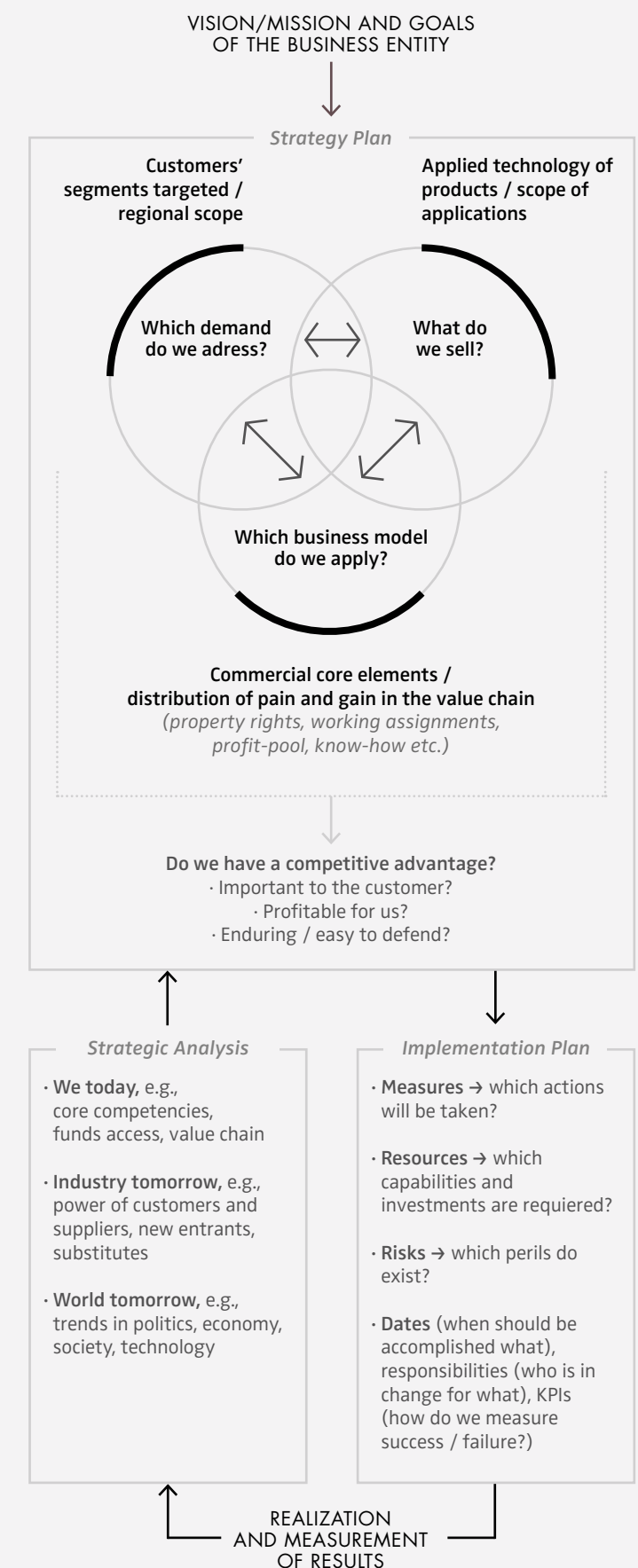


Figure 5: The never-ending strategic cycle

## 2. CORPORATE STRATEGY – STRATEGIC MANAGEMENT AT A CORPORATE LEVEL\*

### 2.1 TASK AND KEY CONCEPT

So far, we have focused our attention at the business unit level, which is active in a limited market environment, where it provides competitive services for customers. It is responsible for its own market success.

Yet, many companies do not just operate in a single market. They operate in numerous markets. These companies, therefore, consist of more than one business unit. In this case, we talk of diversified companies that have a portfolio of business units which can be either similar (e.g., Deutsche Telekom) or very different (e.g., Siemens, ThyssenKrupp). Although companies with multiple business units tend to be large corporations, many SMEs are also “multi-business firms” in this sense.

Pooling different business units into one company presents the additional strategic task of optimizing the strategic alignment of the company as a whole. This is also known as a “corporate strategy.” The term therefore describes strategic management at the corporate level. Whereas the strategy for an individual business unit (or level) is fundamentally the responsibility of its own management, corporate strategy is always a task for the head office.

Performing this task is always an intricate balancing act. On the one hand, the business units’ independence must be fundamentally maintained so they can meet the requirements of the various related markets. On the other hand, their room to maneuver must be restricted through consistent leadership, to a certain degree. After all, this is the only way to create added value across the family of business units in a way that goes beyond merely “lumping together” otherwise independent entities.

This premise can be taken as the basic idea behind corporate strategy – the key concept of “parenting advantage” (see Figure 6). This combines three requirements that must be fulfilled to create the related economic added value:

- First of all, each of the company’s business units must make its own positive contribution. This is initially the task of the (strategic and operational) management of the business units themselves. It only becomes part of corporate strategy if a unit fails to add value over a certain period of time, and instead perhaps even drains resources. In this case, the company as a whole asks whether this unit can remain part of the company’s portfolio.

- Second, the head office must lead and influence the business units in a way that makes a positive contribution. For example, it can instruct the units to pool certain activities (e.g., research and development, procurement, etc.) so as to harness value-enhancing synergies that would be lost without this head office directive. However, this kind of influence can also be detrimental and generate costs. To add value, the head office must therefore direct and measure its influence to ensure that the sum of its positive impact outweighs the negative. The value contributed as a result of the head office’s influence is also referred to as the “corporate premium,” which ensures that “the whole is worth more than the sum of its parts.”

- The third requirement goes even further. It demands that the value contributed by the head office for each business unit must be greater than that which any other head office (a different owner) could achieve if the individual business units were not part of the company in question, but instead integrated into another. This “best owner” requirement ultimately is the very crux of the parenting advantage. It underscores the fact that it only makes sense to integrate a business unit into a company if it provides a benefit (e.g., in the form of synergy effects) that could not be achieved in any other constellation. After all, if this were not true, the company’s value could be increased by selling the business unit to a different company that might be able to generate greater value itself, and would thus be willing to purchase the business unit for a higher sum than its value as an integral part of the current company’s business. This was the case, for example, when Siemens AG sold its automobile activities (at the time called Siemens VDO) to Continental AG. According to external analysts, Continental was prepared to pay 60 percent more for the acquisition than the business unit’s integral value to Siemens at that time. Siemens AG was then able to use this monetary added value to invest in those lines of business for which it genuinely possessed a parenting advantage.

The key concept of parenting advantage thus describes a kind of competitive advantage on the part of the head office as the owner of individual businesses. Like Siemens VDO, alternative “parents” (i.e., other potential owners) can be sought among a business segment’s competitors if merging with a former rival creates value-boosting economies of scale or synergy effects. However, potential parents can also be sought among the company’s suppliers or customers, who might potentially achieve greater added value by integrating an additional downstream or upstream player. Finally, financial investors and the management of that business segment also come into question as potential owners.

These requirements generate two main tasks that corporate strategy must address. First, the business unit portfolio must be shaped. The company must consider which businesses it wants to invest in, how to prioritize them, and which business should perhaps be discontinued in the future (i.e., portfolio design). Second, the company must decide how it wants to influence the business units within the portfolio (i.e., portfolio management). Within the scope of the given portfolio, corporate strategy determines the strategic development of the business units from the perspective – and in the interest – of the company as a whole.

### 2.2 PORTFOLIO DESIGN

Planning a portfolio of business units is a decision that greatly influences the development of the company as a whole. As a consequence, critically questioning the portfolio’s composition on a regular basis forms a crucial part of a company’s corporate strategy. This generally involves making changes to the portfolio, including business unit expansion, acquisition, closure, or sale.

#### 2.2.1 BASIC PRINCIPLE AND INSTRUMENTS OF PORTFOLIO PLANNING

The aim of portfolio design is to create a pool of business units with which the company as a whole can successfully develop and create value. The first step in this process is to consider each individual business unit and evaluate it by asking the three following questions:

1. Is the market in which the business unit operates going to remain attractive in the future? This raises the question of potential profits in a certain market environment.
2. Can the business unit potentially achieve a leading position in its market (i.e., can it generate a sufficient competitive advantage to achieve above-average financial results)?
3. Does the business unit benefit from being part of the larger company? This raises the question of whether the entity would be more competitive and generate better results as part of the group or as a stand-alone business.

Business units that elicit positive answers to all three questions are awarded special priority by the company as the “stars” in its portfolio. Those who have a less-than-clear profile – perhaps because they operate in unattractive

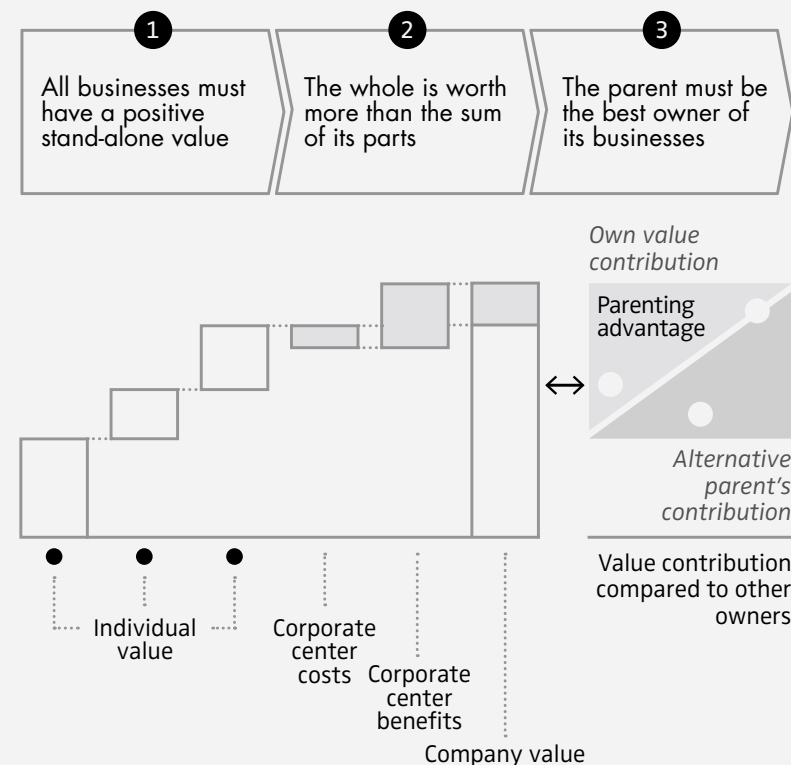


Figure 6:  
The key concept  
of parenting  
advantage

\*The figures in this section on corporate strategy have been taken (and slightly modified) from H. Hungenberg and printed with permission.

markets – attract less attention in comparison. They do not have the potential to develop a competitive advantage, nor do they get much of a benefit from being part of the larger company. This ultimately leads to the question of whether they should remain part of the company's future portfolio.

Besides evaluating each individual business unit and assessing its future significance, portfolio design also involves scrutinizing the entire package and asking whether the company as a whole owns a balanced, differentiated business unit mix. For example, is there a good balance between young, high-risk businesses and mature, lower-risk ones? Achieving the right balance is also important. There should be an equilibrium between the financial surpluses generated by some individual businesses and the funding requirements of others.

In practice, company managers widely use portfolio concepts to assist with portfolio design. Since the term "portfolio concept" began to be used in the context of strategic management at the end of the 1960s, a large number of such concepts have been developed. Many of them are now considered "classic" concepts in management studies. All of these classic concepts use the first two key questions in portfolio design to evaluate both individual business units and the portfolio as a whole.

- Market attractiveness: How attractive is the market in which the business unit operates?
- Competitive strength: How well is the business unit positioned in its market?

They are typically displayed in a matrix that indicates market attractiveness on the vertical axis and competitive strength on the horizontal axis. The individual fields of business are then positioned in this matrix according to their scores on the two scales. All classic portfolio concepts share this common feature. However, they differ with regard to the indicators used to evaluate market attractiveness and competitive strength.

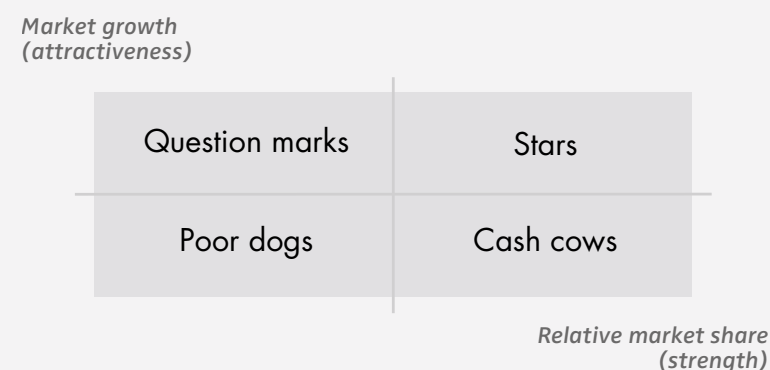
The best-known portfolio concept is probably the growth-share/ product portfolio matrix developed in the late 1960s by the Boston Consulting Group (BCG) (see Figure 7). As the name suggests, in this case the two indicators are market growth (for market attractiveness) and relative market share (for competitive strength). The market growth is generally expressed as a percentage – in terms of the anticipated future growth rate of the market in which the business unit operates. The business unit's relative market share is measured in relation to that of its strongest competitor.

For the sake of clarity, both axes of this matrix are divided into two segments. The dividing lines between them can be set at different points. With regard to the relative market share, the dividing line is generally set at the value of 1. A business unit placed there would thus be exactly as strong as its strongest competitor – with both players possessing an equal market share. With regard to market growth, the dividing line is usually set at the (weighted) average growth for all markets in which the business units of the company in question are active.

This subdivision creates a matrix with four quadrants. Each quadrant's name characterizes the business units it contains and is designed to clarify the respective strategic situation.

- Question marks: Business units in this category have a relatively low market share but are active in markets with potentially high future growth. These markets would certainly be appealing, but the business unit's (relatively) weak position makes it unclear whether it will be able to assert itself against the competition. This is precisely what the term "question marks" means.
- Stars: These business units are also active in fast-growing markets, but they have succeeded in securing a (relatively) high market share. This means they are bigger than their strongest competitor. These units are leaders in growing markets. As a result, they are the aforementioned "stars" in the company's portfolio.

Figure 7: The BCG growth-share/product portfolio matrix



- Cash cows: This quadrant contains the business units that hold strong market share and positions. Yet, the markets in question are growing slower than average, or even stagnating. These are usually "mature" markets. Their very good market position means that these business units generally enjoy a favorable cost position, which helps them generate high profits. As the market is hardly growing, if at all, only relatively low levels of investment are required. The term "cash cow" is thus meant to signify that these business units generate excess funds that can be siphoned off ("milked") for other purposes.

- Poor dogs: This name refers to those business units with a low market share in a market that demonstrates below-average growth, is stagnating, or even shrinking. Although these lines of business no longer require significant investment, their unfavorable market position also means they can hardly bolster the company's success any more. As the term "poor dogs" suggests, these lines of business are often in real trouble and risk being divested.

The business units of the company under examination are placed into this four-quadrant matrix according to the anticipated growth in their markets and the relative market share that they have secured. The size of the circle used to represent each business unit is often varied to reflect its significance for the company in terms of sales, contribution margin, etc.

The BCG growth-share and product portfolio matrix has not entirely escaped criticism. Apart from some concerns about the titles for the four quadrants, the main bone of contention lies in the fact that market attractiveness and competitive strength are each measured by just a single criterion – market growth and (relative) market share, respectively. Yet, it is doubtful whether these two criteria are really the main determining factors for either attractiveness or strength. In some fast-growing markets, such as PCs for example, the other competitive forces are very weak. This would be revealed through Porter's Five Forces analysis, for example (see earlier

section on business strategy). At the same time, a high market share does not necessarily lead to above-average profitability. General Motors – for a long time the largest company in the automobile sector – found this out the hard way.

In light of this observation, analysts applying other well-known portfolio concepts have switched to using multiple criteria to measure market attractiveness and competitive strength. A good example of this is shown in the market attractiveness and business strengths portfolio matrix in Figure 8. It was developed by the business consultancy McKinsey & Company in conjunction with General Electric.

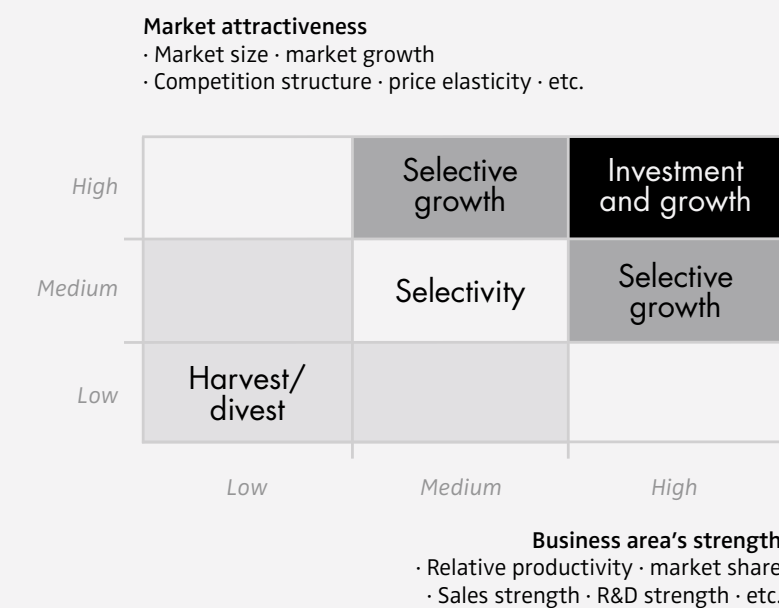
Portfolio concepts assist management with a key corporate strategy task: selecting, prioritizing, and aligning those business units that the company should actively support in the future. Considering the position of individual business units within the portfolio – but also that of the portfolio as a whole – makes it possible to identify which of the existing units should be expanded, maintained, or sold off. In addition, analyzing the portfolio provides initial indications as to whether investments should be made, and if so in which lines of business. This helps build an attractive portfolio for the future.

### 2.2.2 IMPLEMENTING CHANGES TO THE PORTFOLIO

The existing portfolio will almost always need to be modified to achieve a desirable constellation moving forward. Decision makers will choose to give up some business units while adding others. In principle, there are three ways of making these changes to the portfolio:

- Internal development: An internal development involves a company creating a new business unit by its own means (i.e., within the company itself). For example, BMW developed its first electric vehicles internally and marketed them as "i models." The negative version of this – known as portfolio restructuring – involves the liquidation of an existing business unit.

Figure 8: The McKinsey market attractiveness/ business strengths portfolio matrix





- **External development:** External development occurs when the company obtains a new business unit from outside (acquisition). In other words, this unit already exists as a stand-alone business or as part of a different company, as was the case with the acquisition of the US seed producer Monsanto by Bayer AG in 2016. The opposite involves a business unit from within the company being sold or transferred in some other way to an external company (divestment).
- **Collaboration:** Collaborations are hybrid forms of internal/external development. They involve two or more companies merging parts of their activities so as to operate a specific business together. Joint ventures as well as project-based and license-based collaborations are just a few examples of this. One of the most famous joint ventures in Germany was that between Bosch and Siemens under the name BSH – Bosch Siemens Haushaltsgeräte. It ended in 2015 when Robert Bosch GmbH bought out Siemens' stake.

For the sake of clarity, we can start by focusing on portfolio expansion. There are three options: internal development of business units, (external) acquisition, or various forms of collaboration. All three options have advantages and disadvantages; none is better than any of the others by default.

The main advantage of acquisition is that it can usually be completed in much less time than it takes to develop a business unit internally. On the other hand, the acquiring company always runs the risk of losing out in the process, because it can never entirely judge the true performance capacity of the business in advance. Even collaborations, which are often portrayed as the golden medium between acquisition and internal development, have their downsides. These include coordination problems, incompatibilities, and diverging interests between the partners, just to name a few.

### 2.2.3 ACQUISITIONS AS A FREQUENT MEANS OF EXPANDING PORTFOLIOS

Acquisitions are widespread and frequently used to further develop companies' portfolios. This is probably because they tend to be the quickest option for creating a new business unit, as already stated. By purchasing a supplier that already operates on the market, the acquiring company does not need to spend a lot of time investing its own resources in establishing a market presence. It can "hit the ground running" instead.

Even if speed is not a major priority, in some cases it might be impossible to accrue the appropriate internal resources and skills. This is because they are difficult to obtain or replicate (i.e., limited or one-off resources). This often applies in high-tech sectors, for example in cases when established pharmaceutical companies often have no alternative than to

acquire small biotech companies for enormous sums of money to access their staff expertise or patents. It is a similar case in the financial services sector right now, where established players keep on acquiring fin-techs in an attempt to occupy new segments and adopt business models that they could not develop internally, or not quickly enough. One example of this is the acquisition of fin-tech pioneer Fidor, in Munich, by the French banking group BPCE.

Besides these effects, an acquisition can also offer advantages from a market environment perspective. It is generally a simpler and much more cost-effective means of overcoming market-entry barriers, such as distribution system access. By taking over an existing supplier instead, acquisition also avoids creating an additional market competitor. However, there is much debate as to whether it is advisable for companies to make frequent acquisitions. Although the cited advantages clearly make sense, it is often argued that a high proportion of business acquisitions falter in practice. Spectacular, obvious failures keep providing new evidence to support this assertion.

Because acquisitions equate to investment decisions on the acquiring companies' part, their success (or failure) must also be judged primarily in economic terms. In other words, an acquisition can be considered a success if it creates value (i.e., if the acquiring company's value is greater following the acquisition and integration process than beforehand). Past studies have taken a close look at which acquisitions have actually produced value and clear-cut results, and under which circumstances, regardless of methodology. In general, it appears that:

- the majority of acquisitions have not created, but rather depleted, value for the owners of the acquiring company;
- the owners of the acquired company, on the other hand, almost always stand to benefit from an acquisition.

To understand why so many acquisitions do not create value for the owners of the acquiring company, we should further consider the economic aspects of acquisition decisions and ask which approaches exist for creating (or destroying) value this way. To do this, we must consider the four approaches to changing value, displayed in Figure 9.

- **Acquisition premium:** In most cases, the buyer pays a higher price for the acquired company than its actual value prior to the acquisition. This is referred to as the acquisition premium. In the case of Bayer's acquisition of Monsanto, external analysts estimate the premium to have been 30 percent. This reduces the starting value of the acquired company from the perspective of the acquiring company's owners. Simultaneously, this means that the owners of the acquired company benefit from the acquisition. This is particularly apparent in acquisitions of companies that are listed on the stock exchange, whose

share prices generally jump when an interest in acquisition is shown, and the former owners can generate value by selling their shares.

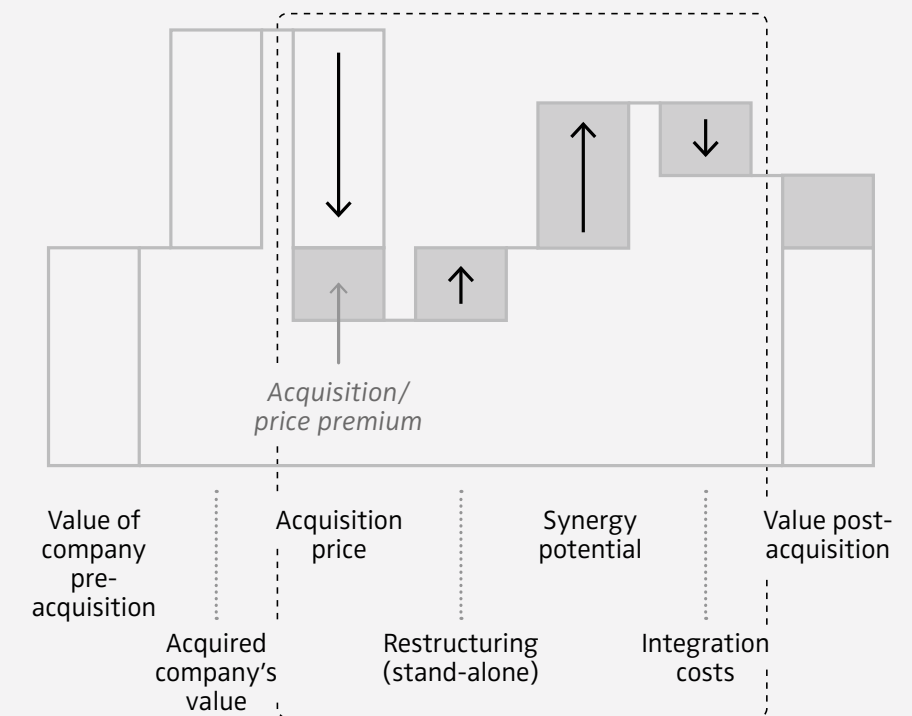
- **Restructuring:** In some cases, the acquired company offers improvement approaches that can be utilized post-acquisition to improve its stand-alone value. As opposed to the advantages that stem from the act of merging the companies, this involves improvements that can be made to the acquired company itself. These are often restructuring or cost-cutting measures that, although possible, had not been performed prior to the acquisition. Private-equity firms often adopt this means of boosting the starting value of the acquired company post-acquisition.
- **Potential for synergies:** In practice, the most important lever for boosting value is the merging of the companies involved. By integrating them, the potential synergies can be harnessed. This can mean lower purchasing costs, better market access, shared use of specialist expertise, or straightforward tax breaks. Synergy effects (i.e., realized potential for synergies) can have financial impact on all value components, such as lower costs (expenditure), increased revenue (incoming payments), or reduced capital costs. The synergy effects that arise from the merger of the acquiring and acquired companies can thus generate a

higher value than the two companies were worth on their own prior to the acquisition. Bayer AG spoke of synergy effects to the tune of €1.5 billion per year from its acquisition of Monsanto, although it did not break the sum down to reveal whether this took the costs of integrating the companies into account.

- **Integration costs:** Integrating the companies involved in an acquisition incurs costs. This includes harmonizing IT, coordinating internal operational processes, and training staff. These costs cut into the increased value from synergy effects. However, because synergies cannot be achieved without integration measures, integration costs are sometimes described as the "Siamese twin" of synergy.

An acquisition process creates no value for the owners of the acquiring company if the aforementioned approach produces a negative rather than a positive net change in value. In other words, either the purchase price was too high ("overbidding"), there was not enough potential for restructuring, the integration was unable to harness sufficient synergy potential, or the integration costs were too high. Ultimately, each of these possibilities indicates that errors were made in the acquisition process, which in their sum led to a destruction of value.

Figure 9: Levers for creating or destroying value through acquisitions



## 2.2.4 DIVESTMENT OF BUSINESS UNITS

Divestments are the logical counterpart to acquisitions, because a company merger must always involve a purchaser as well as a seller. Divestments traditionally attract less attention than acquisitions – probably because acquisitions imply success and growth, whereas divestments are tarred with the brush of failure. In recent years, this perception has changed, with divestments no longer solely being considered the mirror image of acquisitions, but also as independent strategic actions. After all, a divestment is also a measure performed by the selling company in the name of changing its portfolio and creating value.

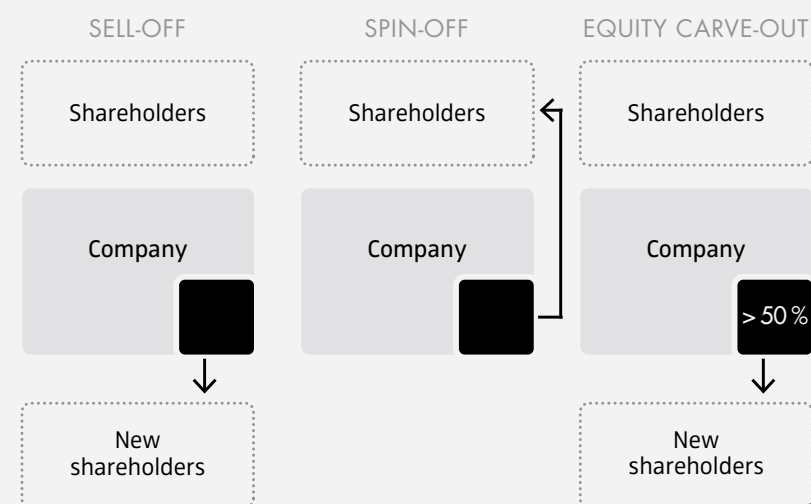
Divestments can be performed in different ways. The following three forms of divestment are usually cited. The main distinctions are whether the divesting company receives payment and whether it (to some extent) retains control over the divested unit (see Figure 10).

- **Selloff** – when a business unit is carved out of a company and sold to an external company or an investor. In return, the selling company receives a cash payment or shares in the acquiring company. In a selloff, the company loses all control over the sold unit. The sale of ThyssenKrupp's US steelwork to Arcelor Mittal and Nippon Steel in 2014 is a good example.

- **Spinoff** – when a business unit is transferred to a new, independent company. Shareholders of the existing company are compensated with shares in the new one. That is why ownership does not immediately change hands. As a rule, the shares in the spun-off object can be traded following the transfer, meaning that the ownership constellation can change from this point onward. In a spinoff, the selling company thus receives no financial reward and loses control over the carved-out unit. Examples include the companies Lanxess and Osram, which came into being as spinoffs from Bayer AG and Siemens AG.

- **Equity carve-out** – when a business unit is transferred to an independent company. The parent company sells shares in this subsidiary to new shareholders, for example as part of a new issuance via the stock exchange. In an equity carve-out, minority shareholdings are offered at first. This is often done at less than 20 percent of the subsidiary's capital, but it is less than 50 percent in any case. In this way, the parent company can keep control over the business unit while raising funds from its sale. Siemens AG is currently preparing this kind of transaction for its "Siemens Healthineers" division. The parent company's ownership structure remains unaffected by the transaction. Most or all of the subsidiary can later be sold via the stock exchange, as happened with Infineon AG, which was founded in 1999 as an equity carve-out from Siemens AG.

Figure 10: Forms of divestment



## 2.3 PORTFOLIO MANAGEMENT

### 2.3.1 TASK AND LINES OF APPROACH IN PORTFOLIO MANAGEMENT

The second task of corporate strategy is portfolio management. This concerns how and with what intensity the head office should influence the management of the business units in its portfolio. Within the scope of the portfolio in question, this influence is ultimately the means by which the head office can contribute to the value of the company as a whole.

Theoretically speaking, a company's head office has three options for influencing business units and contributing value (see Figure 11):

- **Leadership:** A company's head office can exert focused (leadership) influence on individual business units to improve the unit's position in the market or its resources. This allows it to support business operations in the face of competition. The spectrum of measures for directly influencing individual lines of business is very wide and ranges from setting general aims to allocating funds for investment, selecting managers, and directly influencing business activities.
- **Synergy:** This covers all activities that affect multiple business units at the same time. The aim of this influence is to initiate forms of collaboration between the units that

otherwise would not have occurred, and thus harness potential synergies. This includes pooling similar resources (e.g., through joint development and production) or transferring complementary resources (e.g., via technologies and specialist knowledge).

- **Service:** Another way the company's head office can contribute value is by centrally providing functions and services to all business units. Because individual units no longer need to support these efforts, the company's head office can deliver them more cost-effectively to leverage greater economies of scale. Such services typically include HR administration, accounting, taxation, and IT.

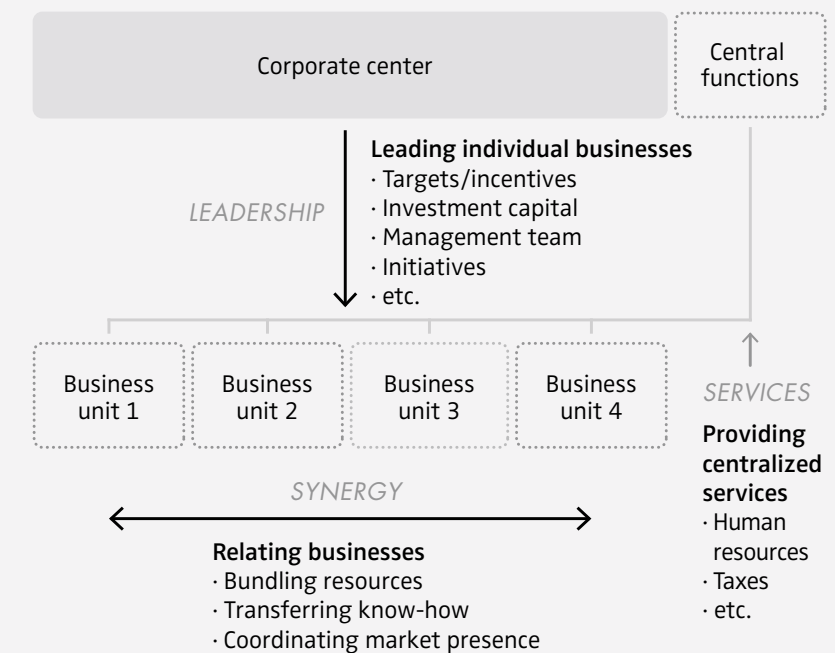
### 2.3.2 SYNERGY MANAGEMENT AS THE MAIN LINE OF APPROACH

There is no question that the main approach of many head offices is to contribute value by identifying and harnessing synergies. Synergy effects arise from integrating one business unit's activities with the activities of one or more other units.

In economic terms, synergies are therefore economies of scope. They are commonly divided into three main types – operational synergies, managerial synergies, and financial synergies:

- **Operational synergies** occur when business units actually perform services and marketing. They can be harnessed by

Figure 11: A head office's options for exerting influence



pooling, or at least coordinating, operational activities in the individual steps of the value-creation chain, such that the business units (at least in certain areas) develop, procure, produce, or sell together. Operational synergies can arise if the business units possess similar or complementary resources and skills. For example, Volkswagen AG constructs models for different brands on the same platforms and uses the same components.

- Managerial synergies occur when certain skills that exist within one of the business units (or the head office) of a company group can be made accessible to the other units. This applies to functional and technological expertise or more general knowledge of best practice. These kinds of skills then only need to be accumulated and maintained once within the entire company, which would not be an option for an independent, stand-alone company. However, harnessing managerial synergies requires at least a certain minimum strategic similarity between the business units.
- Financial synergies exist mainly in the area of financing and taxation for a company's business units. In this case, the business units do not have to raise their own credit, but can instead access better terms and conditions by pooling their borrowing. Not only that, but company-wide cash management is also possible, which reduces financing costs. Last but not least, tax benefits can exist, for example, if losses in one business unit can be offset against profits in another.

Basically, synergies cut costs, increase revenue, improve capital investment, and reduce risks. Thus, harnessing these

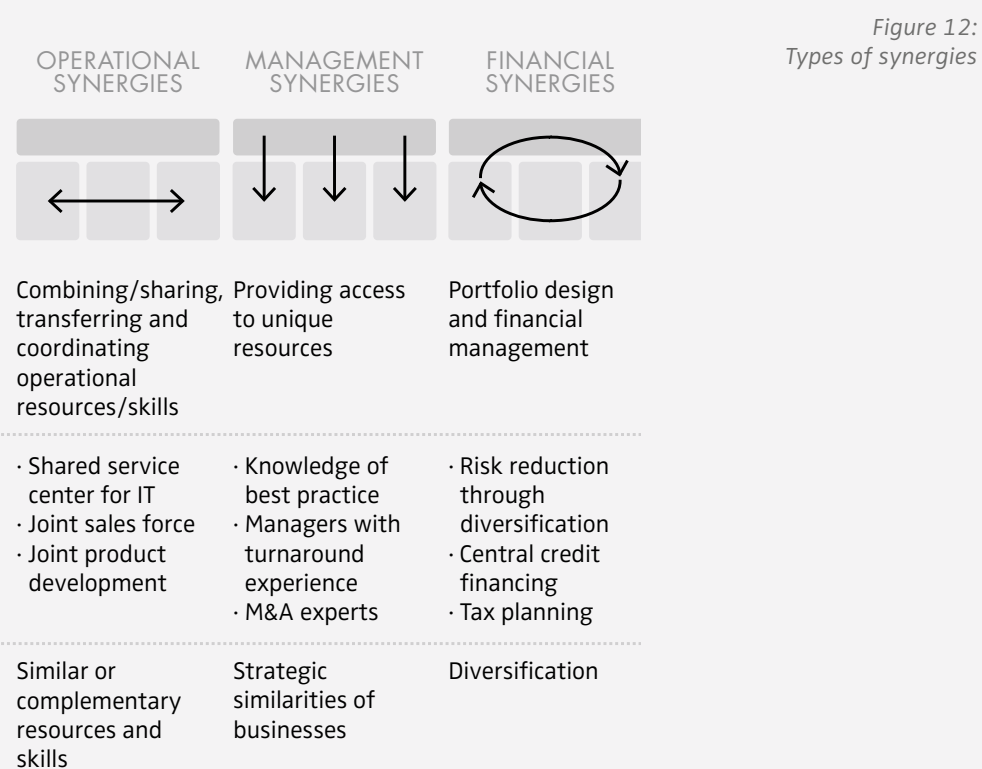
synergies can generate quantifiable added value that none of the company's business units could achieve on its own.

However, two caveats must be borne in mind. The first is that synergies are only potential benefits. Rather than arising of their own accord, synergies often require massive effort to create and maintain them. Thus, whenever collaboration between business units reveals synergies, the costs (both one-off and ongoing) of achieving the anticipated synergy effects must always be considered. Second, collaboration between previously separate units does not always create positive effects exclusively. There can also be negative synergies. When two business units coordinate their marketing activities, for example, one of the units could lose a particular market focus and flexibility as a result.

Harnessing synergies thus provides an extremely good example of the types of challenges that a company's head office faces across every portfolio management activity. It must exert just the right balance of influence so that the positive effects that can be achieved outweigh the potential negative effects and implementation costs. The best option is not maximum influence, but rather applying the right amount and kind of influence to suit the company's precise situation.

#### 2.4 STYLES OF HEAD OFFICE LEADERSHIP

This concept refers to the most appropriate leadership style that a head office can adopt toward the company's business units. It presents blueprints for the kind of influence that the head office can exert over the business units and explains the criteria for selecting a particular style of leadership.



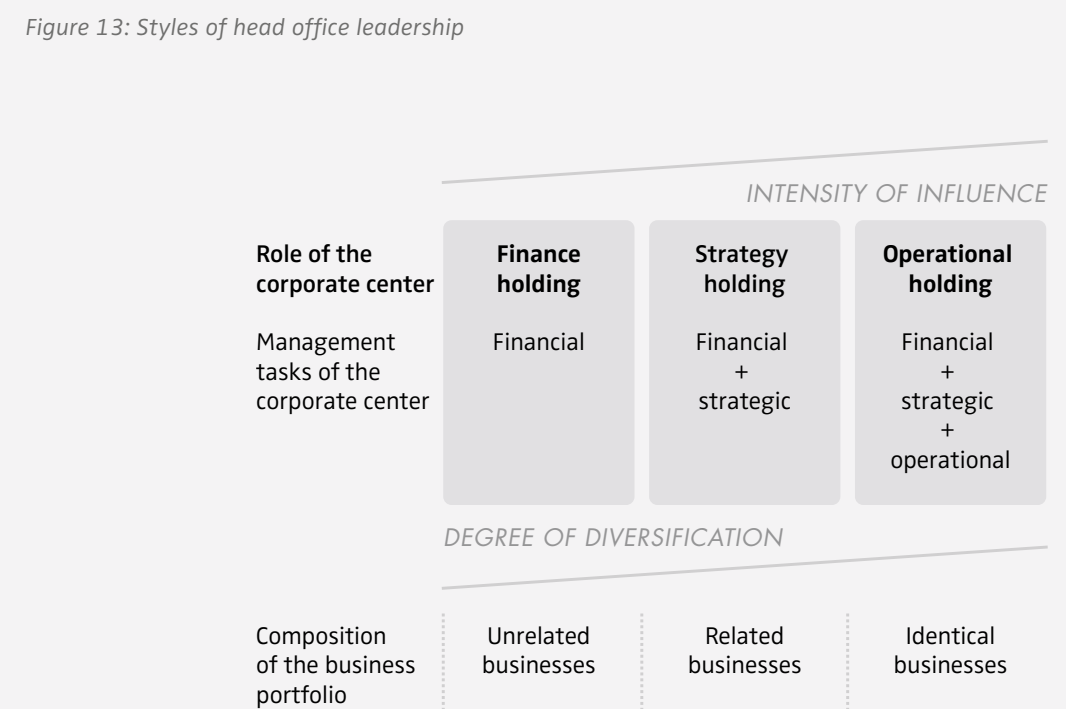
A distinction is often drawn between three different textbook leadership styles: financial holding, strategic holding, and operational holding (see Figure 13).

- Financial holding: This style of leadership involves the head office exerting the least possible influence over the business units. Instead, senior leadership leaves the operational management entirely to the units. The head office does not interfere in the content of their business strategies but only influences them indirectly by setting financial targets (e.g., with regard to value, returns, profit, and cash flow), allocating funds for investment, and appointing the most senior managerial posts in the business units. The focus is on harnessing financial synergies, beyond which business activities are conducted as independently as possible. This style of head-office leadership only makes sense if the business units are very different and would therefore hardly benefit from working together. That is why a financial holding style of leadership is most advisable in diverse conglomerates, such as Dr. Oetker and Haniel for example.
- Strategic holding: The head office exerts greater influence on the business units in this kind of leadership role. It also leaves operational business management to the units and only intervenes in their operational decision processes in exceptional cases. Strategic business tasks, however, remain the responsibility of a fundamental business unit. The head office often exerts considerable influence and might even take over elements of strategy development. The company's head office is also in charge of financial management, for example, by setting financial targets. In this case, managers mainly harness financial and

management synergies. A strategy holding style of leadership is most effective if the business units demonstrate certain (strategic) similarities, which means that they will benefit from skilled influence by the head office and an exchange of strategically relevant skills. This is mainly the case in companies that pursue a relational diversification strategy, such as the Bertelsmann Group and BASF SE.

- Operational holding: This is the kind of leadership role in which the company's head office exerts the most influence on the business units. Going beyond financial and strategic management, it includes setting detailed targets or making individual decisions. It reaches into the sphere of operational decisions and includes procurement, production, and cultivating markets. Accordingly, intensive efforts are often made to harness operational synergies between the business units. An operational holding only makes sense if the units demonstrate very similar operational processes and resources, because only then will the synergy-harnessing potential justify the head office's intensive efforts at exerting such influence. As a result, this style of leadership best matches focused diversification, as exemplified by the VW Group.

These three distinct styles of leadership provide the blueprints for a head office's influence over a company's business units. In each case, the choice of the leadership role determines how far the company's most senior management can – and should – influence the day-to-day work of the business units. These blueprints serve as guidelines to assist the head office in ultimately ensuring the successful development of the company as a whole and its units.





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