Related Diversification

A Case Study in the Jerez Wine Industry

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Abstract

The concept of strategy has its origins in the 50s, when big corporations began to appear and gave name to what we know today as "corporate strategies" [1].

The aim of this project is to analyze the diversification strategy and the different methods used to implement a related and non-related diversification strategy and how does this apply to the *ethnology industry* and more precisely, to the Jerez wine industry.

We will use the methodology of case study. Therefore, we will see two cases from the greatest Jerez wine firms. This way we decide to undertake the study based on the related diversification strategy, we will see how in pour case of study both companies use a mix of two different approaches in terms of implementation, which ended up with the creation of their own "hybrid" strategy of diversification. These hybrid strategies have enabled to the companies not only open the doors of the international market but also to improve their growth perspectives for the near future.

Introduction

Companies as well as armies need a strategy for the same reasons: to justify their actions, the effective use of resources and coordination among decisions taken by different people [1]. Therefore, some people state that organizational strategy come from military strategy, even the origin of the term "strategy" comes from the Greek term "*strategia*" which means "command of the army". Both types of strategies have a common principle: the aim to make use of all the available resources to obtain an advantageous position; it is a combination of tasks committed to a single purpose [1].

According to Johnson and Scholes the strategic decisions are known as those in charge of the adaptation process of the activities undergoing in an organization to its environment and its sudden changes. However, the strategic decisions can be considered also as those oriented to make the most of the current skills and resources available in the company to create the basis for future opportunities arising in the market [5].

In real life practice, strategies developed by companies involve either adjustments or extensions of the environment and scope where they act and the reason why strategic decisions go hand in hand with operational decisions since the real competitive advantage takes place on the operational level [5].

On the further lines, we will see that companies adopt one strategy or another regarding the market limits they want to overcome and the resources available for the firm. A more specialized company will try to expand to businesses related to its "core business" because it will be able to use its "core strengths" to break the entry barriers of the market. While a large corporation that involves very diverse businesses, and not being focused on a single industry, will try to expand to other industries through the

acquisitions that will enable the firm to break down those new entry barriers that could not break by itself [4].

Methodology

The methodology selected for this project has been directed to the so-called qualitative research rather than quantitative, all through the study of the case by conducting questionnaires and interviews with two companies competing in the sector in which we have focused our study. In the next few lines we will argue the reasons why we have chosen this methodology of the method of the case supported by [3].

In the first place, we have chosen qualitative research, which focuses more on deepening the information collected rather than covering the greatest possible number of data. In our case, what we are trying to do is to collect and evaluate information in different forms, basically non-numerical information about a specific number of real-life cases.

Second, the research approach is a case study, since the objective is to analyze and contrast an issue in depth, which has been previously developed in the abstract and introduction. The cases studied will be two companies of the sherry viticulture sector that have used the same diversification strategy (although in different ways) and the study will analyze and compare both the type of related strategies followed by both companies and the methods used to achieve their objectives.

Finally, the method of data collection used has been based on interviewing and issuing questionnaires to both companies. The reason to choose this method is because what is important is to truly know that concerns or goals in the heads of managers led to the taking of such strategic decision.

An approach to the definition of strategy.

The definition of strategy can be understood as “the direction and scope of an organization over the long-term period” ([5]:10) or as “the way through which individuals and organizations reach their objectives” ([1]:40).

The question is why companies look for a Strategy? What does it make it so important?

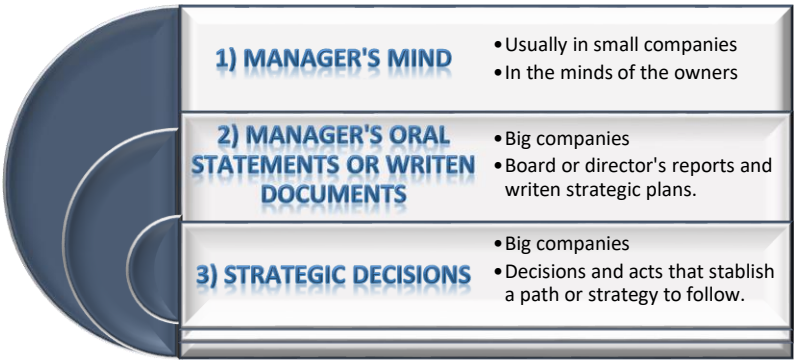
Strategy provides competitive advantage to organizations because it helps to a more effective and efficient resource management to be able to fulfill market needs and challenges while satisfying shareholders expectations ([5]10).

In fact, the Strategic Management model seeks to insert the life of the company in its external environment, so that it can respond effectively to both the opportunities and favorable situations it poses and to those other challenges and threats that also could appear [2].

When companies have a strategy, they know where to go, in other words, they do not lose their “focus” and this makes the decision process and coordination among departments easier and better [1].

2.2. Where is the strategy found?

Strategy can be found either in the minds of the owners of the company, on their oral and written statements and in the decisions, they make.



Own creation based on [1].

The corporate strategy

According to Johnson and Scholes "Strategies exist in the different levels of an organization", at least three different levels of organizational strategy could be identified in any company case of study: Corporate strategy, business unit strategy and operational strategy ([5]:11).

In this case study project, we are going to focus on the corporate strategy of the company. The corporate strategy is on the highest level of the "strategies" hierarchy so it is highly influenced by the owners and investors of the organization and often found in the mission statement [5].

For Grant the strategy is the answer to the question "Where to compete?" and "how to compete?" [1].

The three big corporate strategies

Integration strategy

A key issue in the integration strategy is the market transaction costs. When companies decide to integrate a certain activity or part of the production process it is because the cost of obtaining that certain service in the market (market transaction cost) is higher than the cost of integrating that service or activity into its own production process. On the contrary, companies will tend to outsource certain activities and services when market costs of those ones are lower than the cost for the company to produce them [1].

Internationalization and global strategies

The internationalization is the result of two facts (i) the trading of goods and services in the markets and (ii) the direct investment in other countries (buying and manufacturing goods in other geographical regions around the world). Company's ability to succeed in an international framework is through its resources, capacity and the circumstances surrounding the specific nation on which it develops its activities (so is to say, the economic, political, cultural and social circumstances have an impact on company's success abroad).

Diversification

Choosing the diversification mode

Ramanujam and Varadarajan talk about two diversification modes: Internal growth and acquisition-based growth. They explain how the increase of internal

development costs together with the shortening of product life has made that firms find more attractive to use acquisition-based diversification [7].

Internal diversification is defined as the organization learning process towards the development of the necessary knowledge to enter and compete in a new industry. Internal diversification activities may include product line extension, new product line introduction (either related or truly new products) [6].

Related Vs. Non-related diversification.

When a firm considers going into diversification there are two ways to do it: either related or non-related diversification. Usually the firm that chooses non-related diversification they tend to use acquisition to overcome the entry barriers of the new industry since they do not have the core strengths needed to succeed in that industry. On the other hand, when a firm goes into related diversification they tend to use internal development mode since this type of diversification may concern issues such as coordinating existing resources with the new knowledge requirements and the units responsible for idea generation [6].

Another key point to discuss is the distinction between related and non-related diversification since there are many ways on which two different businesses can be related, as an example the company LVMH (Louis Vuitton- Moët Hennessy) dedicated to the manufacture of bags and Champagne industry; obviously both products are non-related but the company uses the same management skills for both brands [1].

However, Grant defines the idea of "relatedness" and divides it in two different concepts according to the strategic level we are: The operational and the strategic level. We talk about operational level when we refer to similarities in technology and markets in order to share resources during the manufacturing, distribution and commercialization processes while on the strategic level has more to do with the ability to apply the same strategic management systems, resource allocation and control processes to all the businesses of the company [1].

In the case of study we are going to see in the following lines, we find out an hybrid kind of strategy followed by those companies part of the traditional Jerez wine industry.

The diversification of Osborne:

In the case of Osborne, one of the well-known Jerez wine family firms, the most significant changes during the last few years are mainly the transformation of the wineries that became into "instrumental" wineries and stopped to produce as much "sherrys" as before and began to produce more brandy, which is an Spanish product that is beating the "sherrys" especially in the international markets.

The main reason why the company, as many other Jerez wine firms, decided to diversify is because they look for more profitable growing markets. Jerez wines have very low profit margins due to its production system called "Soleras' system" which takes a lot of time until the wine is ready to be sold in the market, which generates high stock costs and low profitability.

As a result Osborne, as well as other Jerez wines' firms, began invest in different wines and spirits certifications of origin, an industry with greater growth rate and a product more popular among consumes of the drinking market:

<u>On the wine industry:</u>

- Montecillo: La Rioja
- Señorio del Cid: La Ribera del Duero.

- Malpica del Tajo: Castilla La Mancha.

<u>On the Spirits industry:</u>

- Osborne Brandy: Jerez.
- Anís del Mono: Cataluña.
- Nordés Atlantic Galician gin: Galicia (the most recent diversification of Osborne).

However Osborne as well diversified in a different area; the meat industry; by acquiring "Cinco Jotas" from the Sanchez Romero Carvajal family, entering I the Iberian ham industry. This last investment has resulted to be in one of the best strategic decisions taken by the firm and the reason why they have become more international; the product tends to be sold at a quite high price and succeeds in important international markets such as China, Russia or the United States. Especially China has become the greatest consumer of "Cinco Jotas" in the international market. The recent acquisition of Osborne to China Forum made that many of the most important brands from the firm came back to the Spanish hands of the Osborne family shareholders, such as Cinco Jotas, Montecillo or Anis del Mono. However strategically it has not supposed any relevant change for the company since the commercial agreement between Osborne and China remains and the firm continues keeping the benefit of trading her goods in the Chinese market. Currently, China stills the first foreign market in the consumption of Cinco Jotas

To take the decision two main issues affecting the market were taken into account: (I) the scarce distribution channels existing (II) and the fact that the hospitality sector is overexploited nowadays. As a result the company decided to go for products that complemented the current activity of the firm and share the distribution channels they already had, while going for products with a greater market growth and scope, and which are easier to sell than the traditional Jerez wine.

The diversification process suffered by Osborne resulted in 4 different business units nowadays:

- The spirits industry.
- The wine industry.
- The meat industry.
- The international line: in charge of taking products overseas.

The related diversification of Gonzalez-Byass

When talking to the firm's president he starts speaking about the diversification process of the company that started up 25 years ago, which was mainly oriented towards wines from other origins and to expand their range of spirits. This diversification suffered a turning point in the year 2000 intensifying the diversification process until nowadays.

This diversification process came with (I) the increase in the number of origins that began to produce high quality wines in Spain, becoming up to 69 different certifications of origin today, and (II) the increase in the variety of consumers tastes.

Finally, the internationalization process suffered by the company intensified the commercialization with United Kingdom, Mexico and the United States, which required a broader and more complete product range in order be more efficient in their trading relations plus achieve superior consumer satisfaction in different markets where they operate.

When deciding where to diversify, the company finally preferred to focus on offering high quality wine and high standard spirits. The reasons that drove the company to exploit those two sectors were: (I) The ability to provide an extra added value thanks to their previous experience on the wine and alcoholic industry when comes to production and commercialization processes, (II) to take advantage of possible synergies in terms of commercialization by producing complementary products that enable to use the distribution channels and commercialization resources that they already had in hospitality and food industry, and (III) since it is a family business, it has been considered more advantageous to focus all efforts and resources on the core business of the firm in order to gain a competitive advantage and continue growing and investing:

1. The search for complementary products to the ones they already have and create synergies in terms of production and distribution processes.
2. Develop a strategic map with the best wine- making Spanish regions, providing a good sample of the Spanish wine diversity in the international markets.
3. Seek for what their core markets need and call for.
4. Prioritize the categories and origins that have the greatest growth in the main markets where the firm operates.

At present the firm produces wine from 9 different origins and 4 different spirit brands, commercializes more than 40 different brands and acts in more than a 100 different markets but with special presence in the Spanish, British, Mexican and North American markets. In addition they have settled a marketing team in some strategic locations around the world such as Brazil, Germany and China. This product diversification helped the company to internationalize and created two separate product lines in the company, premium and high standard products that are generally more quality-oriented than price-oriented; made for those who look for quality first:

<u>On the wine sector:</u>

- González-Byass: Jerez.
- Beronia winery: La Rioja.
- “Viñas del Vero”: Somontano (Huesca).
- Vilarnau cava: San Sadurni d’anoia.
- Beronia Rueda: Valladolid.
- Pazos de Lusco: Rías Baixas.
- Finca Constancia:Toledo.
- Finca Moncloa: Arcos, Cádiz
- Veramonte: Chile

<u>On the spirits sector:</u>

- González Byass brandy: Jérez.
- Nomad Whisky: Scotland (a third party) and Jerez.
- Chinchón de la Alcoholera: Chinchón, Madrid.
- The London N.1: London.
- “Druida” Vodka.

- Destillery in Tomelloso: Ciudad Real.

Osborne Vs. Gonzalez-Byass case of study

	OSBORNE	GONZALEZ BYASS
Diversification type	• **Related** diversification: through complementary products. • Maintenance of traditional core businesses. • Plus an **important investment on food industry→** "Cinco Jotas" main difference with the rest of Jerez winery firms	• **Related** diversification: look for complementary products. • Maintenance of traditional core businesses.
Diversification Method	• Acquisition and commercialization of new certifications of origin: Wine, spirits and Spanish ham.	• Acquisition and commercialization of new certifications of origin: Wine and spirits.
Incentives for diversifying	• Jerez wine is a Mature market and with a very stable sales level. • However, distribution channels are scarce and overexploited.	• Consumer needs call for a broader variety of products. • However, distribution channels are scarce and overexploited.
New products/industries	Three new product lines: • Wines. • Spirits. • Spanish Ham.	• Wine certifications of origin. • Spirits
Why those areas?	• Ability to take advantage of previous experience and distribution channels they already have. • Try to go for complementary products related to the core business in order to specialize and remain competitive. • Products easier to sell and with a greater market growth rate.	• Ability to take advantage of experience and distribution channels they already have. • Try to go for complementary products in order to specialize and remain competitive.

Benefits of choosing these areas	• They can increase their sales rate using their previous experience in new products with greater growth perspectives. • Compete in the international market.	• They cover a greater part of the national and international market: broader variety of products. • Risk spread out among more businesses.
Results	• They became more internationally oriented. • Spread out their products portfolio.	• More flexibility and adaptability to satisfy different consumers needs. • More stability of sales rate. • More international team and target market→increase on their market share.

As we can see on the table above both companies decided to initiate a related diversification strategy based on the potential advantages that both saw in complementary product markets in relation to the company's "core business" concept since its inception.

The Jerez wine industry is a mature and traditional market where the possibilities of growth are limited by a very flat sales rate.

The reason to diversify in wine and spirits is that both Osborne and Gonzalez-Byass had clearly in mind to maintain the family business and name that they had in the industry. They decided that instead of going into a different non-related business, it was worth it to specialize the company on the sector they had been exploiting for many years and take advantage of the reputation as well as the commercialization resources they already had developed.

The key issue was that in the drinking industry the commercialization channels are scarce and overexploited especially by those matured business that have been more time in the market and that have created a proper commercialization network.

Osborne and Gonzalez-Byass understood that this could be an entry barrier for new entrants and competitors but a great competitive advantage for themselves. They could provide their reputation, experience and commercialization network in order to exploit other complementary goods in the drinking industry with a greater profit margin than traditional Jerez wines.

On one side, the drinking product lines on which both firms decided to invest were practically the same:

(I) Wines (certifications of origin).
(II) High standard Spirits.

On the other side while in the case of Gonzalez-Byass they had invested a lot in what we call the “table wines”, Osborne greatest investment was not in wines but in the “Spanish ham” industry. A product that uses the same commercialization resources as

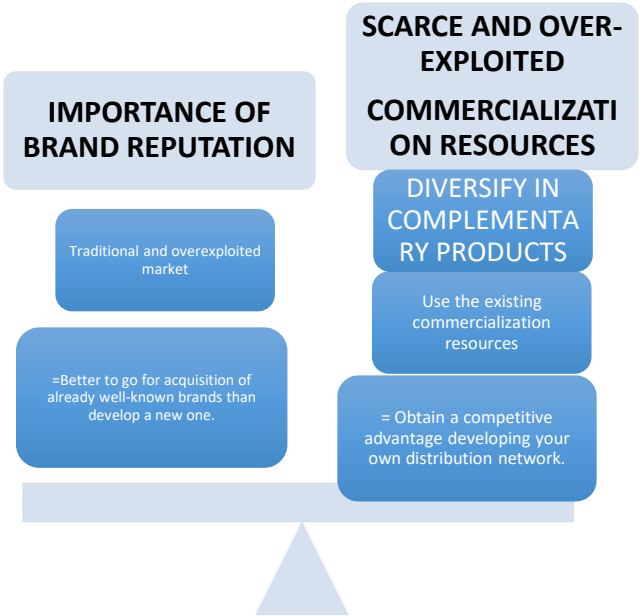
the drinking product lines and, at the same time, has a great value especially in the foreign market.

Osborne invested more on one hand in high standard spirits bying 51% of a Brazilian spirits local distributor. On the other hand they bought “Cinco Jotas” to Sanchez Romero Carvajal a few years ago, a product that has implied a massive growth for the company in the international market and particularly in China, where Osborne has a strategic alliance with the Chinese government. The initiative started with the strategic decision of Osborne letting Chinese companies become shareholders of some of the brands from the Osborne family (China Fosum), in return Chine will provide to Osborne an easy access to the Chinese market. Among the brands sold to Chinese investors was “Cinco Jotas” which resulted in great success and Spanish ham was sold at a considerable high price. The recent acquisition of the Osborne family of some of the brands sold to China resulted in its products coming back to the hands of Spanish shareholders, although not the end of Osborne “easy access” to the Chinese market which stills nowadays and so does the success in the sales of its products over there.

In this ways, Osborne stills taking advantage of the strategic alliance with China that enabled them to enter the Asian market, being nowadays the greatest consumer of Spanish ham in the foreign market and where Osborne has strongly invested more recently especially since the company realized that it was a product with a high potential beyond the Spanish borderlines. Outside Spain the product is more unknown and considered a “luxury good” that is when they decided to invest in this product and renew its image, turning the ham into a “gourmet” product different from the rest of the meat sector.

In terms of the methodology used for the diversification of both family firms they decided to go for a related-diversification through acquisition. While it is commonly thought that companies engaged in a related-diversification strategy tend to use internal development methodology in order to create synergies, we must keep in mind that in the case of the drinking industry it is also important the reputation of your brand and how it is perceived by customers. That is the reason why they decided to acquire other existing high standard alcohol brands, in that way they could offer high quality products that had already a well-known name in the market instead of developing a new one themselves. At the same time, by diversifying in complementary products they could continue using the distribution channels they already had and provide their experience in the way alcoholic drinks are commercialize.

So as a summary we can conclude that both firms had to use a methodology that helped them to overcome both limitations of the market: (I) the importance of reputation in a traditional market and (II) the scarce distribution resources available.



Conclusions

As we see along the case of study, related-diversification of Gonzalez-Byass and Osborne it was a solution towards a critical situation of the Jerez wine industry and a step into the international market while remaining specialized in the market where they had more experience and to which they have been committed for many years.

While Osborne bet for a related diversification based on making the most of its brand "Cinco Jotas", Gonzalez-Byass went for a diversification more oriented towards table wines and certifications of origin.

The decision of diversifying was drawn by a need to look for: (I) products that provide them a higher growth rate and an increase in the sales rates in comparison to Jerez wine whose growth perspectives are limited, and (II) products that will provide them a more international projection.

They opted for a related diversification in terms of products that shared the same commercialization resources. As we mentioned before, degree of relatedness can be given in different forms such as on the operational level by sharing some steps of the manufacturing process or on the strategic level by using for instance the same marketing resources. In this case we can see they share an important part of the strategic level that is the: commercialization process and distribution channels used in the drinking market. We can see as well that this level of relatedness is often non-planned by the firm but given by the market, depending on the limitations of the market where we are moving we will tend to diversify into those products that ease us to confront those limitations.

The drinking market is a market where new entrants will find hard to distribute their products, it is a closed-market owned mainly by a few firms dedicated to the industry for many years and which have their own suppliers and distributors network and where competition is fierce. The distribution channels are mainly two: Hospitality and supermarkets and depending on your "presence" in the market and your availability you will get a higher or lower sales level. Great firms as Osborne and Gonzalez Byass have managed to be present in all this channels because they are able to satisfy market demands in terms of quality, volume and price, that is why you find their products in any supermarket; in addition this firms have been able to create their own distribution points and restaurants (as an example the Cinco Jotas restaurants and "espacios"). This

might be a strong barrier for companies willing to get into this market, but it is a strong advantage for those family companies who know and operate in this market; and Gonzalez-Byass and Osborne knew it.

As a consequence in our case both firms diversified in complementary products where they could use their experience and the distribution channels they already had in order to obtain a strategic advantage.

Despite theories that suggest that a related-diversification strategy tends to use an internal development method while companies with a non-related diversification strategy go for acquisition, we see that in our case both firms do not follow this pattern. In the case of study we see how both firms have opted for a related diversification strategy but they have used an acquisition method to enrich their variety of products. Moreover, we can say that they have used a sort of hybrid strategy in the sense that:

On one side they have acquired several existing well-known alcohol brands and wine certifications of origin (such as Beronia in the case of Gonzalez-Byass or Señorío del Cid in the case of Osborne) instead of developing their own wine brands. The reason is that in the drinking industry the variety of products available in the market are a way broader nowadays than a few years ago, and the only thing that distinguish you from your rivals is how your brand is perceived by consumers in the market, so is to say your image and reputation. In addition it is very hard to obtain a new certification of origin that will give your brand a "name" and a "standard", the quality requirements that new brands have to fulfill when entering the market, especially in the world of certifications of origin, are really strict. That is the reason why for strong firms such as Gonzalez-Byass and Osborne it was easier to buy well-positioned certifications of origin and exploit them to make the most of them instead of creating their own new ones.

On the other side, they decided to invest and focus more on developing their own commercialization network in order to make the most use of it and let all their brands and products take advantage of it. Here is where the firm took a more "internal development" approach and developed an asset they already had and which was essential to succeed in the drinking market. This is due to the market limitations we already talked about: the scarce and overexploited distribution channels.

To sum up we can say that strategies and methodologies used are not fixed patterns, we can see that companies may follow one or two different approaches to achieve their goals and that there are millions of intermediate points between one extreme an the other. Our case is just a good example of a sort of "hybrid" or "intermediate" strategy where the firms adjusted their strategies to their market objectives and not the inverse. We see as well the strong bond existing between diversification and internationalization and how often the first one is used as a driver to achieve the second one.

The important thing to keep in mind is that usually strategies and methods use to implement them will change with market characteristics and limitations, and that them should be adapted and used as a way to overcome limitations existing in the market, in that way we will be able to decrease our weaknesses and increase our potential strengths.

In a changeable world, markets and global economies there is no room for fixed patterns.

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