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Research confirms, time and again, that when most companies diversify into new markets, their profitability is diluted and acquisitions are subsequently unwound—usually by a new CEO intent on creating a more "focused" company. Consider Coca-Cola's forays into wine and filmmaking, Eastman Kodak's venture into pharmaceuticals, and Philip Morris's adventure with Miller Brewing. Of course, adjacency moves are not always a disaster. IBM successfully diversified into services; Disney does quite well with a portfolio ranging from films to fun parks, children's retailing, and cruise ships; Apple successfully entered the highly competitive mp3-player, smartphone, and online music businesses; and Berkshire Hathaway, a rail-to-chocolates conglomerate, has the best 40-plus-year track record of shareholder returns the world has ever seen.

Why do some adjacencies work and others not? In my experience, two factors make the difference: The first is whether entering an adjacency materially improves the value proposition of your current business, and the second is whether it uses enough of your company's distinctive capabilities to give you a right to win in the new market.

As an example of the first factor, consider IKEA, the global home furnishings company. IKEA identifies itself with a mission to provide well-designed products at a lower price than anyone else can offer. And now it's selling televisions. Is this the typical adjacencies thinking? "Hey, if our customers are buying furniture, they might also be in the market for TVs. Why not capture that business while they're already in our stores?" Well, no, IKEA does not see itself as entering the TV market at all. Instead, the company aims to solve a furniture challenge that many of its customers complain about: how to fit the TV—and all the components, gadgets, and tangles of wires that come with it—more seamlessly into the living room. So IKEA has integrated the television into a furniture solution. IKEA is not trying to enter a new business (retailing electronics); rather, it's enhancing the value proposition of its current business (functional home furnishings).

Now, let's consider the second factor, taking Hewlett-Packard as a case in point. HP started out in high-tech measurement machines that require a lot of engineering design and implementation capabilities. When the PC revolution occurred, HP realized that desktop printers were a natural extension of those capabilities—and printers became a hugely successful business for the company. But other adjacencies, such as enterprise computer services, have not been as successful because HP's capabilities were ill matched to their requirements.

HP's fortunes rose and fell based in part on its success with "capability extensions," which enable some companies to benefit from both focus and diversity at

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the same time. Berkshire Hathaway provides a good example. Its core capability is investing capital. Few companies are better at allocating capital than the capital markets, but Berkshire is one of them. CEO Warren Buffett built a company whose way to play is investing mountains of zero-cost capital in well-managed companies that have mountains of opportunities to invest that capital profitably. The insurance side of the company generates the zero-cost capital and the other part (rails, utilities, retailing, etc.) deploys it. Berkshire is the ultimate conglomerate, and yet it's also very coherent: every business in its entire portfolio gains advantage from—and contributes to—its core capability.

Berkshire Hathaway's specific core capability is very rare. But there are plenty of other diversified companies whose portfolios are coherent because they leverage and bring scale to their own unique sets of capabilities across the full enterprise. Good examples are the Danaher Business System, Disney's ability to create and commercialize family-friendly characters, and United Technologies' ACE (Achieving Competitive Excellence) system. In each of these examples, the company is defined more by its capabilities than its portfolio, which at first blush appears to be just a diversity of adjacencies.

The best adjacency moves involve both fortifying the value proposition of your business and leveraging its distinctive capabilities. This is why I said in my last column that Apple's creation of the iPod was one of the all-time best adjacency moves. In the late 1990's, on his famous long walks in the foothills of the Santa Cruz Mountains, Steve Jobs was thinking hard about how to make the Macintosh computer more central to consumers' digital lives. The Internet was becoming mainstream and Jobs wanted to make it easier for consumers to connect their photos, videos, and music with their Macs. Thus was born the iPod, which leveraged the company's amazing capability to bring together technologies that already exist into a beautiful, ergonomic, user-enjoyable package. But not only was the iPod a wild success in its own right, it dramatically enhanced the value proposition of owning other Apple products. The Macintosh business benefited enormously because the iPod increased the computer's utility and made it even more hip to buy. It'll be interesting to see how Apple's recently announced launch of an in-car operating system and its intimations at taking another big run at the television market will unfold. These ventures will succeed to the extent they improve the value proposition of Apple's other products—like the iPod, iPhone, iPad, MacBook, etc.—or leverage the capabilities that have enabled Apple to succeed in a diverse range of product markets.

So, how does a capable strategist choose the best adjacencies strategy for his or her company? I say focus intently on answering this question: What adjacency moves would best enable you to bolster the value proposition of your current business or exploit and scale the distinctive capabilities you already have? Gird yourself to resist the alluring temptation to pursue adjacencies to compensate for slowing growth in your core businesses, exploit a hot growth market, keep up with others, or upgrade your company's growth or margin profile. Such come-ons are what drove airline companies into car rentals, led steel companies into buying construction aggregates, and seduced pharmaceutical companies into consumer products.

These adjacency moves all failed because their motives were wrong, and so those companies missed growth opportunities in their core businesses while also diluting their overall coherence—a double whammy that led to many lost years. The best motive for pursuing adjacencies is to enhance the value proposition of your current business while leveraging and scaling your already-distinctive capabilities. This will strengthen your business and expand its boundaries at the same time, producing high-quality growth of sustainable earnings. +

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