Department of Business and Management

A CHANGE OF CORE BUSINESS: STRATEGICAL ISSUES AND EMPIRICAL EVIDENCES (SUMMARY)

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ACADEMIC YEAR 2012-2013

ABSTRACT

A change of core business: the transition of Royal Philips to the Healthcare industry is a case study that analyses the strategy of Philips, a global leader in the Healthcare Industry. Philips operated in too many industries with a severe impact on efficiency in the 1990´s, which resulted in a sharp decrease in income in 1996. Consequently, Philips started to restructure and sold parts of the business which were underperforming or did not fit in the strategic portfolio. It increased its focus on the Healthcare division through acquisitions as it was a very promising industry. Philips successfully changed its core business which was vital for the survival of the company.

Keywords: Core Business, Strategy, Change, Conglomerate, Electronics Industry

1. Introduction

A study was conducted on the 500 Fortune companies in 1994. In 2004, ten years later, 30% of these companies went bankrupt or were acquired, while 26% changed their core business (Zook, 2007). This means that more than half of the companies experienced a threat with respect to the independence of the company. Moreover, there is a decrease in the expected lifetime of a company from 40-45 years in 1990 to only 18 years in 2008, which is mostly due to the rapid changing business environment (Dervitsiotis, 2011). This shows that companies have a major problem when they do not think beyond the core business. The following case study is about Philips which changed its core business. Philips was very successful until it experienced difficulties in 1996. The problems resulted in a change of strategy and a change of core business. The purpose of this project is to show that it is important to reevaluate business activities continually in order to survive as a company. It is analyzed which measures can be taken when the core business is underperforming. The case can be used for companies which experience difficulties and consider to invest beyond their core business.

2. Literature review

The focus is on conglomerates in the electronics industry as Philips was also a conglomerate in the 1970's. They had 400.000 employees and operated in the music, healthcare, consumer electronics, lighting and several other industries (Veen, Yerkes and Achterberg, 2012). Conglomerates experienced a high growth in the 1960's, but reported less growth in the 1970's and 1980's. Moreover, the amount of conglomerates decreased in the 1980's. As a result, many conglomerates, including Philips, started to restructure their business activities.

2.1 Conglomerates

A company is a conglomerate when it has unrelated businesses, or operates in a mix of related and unrelated industries. Cyriac, Koller and Thomsen (2012) gave a more narrow definition of a conglomerate: "A company with three or more business units that do not have common customers, distribution systems, technologies, or manufacturing facilities". There were many conglomerates in the 1970's and 1980's. They dominated the industry and played a significant role in the economy. The conglomerate strategy was highly favored and only 25 percent of the largest companies were firms who operated only in one industry in the 1980's (Davis, Diekmann and Tinsley, 1994). However, this changed as conglomerates were inefficient which had a significant impact on companies in the electronics industry as most of these companies were large conglomerates.

The share price of some conglomerates decreased with more than 80 percent in 1968 (McDonald and Eastlack, 1971). The P/E ratio of conglomerates declined significantly and were lower than single firms. The main strategy of conglomerates in the 1960's was to acquire companies with a lower P/E ratio. After 1968, this was difficult as single firms had a higher P/E ratio which made acquisitions more expensive. This limited the growth prospects of conglomerates as they were highly dependent on acquisitions. Furthermore, in 1968 there was an increase in interest rates which made it more costly to borrow money for acquisitions (McDonald and Eastlack, 1971). Additionally, an acquisition had less effect on the earnings per share due to new accounting rules (McDonald and Eastlack, 1971). There were also several other reasons why conglomerates struggled with growth such as: intensified competition, shorter product life cycles, rising costs and new technology (McDonald and Eastlack, 1971). Conglomerates were less efficient and therefore its products were highly vulnerable to new competitors. Nevertheless, conglomerates were one of the largest and strongest firms at the end of the 1970's. This started to change in the 1980's.

Several studies showed that conglomerates were valued less on the market when comparing them to single firms (Khorana, Shivdasani, Stendevad and Sanzhar, 2011; Lebaron and Speidell, 1987; Maksimovic and Phillips, 2002). The conglomerate strategy implied that "two plus two is five", but conglomerates on the stock market were valued as "two plus two is three". The study of Lebaron and Speidell (1987) showed that separate parts of the conglomerate had more value separately than all activities together. This was the other way around in the 1960's as synergism resulted in the "two plus two is five effect". The conglomerates were discounted on the stock market because investors were more skeptical towards companies which operated in unrelated industries due to the disappointing results (Lebaron and Speidell, 1987). Moreover, inflation decreased the value of assets which were acquired in the 1960's. Therefore the value of acquisitions was overvalued in the books as it is was worth less in the open market (Lebaron and Speidell, 1987). Another reason for the conglomerate discount was a lower productivity (Maksimovic and Phillips, 2002). The difference in productivity was connected to smaller segments of the conglomerate when comparing it to single firms. Shareholders preferred a company with less divisions as they had a higher productivity and it was easier to manage the activities of a single company. Shareholders experienced agency issues with conglomerates as they found it difficult to manage these large companies. Moreover, it was difficult to understand all activities of conglomerates. As a result, stockholders invested in single companies as they were less diversified, more productive, smaller and easier to supervise. This resulted in a lower value of conglomerates on the stock market.

In the 1980's, conglomerates were taken over by less diversified firms at a high rate due to the conglomerate discount (Davis, Diekmann and Tinsley, 1994). The less diversified firms kept related high performing activities and it sold those activities which were underperforming (Davis, Diekmann and Tinsley, 1994). Less diversified companies adopted a different strategy and were more successful than conglomerates. Consequently, a majority of the companies abandoned the conglomerate strategy and adopted different strategies.

The new strategies were also based on theories of Porter (1987). In his study he recommended companies to choose in which specific business area it want to operate and it need to describe in detail how it want to manage it. The main objective was to increase the overall company value, so that it had more value than the sum of all the separate divisions together. There were four points important regarding the new corporate strategy: portfolio management, restructure, transmit skills and share behaviors (Porter, 1987). The first two points focused on increasing the value of the company through a stronger connection between headquarters and business divisions. The last two points focused on the interaction of divisions between each other in order to increase the total value of the company. This shows that there was a shift from a focus on the size of the company to creating value, which means that companies should not only diversify to increase the size of the company. The most important is that diversification should add value to the company, which is a different approach than the conglomerate strategy in the 1960's.

2.2 The push for a change of core business

A company needs to look within the company in the same or a related industry for a change of core business as acquisitions and joint-ventures have a high risk. Zook (2007) points out that a change of core business can start within the company by finding: an undervalued business division, undiscovered consumer knowledge or underestimated capabilities. These options have low risks and low costs, although the company has to spend time and effort in defining these areas. It is important to consider partnerships with universities, governmental institutions and other companies, if firms lack the capabilities and expertise in a new industry or market (Edwards, 2012).

Companies should consider acquisitions and joint-ventures in case no business opportunities are found within the company. It is recommended to first focus on the same industry and related industries, rather than investing in unrelated industries. As could be seen from the inefficient conglomerates, it is difficult to be successful in unrelated industries. The success of diversifying away from the core business depends on the connection between new activities and current competences. There is a negative impact on the financial performance of the company if the current and new activities are not related (Haveman, 1992). Moreover, a study of Zook (2007) about companies that have successfully restructured their core business shows that the most secure route is to in invest in a business close to home rather than to enter an unfamiliar market. Many companies already have some expertise which can be used to expand in the same industry. This is also confirmed by a study of Edwards (2012), which shows that innovation becomes more risky when the company goes beyond the core, as a firm is not successful if they are many steps away from the core. Furthermore, a company should improve its performance in the industry where it is rather than entering a new market, as in every industry the return is around the same (Hirsh and Rangan, 2013). There are some high growth industries but most of the time this high growth is not sustainable and slows down over time (Hirsh and Rangan, 2013). One the other hand, in some industries there is high growth for a longer period, and therefore Porter (1987) makes a distinction between attractive and not attractive industries. As a result, companies should also pay attention to related industries with high growth.

Companies need to make a list of assumptions before entering a related or unrelated industry (Govindarajan and Trimble, 2011). A company should not invest in an idea if there are too many negative assumptions. If almost all the assumptions are positive, the company needs to invest in the idea by separating the former and the new core business and let them work separately as independent divisions, while they still have the opportunity to exchange resources with each other as this increases the success for a change of core business (Gilbert, Eyring and Foster, 2012). Nevertheless, no separation is needed when both business units have a value creating process for the customer which is similar (Govindarajan and Trimble, 2011). The two business units should only be separated when both units have a different business model.

Both units play a different role in the firm when they are separated, and therefore managers should not treat the two business units equally. The core business remains important and should not be undervalued as it provides cash flows for the company, innovation, and it pays the salaries of the employees (Edwards, 2012; Gilbert, Eyring and Foster, 2012). The new core business requires extra attention through corporate resources (Gilbert, Eyring and Foster, 2012). Nevertheless, a common failure is to over-invest in start-ups and new business opportunities as managers see them as a competitive advantage of the parent company (Clayton, Gambill and Harned, 1999). The best way is to apply the golden rule: "spend a little, learn a lot" (Govindarajan and Trimble, 2011). After spending a little, there is the experimental stage of a few months in which the assumptions are tested. The company discovers if the market assumptions were right or not. Even more important, the managers can also see if the company has the capabilities to be successful with the new business unit. Moreover, the experimental stage provides consumer insight (Edwards, 2012). Managers should not judge the short-term financial performance of a new start-up as if it was part of the core business. This has negative consequences as entrepreneurs leave the company and new ideas do not have any chance of succeeding (Clayton, Gambill and Harned, 1999). Many startups are not successful the first time during the experimentation phase, but it gives the opportunity to gain customer knowledge which helps the firm to be successful next time.

If the new business unit is successful, firms should focus on a leadership position in the market, as in many industries more than 70 percent of the profit pool is gained by the No. 1 and 2 of the market (Zook, 2007). Companies should divest those activities in which they do not have any leadership position, and invest it in those divisions in which they have some market share. The money of the divestures can be used for strengthening the leadership position of the new core business.

3. Methodology

A case study about Philips is used in order to gain more knowledge about a change of core business. Annual reports of Philips (1998-2012), literature, and news articles are used to analyze the firm. The research questions for the Philips case are:

1. Why did they change their core business?
2. How did they change their core business?
3. What were successful decisions and mistakes?

4. Royal Philips Electronics Case

4.1 Change of core business

Philips focused on a large amount of industries which resulted in less efficiency (Freeman and Hannan, 1975). A disadvantage was that the headquarters of Philips had difficulties to understand all the industries and technologies in which it operated. There were also several other disadvantages such as focusing on the size of the company and not focusing on creating value (McDonald and Eastlack, 1971), ineffective acquisitions (Nader and Green, 1979), and Philips did not sufficiently deal with unproductive business units (Attiyeh, 1970). As a result, the market value of Philips on the stock market decreased as the stocks of conglomerates were discounted because investors were more skeptical towards companies which operated in unrelated industries due to disappointing results (Burch and Nanda, 2003).

The managers implemented a restructuring program in order to make the company more flexible (Philips, 1998:36). In 1998 it sold already 25 operations which did not fit to the core business or were underperforming (Philips, 1998:4). In 1999, the divestment plan of Philips continued and it divested over 40 firms (Philips, 1999:4). Philips kept on monitoring the performance of all divisions in order to see whether improvement was needed and if activities belonged to the core business. In 1999, the core business was Consumer Lifestyle as it represented 39.5% of the total revenues and 24% of the total EBITDA (Philips, 1999:49). Nevertheless, Lighting was also important as it accounted for 14.5% of the total revenues and 22% of the total EBITDA. Healthcare was part of the Professional division and accounted for 8% of the total revenues and 6% of the total EBITDA. The healthcare industry was a growing market due to the aging population and the increase in demand for medical products from emerging countries. As a result, Phillips wanted to expand in this market and this started in 2000.

In 2000, Philips sold several business activities which resulted in a gain of €3.6 billion and invested for €3.2 billion (Philips, 2000:2). The divesting plan of 1996 was accomplished and Philips implemented a new strategy for a high growth future which consisted of three steps (Philips, 2000:3). The first step was to have several leadership positions in the market which should result in a positive cash flow. The second step was to have a portfolio with high growth products and services. Consequently, Philips invested more than $4 billion in the Healthcare division in order to increase the variety of products and to explore new high growth products (Philips, 2000:4). The third step of the strategy plan was to be an industry leader which was possible through high investments in R&D. As a result, Philips built several research centers in China, India and a high tech campus in the Netherlands.

Between 2000 and 2003, Philips invested around €5 billion in acquisitions and doubled the size of the Healthcare business unit (Exhibit 1). Moreover, Philips invested around €4.5 billion in the home healthcare activities between 2006 and 2009, the acquisitions were all aimed at strengthening the home healthcare division in which it had to compete with firms such as GE, Siemens and Intel.

The strategies of Philips between 1996 and 2012 were very similar as Philips focused on the core business and sold parts of the business which did not fit in the strategic portfolio. The restructuring strategy of Philips resulted in an increased focus on Healthcare. As a result, Healthcare is now the most important business unit for Philips, as it is both a growing and a profitable part of the company. Exhibit 1 shows that Healthcare reported sales of €10 billion in 2012, Lighting €8.4 billion, and Consumer Lifestyle €6 billion. Regarding EBITA in 2012, Healthcare has an EBITA of €1.3 billion, Consumer Lifestyle €663 million and Lighting €188 million. The Healthcare division became very important, as it accounts for 41% of the total revenues and 61% of the total EBITA. Healthcare received 44% of the R&D investments in 2012. Thus, Philips gives special attention to the Healthcare division. As a result, Philips is now a global leader in the healthcare industry. “They are the largest home healthcare company, being number one in: Monitoring systems, Automated External Defibrillators, Cardiac Ultrasound, Cardiovascular X-ray” (Philips Healthcare, 2013).

4.2 Characteristics found in the change of core business

Philips focused on Healthcare and not on Consumer Lifestyle as it was a more profitable industry and there was a higher growth. Philips changed its core business by research and development, restructuring programs and acquisitions. A mistake of Philips was unrelated diversification as they became inefficient. The success factors were restructuring strategies, finding business opportunities within the company, a focus on Healthcare, cooperation between business units and R&D.

4.3 Links with literature

Philips became a conglomerate due to a high amount of acquisitions in the 1960’s and the 1970’s (Philips Acquisitions, 2013). This was possible as they acquired companies that had low P/E ratios, they borrowed money with a low interest rate, and there were favorable accounting policies which resulted in a direct increase in earnings in the books (McDonald and Eastlack, 1971). Philips invested in several industries as it created diversification, synergism and profitability (Smith and Schreiner, 1969). A disadvantage was that the headquarters of Philips had difficulties to understand all the industries and technologies in which they operated (Berg, 1965). There were also several other disadvantages such as focusing on the size of the company and not focusing on creating value (McDonald and Eastlack, 1971), ineffective acquisitions (Nader and Green, 1979), inefficiency (Freeman and Hannan, 1975; Maksimovic and Phillips, 2002) and they did not sufficiently deal with unproductive business units (Attiyeh, 1970). Philips struggled with growth due to intensified competition, shorter product life cycles, rising costs, high interest rates and new technology (McDonald and Eastlack, 1971). Porter (1987) shows that diversification in unrelated industries results in more disadvantages than advantages which was also the case for Philips.

Philips started the restructuring program in 1996, in which they aimed at selling underperforming activities, paying attention to growth opportunities, and focusing on internal assets. The restructuring program was also very similar to the recommendations of Porter (1987), in which he recommended firms to focus on portfolio management, reorganizing the firm, transmitting skills and sharing behaviors in order to create value. The divestments of Philips were a good decision as it decreased the conglomerate discount, increased the efficiency of remaining activities and it improved the focus of the company (Dittmar and Shivdasani, 2003). The divestments resulted in a focus on Lighting, Consumer Lifestyle and Healthcare. The South Korean government and the IMF recommended conglomerates to have two or three businesses as its core business and to focus on specialization rather than on the conglomerate strategy as this would be more successful (Taniuara, 1993). This is what Philips did as it decided to focus on three business units.

The divesting was accomplished in the year 2000, and Philips implemented a new strategy for a high growth future which consisted of three steps: high growth products, leadership, and an industry shaper (Philips, 2000:3). Philips invested in Healthcare in order to increase the variety of products and to explore new high growth products. Philips had a high chance of success as they already had some expertise in the Healthcare industry which is important for being successful (Edwards, 2012, Kusewitt, 1985; Zook, 2007;). Philips focused more on Healthcare and less on Lighting and Consumer Lifestyle. This was a good decision as there were shrinking profits in Consumer Lifestyle industry (Zook, 2007). The focus on healthcare was very important as business analysts still did not really knew who the company Philips was and what it did (Schwartz, 2007).

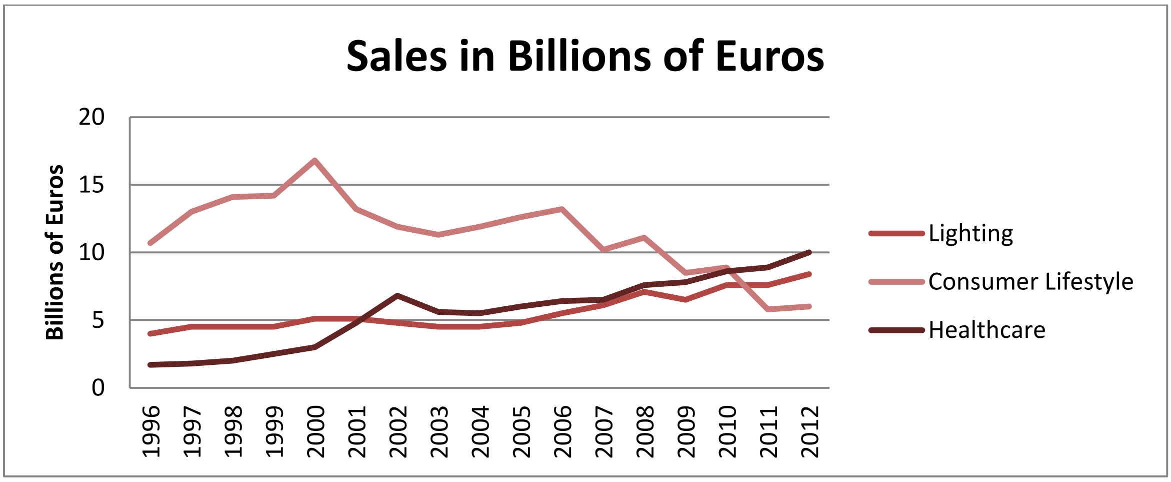
Zook (2007) points out that a change of core business can start within the company by finding: an undervalued business division, undiscovered consumer knowledge or underestimated capabilities, which Philips did as they found the undervalued business division Healthcare. The acquisitions of Philips were also successful as they invested in a business close to home (Zook, 2007), the current and new activities were related (Haveman, 1992), and it was an attractive industry (Porter, 1987), which decreased the risk of acquisitions (Edwards, 2012).

The acquisitions were also successful as Philips invested in its business units and partnerships. A successful firm is one which has the characteristics of a relationship-centered company (Gulati and Kletter, 2005). Therefore successful firms focus on customers, suppliers, alliances and business units in order to remain flexible. Philips focused on partnerships and its business units in order to create value. Philips started partnerships with several important universities in order to strengthen the Healthcare division. A study of Edwards (2012) confirms the importance of partnerships as it is vital to look for partners who have a common interest in order to fill the capability gaps when moving beyond the core business. These partnerships helped Philips to be more innovative and successful.

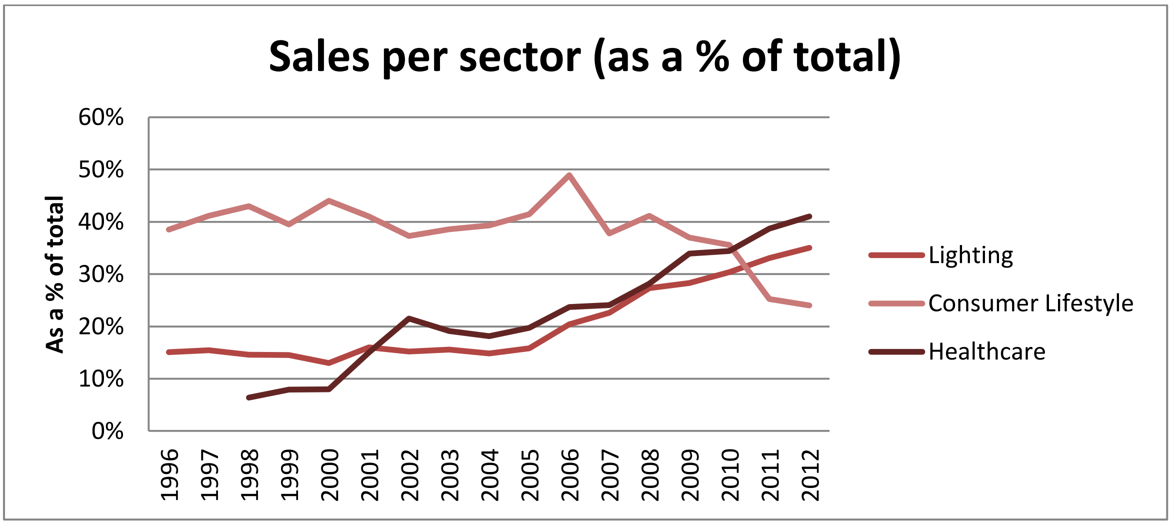
5. Conclusions

The last part of this case study is aimed at giving helpful learning points to readers and to show some relevant points about how it possible to successfully change a company's core business. The first learning point is that a change of core business can start within the company by finding an: undervalued business division, undiscovered consumer knowledge or underestimated capabilities (Zook, 2007). The advantage of these points are low risks and low costs, although the company has to spend time and effort in defining these areas. The second point is to focus on the same and related industries, rather than investing in an unrelated industry as it is difficult to be successful in an unrelated industry. The success of diversifying away from the core business depends on the connection between new activities and current competences. There is a negative impact on the financial performance of the company if the current and new activities are not related (Haveman, 1992). The third point is that is that firms should focus on a leadership position in the new industry, as in many industries only the two largest companies in the industry gain all the profits in the industry (Zook, 2007). The fourth point is to invest in partnerships who have a common interest in order to fill the capability gaps when moving beyond the core business (Edwards, 2012).

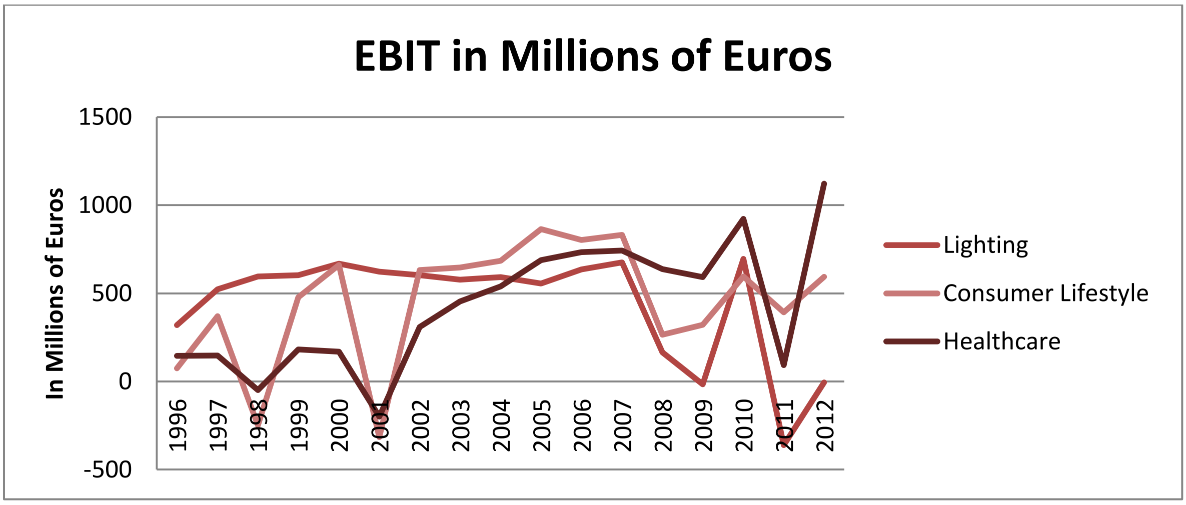
Exhibit 1. Sales and EBIT of Philips.



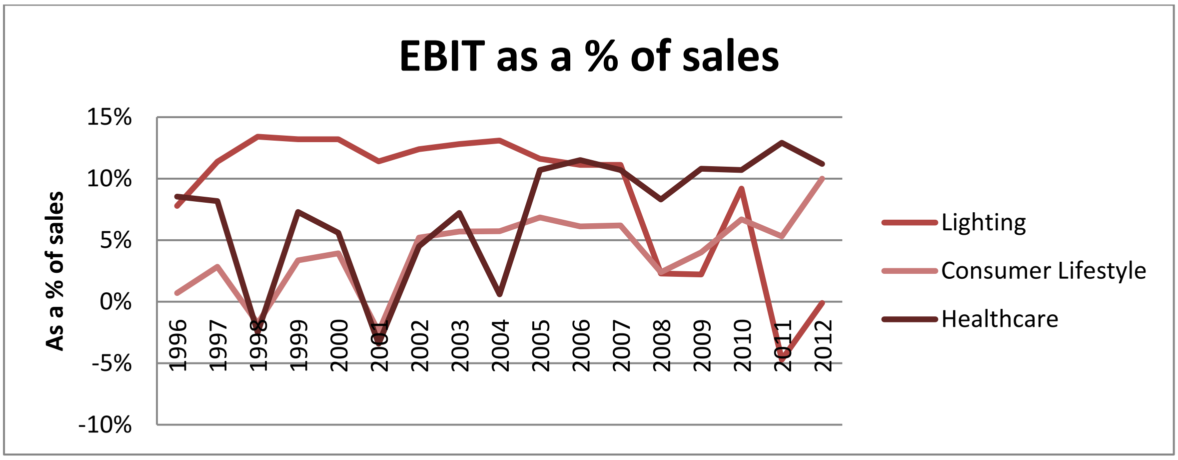
Source: Philips Annual Reports 1998-2012



Source: Philips Annual Reports 1998-2012



Source: Philips Annual Reports 1998-2012



Source: Philips Annual Reports 1998-2012

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