Diversification as a growth strategy for a Financial Services Company

Kuwait Financial Centre (Markaz) – A Case Study

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Abstract

The financial services companies are finding it difficult to maintain sustained natural growth in view of the complex economic environment that is prevalent. In the era of globalization which means less protectionism but more markets open to do business and enhanced competition, diversification and development of core competencies are two critical growth strategies which are adopted by financial service companies worldwide. Diversification can be through offering more products or product lines to the existing market, entering new markets or developing new products to new markets. This research paper has the objective of determining whether diversification is an ideal growth strategy for Financial Services Companies. Kuwait Financial Centre (Markaz), one of the leading Financial Services Company in Kuwait is taken as a case study. The financial performance and strategies of Kuwait Financial Centre from for the years 2000-2004 is taken for the purpose of the study.

Introduction

There were distinct trends noticed towards the turn of the century in the financial services industry.

First, the movement towards large financial conglomerates, stimulated by the ongoing blurring of traditional distinctions between financial products provided by commercial banks, investment banks, insurance companies, and other financial intermediaries, was proving to be transitory.

Second, the basic financial and risk-management skills remained the most important determinant of a company's viability and continued success.

Third, it was noticed that, even in a world of financial conglomerates, there was room for smaller and, in some cases, more specialized market participants.

Last, the supervisory and regulatory structure and practice was evolving to meet all of these challenges, and regulatory authorities were being forced to remain vigilant in carrying out their duties, particularly in the area of antitrust enforcement.

In 2005 these conclusions are still valid. There is a case for diversification in turbulent times. "Just a ball of confusion, that's what the world is today." Those lyrics from The Temptations in 1970 aptly describe the current scenario.

Some of the major factors that influenced the financial service industry during the new century were the 9/11 attack on the twin tower and the far reaching impact it had on the financial markets, and the recession of 2001. Further, although the dot-com craze ended, technological change has continued, and its influence on the present and future of financial services is pervasive. The

situation in Iraq, globalization, differing views on the economy, rising interest rates in US and globally have muddled the situation further. Scandals in United States in which high rollers received secret trading deals have made investors even more wary about mutual funds.

Diversification has proven the wisest strategy for financial services companies in the new century. Globally, mid and small-capitalization value funds excelled generally during the period, while large-cap growth funds sputtered. In sectors, natural resources and telecommunications funds rose, as science and technology funds stumbled. World stock funds saw Japanese funds zoom and gold-oriented funds crash.

With the investors largely just looking at performance numbers, a sideways market doesn't get people terribly excited about mutual funds. Flows into mutual funds will probably continue to be positive but not overwhelming.

The situation calls for cautious optimism. These turbulent times require active fund management. Forecasts show that this decade will not see people sit in an index fund and make much progress because it's much more of a stock-picker decade. Investors in all sizes of companies have become more conscious of balance sheets, good financing and cash earnings.

These call for innovative ideas and diversification to keep ahead in the market.

This research paper aims to find out whether diversification and developing core competencies is a desirable growth strategy for a Financial Services Company.

Research Objectives

1. To determine whether diversification is an ideal growth strategy for a Financial services company in the current economic scenario.
2. To critically analyze the growth of Kuwait Financial Centre (Markaz) during the period 2000-2005 resulting from its diversification strategies and development of core competencies

The research will depend exclusively on secondary data, Kuwait Financial Centre (Markaz) was chosen as a case study in view of the market leadership enjoyed by the company and its pursuit of diversification as a growth strategy post 1997.

For the purpose of finding out the growth and financial health of the company during the research period the following parameters were used,

- Earnings per share
- Net Profit
- Return on Equity
- Assets under Management

It is felt that the above parameters are sufficient indicators of the organizations growth and success.

Diversification as a growth strategy

Does diversification tackle the issue of stability and growth for financial service organizations? It has long been a tenant of those who favor larger financial services companies that such entities are, by definition, more diversified than their specialized counterparts. Therefore, the argument goes that the larger financial services companies will benefit from higher earnings source diversification (Denenis and Nurullah, 2000), increased operating earnings stability (Santomero and Chung, 1992), and higher valuations (Boyd and Graham, 1988). Assuming that each business line or geographic area is

independent, the argument is so direct as to follow from the simple law of large numbers.

However, proponents of the stability argument assert that such broad product Capabilities may permit better performance for more technical reasons as well. They extend the scope economies story above to reduced volatility as well, by alleging that various synergies are involved in different but related businesses. Black, for one, argued that the universal institutions have better monitoring capacity, which will reduce the risk to the firm, an argument made by Fama as well (Black, 1975, Fama, 1980). Steinherr presents empirical evidence that universal institutions "achieve a better risk-return tradeoff" and that universal institutions have "reduc[ed] variability of income from lending activity." Thus, the universal institutions should be safer, and less susceptible to insolvency.

Together, such benefits from earnings diversification, due to either broadening the geographic reach of an institution or increasing the breadth of products and services offered, may increase firm value in several ways. First, reduced risk directly translates into reduced probability of incurring distress costs. This is because the probability of insolvency concerns or even a credit rating downgrade is reduced due to the diversification of business units under one corporate umbrella. (Stulz, 1984, Santomero, 1995). This, in turn, reduces expected funding costs and directly effects reported earnings. Second, if firms face a tax schedule that is less than strictly proportional, then reduced volatility will lead to a decline in the expected tax burden, raising expected net after tax income (Santomero, 1995). Third, earnings from lines of business where customers value an institution's reputation for stability may be increased. Finally, the firm may be able to increase the level of some risky, yet profitable, activities such as commercial lending increased without additional capital being necessary (Saunders and Walter, 1994).

As they gauge their level of expertise for each competency, financi institutions face tough choices. Firms must determine which they shoul retain internally, which should be outsourced by partners and which, if any they should discontinue.

While developing core competencies deciding which business goals are mos important and achievable can help executives establish priorities and star planning. Excelling at a particular competency requires a variety of corporate capabilities. Some of the specific competencies can be,

- Increasing customer penetration
- Identifying acquisition targets
- Increasing wallet share
- Improving understanding of customer profitability
- Increasing customer retention
- Achieving scale efficiencies in particular products
- Performing higher quality, more efficient product development
- Applying shared processes across products
- Decreasing systemic risk via portfolio that represents a diverse set of business and geographies
- Reducing losses due to operational risk through automation and monitoring
- Lowering credit losses through customer knowledge and improved underwriting and collection processes
- Leveraging securitization to transfer credit risk
- Increasing collaboration and innovation across lines of business
- Obtaining accurate and timely information on state of the business
- Maintaining low overhead through efficient procurement
- Operating in a secure, efficient, resilient environment

this competency-driven era, some companies will leverage size or global presence to compete in multiple areas, while others will try to dominate a particular niche. As the industry fragments, significant questions need to be answered. Firms may face great difficulty in assessing their own core competencies and in deciding whether to give up parts of the value chain. By honing specific competencies now, a firm should be better positioned to assume its desired role in the new environment, instead of being relegated to an inferior marketplace position by default.

Success in creating sustainable value - "intelligent growth" - requires focus on chosen core competencies in conjunction with customer value. Within this new environment, firms must start by evaluating their proficiencies, and then using those results, decide how to specialize. Companies will need a sound, executable plan to master one or more of six key competencies:

• **Customer insight** - The ability to understand and accurately anticipate the needs and preferences of customers

• **Fulfillment** - The ability to develop a comprehensive set of integrated touch points between the customer and the enterprise, providing cost effective, seamless service

• **Production/transaction processing** - The ability to efficiently develop products and conduct transactions by eliminating unnecessary processes, avoiding process duplication and taking advantage of scale efficiencies

• **Portfolio/risk management** - The ability to manage the overall portfolio of products and services, along with the corresponding aggregate risk of the enterprise

• **Enterprise** - The ability to provide an efficient foundation for centralized processes and management information systems

• **Infrastructure** - The ability to optimize underlying information technology systems and supporting processes that enable the enterprise to achieve business objectives.

The future of financial services: Intelligent growth

In the financial services industry today, diminishing results from "tried and true" growth strategies are causing a shift away from monolithic financial institutions toward competency-led enterprises. To keep growing, firms are being forced to consider competing in new ways. Some key competencies are discussed below which will enable the companies to assess their current strengths in preparation for the future financial services marketplace.

During the last decade financial services industry have pursued three distinct strategies, revenue diversification through wide institution of fees, consolidation through mergers and acquisitions and risk transference through asset securitization. However, returns from each of the value creation strategies of the 1990's are evaporating

Most major markets have seen non-interest income level off, very few mergers have realized the anticipated gains in shareholder value and advanced markets, such as the U.S., have seen outstanding balances for loan securitization settle into a stable range. As companies strive to attain growth, the industry is facing deconstruction, with firms choosing to specialize - for example, to act as a product supplier, a distributor, a processing utility or as a provider of risk, insight or compliance services.

Financial institutions, hoping to maintain the competitive edge will have to operate with increasingly independent business models.

This emphasis on specialization will require modification of the corporate mind-set. Instead of describing themselves as asset managers, fund managers, bankers, insurers or brokers, for example, financial institutions will present themselves as entities that offer borrowing, insuring or investing services. In

- Having flexibility to cost effectively add new processes and alter existing processes
- Maintaining low total cost of ownership
- Customer segmentation

Throughout the financial services industry, the majority of segmentation is traditionally performed in the first two stages based on demographics, habits and preferences, with the third stage, profitability management, remaining largely untapped.

Kuwait Financial Centre (Markaz) – Case Study

The Kuwait Financial Centre (Markaz) was established in 1974 by the late Sheikh Ali Sabah Al-Salem Al-Sabah subsequent to the first oil shock. The objective was to create a leading financial institution capable of channeling oil wealth into the development of Kuwait's infrastructure and investing the excess in the best investment prospects worldwide. Central to the vision was the firm belief that without a properly regulated and active capital market, the Kuwaiti private sector would not be able to develop its capabilities to execute the large-scale private and government projects necessary for the transformation of Kuwait into a modern economy. This belief is well entrenched in the way Markaz conducts business today.

Markaz has remained ahead of competition in Kuwait by introducing sophisticated financial products and venturing into new markets. 1976 saw the establishment of the first merchant bank in Korea, in partnership with Hyundai Engineering & Construction Company. Real estate investment activity in the United States was started in 1978, based in Los Angeles, California, and this was followed in 1979 by the acquisition of a major stake in the Bank of Lebanon and Kuwait

The company faced a setback in 1990. Iraq's invasion of Kuwait in 1990 brought a halt to its business activities. Because of the resulting loss of business and the financial losses, the activities of the company between Liberation Day and 1997 remained restricted to foreign exchange and management of its investments. It took seven years for Markaz to recover from the losses.

Between 1996 and 1999, Markaz restructured its operations to capitalize on the emerging opportunities in the Kuwaiti market. It divested a substantial part of its non-core assets, affiliates, and subsidiaries abroad, raised its paid-in-capital to KD 50 million, listed its shares on the Kuwait Stock Exchange in April 1997, and embarked on an ambitious plan to once again become a full-service investment company.

Markaz had no assets under its management in 1997. To turn things around, it implemented a strategy which was simultaneously aimed at growth through diversification while developing core competencies. At the end of 2004, Markaz had more than USD 2.423 billion in Assets under Management, across four asset classes: Domestic Equities, International Equities, Private Equities, and Real Estate. Its Corporate Finance Department has led and managed in excess of USD 600 million in Equities and Bond issues since 1997.

This performance was not accidental, but a result of well planned strategy of diversification. Post 1997, Markaz has adopted diversification as a growth strategy to maintain its competitive edge. The diversification has been in three distinct directions.

First, Markaz has added product lines to its existing product portfolio. Previously, Markaz was offering only 3 product lines, i.e., Local Investment, International Investment and Private Equity. The following product lines were added to attract new customers and to offer a broader range of products

to its existing customers, Client Relations & Marketing, Corporate Finance, Real Estate and Treasury and Foreign Exchange.

Second, Markaz increased the depth of each of its product line to cater to the needs of the individual and institutional clients. At the end of 2004, Markaz has seven distinct product lines offering 21 specialized services.

Lastly, Markaz went in for investing on a global level to reduce the risk. The investments were made in US, Europe, Asia, Latin America and Middle East and North Africa.

To a large extent the restructuring of the company's activities were necessitated by environmental constraints. Geo-political tensions, terrorism, rising of oil prices, the decline of the US dollar and the tightening monetary stances of Central Banks all hindered the economic and financial indicators of the world markets during the research period. This also resulted in repatriation of Kuwaiti capital and demand for capital in Kuwait.

Markaz identified Corporate Finance Services as a critical area to develop core competency. Market segmentation was used by Markaz to fuel its growth. Separate product lines were developed to cater to a niche segment, Corporate Clients. A need was identified for managing the funds of Corporate Clients and for financing their development plans. This market was further segmented and a smaller, important niche of family owned businesses aiming to expand were identified. These companies required specialized services to go public in order to take them to the next level of operations.

Kuwait witnessed a real estate and construction boom post liberation of Iraq in early 2003. Markaz identified this sector as a growth potential and has in its portfolio four Real Estate Funds to cater to this market segment.

With a view to developing client relationship as an area of core competency, a separate department was formed in 2004. This department is to act as a focal point for contact with the customers through a series of innovative services.

Across industries, the new product development capability has traditionally not been cost- effective. One estimate states that 46 percent of resources devoted to the development and launch of new products are spent either on products that fail or that never even gets to market.

In general, the pursuit of product innovation in the financial services industry has been impeded by the restrictions inherent in siloed legacy systems, which limit the types of products that firms can offer. By involving all stakeholders early, Markaz has found ways to design innovative products that the market embraces - and ones that the firm can deliver. Markaz modified its new product development process to become more customer centered. The focus shifted from a product-centric environment to one that is customer centric. The company pursued four goals: to develop a product without using traditional "product-push" perspective, to create a comprehensive range of products catering to diversified customers, to focus institutional investors who need specialized service and to increase the effectiveness of and leverage employees skills in selling, consulting and servicing.

Markaz involved all relevant parties early in development. Senior management, marketing, agents, and client groups collaborated on product design, thereby reducing resistance to the new product. The sales force provided a window into the customer's needs, while senior management had the vision of a product that would succeed in the changed economic scenario.

It has to be analyzed whether the diversification strategies, development of core competencies and new products resulted in growth for Markaz. Towards

this end, the financial performance of the company for the years 2000-2004 was analyzed.

The following parameters were used to determine the growth achieved by the company and its financial health,

- Earnings per share
- Net Profit
- Return on Equity
- Assets under Management

Earnings per Share

Table 1: Earnings per Share of Kuwait Financial Centre (Markaz) for the period 2000-2004

in fils

Year	Earnings per Share
2000	8
2001	11
2002	9
2003	25
2004	35

(Source: Annual Reports 2000-2004)

Except for the year 2002, Earnings per share have shown a consistent increase from 2000 to 2004. The growth is 4.375 times over the 5 year period

Net Profit

Table 2: Net Profit of Kuwait Financial Centre (Markaz) for the period 2000-2004

in million KD

Year	Net Profit
2000	2.94
2001	4.18
2002	3.54
2003	9.63
2004	13.14

(Source: Annual Reports 2000-2004)

The company has shown excellent growth in net profit in all the five years except 2002. The net profit of 2004, KD million 13.14 is 776.25% of its net profit in 2000.

Return on Equity

Table 3: Return on Equity of Kuwait Financial Centre (Markaz) for the period 2000-2004

in %

Year	Return on Equity %
2000	5.69
2001	8.12
2002	6.81
2003	13.56
2004	16.14

(Source: Annual Reports 2000-2004)

Again the indicator is very positive for all the years. The Return on Equity has grown to 16.14% in 2004 from 5.69% in 2000.

Assets under Management

Table 4: Assets under Management of Kuwait Financial Centre (Markaz) for the period 2000-2004

in million US $

Year	Assets under management
2000	493
2001	768
2002	1180
2003	1778
2004	2423

(Source: Annual Reports 2000-2004)

The Assets under management has grown steadily as a result of diversification strategies adopted and has increased by 4.91 times during the period and stands at a healthy $ 2423 million in 2004.

Judging by the above parameters, it is irrefutable that Markaz's strategy of diversification and developing core competencies has resulted in sustained growth during the period 2000-2004.

Conclusion

It is clear that diversification is an ideal strategy to be adopted by Financial Services Companies to maintain growth. Increasingly, the finance sector will move away from specialization by industry. Future value creators will excel in their chosen competencies either organically or through partnerships and apply that expertise across industries. By aligning themselves around core competencies now, financial firms can be better positioned to prevail in the changed economic environment. Diversification will serve as a vehicle for growth. The companies have to be innovative and responsive to customer needs to stay ahead in the market place.

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