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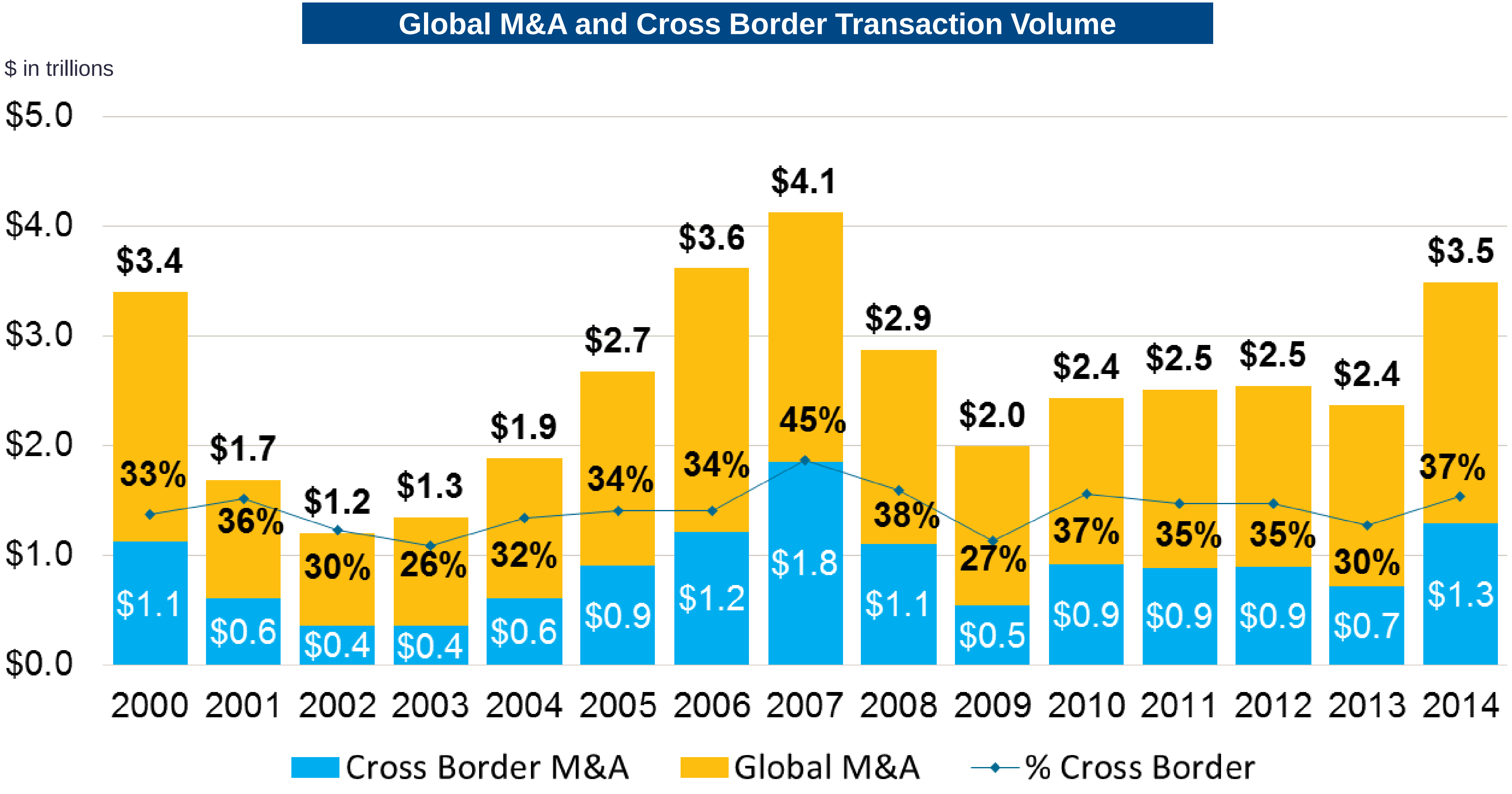
Competitive and Corporate Strategy

Acquisitions in a Global Context

Professor Harbir Singh

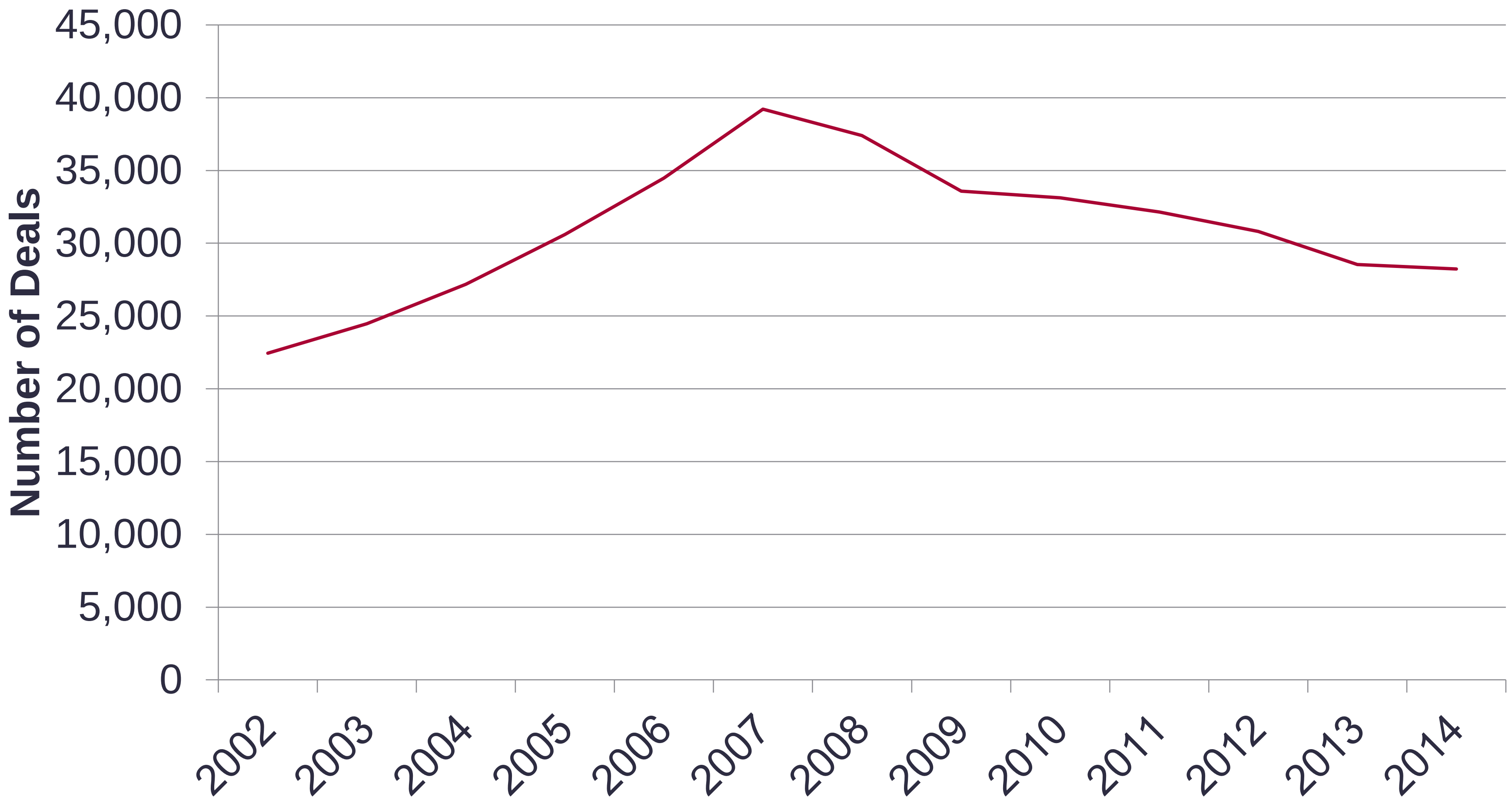
Cross Border Transaction Volume

2014 cross border volume is up versus 2013 and consistent with recent averages



Source: Thomson Financial based on rank date excluding equity carveouts, exchange offers and open market repurchases. As of 12/31/14.
Cross Border is defined as a company in one country transacting with a company in another country.; presentation by Gary Matt (Barclays Bank) at the Wharton School,

Global M&A Volume

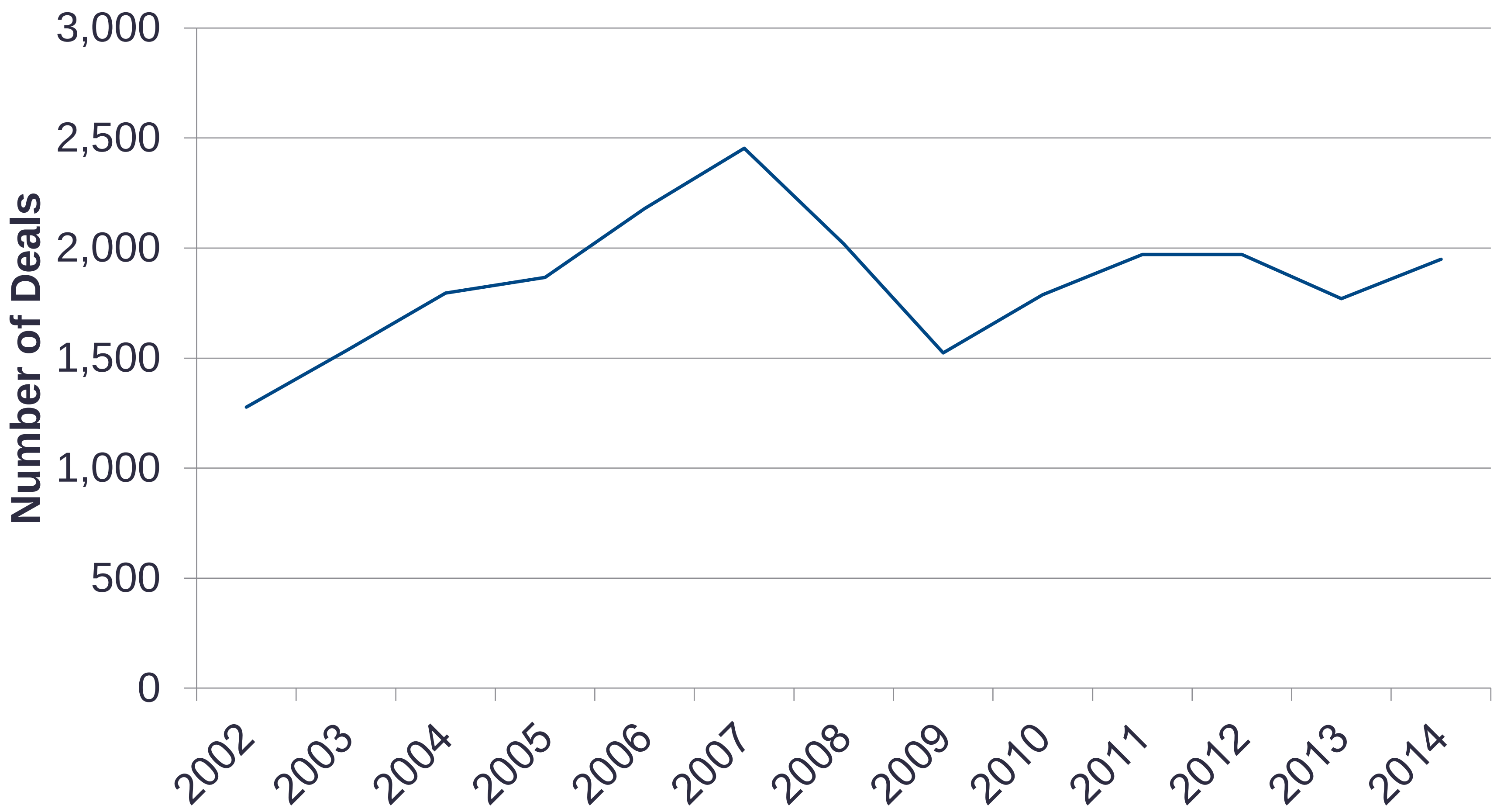


Data Source: Thomson ONE M&A module, deals completed 1/1/02-12/31/14

United States M&A Volume

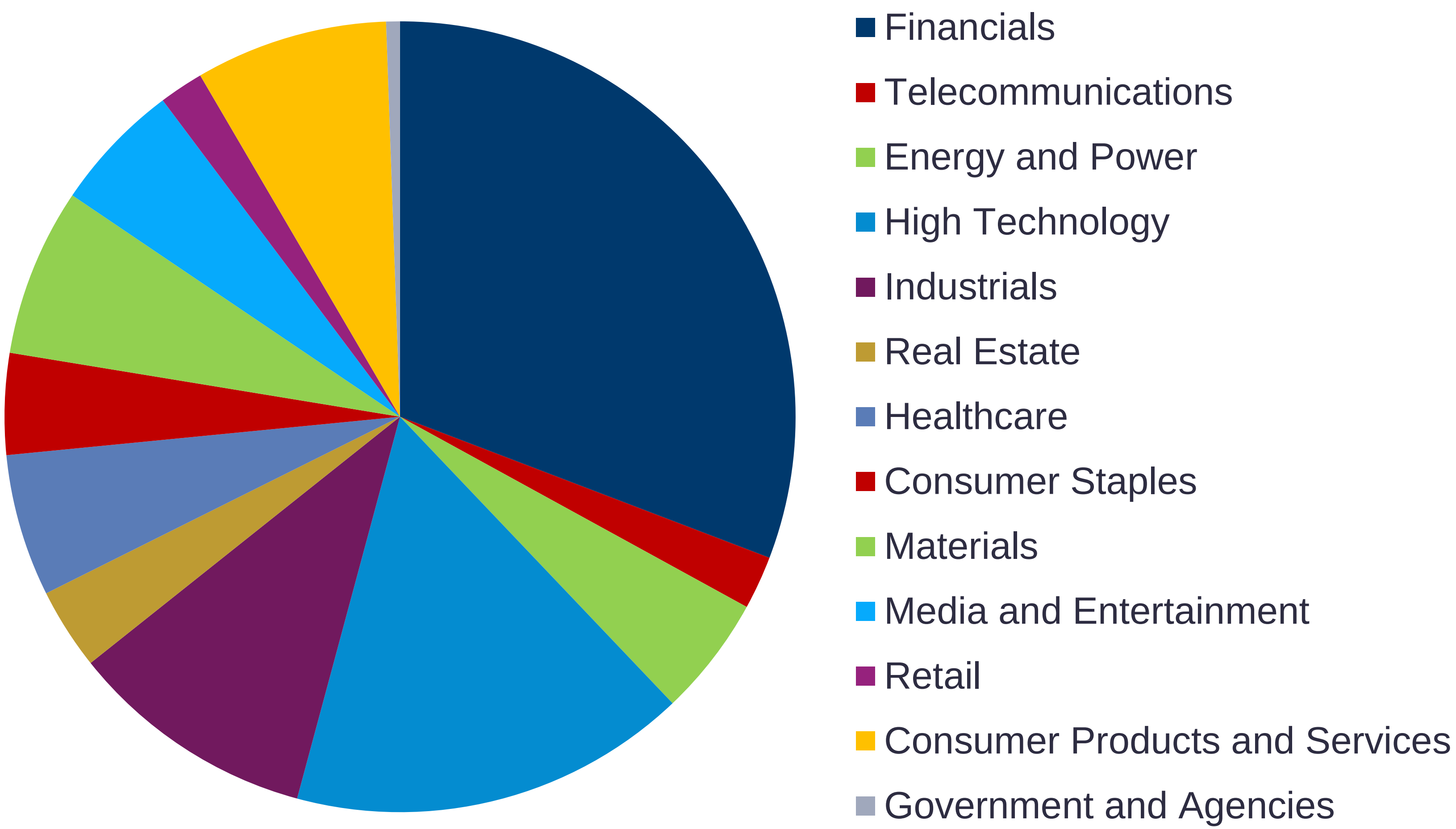
Data Source: Thomson ONE M&A module, deals completed 1/1/02-12/31/14
U.S. Targets and Acquirers

U.S. Outbound M&A Volume



Data Source: Thomson ONE M&A module, deals completed 1/1/02-12/31/14
U.S. Acquirers, Non-U.S. Targets

U.S. Outbound M&A by Industry (# Deals)



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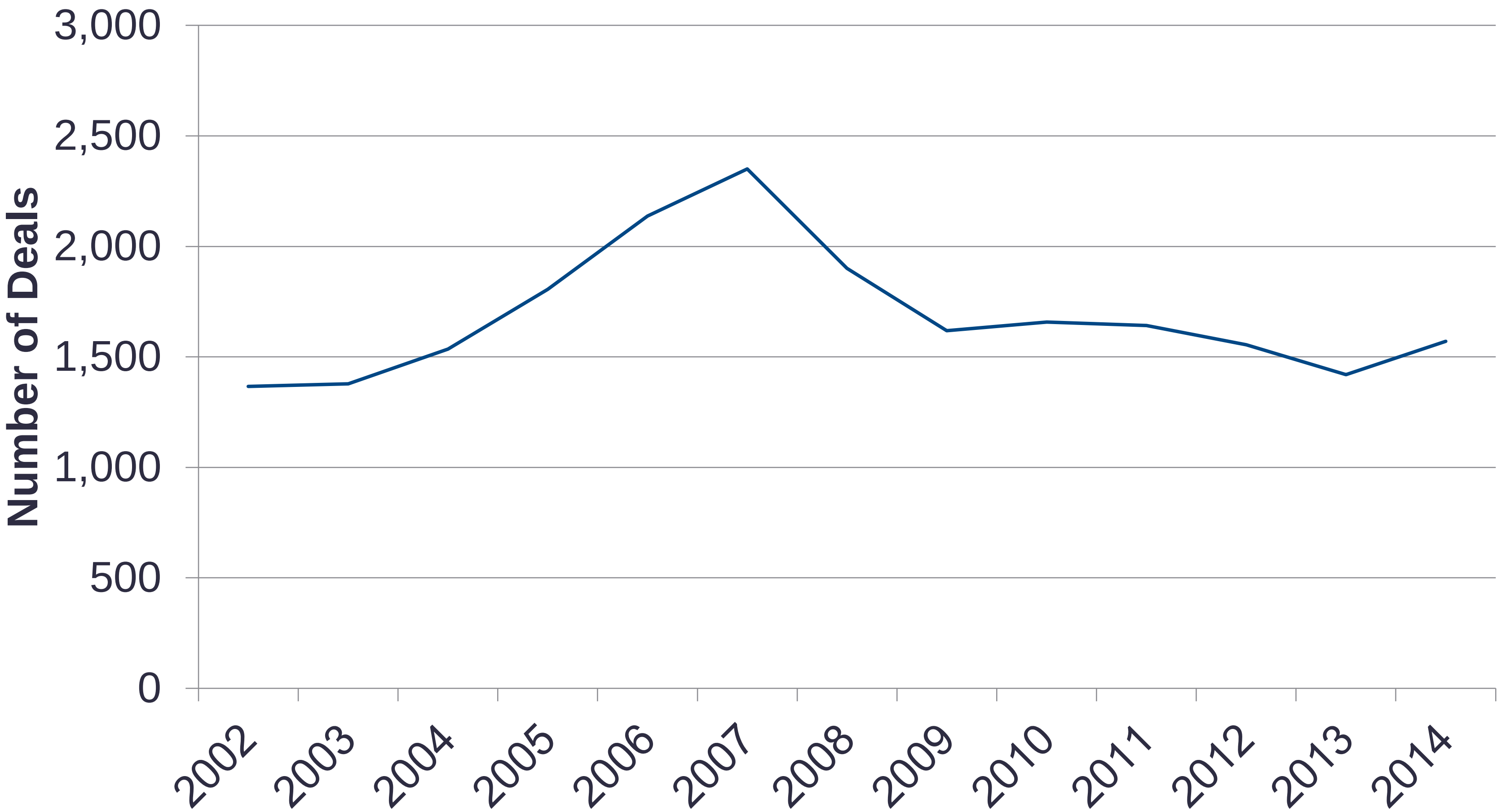

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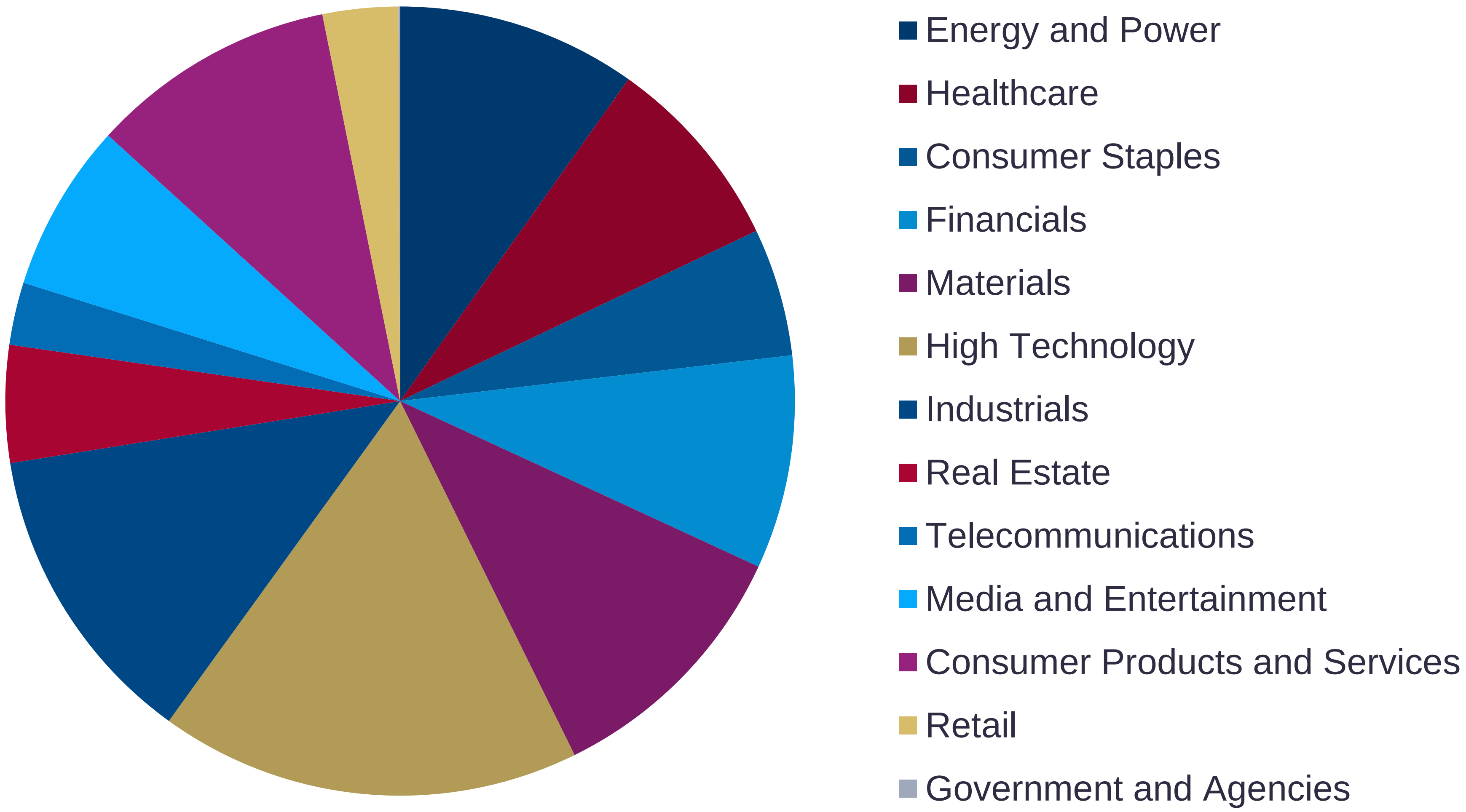

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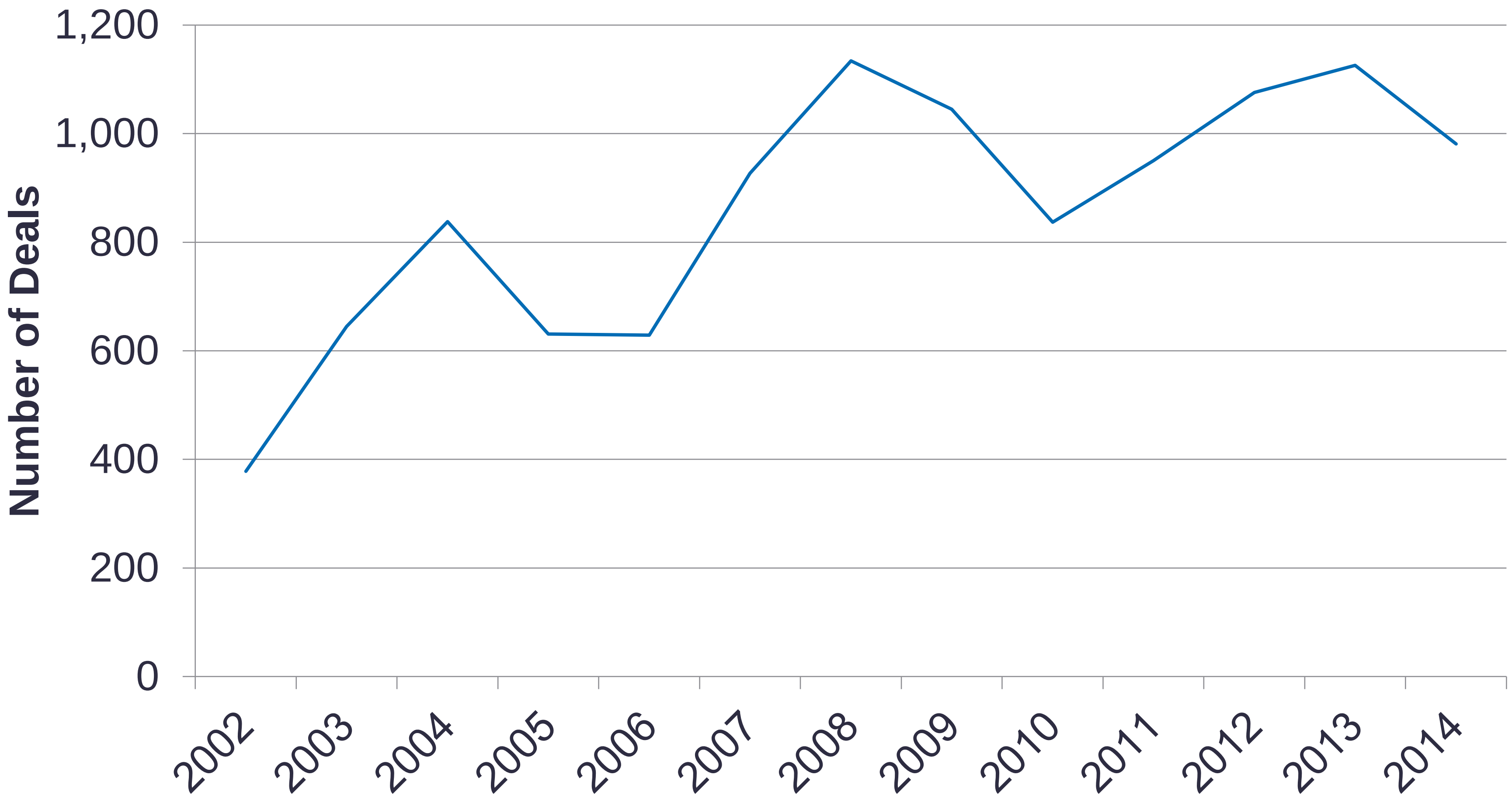
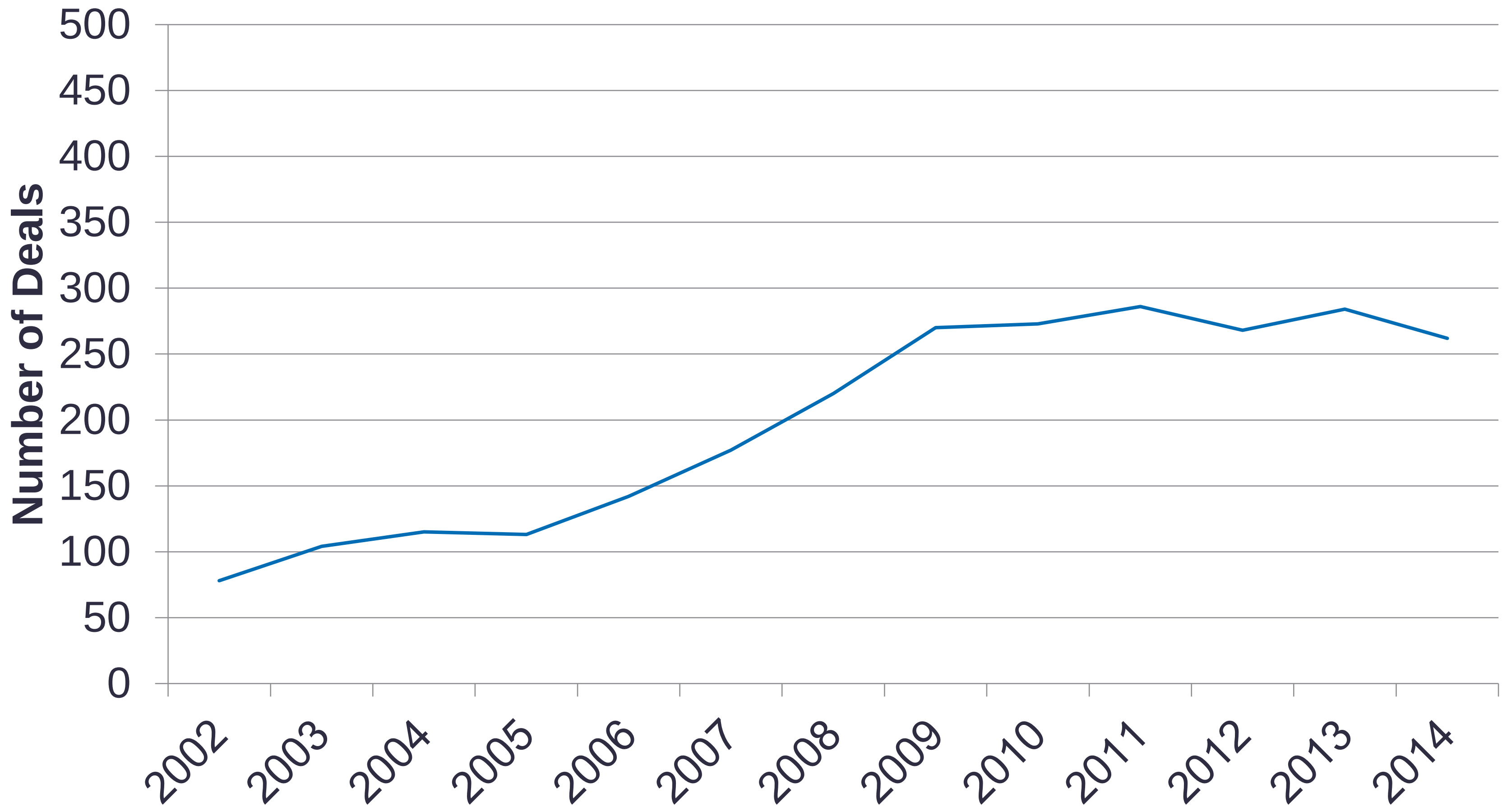
U.S. Targets, Non-U.S. Acquirers

China M&A Volume



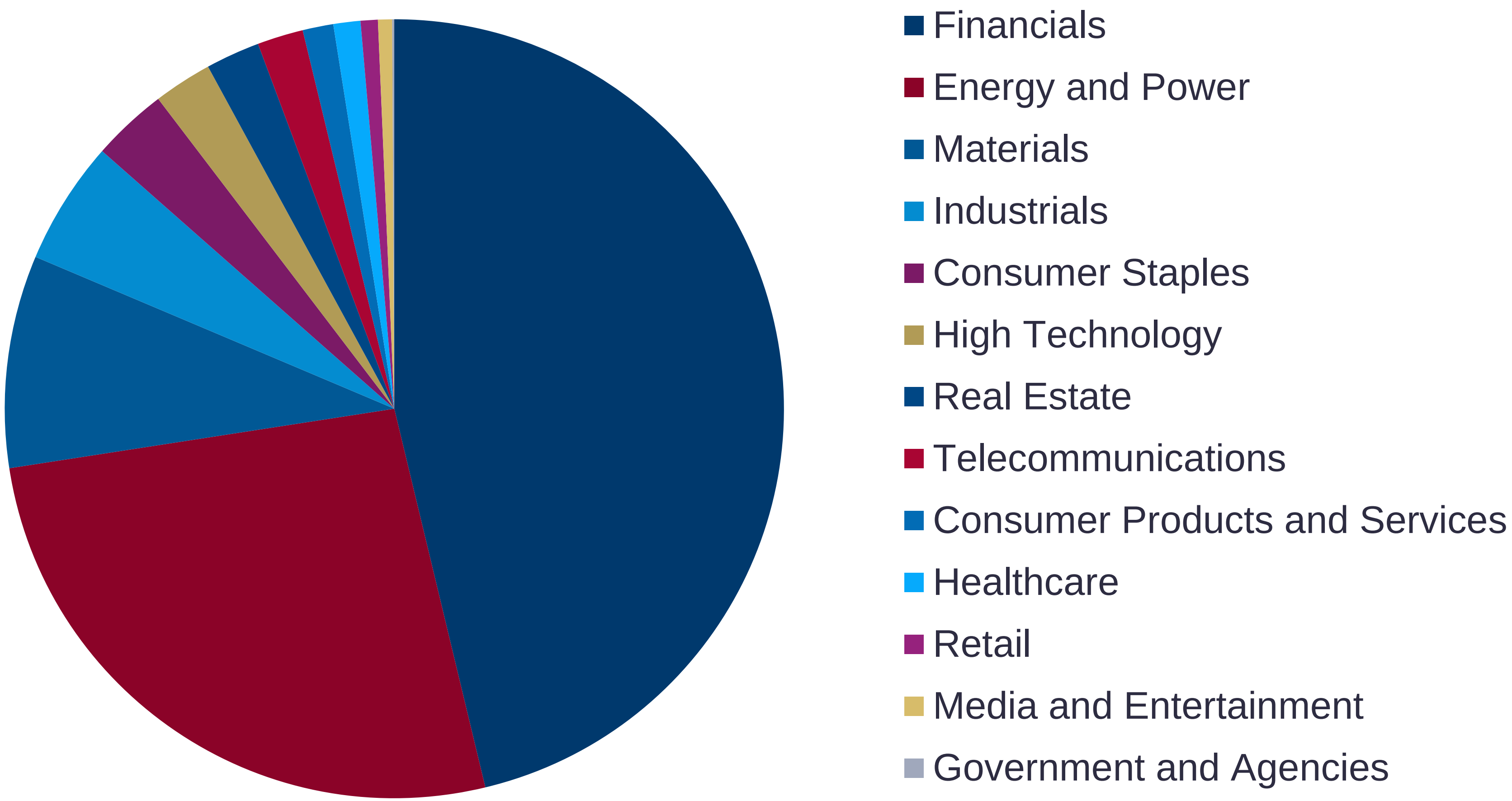
Data Source: Thomson ONE M&A module, deals completed 1/1/02-12/31/14
China Targets and Acquirers

China Outbound M&A Volume



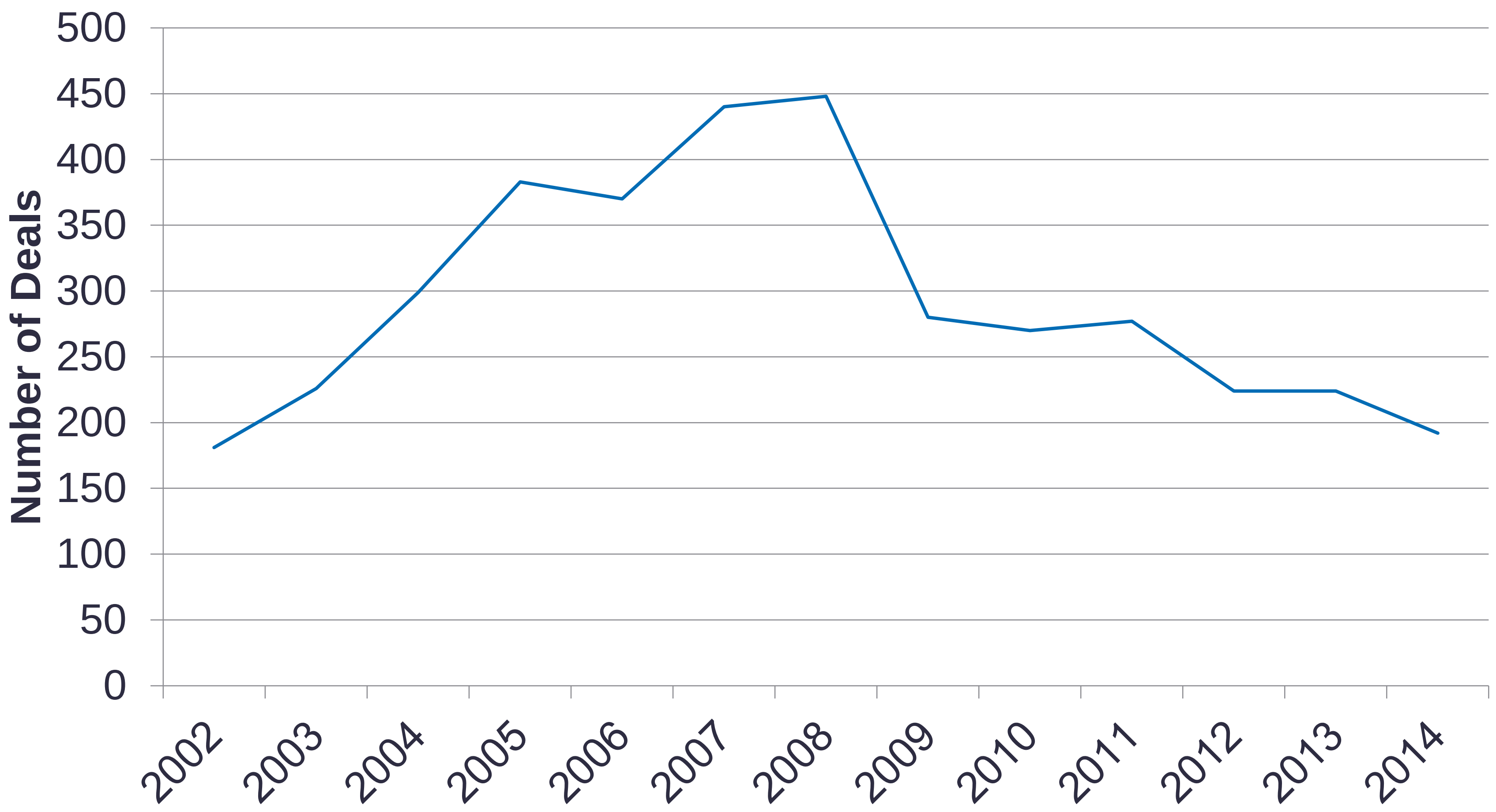
Data Source: Thomson ONE M&A module, deals completed 1/1/02-12/31/14
China Acquirers, Non-China Targets

China Outbound M&A by Industry ($)



Reflects Ranking Value including Net Debt of Target ($Mil)
Data Source: Thomson ONE M&A module, deals completed 1/1/02-12/31/14
China Acquirers, Non-China Targets

China Inbound M&A Volume



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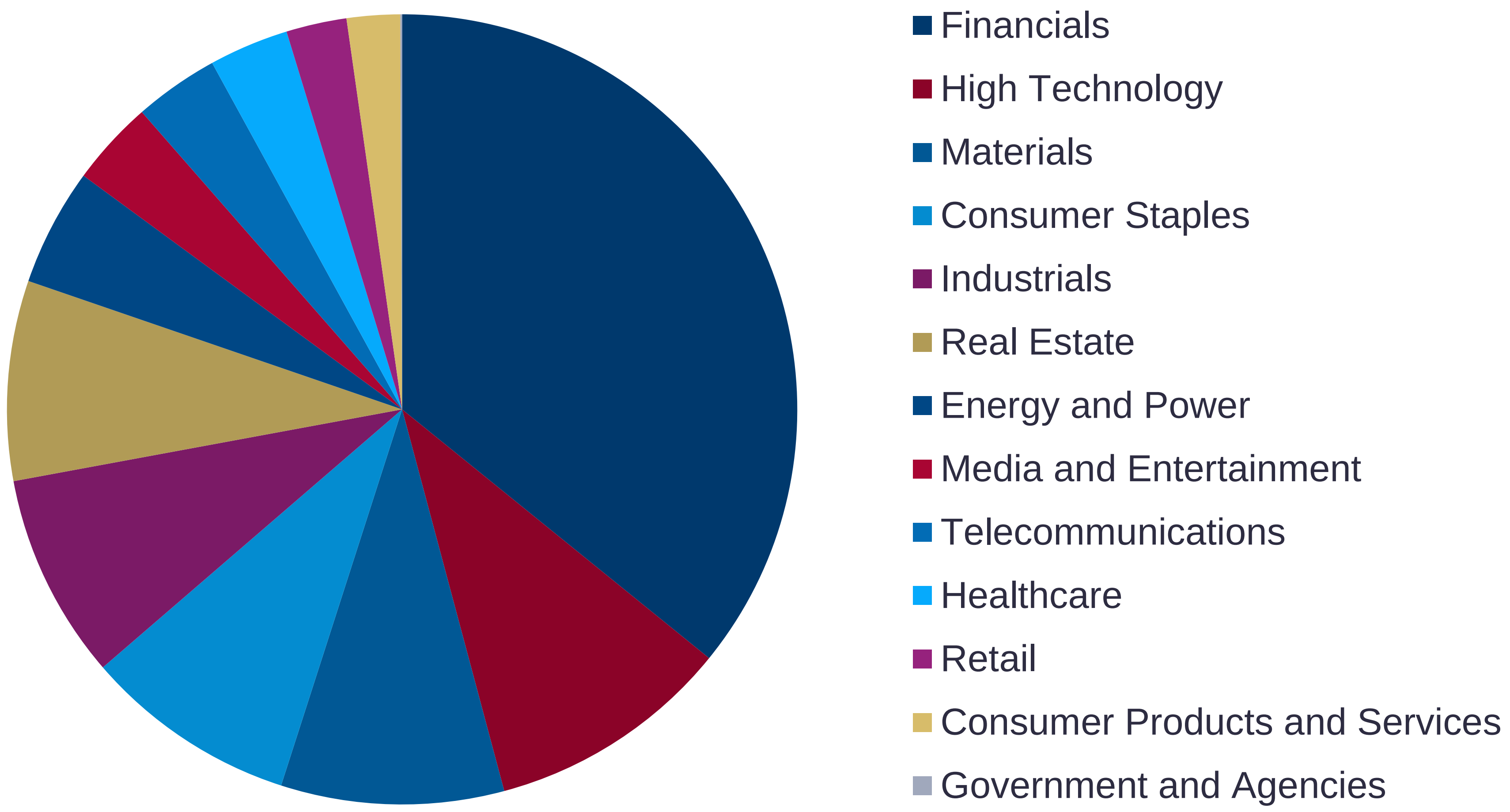
China Targets, Non-China Acquirers

China Inbound M&A by Industry ($)



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China Targets, Non-China Acquirers

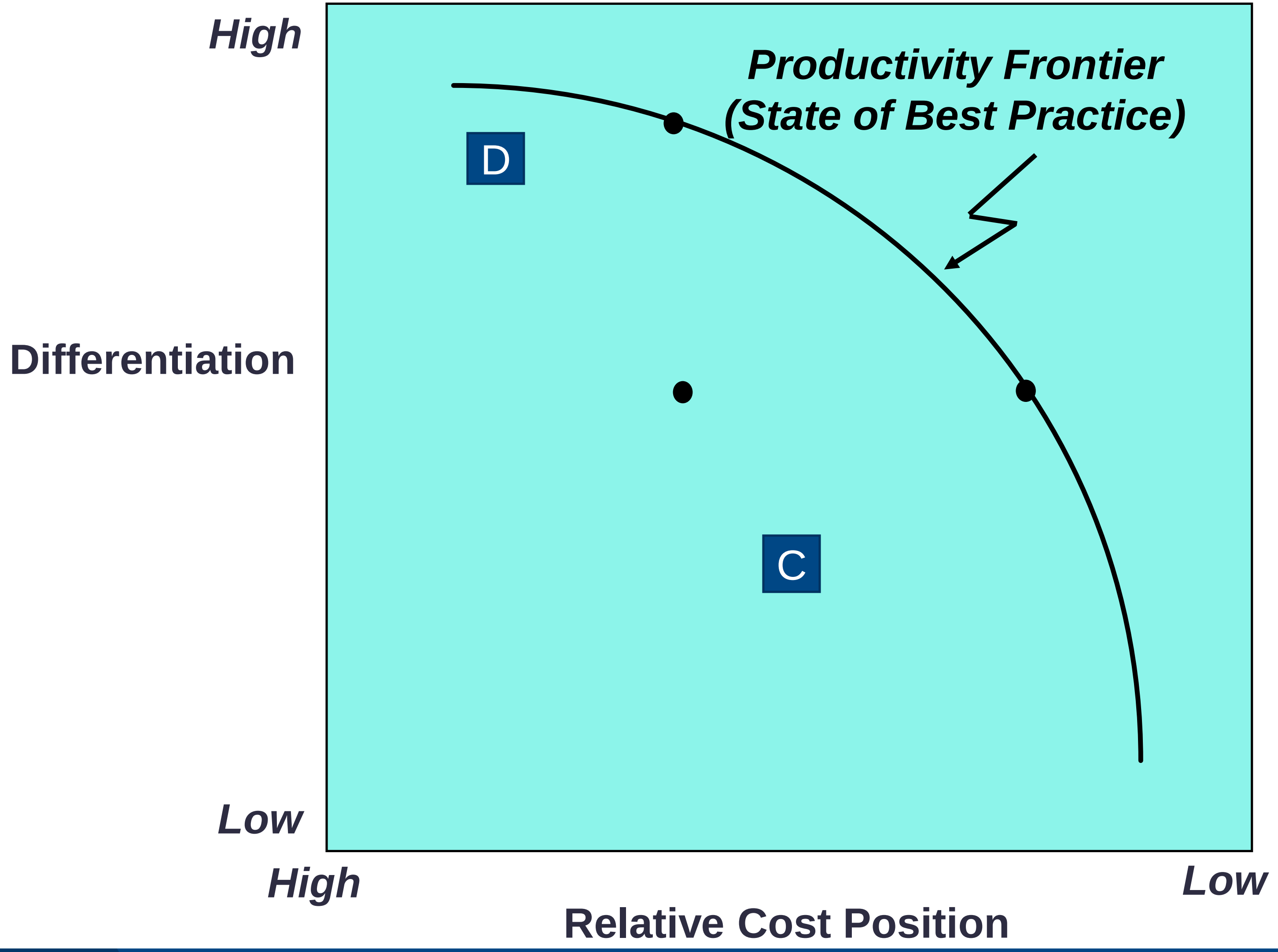
Global M&A summary

- Mergers and acquisitions widespread across industries and over time
- There is substantial global merger and acquisition activity at about 37 percent of all transactions in 2014
- Drivers of merger activity still are based on creation of joint competitive advantage

DaimlerChrysler: A Troubled Merger

- Merged in 1998 in a “merger of equals”
- Contentious merger
    - Lawsuit by Kirk Kerkorian (financier) in 2000 claiming deceitful practices to convince selling shareholders,
        - Lost but had adverse publicity
- Value lost: total purchase price $37 billion, divestiture value $7 billion

Positioning: Cost and Differentiation



Source: Porter (2004)

DaimlerChrysler

- ***Positioning***: *Net negative synergies*. Positive: get broader product line, access to US, access to Jeeps and Minivans. Negatives: brand dilution, lack of scale economies, lack of competitive advantage.
- ***Capabilities***: *Net negative synergies*. Positives: potential design wins, engineering upgrade for Chrysler, platforms for mid priced SUVs. Negatives: cultural conflict, differences in long term engineering goals: value engineering vs engineering for quality and design.
- ***Competition***: *Net negative synergies*. Competition takes place at the product level in each geography. Not clear wins at least for first five years.

Lenovo and IBM

- Started in 1984 from the Chinese Academy of the Sciences – as an entrepreneurial unit. Eventually innovated in creating a circuit board to process Chinese characters on IBM PC
- Imported PCs and then eventually produced them under own name – Lenovo
- By 2000 Lenovo had 30% of the Chinese market
- In 2005 Lenovo acquired IBM's PC business for $1.25 billion in cash and stock. Lenovo had use of IBM Thinkpad brand name for five years
- Complementarity: Lenovo had 30% of the desktop market and 10 % of laptops in 2005; IBM had 5% of the desktop market and 17% of the laptop market. Overseas there was total complementarity with Lenovo near zero and IBM with worldwide presence

Source: Case information from Lenovo case written by Dr. Neng Liang, CEIBS

Post Deal for Lenovo

- Ownership 35% public, 19% IBM and 46% Legend Holdings, parent of Lenovo, from pre-deal 43% public and 57% Legend
- Three private equity people on the board of Lenovo – Mr. James Coulter (TPG), Dr. Weijian Shan (Newbridge) and William Otto Grabe (General Atlantic)
- Board changed from insiders to more diverse one with many outsiders. Challenges came from independent director on dividend policy
- Choice of board made it clear that Lenovo had aspirations to be a global player

Lenovo's Restructured Operations, 2005-13

Before 2005 IBM PC acquisition for $1.75 billion: Headquarters in Beijing, sales and operations in greater China. **Moved to:** globally oriented sales and governance

2014: Used acquisition to add resources to businesses in servers and smartphones. Acquires Motorola Mobility from Google for $2.9 billion and server business from IBM for $2.3 billion, January, 2014.

Lenovo Ownership %	**2003**	**2005**	**2013**
Legend Holdings Limited	57.8	57.0	32.4
Public shares	39.9	20.4	60.3
Private equity companies	0	9.5	0
IBM	0	12.3	0
Directors	0.3	0.8	7.3

Management and Process Issues

- Stephen Ward- first leader.
    - Assured former IBM employees that headcount would not go down, developed a unified compensation system.
- Just a year later Ward was replaced by William Amelio. Lenovo accelerated supply chain integration, cost cutting, moved office to North Carolina, moved jobs closer to base in China.
- By Spring 2008, sales had grown globally from $3 Bn to $17 Bn.
- Disagreement between Chairman Yang and CEO Amelio.

Management and Process Issues

- Cultural conflicts:
  - Yang was more team based, more delegation.
  - Amelio was more centralized, reaching down into organization to speed decision making.
  - Lenovo was more team spirit
  - IBM had more respect for the individual

Post 2010

- Amelio eventually leaves. Yang became CEO and Chairman, and Liu Chuanzhi became non-Executive Chair.
- Lenovo continued to grow in the laptop market.
- 2014 revenue $38.7 Bn; 54,000 employees
- Key challenges:
  - Mobile computing, smartphones (Lenovo Golden Warrior for $110)
  - Servers
  - Global positioning
  - Tablets, laptops, desktops
- Deals:
  - Acquired IBM's server lines, IBM System X and IBM Blade Center for $2.3 Bn
  - Acquired Motorola mobility from Google for $2.91 Billion in Jan 2014

Implications for Global Strategy

- Acquisitions are an important instrument in transforming the firm for global competition
- Developing strong acquisition identification, deal structuring and integration capabilities is critical
- Role of alliances to enter markets
- Role of acquisitions as end games of alliances
- Corporate governance standards emphasize active, independent directors (seen from the Lenovo example among others)
- Creation of new value chains via alliance and acquisition transactions

Summary

- Competitive advantage arises from superior value delivered to customers, best combinations of cost and differentiation
- Acquisitions and alliances can be used effectively to develop global competitive advantage
- Acquisitions can create or destroy value (example Lenovo or Daimler) and are a critical tool for strategic change
- Firms and intermediaries need to develop competence in all dimensions of resource redeployment: acquisitions, alliances and divestitures to adapt to a rapidly changing global environment

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Competitive and Corporate Strategy

Corporate Acquisitions: Strategic Issues

Professor Harbir Singh

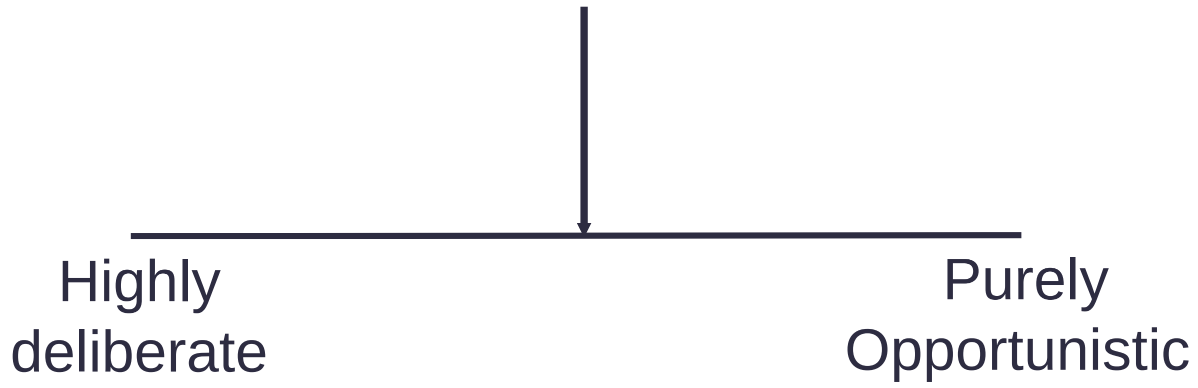
Key Decisions

- Strategic drivers of the acquisition
  - Does the target make sense?
  - How does it combine with our operations?
  - Target's view: should we sell? Why?
- Market drivers
  - Pricing
  - Deal structure
  - Responding to developments in the market: revising price, timing, exit strategy
- Post Acquisition
  - Integration process
  - Power struggles, culture wars

Motivations for Acquisition

- <u>External Factors</u>
  - Industry consolidation
  - Chance to exploit acquired skills
  - Take advantage of synergies

- <u>Factors associated with base business</u>
  - Extending capabilities into new markets
  - Managing growth in a rapidly expanding market



The only legitimate motivation is the creation of long term economic value, and this is achieved by creating competitive advantage (and paying price below acquirer-specific value)

ASSESSING SOURCES OF COMPETITIVE ADVANTAGE

Competitive Advantage, Acquisitions, and Shareholder Value

Competitive Advantage:

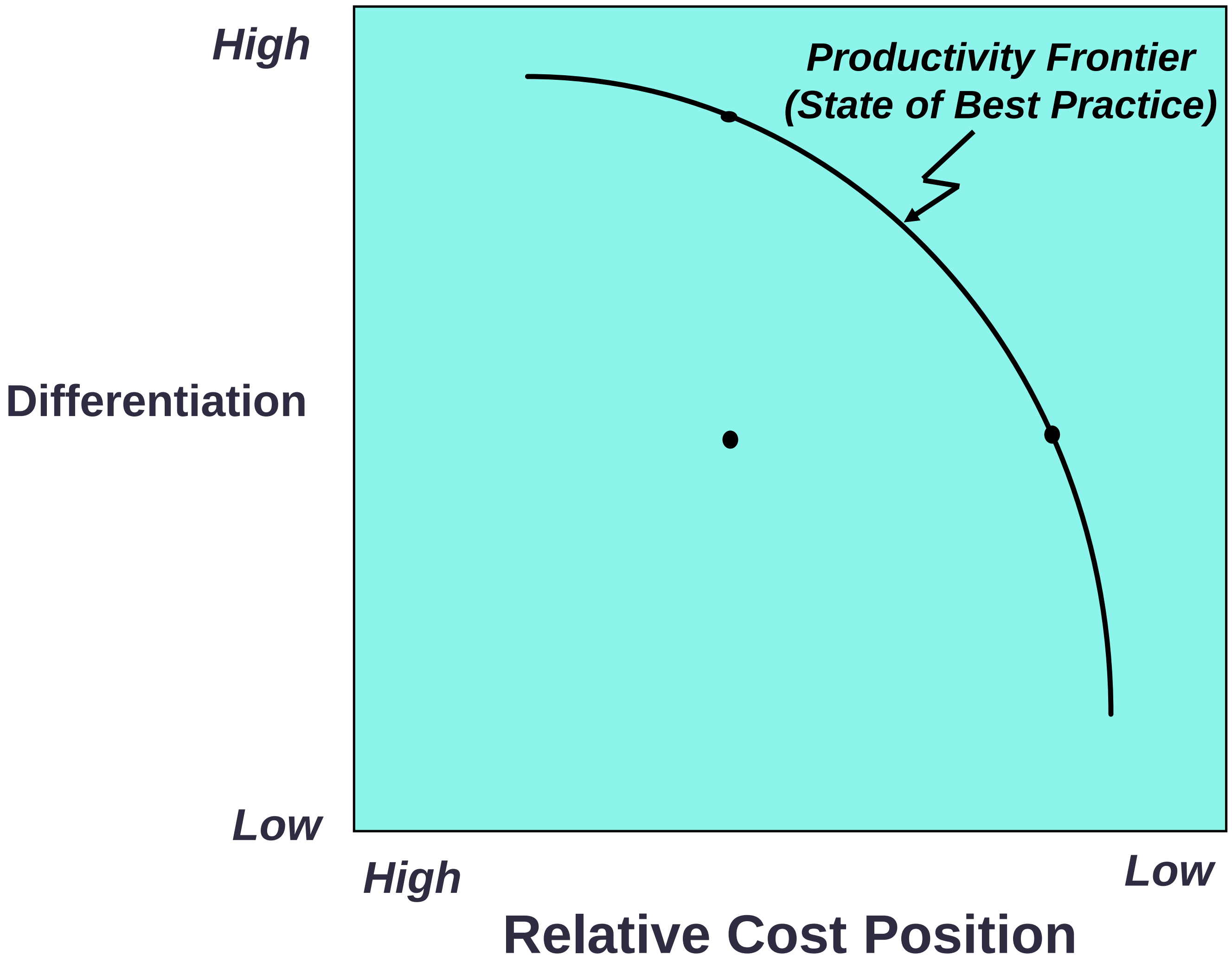
- Ability to transform inputs into goods and services at level better than competitors

Strategy:

- Goal and set of policies designed to achieve competitive advantage in a particular marketplace

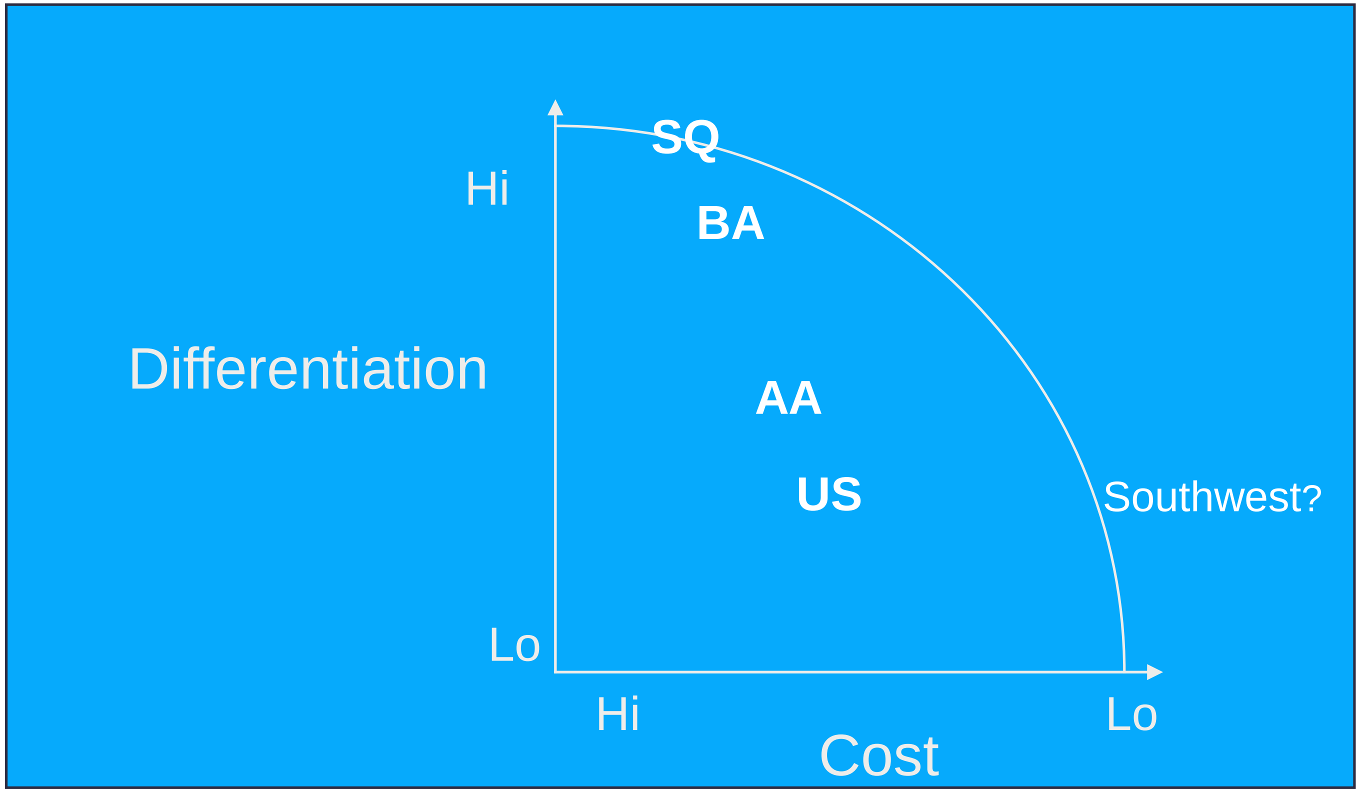
Question: How will an acquisition change the relationship between inputs and competitive advantage?

Positioning: Cost and Differentiation



Source: Porter (1996)

Strategic Positioning in the Airline Industry



Q: How does the USAirways/American merger affect their positioning?

Positioning of USAir and American

- Differentiation
  - The highest differentiation (and highest cost) position is that of SQ (Singapore Airlines).
  - American (the merged airline) would have to find a way to migrate both the erstwhile American and USAir to a higher level of service.
- Relative Cost
  - The best cost at the same level of differentiation is that of Southwest Airlines.
- Implication
  - American will move closer to the frontier, higher in differentiation and somewhat lower in cost, but not all the way to get to the frontier.
- Strategic positioning of acquisitions has to include pre and post acquisition locations in the cost-differentiation space.

Positioning: Implications

- For every point on the graph, there is a combination of cost and differentiation
- Working towards a point on the frontier = Strategic Positioning: what combination of cost and differentiation (a) is feasible for you, and (b) creates the most long term competitive advantage
- Getting to frontier is operational effectiveness, ie for that level of differentiation, we are at the lowest cost position, and vice versa
- Competing by pushing out to the frontier (and have others follow the same game) is very difficult to achieve and sustain

Attributes of Positioning

- Position on the cost-differentiation space
- Emphasis on uniqueness, raising barriers to imitation
- Protecting value: raising barriers to entry
- Protecting value: raising barriers to substitution
- Enhancing/protecting power in supply chain
- Innovating on activity systems

Sources Of Value From Acquisitions: Value Creation Potential

- Efficiency considerations
  - Economies of scale in production
  - Economies of scope in shared resources
  - Influencing the cost positions of acquired firm
    Example: Cost cutting transactions
- Market power considerations
  - Influencing the revenue positions of acquired firm through intangible assets
  - Use of specialized resources from other markets to build competitive advantage
    Example: Revenue enhancing transactions – Google and YouTube
- Changing the strategic game
  - Acquisitions as transactions reflecting new rules of competition in the industry
    example: Vodafone in the cellular industry early days

Market Considerations

Pitfalls Resulting in Overpayment

Value Creation: Issues

The acquirer has a floor price of 12 and ceiling of 14, while the other bidder has a ceiling of 16. Often the first bidder stays in the game beyond their ceiling price, which is irrational.

The negotiating range is determined by:

book value	current market value 10	floor price 12	ceiling price 1 14	ceiling price 2 16

Need to establish a negotiation range based on scenarios and probability assessments

Factors Contributing to Overbidding

- Overconfidence about value creation
- Lack of information about other potential bidders and their maximum prices
- Tendency of managers not to exit a bidding process
- Poor due diligence processes – not accounting adequately for negative information (ignoring or discounting)

Key Decisions

- Strategic drivers of the acquisition
  - How well do we understand the drivers of value in the transaction?
  - Synergy is not enough – we have to account for premium paid
  - Negative synergies have to be dealt with
- Market drivers
  - Value is acquirer-specific – compare with other combinations
  - Deal structure
  - Responding to developments in the market: revising price, timing, exit strategy
- Post Acquisition
  - Integration process
  - Power struggles, culture wars
  - Investing in acquisition management capability as in Cisco

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Competitive and Corporate Strategy

Strategic Alliances

Professor Harbir Singh

The New Competitive Environment

- Higher rates of market change
- High rates of capital expenditure
- Increased need to fuel revenues through innovation
- Need to show continued increases in earnings to create shareholder value

A NEW ORDER
OF
COMPETITION?

Strategic Alliances

- A strategic alliance is a cooperative arrangement between two or more organizations designed to achieve a shared strategic goal
- There are two general types of alliances: equity-based and non-equity-based
- Most technology based and global industries have alliances as modes of linking firms with external resources
- Examples:
  - Airlines (Star Alliance)
  - Apple and cell phones with app providers
  - Rewards cards
  - Car manufacturing

Objectives of Alliances

- Risk/reward sharing
  - Aerospace joint ventures, e.g. for Boeing 787
- Market entry or extension
  - Otis-Tianjin joint venture in China
- Sharing technological and innovative activities
  - Alliances for joint research and development in biotechnology
- Respond to regulatory constraints
  - Airlines alliances limited ownership overseas

Organizational Challenges in Alliances

- Lack of trust
- Cultural clashes
- ‘Temporary arrangement’ with no long term plan
- Unclear performance measures: learning, financial performance, flexibility?
- No parent firm support
    - Create an alliance management infrastructure

Case Example: Pfizer – Warner Lambert Alliance to sell Anti Cholesterol Drug Lipitor

Pfizer – Warner Lambert Formation: 1996

- In 1996, Warner Lambert scientists developed an anti cholesterol drug, Lipitor
  - Easier to prescribe than existing drugs
  - Had very good patient outcome
  - They did not have marketing strength to get scale to recover development costs.
- Pfizer at this time had the largest sales force but no compound in this area to service an important market for prevention or slowdown of heart disease.
- Pfizer would provide *complementary marketing capability* to Warner Lambert's *technological capabilities*.

Pfizer – Warner Lambert Formation: 1996

- They developed an alliance where Pfizer would market Lipitor to cardiologists.
  - Incentive for Pfizer to get market share quickly
  - Pfizer paid $205 million up front for contributing to the already incurred development expense for Lipitor
- In the very first year, sales reached $ 1 billion.
  - This was because of a superior combination of technological and marketing capabilities that beat strong competition from top firms

Pfizer-Warner Lambert 1999

- By 1999 the alliance was highly successful. There were three reasons:
  - Complementary capabilities
    - Warner Lambert’s patented drug as the most efficacious on the market in terms of patient outcomes and ease of use (less testing of liver for side effects)
  - Specialized assets
    - Pfizer customized its distribution of cholesterol reducing drugs to Lipitor. The name got associated with Pfizer.
  - Creating a well functioning interface
    - The Warner Lambert people worked hard to try to create a seamless organization in marketing, despite cultural differences.

Pfizer-Warner Lambert 1999

- Power struggles and Acquisition
  - Over time cultural differences and some resentment of Pfizer's sales teams' arrogance prompted Warner Lambert to seek to merge with another company, American Home Products. In the end, Pfizer acquired Warner Lambert for $90 billion.
- Takeaway: Lipitor's great success as a product, $12 billion in revenue, made this the most successful alliance in history.

Alliance Capabilities in use

- Pfizer and Warner Lambert JV
  - Creation of the alliance function
  - Investment in interfirm knowledge sharing routines
  - Creation of partnering routines within the joint marketing organization
  - Training and institutionalization of this system throughout the organization.

Choice Between Acquisition and Alliances

- Synergy type:
  - Modular – pooling (code sharing in airlines)
  - Sequential (pharma tech sourcing)
  - Reciprocal (Exxon Mobil)
- Nature of Resources
  - soft vs hard assets
- Extent of redundancy
- Degree of market uncertainty
- Level of competition for the resources

Pfizer Created Shareholder Value During the Time of the Alliance

Conclusions/Implications

- Role of complementary capabilities in commercializing technology and building joint competitive advantage
- Role of joint value creation through coordination and predictable process
- Long term impact of alliances on competitive advantage.

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Competitive and Corporate Strategy

Strategy Implementation: The Turnaround of Nissan

Professor Harbir Singh

Progress in Nissan 1998 - 2016

Nissan 1998 Altima

Nissan Leaf 2016 Electric Car

Nissan Background

- Important global company, history of reliable products
- Gradual decline over the 90s, culminating in losses of $1 billion per year, including high debt service
- Approached all major auto companies for $5 billion investment in exchange for 36% stock
- All refused, except Renault, which infused $5 billion for 36% stock and the joint venture
- CEO of Renault looked within for people who could manage the alliance and turned to Carlos Ghosn, a Vice President who had come from Michelin

Carlos Ghosn, CEO Renault Nissan

Situation

- Losses in 6 of last seven years
- 4 of 43 models profitable in home market
- 1998 spend $1 billion in debt service alone

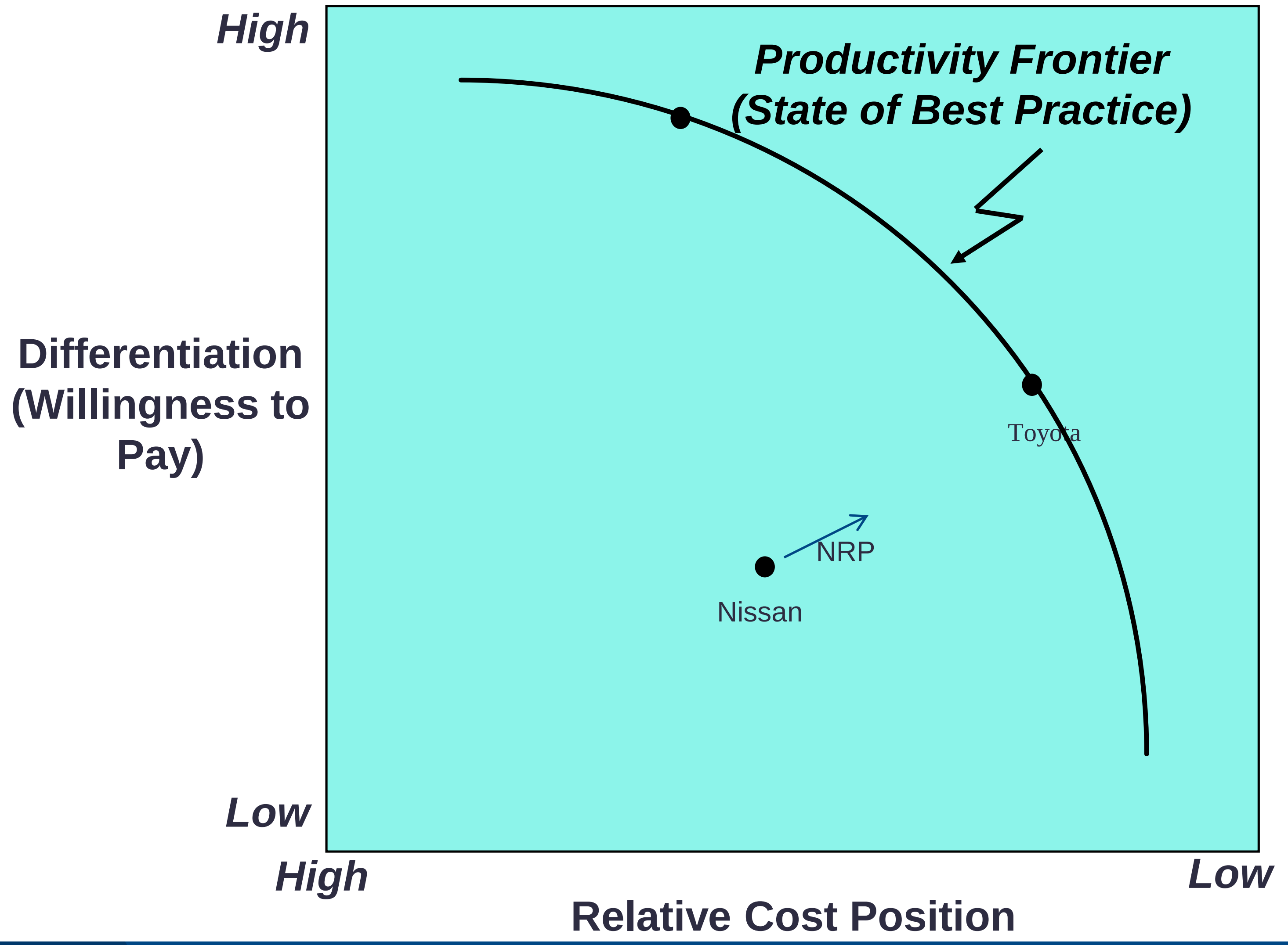
Carlos Ghosn

- Had turned around Michelin
- Recruited to Renault to create efficiency
- Took job on Nissan under condition of full control and take up to 20 execs with him
- Initially named COO in June 1999
- Had board meeting in English
- Public speech: I come to Japan not for Renault, but for Nissan

Strategic Diagnosis: Renault Nissan Problems

- A bloated supply chain, with probably 30% more suppliers than needed
- Too many factories, needed to retire about 30% of capacity
- Too platforms for cars (24 vs under 16 by rivals)
- Too many employees, by about 15%
- ➔ all resulting in bankruptcy and need for $5 billion injection

Cost and Differentiation



Source: Porter (1996)

Renault-Nissan (continued)

- Five point diagnostic
  - Lack of clear profit orientation
  - Insufficient focus on customers
  - Lack of cross functional work
  - Lack of sense of urgency
  - No shared vision
- Three pronged remedy (Nissan Revival Plan, NRP)
  - Drop purchasing costs by 20% - changing, globalizing supply chain
  - Dismantle kieretsu network on cost-benefit basis
  - Drop capacity by 30%

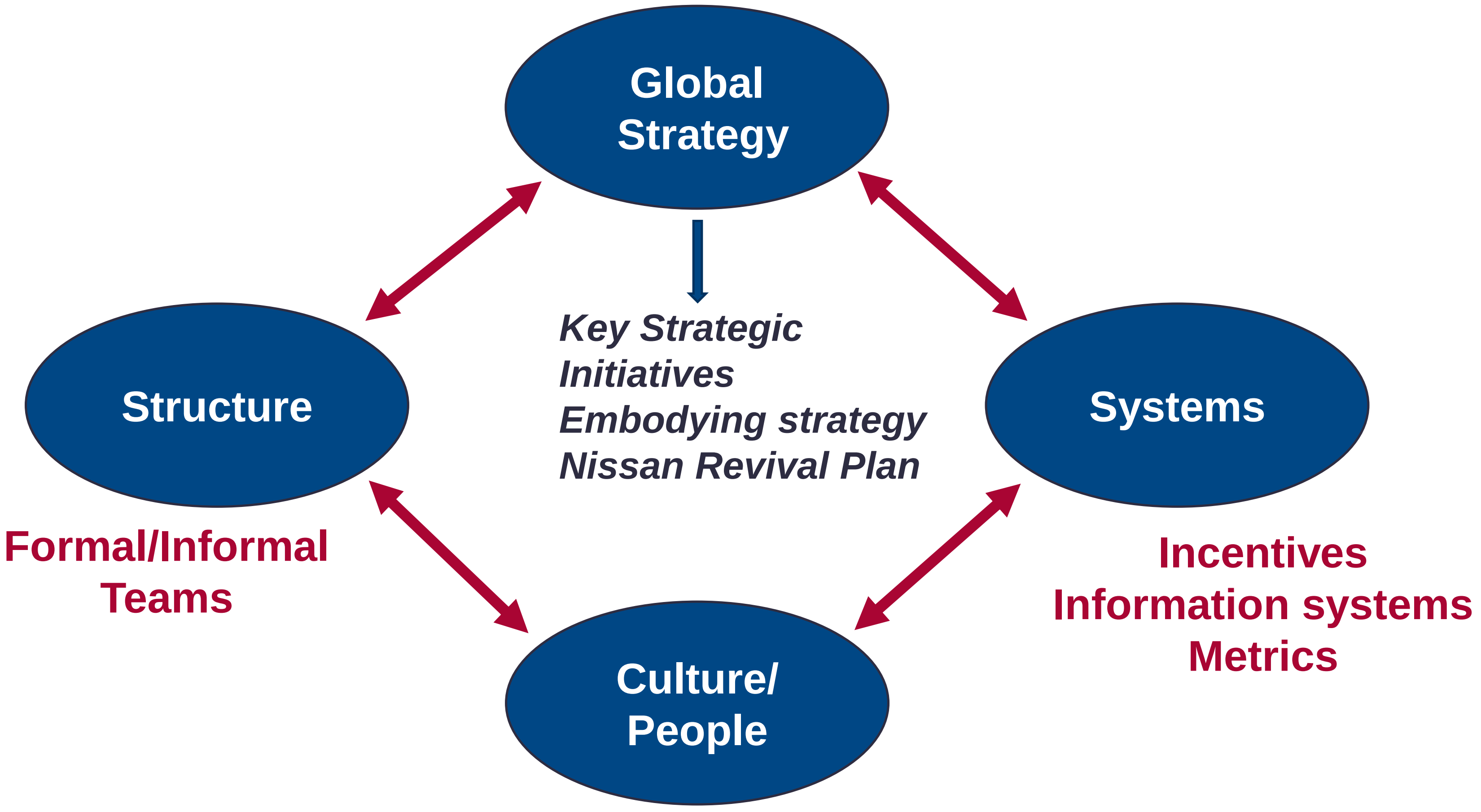
Nissan Revival Plan

- Stock incentive plan for senior execs
- English for all
- No pre conceived ideas
- Nine areas of change: including manufacturing, supply chain, business development, R&D, sales and mktg, Gen and admin, finance and cost, organization, parts complexity
- Assigned cross functional teams with execs in their 30s and 40s led by Nissan
    - Three month report out period
    - Come up with specific initiatives

Renault-Nissan

- Week 1
  - Three new board members
  - Stock incentive plan
  - New language policy – English
- Month 1
  - No pre-conceived notions
  - Nine Cross Functional teams – across departments, divisions, geographies
  - Three guidelines:
    - Develop business and reduce costs
    - Three months for final decisions

Strategy is implemented in the context of structure, systems, and people



Implications

- Strategy is first diagnosed using the value proposition – differentiation and cost in the market.
- Development of the Vision – The revival of Nissan.
- Creation of initiatives that best represent the vision
- Use of Structure, systems, people and culture to reinforce the implementation of the initiatives, measured by well developed metrics
- Strategy and leadership are intertwined

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Competitive and Corporate Strategy

Components and Tests of a Strategy

Professor Harbir Singh

Components and Tests of a Strategy

- Vision
  - Link to core values
  - Motivating
  - Actionable
  - Link to measurable goals; go long term, >=5 years
  - OUTPUT: statements of vision and goals

- Steve Jobs Vision Elements
  - Functionality
  - Usability
  - Esthetics

Components and Tests of a Strategy

- Positioning and Market Analysis
  - Value Proposition
    - Basis of competition – cost vs differentiation
    - Choice of segments
  - Protecting Value
    - Barriers to entry, substitutes
    - Power in the supply chain
    - Role of partners, complementors
    - Rivalry
  - OUTPUT: choice of markets, drivers of advantage

Components and Tests of a Strategy

- Analysis of capabilities
  - Summarize areas of leadership, parity and disadvantage
  - OUTPUT: statement of capability advantage, parity, and interventions to improve

- Competitor Analysis
  - Competitor capabilities
  - Competitor tendencies, priorities
  - Competitive Reaction – intensity, motivation, blind spots

- Scenario creation
  - Market – optimistic/pessimistic
  - Competitors – optimistic/pessimistic
  - OUTPUT: Four categories result – assign probabilities, give names to each

Components and Tests of a Strategy

- Create strategic initiatives
  - Apple- Launch of the iPod
    - Solved the problem of the mp3 player
    - Apple was able to launch iTunes
  - Gorilla Glass
    - Steve jobs felt it was the brightest medium
- Formulation and implementation that are tied by initiatives

Factors in Strategy Implementation

- Identify enablers/obstacles
  - What are the main organizational enablers, and what are the main organizational and strategic obstacles?
  - Identify how to enhance enablers, limit/eliminate obstacles
- Strategic Budgeting
  - Develop budgets on how the strategic resources will be brought to bear upon the strategic initiatives
  - Identify milestones, incent people to achieve them, think about financial and non-financial incentives
  - Assess/modify systems: information, control, reward, to support the strategic initiatives
- Recalibration/revisiting
  - Annual/predictable review and recalibration of plans

Strategy Tests

- Role of unique value proposition
- Role of key assets driving price-cost margin
- Key underlying activities and capabilities driving differentiation
- Difficulty in imitation
- Persistence, continuity
- Role of process: select initiatives and context. Context includes structure, systems (reward, information, control), people, and culture

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