

14 External Growth Strategies: Mergers, Acquisitions, and Alliances

When it comes to mergers, hope triumphs over experience.

—IRWIN STELZER, US ECONOMIST AND COLUMNIST

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Introduction and Objectives

Mergers, acquisitions, and alliances are important instruments of corporate strategy. They are the principal means by which firms achieve major extensions in the size and scope of their activities—often within a remarkably short period of time. Mergers and acquisitions have created many of the world's leading enterprises:

- ◆ In 1993, Interbrew was a Belgian brewer with annual sales of \$1.4 billion. A sequence of acquisitions that included Labatt (Canada), Bass (UK), Beck's (Germany), AmBev (Brazil), Anheuser-Busch (US), Modelo (Mexico), and SAB Miller (UK) created Anheuser-Busch Inbev—the world's largest beer company with 319 breweries and annual sales of \$46 billion.
- ◆ Cable provider Comcast became the biggest US media company through acquiring Metromedia (1992), QVC (1995), AT&T Broadband (2002), Adelphia Communication and MGM (2005), NBC Universal (2011), and DreamWorks Animation (2016). In 2018 it was vying with Walt Disney to acquire Twentyfirst Century Fox.
- ◆ EssilorLuxottica has grown to be the world's dominant eyewear company as a result of Luxottica's acquisitions of Ray-Ban, Lenscrafters, PearleVision, Sunglass Hut and Oakley, and, finally, its 2017 merger with Essilor.

Mergers and acquisitions can also have disastrous consequences:

- ◆ Royal Bank of Scotland's 2007 acquisition of ABN AMRO was a key factor in the bank's near collapse and subsequent rescue by the British government the following year.
- ◆ The 2006 merger of Alcatel-Lucent created a telecom hardware giant with sales of \$25 billion and a market capitalization of \$36 billion. By 2016, it had accumulated losses of \$5 billion, sales had fallen by 40%, and the company was acquired by Nokia for \$17 billion.
- ◆ Daimler-Benz's merger with Chrysler is widely regarded as one of the most disastrous merger of all time. The losses arising from Daimler's ownership Chrysler from 1998 to 2007 amounted to about \$48 billion.

Alliances provide a means to access the resources and capabilities of other firms without the costs and risks of a full merger. However, they do bear risks: Danone's disastrous relationship with its Chinese partner Wahaha and VW's failed alliance with Suzuki dented both companies' Asian strategies.

If mergers, acquisitions, and alliances are to contribute to firms' strategic objectives, we must recognize that they are not strategies in themselves: they are tools of strategy—the means by which a firm implements its strategy. Hence, in previous chapters, we have already considered the role of acquisitions and alliances in relation to capability building, technology strategy, international expansion, and diversification. In this chapter we draw together these separate strands and consider what we know about managing these modes of external growth.

Given the diversity in their motives, contexts, and outcomes, decisions concerning mergers, acquisitions, and alliances need to take account of their specific strategic goals, the characteristics of the partner firms, and their industry and national environments. We shall develop a structured approach to analyzing the value-creating potential and risks of these arrangements and consider how they can be managed to best achieve a positive outcome.

By the time you have completed this chapter, you will be able to:

- ◆ Understand the factors that motivate mergers and acquisitions and assess their potential to create value in the light of the challenges of post-merger integration.
- ◆ Recognize the different motives for strategic alliances and the circumstances in which they can create value for the partners.

Mergers and Acquisitions

The Pattern of M&A Activity

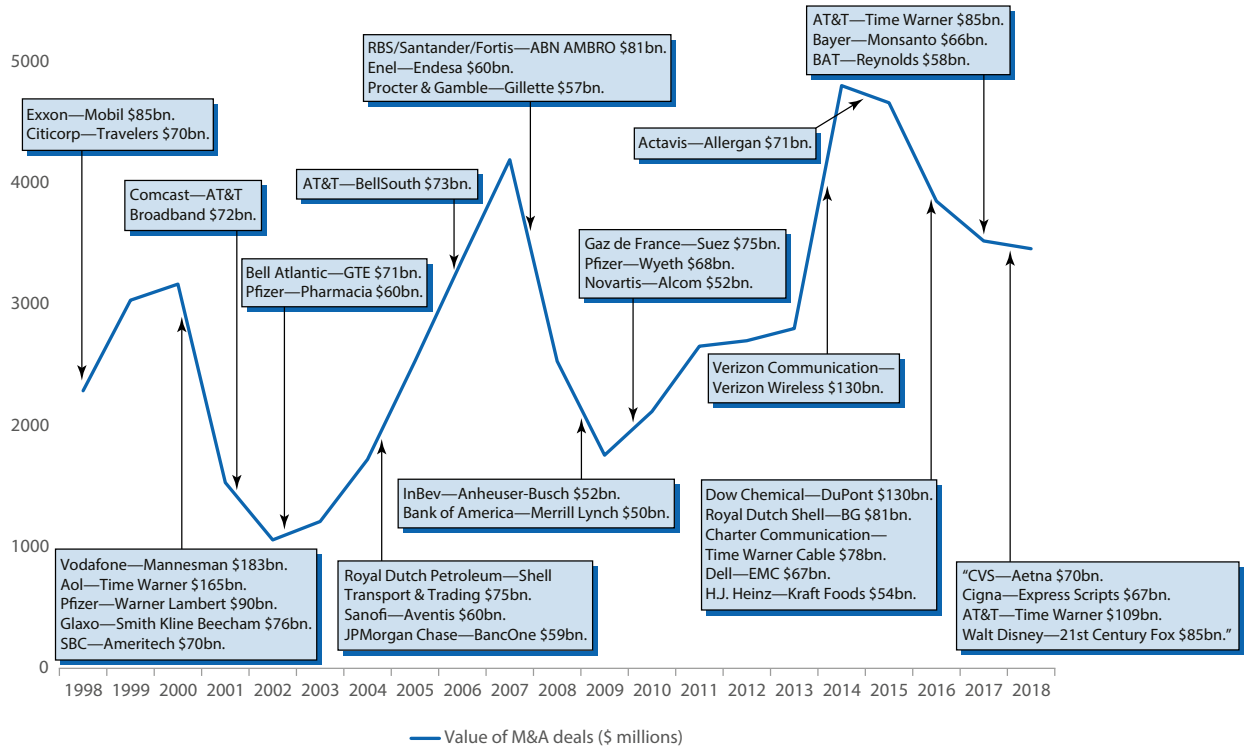
An **acquisition** (or *takeover*) is the purchase of one company by another. This involves the acquiring company (the *acquirer*) making an offer for the common stock of the other company (the *acquiree* or *target* company). Acquisitions can be “friendly,” that is when they are supported by the board of the target company, or “unfriendly,” when they are opposed. In the latter case they are known as *hostile takeovers*.

A **merger** is the amalgamation of two companies to form a new company. This requires agreement by the shareholders of the two companies, who then exchange their shares for shares in the new company. Mergers typically involve companies of similar size (Daimler and Chrysler; Exxon and Mobil), although, as in these two examples, one firm is usually the dominant partner. Although less frequent than acquisitions, mergers are often preferred because of their tax advantages and (for the dominant partner) they avoid having to pay an acquisition premium. For cross-border combinations, mergers may be more politically acceptable than acquisitions because they avoid “foreign domination” (e.g., Alcatel and Lucent, Mittal Steel and Arcelor).

The term *merger* is sometimes used to denote both mergers and acquisitions—I shall follow this popular convention.

Mergers first became prominent in the United States during the late 19th century. To avoid competition, rival companies assigned their shares to a board of trustees which determined their prices and marketing policies. John D. Rockefeller’s Standard Oil was the most prominent of these trusts. Following the Sherman Antitrust Act of 1890, holding companies displaced trusts as the preferred means of consolidating industries. Thus, in 1899, Standard Oil of New Jersey became the owner of controlling stakes in the 40 member companies of the Standard Oil Trust, while General Motors became the holding company for 23 automotive companies acquired between 1908 and 1918.¹

Since the mid-20th century, mergers and acquisitions (M&A) have increased in frequency and have become a generally accepted mode of corporate development—even in Japan, South Korea, and China. M&A activity follows a cyclical pattern, usually correlated with stock market cycles. However, the types of mergers and acquisitions have changed over time. During the 1960s and 1970s, most mergers and acquisitions were directed toward diversification—with conglomerate companies especially active. During 1998–2000, TMT (technology, media, and telecoms) accounted for one-half of all

FIGURE 14.1 Worldwide mergers and acquisitions 1998–2018

Sources: Dealogic; Reuters; media reports.

M&A. During 2000–2008, the boom in financial services and natural resources stimulated a surge of M&A activity in these sectors. Since the financial crisis of 2008, the biggest M&A deals have been horizontal mergers consolidating sectors such as chemicals, beer, food, media and communications, and pharmaceuticals. Figure 14.1 shows the cycles in M&A activity since 1998 and some of the biggest deals.

Are Mergers Successful?

The chief attraction of mergers and acquisitions is the speed at which they can achieve major strategic transformations. We have seen how M&A has allowed Anheuser-Busch InBev and EssilorLuxottica to dominate their industries. For other companies, acquisitions have allowed them to redefine their businesses. For Nokia, the sale of its handset division to Microsoft and takeover of Alcatel-Lucent transformed it from a supplier of mobile devices into a network infrastructure provider. The Chinese car producer, Geely, has used its acquisitions of Volvo, Proton/Lotus, and London taxi maker, Manganese Bronze to launch it on to the world stage.

Yet, these strategic attractions can obscure the risks inherent in mergers and acquisitions. Research into the performance consequences of mergers and acquisitions points to their generally disappointing outcomes. Empirical studies focus upon two main performance measures: shareholder returns and accounting profits.

Evidence from Shareholder Returns Studies of the impact of M&A announcements on the share prices of bidding and acquired companies have found that:

- The overall effect is a small gain in stock market value: typically around 2% of the combined market value of the merging companies.² The trend over time has been for the returns from mergers and acquisitions improve. Mergers and acquisitions occurring during 2000–2009 reduced the combined value of the companies involved by about 2%; those occurring during 2010–2014 generated average returns of 12%.³
- The gains from acquisition accrue almost exclusively to the shareholders of the acquired firms. This reflects the acquisition premium paid by acquiring firms. Between 2000 and 2014 the average acquisition premium was 27%. As a result, the overall returns to the shareholders of acquiring firms averaged –4% between 2000 and 2014.⁴

However, these findings relate only to short-term stock market responses to merger announcements and reflect investors' expectations rather than actual outcomes—which inevitably require several years to materialize.

Evidence from Accounting Profits To trace the actual outcomes of mergers and acquisitions we need to observe post-merger performance over several years and compare it to the companies' performance prior to merging. The problem here is separating the effects of the merger from the multitude of other factors that influence companies' performance over time. Hence, it is hardly surprising that the many studies that use accounting data to compare post-merger profitability with pre-merger profitability show little consistency in their findings: "the results from these accounting-based studies are all over the map."⁵

The Diversity of Mergers and Acquisitions The lack of consistent findings regarding the outcomes of mergers and acquisitions is hardly surprising given their diversity. They are motivated by different goals, take place under different circumstances, involve highly complex interactions between the companies involved, and are conducted by management teams of differing competencies. Yet, even when mergers and acquisitions are grouped into different categories, the performance outcomes remain unclear. For example, one might expect that horizontal mergers (which increase market share and offer gains from scale economies) would be more successful than diversifying mergers; among diversifying mergers, it would be expected that the acquisition of firms in related businesses would outperform unrelated acquisitions. Yet both these highly plausible predictions fail to find robust empirical support.

Even in the case of individual mergers and acquisitions, the outcomes are seldom predictable. Table 14.1 lists mergers and acquisitions from recent decades that the financial press has identified as either successes or failures. Yet, in few cases were the predictions—either of the stock market or by expert commentators—accurate about the consequences. The disastrous mergers between Daimler and Chrysler and between AOL and Time Warner were much lauded initially. Conversely, the highly successful Exxon–Mobil and Tata–Jaguar Land Rover combinations were greeted with widespread skepticism at the time.

In the absence of clear general findings about the outcomes of mergers, we need to recognize that each combination of companies is a unique event that must be

TABLE 14.1 Success and failure among prominent mergers and acquisitions

Successes	Failures
Exxon–Mobil	Daimler–Chrysler
Procter & Gamble–Gillette	AOL–Time Warner
Walt Disney Co.–Pixar	Royal Bank of Scotland–ABN AMRO
Tata Motor–Jaguar Land Rover	Hewlett Packard–Autonomy
Sirius–XM Radio	Bank of America–Countrywide
Cemex–RMC	Alcatel–Lucent
Bank of America–Merrill Lynch	Sprint–Nextel
Heinz–Kraft Foods	Sears–K Mart
Geely–Volvo	Microsoft–Nokia
Dell–EMC	News Corp.–MySpace

Sources: Based upon lists of “best” and “worst” mergers published by *Forbes*, *Fortune*, CNBC, and Bloomberg.

considered on its own merits. This means we must subject M&A decisions to careful strategic appraisal. Let us start by considering the different goals that motivate mergers and acquisitions.

Motives for Mergers and Acquisitions

Managerial motives A major reason why shareholders should view acquisitions with extreme skepticism is because they are so appealing to CEOs. Managerial incentives, both financial and psychological, tend to be associated more with a company's size than with its profitability. Acquisition offers the fastest route to corporate growth. Even more dangerous is CEOs' quest for celebrity status; again, large-scale acquisitions are the surest way a CEO can gain media coverage while projecting an image of power and influence.

The tendency for acquisitions to be led by male business leaders points to the role of biological and psychological forces. Corporate empire builders may be subject to the same sexual urges that drive bulls and stags to amass herds of females.⁶ Once they have embarked on acquisitive growth, business leaders such as Jean-Marie Messier at Vivendi Universal, Fred Goodwin at Royal Bank of Scotland, and Bernie Ebbers at WorldCom appear to be victims of *hubris*: exaggerated self-confidence that leads to distorted judgment and an ever-growing gap between perception and reality.⁷

The stock market may collude with such behavior. Overvalued equity encourages companies to make equity-financed acquisitions that can help support their share price.⁸ AOL's merger with Time Warner was motivated, in part, by AOL's inflated stock market valuation.

A further factor encouraging imprudent mergers and acquisitions is imitation among companies. We have seen that M&A activity is highly cyclical, with a heavy clustering in specific sectors: the petroleum mergers of 1998–2002; the telecoms merger waves of 1998–2005 and 2013–2015; and the global consolidation in beer, pharmaceuticals, and media since 2010.⁹ This sectoral clustering reflects firms' propensity to follow the leader: if firms resist the urge to merge, they risk being left at the fringes of the dance floor with only unattractive dancing partners left.

Let us ignore for the moment the interests of managers and consider the interests of shareholders. If mergers and acquisitions are directed toward creating shareholder value, we can distinguish two sources of value creation: *financial* and *strategic*.

Financially Motivated Mergers Mergers and acquisitions can generate shareholder value simply as a result of stock market inefficiencies or through tax benefits or financial engineering.

- Stock market valuations are determined by expectations of future profit streams and risks which are conditioned by psychological factors. As a result, privileged information, or superior analysis of generally available information, can provide the basis for identifying and acquiring under-valued companies. Warren Buffett's genius for spotting well-managed, strategically well-positioned companies whose potential the stock market has not fully recognized, is the basis for Berkshire Hathaway's history of successful acquisition.
- Acquisitions can allow a company to reduce its tax bill. For example, a poorly performing company may be an attractive takeover target simply because of the value of its tax credits to the acquirer. Acquisition also provides a mechanism for a company to relocate to a lower-tax jurisdiction. In 2016, Pfizer abandoned its \$150 billion tax-inversion merger with Irish-domiciled Allergan when the US government amended its tax regulations to eliminate the tax savings from "tax-inversion takeovers."¹⁰
- By changing the capital structure of an acquired company an acquirer may reduce its cost of capital, thereby creating value. Leveraged buyouts (LBOs) are acquisitions of companies (or divisions of companies) that are financed mainly by debt. Such acquisitions can create value as a result of debt being cheaper than equity. A study of 701 private equity deals is completed between 1990 and 2013 found that 31% of the value created resulted from increasing financial leverage.¹¹

Strategically Motivated Mergers For the most part, value creation from mergers and acquisitions is the result of their potential to increase the underlying profits of the firms involved. On the basis of the major sources of such value creation, we can identify several categories of mergers and acquisitions:

- *Horizontal mergers* can increase profitability by means of cost economies and enhanced market power resulting from combining firms that compete within the same market. US airline mergers—including United and Continental Airlines, American and US Airways, and Delta and Northwest—have played a major role in eliminating excess capacity, exploiting scale economies, and moderating price competition in the industry. Similarly, the \$145 billion merger between Dow Chemical and Du Pont was motivated by the potential both for cost savings and increased pricing power.¹²
- *Geographical extension mergers* are the principal means through which companies enter foreign markets. Between 1980 and 2003, HSBC transformed itself from a local Hong Kong bank into one of the world's leading global banks through acquiring 17 different banks across 12 different countries. For many Chinese companies—Lenovo, ChemChina, Haier, and Tencent, to mention but a few—foreign acquisitions offer the quickest route to build global presence and

to overcome the “liabilities of foreignness”—especially lack of brand recognition, lack of local knowledge, and barriers to distribution. Spurred by the trend toward globalization, cross-border mergers as a proportion of all mergers grew from 19% in 1996 to 31% in 2016.¹³

- *Vertical mergers* involve the acquisition of either a supplier or a customer. In 2013, the world’s fourth-biggest mining company, Xstrata, merged with the world’s biggest commodities trader, Glencore International, to form a vertically integrated metals supplier. As discussed in Chapter 10 (see Strategy Capsule 10.2), mergers between content producers and distributors have been a major theme in the restructuring of the media sector in recent years.
- *Diversifying mergers.* Acquisition is the predominant mode of diversification for firms. The alternative—diversification by means of a new business start-up—is too slow for most companies. While internal “business incubators” can successfully develop new business ventures, such start-ups seldom provide the basis for major diversifications. Established technology giants may diversify through one or two major acquisitions—Dell’s takeover of EMC or Nokia’s purchase of Alcatel-Lucent—or through multiple smaller acquisitions. IBM’s transition from a hardware to a software and services company involved the acquisition of 115 companies between 2000 and 2011. Microsoft’s entry into video games with the launch of Xbox in November 2001 was preceded by the acquisition of several small companies that supplied 3D graphics hardware, video game controllers, and video games.

Among all these M&A categories, the primary goal may be less to acquire the *business* of the target company than to acquire its *resources and capabilities*. We discovered in Chapter 5 that the most valuable resources and capabilities are those that are not transferable and not easily replicated. Obtaining such resources and capabilities may require acquisition. UK-based Reckitt Benckiser has used acquisition to build a large portfolio of brands: Clearasil skin products, Dettol disinfectant, Durex contraceptives, Finish dishwashing products, Nurofen analgesics, Scholl footcare products, Woolite laundry products, French’s mustard, and many more. US-based Fortune Brands has followed a similar strategy.

In technology-based industries, established companies regularly acquire small, start-up firms in order to access their technology. During 2010–2017, Google acquired 166 companies to grow its technical capabilities in robotics, imaging, internet security, artificial intelligence, facial recognition, virtual reality, and cloud computing. Each year, Microsoft hosts its VC Summit, where venture capitalists from all over the world are invited to market their companies. Walt Disney’s 2006 acquisition of Pixar, the animated movie studio founded by John Lasseter and Steve Jobs, is a classic example of a large established company acquiring a small start-up in order to obtain technical and creative capabilities.

Acquisition can short circuit the tortuous process of developing internally a new organizational capability, but it poses major risks. To begin with, acquisitions are expensive. In addition to the acquisition premium that must be paid, the targeted capability comes with a mass of additional resources and capabilities that are surplus to requirements. Most importantly, once the acquisition has been made, the acquiring company must find a way to integrate the acquiree’s capabilities with its own. All too often, culture clashes, personal frictions between senior managers, or incompatible management systems can result in the degradation or destruction of the very capabilities the acquiring company was seeking.

Managing Mergers and Acquisitions: Pre-merger Planning

The unsatisfactory performance outcomes of most mergers and acquisitions suggest that M&A decisions need to be based upon a clear understanding by the companies involved of what their strategies are and how the proposed merger or acquisition will contribute to that strategy. This needs to be followed by a detailed and realistic assessment of the likely outcomes of the merger or acquisition. This is easier with some types of mergers and acquisitions than it is with others. In the case of horizontal acquisitions, it is usually possible, not just to identify the sources of cost savings from integrating the companies, but also to quantify those savings. Other sources of synergy—in particular benefits from revenue enhancement and innovation—are more elusive. In general, acquiring companies overestimate the gains from mergers.

In relation to costs, McKinsey & Company found that 60% of mergers achieved their cost targets, but a quarter of mergers overestimated cost savings by at least 25%. Forecasts of revenue synergies tended to be widely inaccurate: 70% of mergers overestimated revenue synergies. McKinsey suggests that acquiring companies are especially blind to revenue dis-synergies—a major source of which is the tendency for the customers of the acquired firm to defect.¹⁴ In mergers between retail banks, the cost savings from closing overlapping branches can easily be offset by the consequent loss of customers. In the case of many diversifying mergers within financial services, the potential for cross-selling and customers' desire for one-stop shopping have been wildly optimistic. The risk is that acquirers fall victim to their own propaganda: in seeking to persuade the stock market about the benefits of an acquisition, they believe their own inflated estimates of potential synergies.

Sound M&A decisions require objective, quantitative analysis. One approach uses a discounted cash flow approach to determine the value of a potential acquisition of to the buyer, and hence the maximum bid price:

- 1** Start with the target company's current market capitalization. Given the target company's cost of equity capital, what does this imply about the future net cash flows that the market expects?
- 2** How reasonable are these cash flow expectations? Is there any reason to believe that the stock market may be underestimating these future cash flows? For example, the market may be undervaluing either the profit prospects for the industry or the target company's potential for competitive advantage.
- 3** What is restructuring potential? First, can the net cash flows of the target company be improved by increasing profit margins (by reducing costs, raising prices, or disposing of unprofitable lines of business) or by reducing capital investment? Second, can the cost of capital be lowered by increasing financial leverage? The excess of the restructured NPV over the as-is NPV (calculated above) shows the potential for adding value through restructuring.
- 4** What is the potential for synergy? If the target company is merged into the acquiring company, what sources of synergy can be exploited? In the short-term, these will include cost savings from combining headquarters services, consolidating plants, and merging operations. Longer term, they will include the more speculative benefits of transferring capabilities and exploiting new business opportunities. Synergies may accrue both to the acquiring and the acquired companies. As we have already observed, it is important to recognize the costs of exploiting synergies and not just their benefits.

A key impediment to assessing the potential for a merger or acquisition to add value, is what Carliss Baldwin refers to as “fragility risk”: the risk that the implementation phase will go awry such that the potential benefits of the merger are never realized and the underlying businesses of the partnering firms are damaged.¹⁵ Evaluating fragility risk is very difficult, however it is likely to be correlated with the number of changes that the acquirer will need to make in the target company’s business operations (and in its own operations) following the deal. A further problem in estimating the potential value added from acquisition is the acquirer’s limited knowledge of the target company. Even friendly takeovers are still prone to information asymmetry—the seller knows much more about the acquisition target than the buyer, so the acquirer can be hoodwinked into overpaying (the so-called *lemons problem*). Hewlett-Packard’s disastrous \$11 billion takeover of British software firm Autonomy in 2011 exemplifies this problem.¹⁶

Better pre-merger planning requires not only improved information, but also better analysis. Concerns over confidentiality can result in an M&A team being too small to provide the expertise needed to adequately appraise a potential acquisition.¹⁷

Managing Mergers and Acquisitions: Post-merger Integration

The risks inherent in mergers and acquisitions is revealed by the numbers that fail—including some which were meticulously planned. The combination of Daimler-Benz and Chrysler was exemplary in its pre-merger planning; yet, the outcome was disappointing. Not only did Chrysler’s problems appear to be intractable but also Chrysler’s demands on the group’s top management negatively impacted Daimler-Benz’s core business.¹⁸

Consistent with the observation that M&A risks depend upon the number of post-merger changes that must be managed, it appears that, where the potential benefits of mergers and acquisitions are great, so too are the costs and risks of integration. Thus, Capron and Anand argue that cross-border acquisitions typically have the strongest strategic logic.¹⁹ Yet the evidence of DaimlerChrysler, BMW-Rover, and Alcatel-Lucent suggests that the complexities of cross-border integration—accentuated by differences in both corporate and national cultures—makes post-merger assimilation especially fraught.

It is increasingly being recognized that managing acquisition is a rare and complex organizational capability that needs to be developed through explicit, experience-based learning. Acquisition performance improves with experience—though not at first. There appears to be a learning threshold, after which subsequent acquisitions add value.²⁰ However, the learning from acquisitions needs to be explicitly managed, for example, the codifying of acquisition processes appears to be conducive to acquisition success.²¹

Ultimately, successful mergers and acquisition require combining pre-acquisition planning with post-acquisition integration. Most case studies of failed mergers identify poor post-acquisition management as the key problem. Yet, in many instances, these integration problems could have been anticipated. Hence, the critical failure was going ahead with the acquisition without adequate assessment of the challenges of post-merger management. In Quaker Oats’ acquisition of Snapple (“the billion-dollar blunder”), the critical problem—the impediments to integrating Snapple’s distribution system with that of Quaker’s Gatorade—was evident to the marketing managers and the franchised distributors of the two companies prior to the takeover.²² Conversely, Walt Disney’s acquisition of Pixar was preceded by an anticipation of the problems that

STRATEGY CAPSULE 14.1

Walt Disney Company and Pixar

Most industry observers were pessimistic about Disney's \$7.4 billion acquisition of rival animated movie producer Pixar in 2006. Most acquisitions of movie studios had experienced major difficulties: General Electric's NBC acquisition of Universal Studios and Viacom's of DreamWorks. The worries were that Disney's corporate systems would suppress Pixar's creativity and that Pixar's animators would leave. Although the two companies had allied for several years (Disney distributed Pixar movies), the relationship had not been a smooth one.

Yet the acquisition is generally regarded as being highly successful. Since the acquisition, several Disney/Pixar animated movies, including *Toy Story 3* and *Frozen*, have been massive box office successes and have generated huge revenues from DVDs, video streaming, and licensing. Disney's CEO, Bob Iger, claims that, compared with the earlier alliance between the two companies, ownership of Pixar has facilitated the closer coordination needed to exploit the synergies between the two companies.

Factors contributing to the success of the merger included:

- ◆ A high level of personal and professional respect among the key personnel at Pixar and Disney. In announcing the acquisition, CEO Iger commented: "We also fully recognize that Pixar's extraordinary record of achievement is in large measure due to its vibrant creative culture, which is something we

respect and admire and are committed to supporting and fostering in every way possible."

- ◆ Rapid and honest communication to Pixar employees about the merger and its implications.
- ◆ Careful pre-acquisition planning specifying which elements of Pixar would remain unchanged and which would be adapted to and integrated with Disney's existing activities and practices.
- ◆ Appointing Pixar's president, Edwin Catmull, as head of Walt Disney Animation Studios.
- ◆ Bob Iger's personal experience of working for companies that were the subject of takeovers.
- ◆ Explicit guidelines designed to protect Pixar's creative culture, including a continuation of Pixar employees' generous fringe benefits and loosely defined employment conditions.
- ◆ Honoring commitments: according to Edwin Catmull: "Everything they've said they would do, they have lived up to."

In one respect, the Disney-Pixar merger flouted conventional wisdom. According to Bob Iger: "There is an assumption in the corporate world that you need to integrate swiftly. My philosophy is exactly the opposite. You need to be respectful and patient."

Sources: The Walt Disney Company Press Release, "Disney Completes Pixar Acquisition," (Burbank, CA, May 5, 2006); "Disney: Magic Restored," *The Economist* (April 17, 2008); "Disney and Pixar: The Power of the Prenup," www.nytimes.com/2008/06/01/business/media/01pixar.html?pagewanted=all.

might arise, followed by a careful and sensitive approach to planning, and then implementing, the integration of Pixar (Strategy Capsule 14.1).

Clay Christensen and colleagues argue that acquisition targets need to be carefully selected to match the strategic objective of the acquisition.²³ They distinguish between acquisitions which *leverage a firm's existing business model* from those

intended to *re-invent its business model*. Acquisitions that leverage the existing model need to carefully specify how the proposed acquisition will augment the existing business model. For example, if the goal is to reduce cost, basic questions need to be asked:

- Will the acquisition's products fit into our product catalogue?
- Do its customers buy products like ours, and vice versa?
- Will the acquired company's products fit into our existing supply chain, production facilities, and distribution?
- Can our people readily service the customers of the acquired company?

The answers to these questions will indicate what needs to be done when integrating the acquisition within the acquirer's existing business. However, if the purpose of the acquisition is to re-invent the firm through acquiring a disruptive business model, integration should be avoided to allow the acquired business model to flourish. Thus, when EMC acquired VMware—with its disruptive business model that allowed customers to substitute software for hardware in their server businesses—EMC chose to operate VMware as a separate company (as did Dell when it acquired EMC.)²⁴

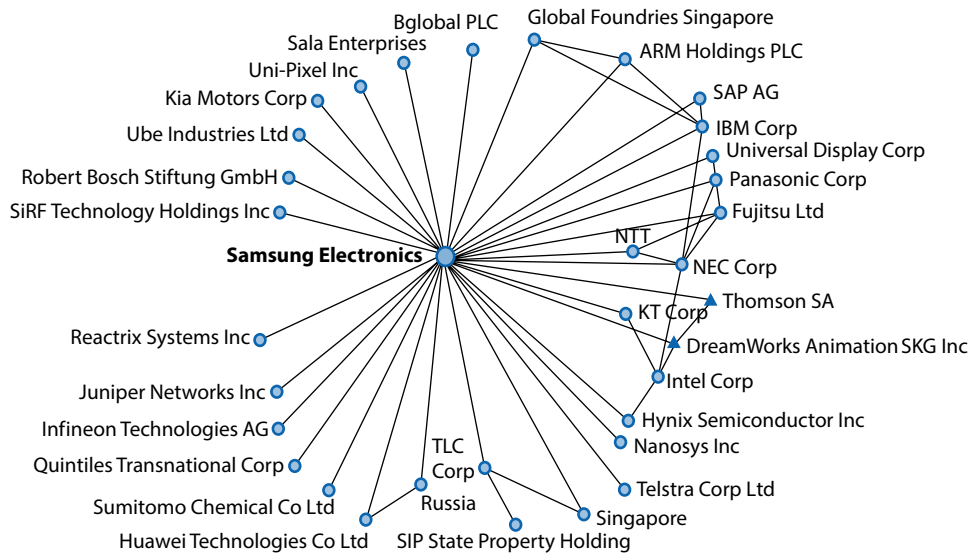
Strategic Alliances

A **strategic alliance** is a collaborative arrangement between two or more firms to pursue agreed common goals. Strategic alliances take many different forms:

- A strategic alliance may or may not involve equity participation. Most alliances are agreements to pursue particular activities and do not involve any ownership links. The alliance between IBM and Apple announced in July 2014 involves the two companies jointly developing enterprise apps and IBM distributing Apple products to its corporate customers. The idea behind the tie-up is to combine Apple's hardware expertise and leadership in mobile devices with IBM's big data, analytics, and cloud computing capabilities to develop enterprise mobility applications.²⁵ In other strategic alliances, equity stakes can reinforce the alliance agreement. General Motors' alliance with ride-share provider, Lyft, to develop self-driving cars involved GM taking a \$500m equity stake in Lyft.²⁶
- A *joint venture* is a particular form of equity alliance where the partners form a new company that they jointly own. CFM International, one of the world's leading suppliers of jet engines, is a 50/50 joint venture between General Electric of the US and Snecma of France. Volkswagen is China's leading automobile brand through its joint ventures with SAIC Motor and FAW Group.
- Alliances are created to fulfill a wide variety of purposes:
 - Star Alliance is an agreement among 25 airlines (including United, Lufthansa, and Air Canada) to code share flights and link frequent-flier programs.

- Automobili Lamborghini and Callaway Golf Company formed an R&D alliance in 2010 to develop advanced composite materials.
- GlaxoSmithKline and Dr Reddy's Laboratories (a leading Indian pharma company) formed an alliance in 2009 to market Dr Reddy's products in emerging-market countries through GSK's sales and marketing network.
- The Rumaila Field Operating Organization is a joint venture comprising China National Petroleum Company, BP, and South Oil Company to operate Iraq's biggest oilfield.
- Alliances may be purely bilateral arrangements or they may be a part of a network of inter-firm relationships. Most companies that assemble complex manufactured products are supported by a supplier network comprising hundreds of enterprises. Toyota's supplier network comprises first-level, second-level, and tertiary suppliers bound by long-term relationships with Toyota and supported by a set of routines that permit knowledge sharing and continuous improvement.²⁷ Another type of alliance network is the localized industry cluster that characterizes the industrial districts of Italy (e.g., Prato woolen knitwear cluster, Carrara stonecutting cluster, and Sassuolo ceramic tile cluster). The Hollywood film industry represents another such cluster. Relationships within these localized networks are based upon history and proximity; they are informal rather than formal; and they involve both cooperation and intense rivalry.²⁸ In sectors affected by technological changes from multiple sources, alliances can play a vital role in innovation and adaptability. Figure 14.2 shows Samsung Electronics' extensive network of alliances.

FIGURE 14.2 The strategic alliances of Samsung Electronics, 2014



Source: Professor Andrew Shipilov, Insead.

Motives for Alliances

Most inter-firm alliances are created to exploit complementarities between the resources and capabilities owned by different companies:

- Bulgari Hotels and Resorts is a joint venture that combines Bulgari's reputation for luxury and quality with Marriott International's capabilities in developing and operating hotels.
- Uber and Volvo Cars established a project to develop fully-autonomous cars using Uber's software capability with Volvo's vehicle design and manufacturing capability.
- The Oneworld airline alliance—comprising American Airlines, British Airways, Cathay Pacific, Japan Airlines, Qantas, Qatar Airways, and nine other airlines—allows member airlines to offer through-ticketing on one-anothers' routes, coordinate their schedules, and link their frequent flier schemes.
- The alliance between Panasonic and Tesla combines Panasonic's battery capabilities with Tesla's automotive and photovoltaic capabilities. The main activity of the alliance is the two companies' joint production of battery packs within Tesla's Gigafactory in Nevada.

There has been a debate in the literature as to whether the primary aim of strategic alliances is to *access* the partner's resources and capabilities or to *acquire* them through learning.²⁹ The strategic alliance between Marriott International and Alibaba announced in August 2017 allows Marriott to access the millions of Chinese tourists who make hotel reservations through Alibaba and payments through Alipay, while expanding Alibaba's presence outside of China.³⁰ Conversely, the South China Locomotive & Rolling Stock Corp.'s alliances with Bombardier and Siemens were motivated primarily by the desire to acquire their technology.³¹ In most instances alliances are about accessing rather than acquiring capabilities: for most firms the basic rationale of alliances is that they allow the firm to specialize in a limited range of capabilities while enabling the exploitation of specific opportunities that require a wider range of capabilities.³²

A major advantage of such alliances is the flexibility they offer: they can be created and dissolved fairly easily, their scope and purpose can change according to the changing requirements of the parties, and (for non-equity alliances) they typically involve modest investments. This flexibility and low cost is especially advantageous for making option-type investments.³³ Alphabet's technology-based new ventures make extensive use of alliances. Its Waymo autonomous driving unit has alliances with Robert Bosch, Nvidia, FiatChrysler, and Lyft. Google's Calico subsidiary, whose goal is to extend human life, has alliances with AbbVie, The Broad Institute, and C4 Therapeutics.

Alliances also permit risk sharing. In petroleum, most upstream projects are joint ventures. Kazakhstan's Kashagan field, the world's biggest oil discovery of the past 40 years, has required investment of \$105 billion, which is spread among a consortium of seven companies including Eni, Shell, and ExxonMobil.

Managing Strategic Alliances

It is tempting to view a strategic alliance as a quick and low-cost means to extend the resources and capabilities available to a firm. However, managing alliance relationships is itself a critically important organizational capability. *Relational capability* comprises building trust, developing inter-firm knowledge sharing routines, and establishing mechanisms for coordination.³⁴ The more a company outsources its value chain activities to a network of alliance partners, the more it needs to develop the systems integration capability to coordinate and integrate the dispersed activities.³⁵ The delays that plagued the launch of the Boeing 787 Dreamliner are one indicator of the challenges of managing a network of alliances in developing a complex, technologically-advanced product.³⁶

There is a lack of comprehensive evidence relating to the overall success of strategic alliances. Alliance formations tend to be met with favorable stock market responses,³⁷ but longer-term data on alliance performance is conspicuously absent. McKinsey observes that even alliance participants lack knowledge of the costs and benefits of their alliances. McKinsey recommends establishing a system to track alliance performance as a vital component of effective alliance management.³⁸

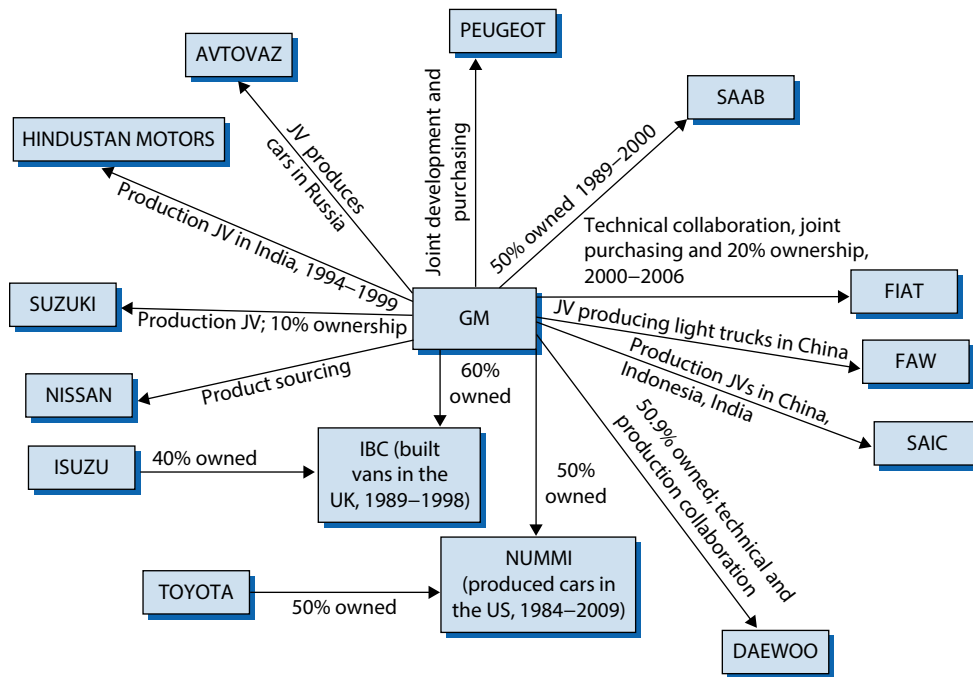
Cross-border alliances play a particularly important role in internationalization strategy, where they can also pose acute management problems. When entering an overseas market, the internationalizing firm will typically lack the local knowledge, political connections, and access to distribution channels that a local firm will possess. At the same time, acquiring a local firm may not be an attractive option, either because local regulations or ownership patterns make acquisition difficult or because of the large and irreversible financial commitment involved. In such circumstances, alliances—either with or without equity—can be an attractive entry mode. By sharing resources and capabilities, alliances economize on the investment needed for major international initiatives. The FreeMove Alliance formed by Telefonica (Spain), TIM (Italy), T-Mobile (Germany), and Orange (France) created a seamless third-generation, wireless communication network across Europe at a fraction of the cost incurred by Vodafone, allowing each firm access to the mobile network of the leading operator in at least five major European markets.³⁹

Some firms have made extensive use of strategic alliances to build their international presence. Figure 14.3 shows General Motors' network of strategic alliances. Some of these generated few benefits for GM (e.g., the alliances with Fiat, Isuzu, and Suzuki); others led to full acquisition of the alliance partner (Daewoo, Saab).

For the local partner, an alliance with a foreign firm can also be an attractive means of accessing resources and capabilities. In many emerging-market countries—notably China and India before their accession to the World Trade Organization—governments often oblige foreign companies to take a local partner in order to encourage the flow of technology and management capabilities to the host country.

However, for all their attractions, international alliances are difficult to manage: the usual problems that alliances present—those of communication, agreement, and trust—are exacerbated by differences in language, culture, and greater geographical distance. Danone's joint venture with Wahaha created the largest beverage company in China; however, misunderstanding and misaligned incentives resulted in the joint venture collapsing in 2011.⁴⁰

It is tempting to conclude that international alliances are most difficult where national cultural differences are wide (e.g., between Western and Asian companies).

FIGURE 14.3 General Motors' network of international alliances

However, some alliances between Western and Asian companies have been highly successful (e.g., Fuji/Xerox and Renault/Nissan). Conversely, many alliances between Western companies have been failures: BT and AT&T's Concert alliance, the GM/Fiat alliance, and Swissair's network of airline alliances. Disagreements over the sharing of the contributions to and returns from an alliance are a frequent source of friction, particularly in alliances between firms that are also competitors. When each partner seeks to access the other's capabilities, "competition for competence" results.⁴¹ During the 1980s, Western companies fretted about losing their technological know-how to Japanese alliance partners. In recent years, Western companies have been dismayed by the speed at which their Chinese partners have absorbed their technology and emerged as international competitors. In rail infrastructure, China's state-owned companies have used their partnerships with Germany's Siemens, France's Alstom, Japan's Kawasaki Heavy Industries, and Canada's Bombardier to build homegrown capabilities that are now being exported.⁴² The complaints made by Western companies against their Chinese joint-venture partners in 2012 are almost identical to those made against Japanese joint-venture partners in the 1980s.⁴³

Firms must also choose which growth mode to follow. Typically, companies have a bias toward either internal or external growth and between either acquisition or alliance without considering fully the relative merits of each. Within the telecom sector, firms that used a combination of growth modes—internal development, alliances, and acquisitions—were more successful than those that stuck to a single mode.⁴⁴ Strategy Capsule 14.2 considers the issues involved.

STRATEGY CAPSULE 14.2

Choosing the Right Growth Path: Internal Development *vs.* Contracts, *vs.* Alliances, *vs.* Acquisitions

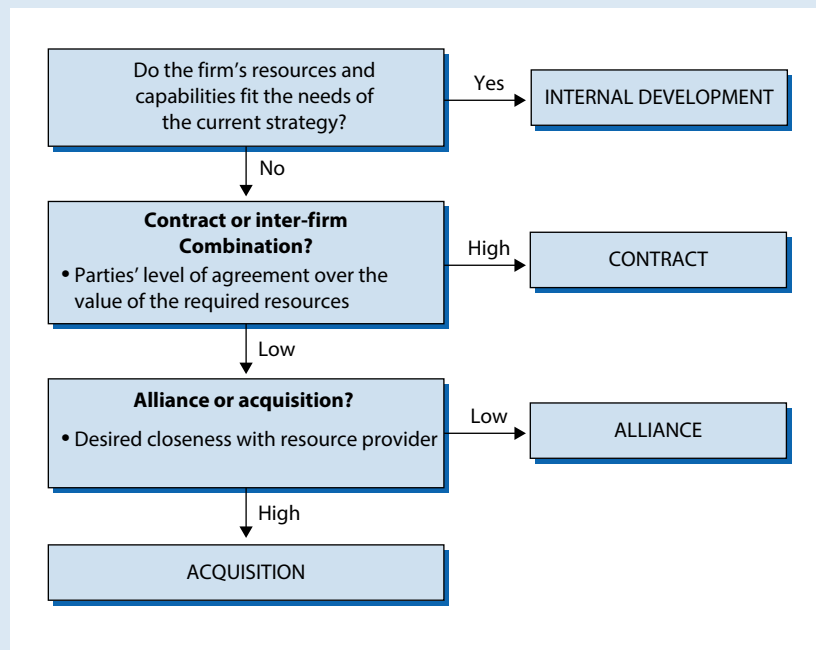
Choosing the best way to grow requires a careful consideration of a firm's *resource gap*: the resources needed for its strategy relative to the resources it already possesses.

Capron and Mitchell outline a three-step approach to deciding a firm's growth mode (Figure 14.4).

- 1 The resources a firm needs for its future development are usually different from those it currently possesses. But how different? The greater the gap, the greater the likelihood it will need to seek these externally rather than develop them internally.
- 2 If resources are needed from outside the firm, typically the easiest way to obtain them is through a contractual agreement (e.g., licensing a specific technology). But such contracts require agreement over the value of the resources concerned; in the absence of such consensus, a contractual agreement may be impossible.

- 3 How deeply involved does the firm need to be with its partner in order to effectively transfer and integrate the resources required? If the depth and complexity of involvement is low then an alliance will suffice. However, if closer involvement is needed, then the fuller integration potential offered by acquisition is preferable. Researchers at the Wharton School reached a similar conclusion: systemic linkages between the firms—"reciprocal synergies"—favor acquisition; "modular" and "sequential" linkages are better managed through alliances. They also note that choosing whether to ally or acquire depends upon the type of resources involved. Tangible resources such as manufacturing plants or mineral resources are better integrated through mergers and acquisitions; "soft resources" such as people and knowledge can be linked via alliances.

FIGURE 14.4 Choosing the right growth path



Sources: L. Capron and W. Mitchell, "Finding the Right Path," *Harvard Business Review*, (September–October 2010): 102–110; J. Dyer, P. Kale, and H. Singh, "When to Ally and When to Acquire?" *Harvard Business Review* (July–Aug 2004): 109–115.

Summary

Mergers and acquisitions can be useful tools of several types of strategy: for acquiring particular resources and capabilities, for reinforcing a firm's position within an industry, and for achieving diversification or horizontal expansion.

However, despite the plausibility of most of the stated goals that underlie mergers and acquisitions, most fail to achieve these goals. Empirical research shows that the gains flow primarily to the shareholders of the acquired companies.

These disappointing outcomes may reflect the tendency for mergers and acquisitions to be motivated by the desire for growth rather than for profitability. The pursuit of growth through merger is sometimes reinforced by CEO hubris, producing a succession of acquisitions that will ultimately lead to the company failing or restructuring.

A second factor in the poor performance consequences of many mergers are the unforeseen difficulties of post-merger integration. However, the diversity of mergers and their outcomes makes it very difficult to generalize about the types of merger or the approaches to integration that are associated with success.

Strategic alliances take many forms. In common is the desire to exploit complementarities between the resources and capabilities of different companies. Like mergers and acquisitions, and like relationships between individuals, they have varying degrees of success. Unlike mergers and acquisitions, the consequences of failure are usually less costly. As the business environment becomes more complex and more turbulent, the advantages of strategic alliances both in offering flexibility and in reconciling specialization with the ability to integrate a broad array of resources and capabilities become increasingly apparent.

Self-Study Questions

1. Most of the mergers and acquisitions shown in Figure 14.1 are horizontal (i.e., they are between companies within the same sector). Some of these horizontal mergers and acquisitions are between companies in the same country; some cross national borders. Are there any reasons why horizontal mergers and acquisitions are likely to be more beneficial than other types of mergers and acquisitions (diversifying and vertical) and involve less risk? Among these horizontal mergers and acquisitions, which do you think will be more successful: those between companies in the same country or those that cross borders?
2. A large number of studies examining the success of M&A have examined their impact on shareholder returns. Most of these studies measure changes in the market value of the merging companies from before the merger announcement to several months after. What do these studies tell us about the effects of mergers and acquisitions?
3. Commenting on the Pixar acquisition (Strategy Capsule 14.1), Disney's CEO stated: "You can accomplish a lot more as one company than you can as part of a joint venture." Do you agree?

Illustrate your answer by referring to some of the joint ventures (or alliances) referred to in this chapter. Would these have been more successful as mergers?

4. In the motor industry, companies have followed different internationalization paths. Toyota expanded organically, establishing subsidiaries in overseas markets. Ford went on an acquisition spree, buying Volvo, Jaguar, Land Rover, and Mazda. General Motors has made extensive use of strategic alliances (Figure 14.3). Which strategy is best? Which strategy would you recommend to Chinese automobile manufacturers such as SAIC and Dongfeng?

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