Diversifying and Managing Acquisitions Globally

OPENING CASE **Emerging Markets: Emerging Acquirers from China and India**

Multinational enterprises (MNEs) from emerging economies, especially China and India, have emerged as a new breed of acquirers around the world. Provoking "oohs" and "ahhs," they have grabbed media headlines and caused controversies. Anecdotes aside, what are the patterns of these new global acquirers? How do they differ? Only recently has rigorous academic research been conducted to allow for systematic comparison (Table 9.1).

Overall, China's stock of outward foreign direct investment (OFDI) (1.7% of the worldwide total) is more than three times that of India (0.5%). One visible similarity is that both Chinese and Indian MNEs seem to use acquisitions as their primary mode of OFDI. Throughout the 2000s, Chinese firms spent US$130 billion to engage in acquisitions overseas, whereas Indian firms made acquisition deals worth US$60 billion.

MNEs from China and India target industries to support and strengthen their own most competitive industries at home. Given China's prowess in manufacturing, Chinese firms' overseas acquisitions primarily target energy, minerals, and mining—crucial supply industries that feed their operations at home. Indian MNEs' world-class position in high-tech and software services is reflected in their interest in acquiring firms in these industries.

The geographic spread of these MNEs is indicative of the level of their capabilities. Chinese firms have undertaken most of their deals in Asia, with Hong Kong being their most favorable location. In other words, the geographic distribution of Chinese acquisitions is not global; rather, it is quite regional. This reflects a relative lack of capabilities to engage in managerial challenges in regions distant from China, especially in more-developed economies. Indian MNEs have primarily made deals in Europe, with the UK as the leading target country. For example, acquisitions made by Tata Motors (Jaguar Land Rover [JLR]) and Tata Steel (Corus Group) propelled Tata Group to become the number-one private-sector employer in the UK. Overall, Indian firms display a more global spread in their acquisitions, and demonstrate a higher level of confidence and sophistication in making deals in developed economies.

From an institution-based view, the contrasts between the leading Chinese and Indian acquirers are significant. The primary players from China are state-owned enterprises (SOEs), which have their own advantages (such as strong support from the Chinese government) and trappings (such as resentment and suspicion from host-country governments). The movers and shakers of cross-border acquisitions from India are private business groups, which generally are not viewed with strong suspicion. The limited evidence suggests that M&As by Indian firms tend to create value for their

TABLE 9.1 Cross-Border Acquisitions Undertaken by Chinese and Indian MNEs.

	Chinese MNEs	Indian MNEs
Top target industries	Energy, minerals, and mining	High-tech and software services
Top target countries	Hong Kong	United Kingdom
Top target regions	Asia	Europe
Top acquiring companies involved	State-owned enterprises	Private business groups
% of successfully closed deals	47%	67%

SOURCE: Extracted from S. Sun, M.W. Peng, B. Ren, & D. Yan, 2012, A comparative ownership advantage framework for cross-border M&As: The rise of Chinese and Indian MNEs, *Journal of World Business*, 47: 4–16.

shareholders. However, acquisitions by Chinese firms tend to destroy value for their shareholders—indicative of potential hubristic and managerial motives evidenced by empire building.

Announcing high-profile deals is one thing, but completing them is another matter. Chinese multinationals have a particularly poor record in completing the overseas acquisition deals they announce. Fewer than half (47%) of their announced acquisitions were completed, which compares unfavorably to Indian MNEs' 67% completion rate and to a global average of 80%–90% completion rate. Chinese MNEs' lack of ability and experience in due diligence and financing is one reason, but another reason is the political backlash and resistance they encounter, especially in developed economies. The 2005 failure of CNOOC's bid for Unocal in the United States and the 2009 failure of Chinalco's bid for Rio Tinto's assets in Australia are but two high-profile examples.

Even assuming successful completion, integration is a leading challenge during the post-acquisition phase. Acquirers from China and India have often taken the "high road" to acquisitions, in which acquirers deliberately allow acquired target companies to retain autonomy, keep the top management intact, and then gradually encourage interaction between the two sides. In contrast, the "low road" to acquisitions would be for acquirers to act quickly to impose their systems and rules on acquired target companies. Although the "high road" sounds noble, this is a reflection of these acquirers' lack of international management experience and capabilities.

From a resource-based view, examples of emerging acquirers that can do a good job in integration and deliver value are few. According to the *Economist*, Tata "worked wonders" at JLR by increasing 30% sales and keeping the factory at *full* capacity. This took place during a recession when European automakers were suffering. According to *Bloomberg Businessweek*, Lenovo was able to "find treasure in the PC industry's trash" by turning around the former IBM PC division and using it to propel itself to become the biggest PC maker in the world. In ten years it grew from a US$3 billion company to a US$40 billion one. However, Lenovo knew that worldwide PC sales were going down, thanks to the rise of mobile devices. In response, it recently bought "the mobile phone industry's trash"—Motorola Mobility division—from Google and endeavored to leverage the Motorola brand to become a top player in the smartphone world. This deal quickly made Lenovo the world's third best-selling smartphone maker, after Samsung and Apple.

SOURCES: Based on (1) BBC News, 2014, Lenovo completes Motorola takeover after Google sale, October 30: www.bbc.co.uk; (2) *Bloomberg Businessweek*, 2014, Jackpot! How Lenovo found treasure in the PC industry's trash, May 12: 46–51; (3) Y. Chen & M. Young, 2010, Cross-border M&As by Chinese listed companies, *AsiaPacific Journal of Management*, 27: 523–539; (4) *Economist*, 2012, The cat returns, September 29: 63; (5) S. Gubbi, P. Aulakh, S. Ray, M. Sarkar, & R. Chittoor, 2010, Do international acquisitions by emerging economy firms create shareholder value? *Journal of International Business Studies*, 41: 397–418; (6) O. Hope, W. Thomas, & D. Vyas, 2011, The cost of pride, *Journal of International Business Studies*, 42: 128–151; (7) S. Lahiri, B. Elango, & S. Kundu, 2014, Cross-border acquisition in services, *Journal of World Business*, 49: 409–420; (8) S. Lebedev, M. W. Peng, E. Xie, & C. Stevens, 2015, Mergers and acquisitions in and out of emerging economies, *Journal of World Business* (in press); (9) S. Sun, M. W. Peng, B. Ren, & D. Yan, 2012, A comparative ownership advantage framework for cross-border M&As: The rise of Chinese and Indian MNEs, *Journal of World Business*, 47: 4–16; (10) Y. Yang, 2014, "I came back because the company needed me," *Harvard Business Review*, July: 104–108.

Why have firms from emerging economies such as China and India significantly expanded their international footprint? Why do they focus on industries related to their existing areas of excellence? Why are they interested in using acquisitions as a mode of entry? How successful (or terrible) have their acquisitions been? These are some of the key questions driving this chapter.[1]

Starting from this chapter, Part III (Chapters 9, 10, 11, and 12) focuses on **corporate-level strategy (or, in short, corporate strategy)**, which is how a firm creates value through the configuration and coordination of its multimarket activities. In comparison, Part II (Chapters 5, 6, 7, and 8) dealt with **business-level strategy**, defined as ways to build competitive advantage in an identifiable market. While business-level strategy is very important, for larger, multimarket firms, corporate-level strategy is equally or perhaps more important.[2] In other words, an understanding of corporate-level strategy helps us see the "forest," whereas business-level strategy focuses on "trees."

In this chapter, we focus on a key aspect of corporate strategy, **diversification**, which is adding new businesses to the firm that are distinct from its existing operations. Diversification is probably the single most researched, discussed, and debated topic in corporate strategy.[3] It can be accomplished along two dimensions. The first is **product diversification**—through entries into different industries. The second is **geographic diversification**—through entries into different countries. Although market entries can entail greenfield investments (see Chapter 6) and strategic alliances (see Chapter 7), our focus here is on acquisitions.

We will first introduce product and geographic diversification. Then, we will develop a comprehensive model, drawing on the strategy tripod. Acquisitions are examined next, followed by debates and extensions.

PRODUCT DIVERSIFICATION

Most firms start as small businesses focusing on a single product or service with little diversification—known as a **single business strategy**. Over time, a product diversification strategy, with two broad categories (related and unrelated), may be embarked on.

Product-Related Diversification

Product-related diversification refers to entries into new product markets and/or activities that are related to a firm's existing markets and/or activities. The emphasis is on **operational synergy** (also known as **scale economies or economies of scale**), defined as increases in competitiveness beyond what can be achieved by engaging in two product markets and/or activities separately. In other words, firms benefit from declining unit costs by leveraging product relatedness—that is, $2 + 2 = 5$. The sources of operational synergy can be (1) technologies (such as common platforms), (2) marketing (such as common brands), and (3) manufacturing (such as common logistics).

Product-Unrelated Diversification

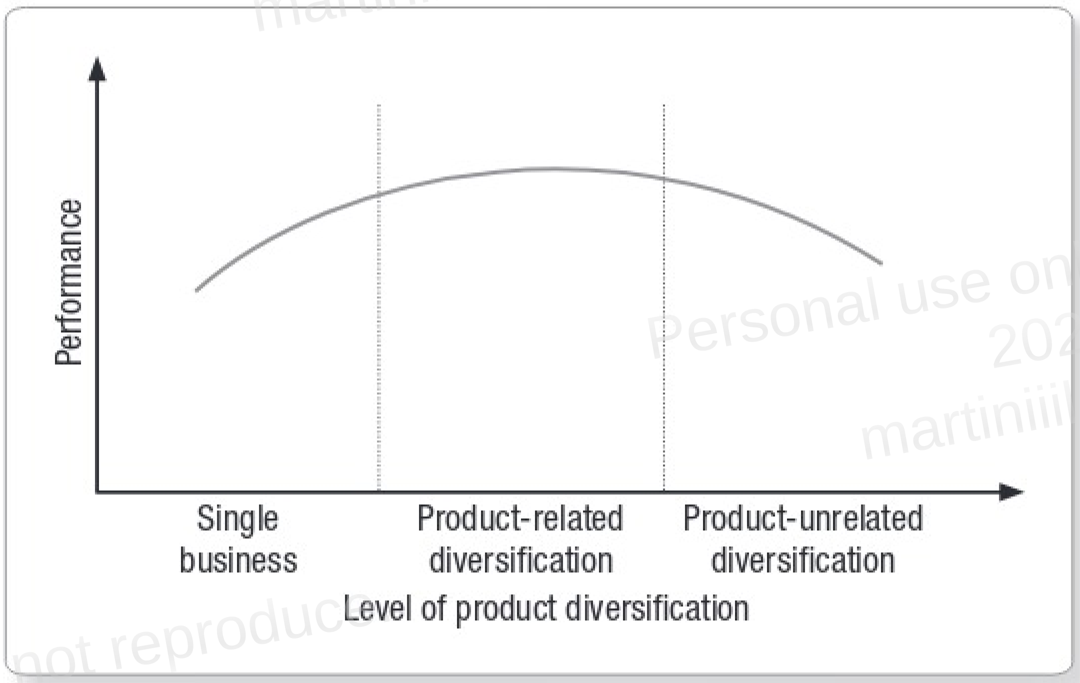
Product-unrelated diversification refers to entries into industries that have no obvious product-related connections to the firm's current lines of business.[4] Product-unrelated diversifiers (such as Samsung) are called **conglomerates**, and their strategy is known as **conglomeration**. Instead of operational synergy, conglomerates focus on **financial synergy** (also known as **scope economies or economies of scope**)—namely, increases in competitiveness for each individual unit financially controlled by the corporate headquarters beyond what can be achieved by each unit competing independently as a stand-alone firm.

The mechanism to obtain financial synergy is different from operational synergy. The key role of corporate headquarters is to identify and fund profitable investment opportunities, such as the new industries that Samsung Group has entered recently—solar panels, biotech drugs, and electric car batteries. In other words, a conglomerate serves as an **internal capital market** that channels financial resources to high-potential high-growth areas. Given there are active external capital markets that try to do the same, a key issue is whether units affiliated with conglomerates in various industries (such as GE's aircraft engine division) outperform their stand-alone independent competitors in respective industries (such as Rolls-Royce). Stated differently, at issue is whether, by operating internal capital markets, corporate headquarters can do a *better* job in identifying and taking advantage of profitable opportunities than external capital markets. If conglomerate units beat stand-alone rivals (which is something most GE units consistently do), then there is a **diversification premium** (or conglomerate advantage)—in other words, product-unrelated diversification adds value.[5] Otherwise, there can be a **diversification discount** (or conglomerate disadvantage), when conglomerate units are better off by competing as stand-alone entities.

Product Diversification and Firm Performance

Hundreds of studies, mostly conducted in the West, suggest that, on average (although not always), performance may increase as firms shift from single business strategies to product-related diversification, but performance may decrease as firms change from product-related to product-unrelated diversification—in other words, the linkage seems to be an inverted U shape (Figure 9.1).[6] Essentially "putting all your eggs in one basket," a single business strategy can be potentially risky and vulnerable. "Putting your eggs in different baskets"—product-unrelated diversification—may reduce risk, but its successful execution requires strong organizational capabilities that many firms lack (discussed later). Consequently, product-related diversification, essentially "putting your eggs in *similar* baskets," has emerged as a balanced way to both reduce risk and leverage synergy since the 1970s.

FIGURE 9.1 Product Diversification and Firm Performance.



SOURCE: Adapted from R. Hoskisson, M. Hitt, R. D. Ireland, & J. Harrison, 2008, *Competing for Advantage*, 2nd ed. (p. 214), Cincinnati: Cengage Learning.

However, important caveats exist. Not all product-related diversifiers outperform unrelated diversifiers. In an age of "core competencies," the continuous existence and prosperity of the likes of GE, Siemens, and Virgin Group suggest that for a small group of highly capable firms, conglomeration may still add value in developed economies. In addition to its online retail roots, Amazon has marched into cloud computing, e-payment, reading devices, drones, and entertainment—clearly becoming a "new age" conglomerate. Moreover, in emerging economies, a conglomeration strategy seems to be persisting, with some units (such as those affiliated with South Korea's Samsung Group, India's Tata Group, and Turkey's Koc Group) outperforming stand-alone competitors.[7]

The reason many conglomerates fail is not because this strategy is inherently unsound, but because firms fail to implement it. Conglomeration calls for corporate managers at headquarters to impose a strict financial discipline on constituent units and hold unit managers accountable—of the sort GE's former chairman and CEO, Jack Welch, famously imposed on all divisions, "Either become the world's top one or two in your industry, or expect your unit to be sold." However, most corporate managers are not so "ruthless," and they may tolerate poor performance of some units, which can be subsidized by better units.[8] By robbing the better units to aid the poor ones, corporate managers in essence practice "socialism." Over time, better units may lose their incentive to do well, and eventually *corporate* performance suffers.

GEOGRAPHIC DIVERSIFICATION

Although geographic diversification can be done within one country (expanding from one city, state, or province to another), in this chapter we focus on **international diversification**—namely, the number and diversity of countries in which a firm competes (see also Chapter 6).

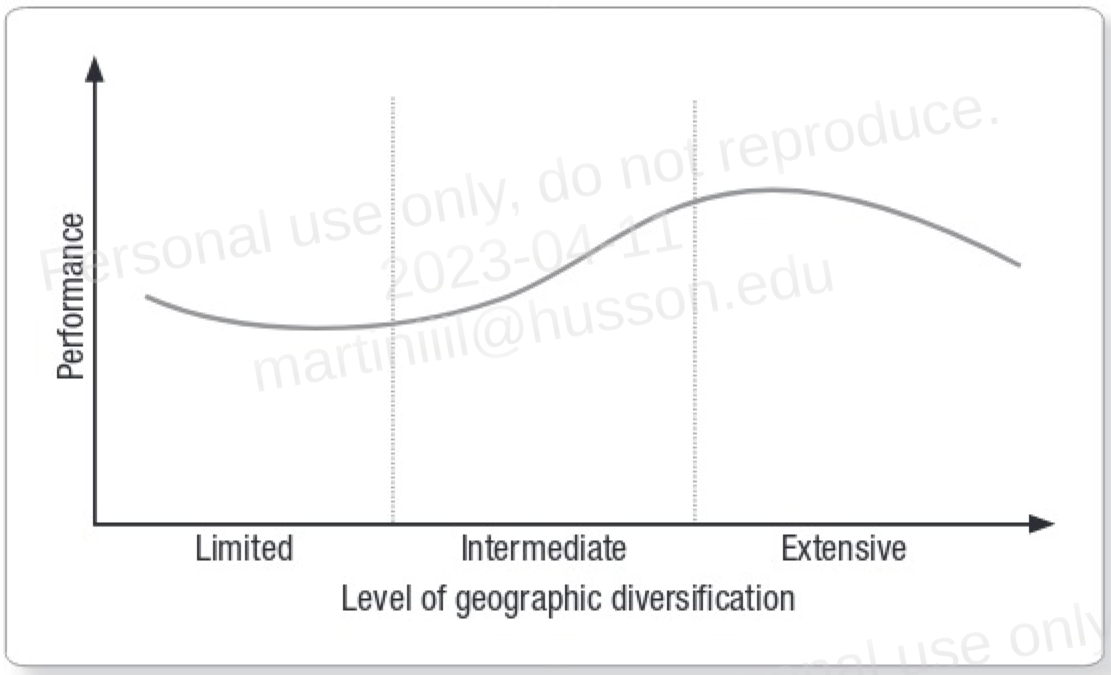
Limited versus Extensive International Scope

Two broad categories of geographic diversification can be identified. The first is limited international scope, such as US firms focusing on NAFTA markets and Spanish firms concentrating on Latin America. The emphasis is on geographically and culturally adjacent countries in order to reduce the liability of foreignness (see Chapters 4 and 6 for details). The second category is extensive international scope, maintaining a substantial presence beyond geographically and culturally neighboring countries. For example, the largest market for Yum! Brands (which operates KFC and Pizza Hut restaurants) is China. The largest market for Manpower (which provides part-time staff to employers) is France. While neighboring countries are not necessarily "easy" markets, success in distant countries obviously calls for a stronger set of advantages to compensate for the liability of foreignness there.

Geographic Diversification and Firm Performance

In this age of globalization, we frequently hear the calls for greater geographic diversification: All firms need to go "global," non-international firms need to start venturing abroad, and firms with a little international presence should widen their geographic scope. The ramifications for firms failing to heed such calls are presumably grave. However, the evidence is *not* fully supportive of this popular view. As captured by the S curve in Figure 9.2, two findings emerge. First, at a low level of internationalization, there is a U-shaped relationship between

FIGURE 9.2 Geographic Diversification and Firm Performance: An S Curve.



SOURCES: Adapted from (1) F. Contractor, S. Kundu, & C.-C. Hsu, 2003, A three-stage theory of international expansion: The link between multinationality and performance in the service sector (p. 7), *Journal of International Business Studies*, 34: 5–18; (2) J. Lu & P. Beamish, 2004, International diversification and firm performance: The S-curve hypothesis (p. 600), *Academy of Management Journal*, 47: 598–609.

geographic scope and firm performance, which suggests an initially negative effect of international expansion on performance before the positive returns can be realized. This stems from the well-known hazard of liability of foreignness (see Chapter 6). Second, at moderate to high levels of internationalization, there is an inverted U shape, implying a positive relationship between geographic scope and firm performance—but only to a certain extent, beyond which further expansion is again detrimental. In other words, the conventional wisdom—"the more global, the better"—is actually misleading.

Not all firms have been sufficiently involved overseas to experience the ups and downs captured by the S curve in Figure 9.2. Many studies report a U-shaped relationship, because they only sample firms in the early to intermediate stages of internationalization. Small, inexperienced firms are often vulnerable during the initial phase of overseas expansion. On the other hand, many other studies document an inverted U shape, because their samples are biased for larger firms with moderate to high levels of diversification. Many large multinational enterprises (MNEs) have a "flag planting" mentality, bragging about how many countries in which they have a presence. However, their performance, beyond a certain limit, often suffers, thus necessitating withdrawals. Wal-Mart, for example, had to withdraw from Germany, India, and South Korea.

Given this complexity, it is hardly surprising there is a great debate about geographic diversification.[9] Shown in Figure 9.2, there indeed is an intermediate range within which firm performance increases with geographic scope, leading some studies that sample firms in this range to conclude that "there is value in internationalization itself because geographic scope is found to be related to higher firm profitability."[10] However, other studies, which sample firms with a high level of geographic scope, caution that "multinational diversification is apparently less valuable in practice than in theory."[11] Consequently, the recent consensus emerging out of the debate is to not only acknowledge the validity of both perspectives, but also to specify conditions under which each perspective (geographic diversification *helps* or *hurts* firm performance) is likely to hold.[12]

COMBINING PRODUCT AND GEOGRAPHIC DIVERSIFICATION

Although most studies focus on a single dimension of diversification (product or geographic) that is already very complex, in practice, most firms (except single-business firms with no interest to internationalize) have to entertain both dimensions of diversification *simultaneously*.[13] Figure 9.3 illustrates the four possible combinations. Firms in Cell 3 are **anchored replicators**, because they focus on product-related diversification and a limited geographic scope. They seek to replicate a set of activities in related industries in a small number of countries anchored by the home country.

Firms in Cell 1 can be called **multinational replicators** because they engage in product-related diversification on the one hand and far-flung multinational expansion on the other hand. Most automakers such as Volkswagen, Renault, and Nissan have pursued this combination.

Firms in Cell 2 can be labeled as **far-flung conglomerates** because they pursue both product-unrelated diversification and extensive geographic diversification. MNEs such as Bombardier, GE, Mitsui, Samsung, Siemens, and Vivendi Universal serve as cases in point.

Finally, in Cell 4 we find **classic conglomerates**, which engage in product-unrelated diversification within a small set of countries centered on the home country. Current examples include India's Tata Group, Turkey's Koc Group, and China's Hope Group.

Migrating from one cell to another, although difficult, is possible. For instance, most of the current multinational replicators (Cell 1) can trace their roots as anchored replicators (Cell 3). One interesting migratory pattern in the last two decades is that many classic conglomerates, such as Denmark's Danisco and Finland's Nokia, which formerly dominated multiple unrelated industries in their home countries, have reduced their product scope but significantly expanded their geographic scope—in other words, migrating from Cell 4 to Cell 1.[14] In broad strategic terms, this means that the costs for doing business abroad have declined and that the costs for managing conglomeration have risen. In other words:

Costs in Cell 4 (managing conglomeration while mostly staying at home)	>	Costs in Cell 1 (doing business extensively abroad but maintaining product relatedness in diversification)

FIGURE 9.3 Combining Product and Geographic Diversification.

Geographic Scope	*Product Scope*: Related	*Product Scope*: Unrelated
Extensive	(Cell 1) *Multinational replicator*	(Cell 2) *Far-flung conglomerate*
Limited	(Cell 3) *Anchored replicator*	(Cell 4) *Classic conglomerate*

Further, asserting that firms in a particular cell will always outperform those in other cells is naïve if not foolhardy. In *every* cell, we can find both highly successful and highly unsuccessful firms. Next, we explore why this is the case.

A COMPREHENSIVE MODEL OF DIVERSIFICATION

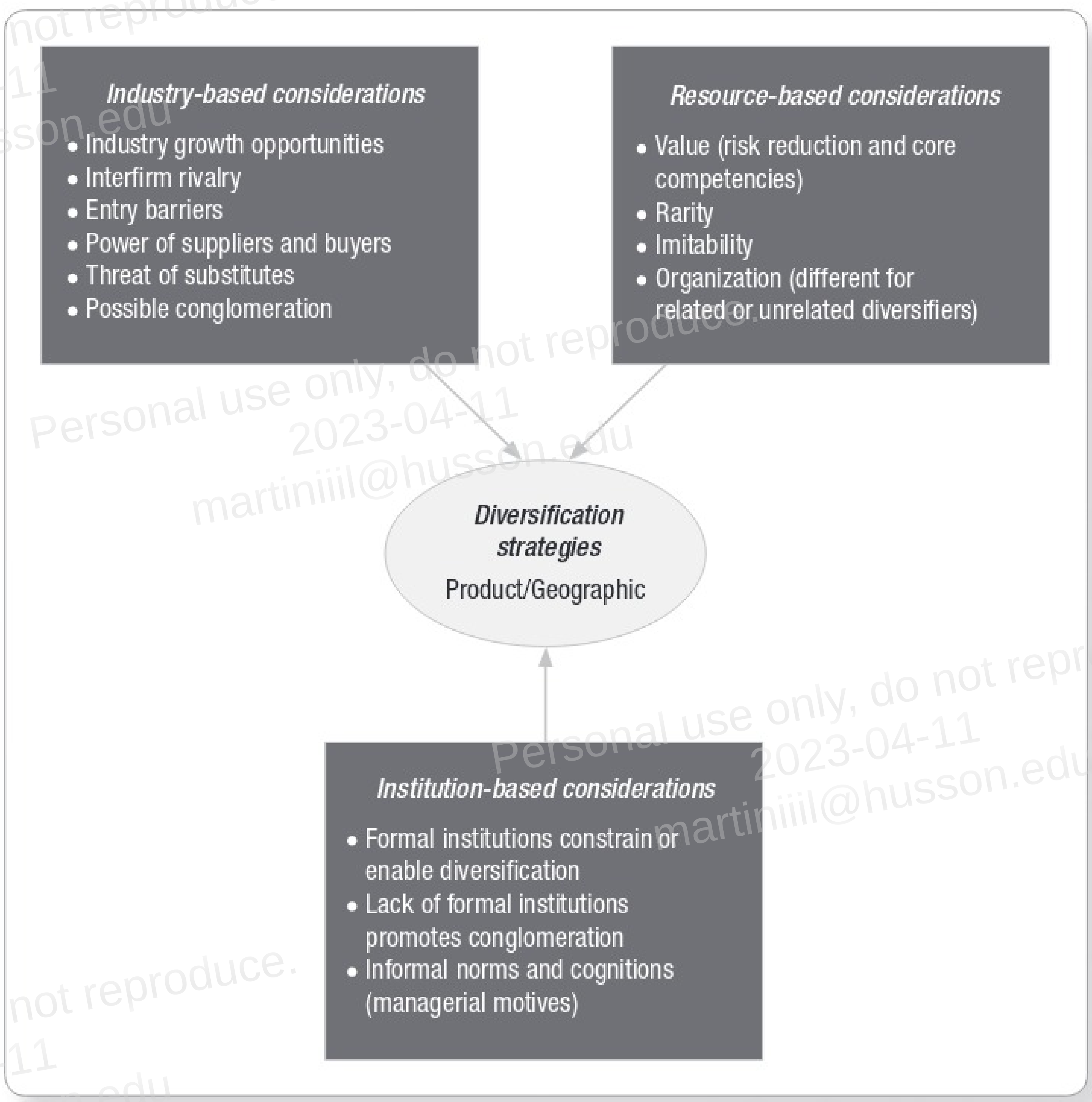
Why do firms diversify? The strategy tripod suggests a comprehensive model of diversification (Figure 9.4) to answer this complex and important question.

Industry-Based Considerations

A straightforward motivation for diversification is the growth opportunities in an industry. If an industry has substantial growth opportunities (such as biotechnology), most incumbents have an incentive to engage in product-related and/or international diversification. However, if it is a "sunset" industry (think of typewriters), many incumbents have to exit and pursue opportunities elsewhere.

In addition to growth opportunities, the structural attractiveness of an industry, captured by the five forces framework, also has a significant bearing on

FIGURE 9.4 A Comprehensive Model of Diversification.



diversification. Intense interfirm rivalry may motivate firms to diversify. PepsiCo diversified into sports drinks. When demand for carbonated beverages (such as Mountain Dew) flattened out, PepsiCo's considerable distribution capabilities could find some synergy by adding the newly acquired Gatorade products.

Second, high entry barriers facilitate certain kinds of firms to diversify. For example, most of the industries that Samsung successfully competed in—LCD and mobile phones—are characterized by high entry barriers. The new industries that Samsung has aggressively entered—such as solar panels and electric car batteries—share the same characteristics. The choices are not random. Samsung has deliberated targeted such capital-intensive industries that would scare away a lot of potential entrants due to high entry barriers.

The bargaining power of suppliers and buyers may prompt firms to broaden their scope, by acquiring suppliers upstream and/or buyers downstream. For example, Coca-Cola recently acquired its leading bottlers.

The threat of substitutes also has a bearing on diversification. Kodak and Fuji have been broadsided by Canon, Samsung, and HP, which diversified into digital cameras—a substitute for films. None of these electronics firms had been regarded as a rival by Kodak and Fuji until recently.

In summary, the industry-based view, by definition, has largely focused on product-related diversification with an industry focus (often in combination with geographic diversification). Next, we introduce resource-based and institution-based considerations to enrich this discussion.

Resource-Based Considerations

Value

Does diversification create value?[15] The answer is "Yes," but only under certain conditions.[16] Compared with non-diversified single-business firms, diversified firms are able to spread risk. Even for over-diversified firms that have to restructure, no one is returning to a single business with no diversification. The most optimal point tends to be some moderate level of diversification.

Beyond risk reduction, diversification can create value by leveraging certain core competencies and capabilities. Honda is renowned for its product-related diversification by leveraging its core competencies in internal combustion engines. It not only competes in automobiles and motorcycles, but also in boat engines and lawnmowers. HondaJet represents its most recent efforts. Will HondaJet fly high?

Rarity

For diversification to add value, firms must have rare and unique skills. Although acquirers from emerging economies generally have a hard time delivering value from their acquisitions, Lenovo, according to *Bloomberg Businessweek*, was able to "find treasure in the PC industry's trash" by turning around the former IBM PC division and using it to propel itself to become the biggest PC maker in the world (see the Opening Case).[17] Such skills are not only rare among emerging acquirers, but also rare among many established acquirers—think of the DaimlerChrysler fiasco (1998–2007).

Imitability

While many firms undertake acquisitions, a much smaller number of them have mastered the art of post-acquisition integration.[18] Consequently, firms that excel in integration possess *hard-to-imitate* capabilities. At Northrop, integrating acquired businesses has progressed to a "science." Each must conform to a carefully orchestrated plan listing nearly 400 items, from how to issue press releases to which accounting software to use. Unlike its bigger defense rivals such as Boeing and Raytheon, Northrop thus far has not stumbled with any of the acquisitions.

Organization

Fundamentally, whether diversification adds value boils down to how firms are organized to take advantage of the benefits while minimizing the costs.[19] Since Chapter 10 will be devoted to organizational issues in geographic diversification, here we focus on product diversification. Given the recent popularity of product-related diversification, many people believe that product-unrelated diversification is an inherently value-destroying strategy. However, this is not true. With proper organization, product-unrelated diversification can add value.

Shown in Table 9.2, product-related diversifiers need to foster a centralized organizational structure with a cooperative culture. The key is to explore operational linkages among various units, and some units may need to be pulled back to coordinate with other units. For example, to maximize corporate profits, Disney's movie division producing the movie *High School Musical* (and its sequels *High School Musical 2* and *3*) had to wait before launching the movie until its merchandise divisions were ready to hawk related merchandise, such as books, DVDs, video games, onstage musicals, ice-skating shows, Valentine's Day cards, blankets, and pillow covers. If movie managers' bonuses were linked to the annual box-office receipts, they would obviously be eager to release the movie. But if bonuses were linked with overall corporate profits, then movie managers would be happy to assist and coordinate with their merchandise colleagues and would not mind waiting for a while. Consequently, corporate headquarters should not evaluate division performance solely based on strict financial targets (such as sales). The principal control mechanism is **strategic control (or behavior control)**, based on largely subjective criteria to monitor and evaluate units' contributions with rich communication between corporate and divisional managers.

However, the best way to organize conglomerates is exactly the *opposite*. The emphasis is on **financial control (or output control)**, based on largely objective criteria (such as return on investment) to monitor and evaluate units' performance. Because most corporate managers have experience in only one (or a few) industry and none realistically can be an expert in the wide variety of unrelated industries represented in a conglomerate, corporate headquarters is forced to focus on financial control, which does not require a lot of rich industry-specific knowledge. Otherwise, corporate managers will experience a tremendous **information overload** (too much information to process). Consequently, the appropriate organizational structure is decentralization with substantial divisional autonomy—in other words, structurally separate units. To keep divisional managers focused on financial performance, their compensation should be directly linked with quantifiable unit performance. Thus, the relationship among various divisions is competitive, each trying to attract a larger share of corporate investments. Such competition within an internal capital market is similar to stand-alone firms competing for more funds from the external

TABLE 9.2 Product-Related versus–Unrelated Diversification.

	Product-Related Diversification	Product-Unrelated Diversification
Synergy	Operational synergy	Financial synergy
Economies	Economies of scale	Economies of scope
Control emphasis	Strategic (behavior) control	Financial (output) control
Organizational structure	Centralization	Decentralization
Organizational culture	Cooperative	Competitive
Information processing	Intensive rich communication	Less intensive communication

capital market. The Virgin Group, for example, considers itself as "a branded venture capital firm" whose portfolio includes airlines, railways, beverages, and music. The corporate headquarters supplies a common brand (Virgin) and leaves divisional managers "alone" as long as they deliver sound performance.

Overall, the key to adding value through either product-related or product-unrelated diversification is the appropriate match between diversification strategy and organizational structure and control. Conglomerates often fail when corporate managers impose a more centralized structure undermining lower-level autonomy.

Institution-Based Considerations

Formal Institutions

Formal institutions affect diversification strategies.[20] The rise of conglomerates in the 1950s and the 1960s in developed economies was inadvertently promoted by formal constraints designed to curtail product-related diversification. In the United States, the post-1950 antitrust authorities viewed product-related diversification (especially mergers), designed to enhance firms' market power within an industry, as "anticompetitive" and challenged them (see Chapter 8). Thus, firms seeking growth were forced to look beyond their industry, triggering a great wave of conglomeration. By the 1980s, the US government changed its mind and no longer critically scrutinized related mergers within the same industry. It is not a coincidence that the movement to dismantle conglomerates and focus on core competencies has taken off since the 1980s.

Similarly, the popularity of conglomeration in emerging economies is often underpinned by their governments' protectionist policies. Conglomerates (often called **business groups** in emerging economies) can leverage connections with governments by obtaining licenses, arranging financing (often from state-owned or state-controlled banks), and securing technology. As long as protectionist policies prevent significant foreign entries, conglomerates can dominate domestic economies. However, when governments start to dismantle protectionist policies, competitive pressures from foreign multinationals (as well as domestic non-diversified rivals) may intensify. These changes may force conglomerates to improve performance by reducing their scope.[21]

Likewise, the significant rise of geographic diversification undertaken by numerous firms can be attributed, at least in part, to the gradual opening of many economies initiated by formal marketing-supporting and market-opening policy changes (see Chapter 6).

Informal Institutions

Informal institutions can be found along normative and cognitive dimensions. Normatively, managers often seek to behave in ways that will not cause them to be noticed as different and consequently singled out for criticism by shareholders, board directors, and the media. Therefore, when the norm is to engage in conglomeration, more managers may simply follow such a norm. Poorly performing firms are especially under such normative pressures. While early movers in conglomeration (such as GE) may indeed have special skills and insights to make such a complex strategy work, many late movers probably do not have these capabilities and simply jump on the "bandwagon" when facing poor performance.[22] Over time, this explains—at least partially—the massive disappointment with conglomeration in developed economies.

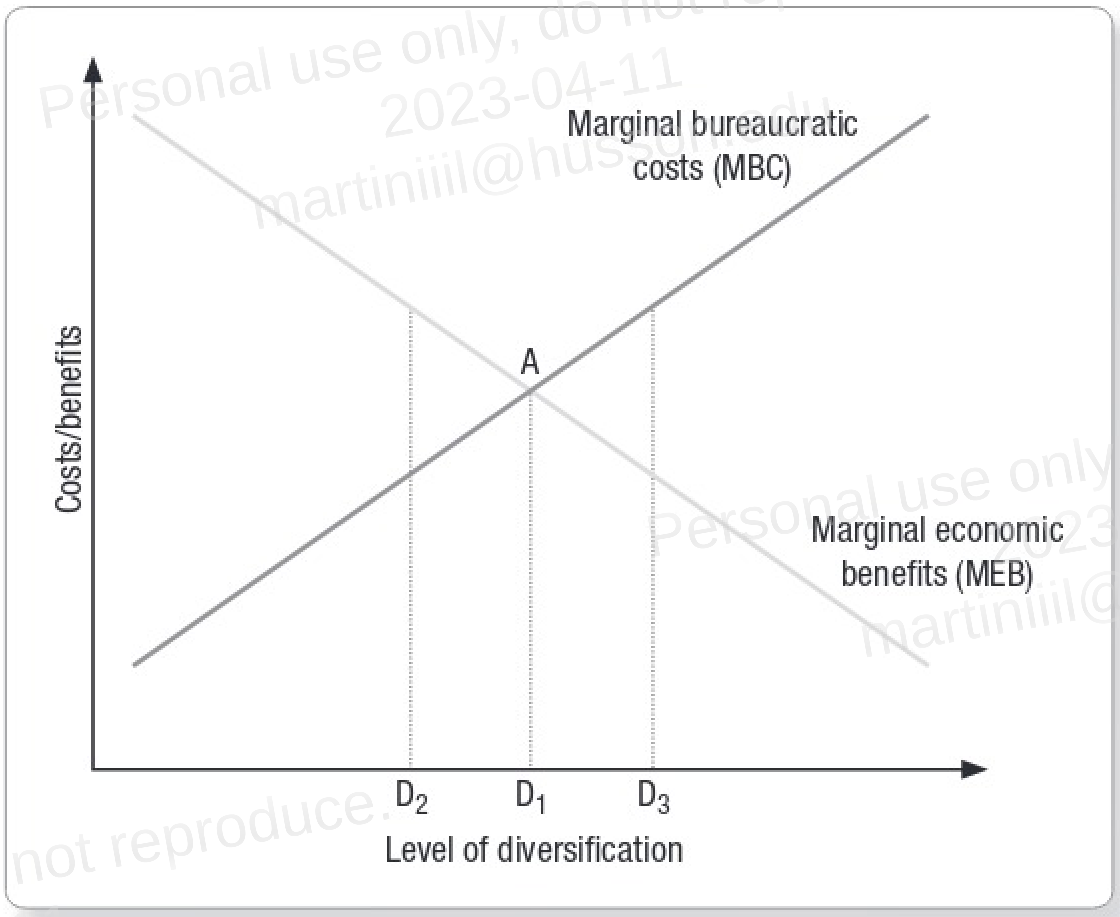
Another informal driver for conglomeration is the cognitive dimension—namely, the internalized beliefs that guide managerial behavior. Managers may have motives to advance their personal interests that are not necessarily aligned with the interests of the firm and its shareholders.[23] These are called managerial motives for diversification, such as (1) reduction of managers' employment risk and (2) pursuit of power, prestige, and income. Because single-business firms are vulnerable to economy-wide ups and downs (such as recessions), managers' jobs and careers may be at risk. Thus, managers may have an interest to diversify their firms in order to reduce their own employment risk. In addition, since power, prestige, and income are typically associated with a larger firm size, some managers may have self-interested incentives to over-diversify their firms, resulting in value destruction. Such excessive diversification is known as empire building (see Chapter 11).

In summary, the institution-based view suggests that formal and informal institutional conditions directly shape diversification strategy.[24] Taken together, the industry-based, resource-based, and institution-based views collectively explain how the scope of the firm evolves around the world.

The Evolution of the Scope of the Firm[25]

At its core, diversification is essentially driven by economic benefits and bureaucratic costs. **Economic benefits** are the various forms of synergy (operational or financial) discussed earlier. **Bureaucratic costs** are the additional costs associated with a larger, more diversified organization, such as more headcounts and more complicated information systems. Overall, it is the difference between the benefits and costs that leads to certain diversification strategies. Since the economic benefits of the last unit of growth (such as the last acquisition) can be defined as **marginal economic benefits (MEB)** and the additional bureaucratic costs incurred as **marginal bureaucratic costs (MBC)**, the scope of the firm is thus determined by a comparison between MEB and MBC. Shown in Figure 9.5, the optimal scope is at point A, where the appropriate level of diversification should be D_1. If the level of diversification is D_2, some economic benefits can be gained by moving up to D_1. Conversely,

FIGURE 9.5 What Determines the Scope of the Firm?



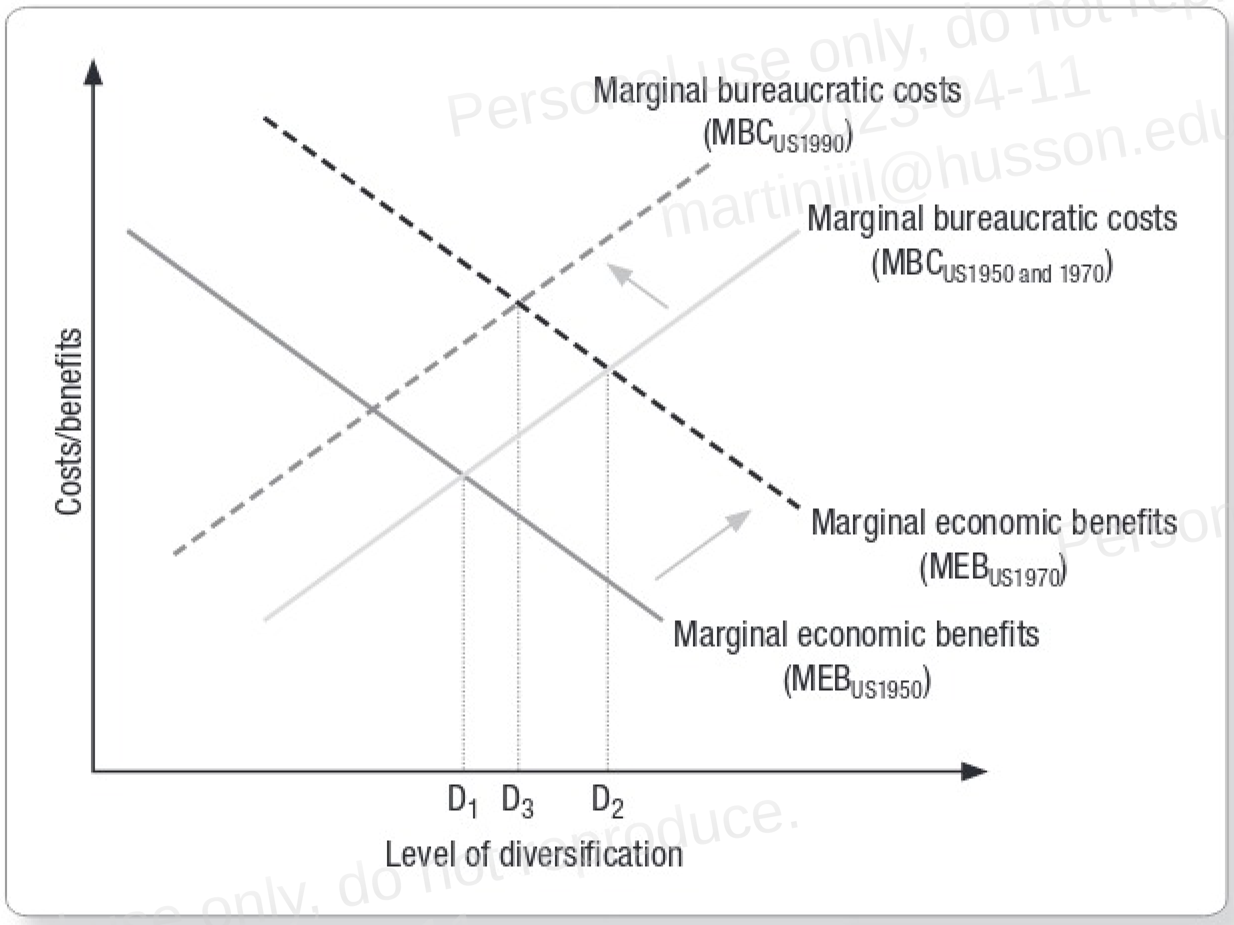
SOURCE: Adapted from G. Jones & C. Hill, 1988, Transaction cost analysis of strategy-structure choices (p. 166), *Strategic Management Journal*, 9: 159–172.

if a firm over-diversifies to D_3, reducing the scope to D_1 becomes necessary. Thus, how the scope of the firm evolves over time can be analyzed by focusing on MEB and MBC.[26]

In the United States (Figure 9.6), between the 1950s and the 1970s, if we hold MBC constant (an assumption relaxed later), the MEB curve shifted upward, resulting in an expanded scope of the firm on average (moving from D_1 to D_2). This is because (1) growth opportunities within the same industry through product-related diversification, especially for large firms, were blocked by formal institutions, such as antitrust policies; (2) the emergence of organizational capabilities to derive financial synergy from conglomeration; and (3) the diffusion of these actions through imitation, leading to an informal but visible norm among managers that such product-unrelated growth was legitimate. During that time, external capital markets, which were less sophisticated, were supportive, believing that conglomerates had an advantage in allocating capital.

However, by the early 1980s, significant transitions occurred along industry, resource, and institutional dimensions. First, M&As within the same industry were no longer critically scrutinized by the government, making it unnecessary to focus on unrelated diversification in different industries. Second, a resource-based analysis suggests that given the VRIO hurdles, it would be extremely challenging—though not impossible—to derive competitive advantage from conglomeration (see Table 9.2). In other words, with an expanded scope of the firm, MBC also increased, often outpacing the increase in MEB (Figure 9.6). Many firms over-diversified and destroyed value by operating beyond D_1 in Figure 9.5 (such as D_3). Consequently, a dramatic reversal in US investor sentiment occurred toward conglomeration: positive in the 1960s, neutral in the 1970s, and negative in the 1980s. Parallel to these developments, external capital markets became better developed, with more analysts and more transparent and real-time reporting, all of which allowed for more

FIGURE 9.6 The Evolution of the Scope of the Firm in the United States: 1950–1970 and 1970–1990.



SOURCE: M. W. Peng, S.-H. Lee, & D. Wang, 2005, What determines the scope of the firm over time? A focus on institutional relatedness (p. 627), *Academy of Management Review*, 30: 622–633.

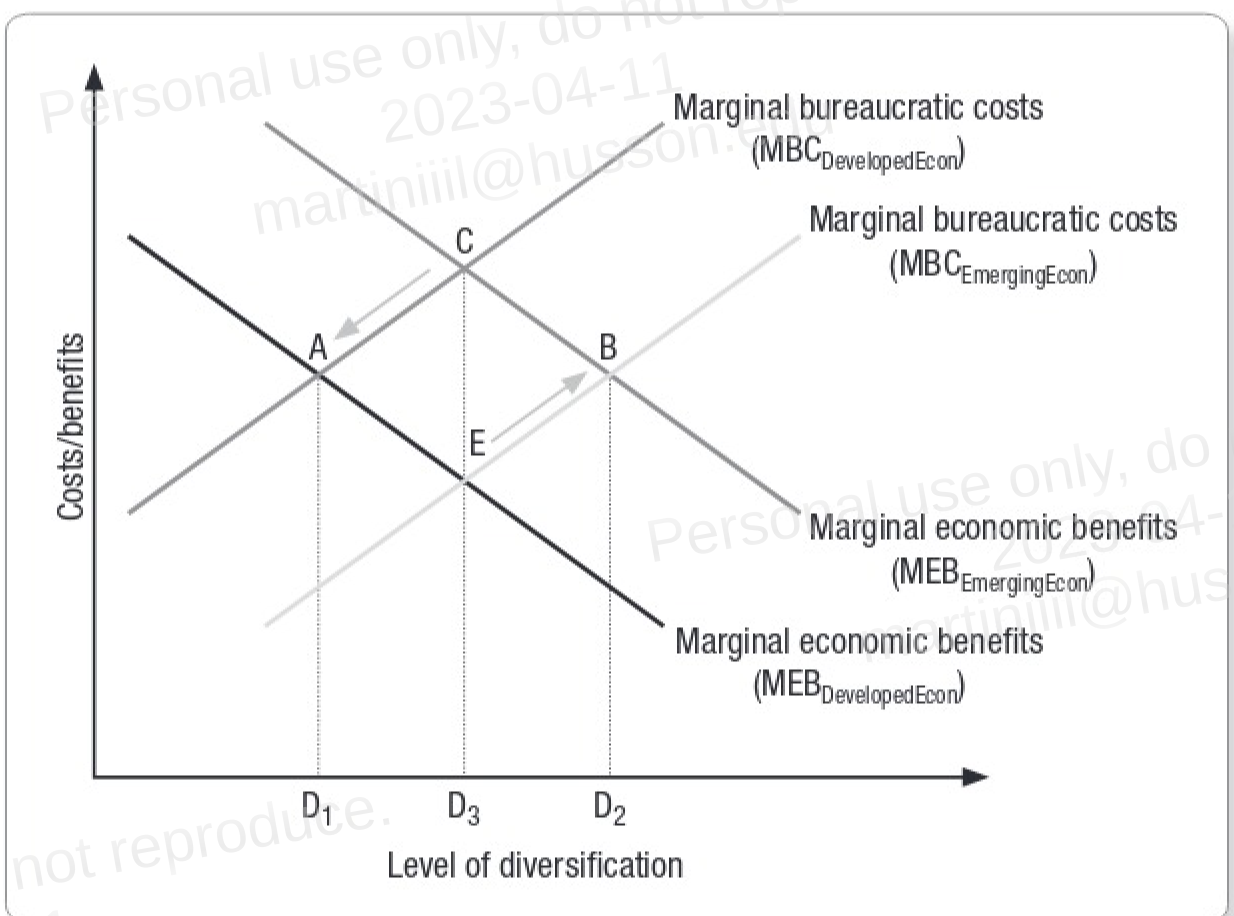
efficient channeling of financial resources to high-potential firms. As a result, the conglomerate advantage serving as an internal capital market became less attractive. Finally, informal norms and cognitions changed, as managers increasingly became more disciplined and focused on shareholder value maximization and believed that reducing the scope of the firm was the "right" thing to do. All these combined to push the appropriate scope of the firm from D_2 to D_3 in Figure 9.6 by the 1990s.

Globally, an interesting extension is to understand the puzzle as to why conglomeration, which has been recently discredited in developed economies, is not only in vogue, but also in some (but not all) cases adds value in emerging economies. Figure 9.7 shows how conglomerates in emerging economies may add value at a higher level of diversification, whereby firms in developed economies are not able to. This analysis relies on two crucial and reasonable assumptions. The first is that at a given level of diversification, $MEB_{EmergingEcon} > MEB_{DevelopedEcon}$. This is primarily because underdeveloped external capital markets in emerging economies make conglomerates as internal capital markets more attractive.

A second assumption is that at a given level of diversification, $MBC_{EmergingEcon} < MBC_{DevelopedEcon}$. In emerging economies, because of the weaknesses of formal institutions, informal constraints rise to play a *larger* role in regulating economic exchanges (see Chapter 4). Most conglomerates in these countries are family firms, whose managers rely more on informal personal (and often family) relationships to get things done. Relative to firms in developed economies, firms in emerging economies typically feature a lower level of bureaucratization, formalization, and professionalization, which may result in lower bureaucratic costs.

Consequently, for any scope between D_1 and D_2 (such as D_3) in Figure 9.7, firms in developed economies at point C need to be downscoped toward point A (D_1), whereas there is still room to gain for firms in emerging economies at point E, which can move up to point B (D_2). However, bear in mind that conglomerates in emerging economies confront the same problem that plagues those in developed

FIGURE 9.7 The Optimal Scope of the Firm: Developed versus Emerging Economies at the Same Time.



SOURCE: M. W. Peng, S.-H. Lee, & D. Wang, 2005, What determines the scope of the firm over time? A focus on institutional relatedness (p. 628), *Academy of Management Review*, 30: 622–633.

economies: The wider the scope, the harder it is for corporate headquarters to coordinate, control, and invest properly in different units. It seems evident that for conglomerates in emerging economies, there is also a point beyond which further diversification may backfire. In 1997, conglomerates in South Korea hit a wall, having diversified too much ranging from "missiles to noodles." The painful financial crisis forced some much-needed restructuring, which essentially pushed these conglomerates that had operated in a zone right of D_2 back to D_2 in Figure 9.7 (or, alternatively from D_3 to D_1 in Figure 9.5). Since 1997, the restructured and down-scoped conglomerates such as Samsung and LG have been able to scale new performance heights.[27]

Overall, industry dynamics, resource repertoires, and institutional conditions are not static, nor are diversification strategies. The next two sections describe acquisitions as a primary means for expanding the scope of the firm.

ACQUISITIONS

Setting the Terms Straight

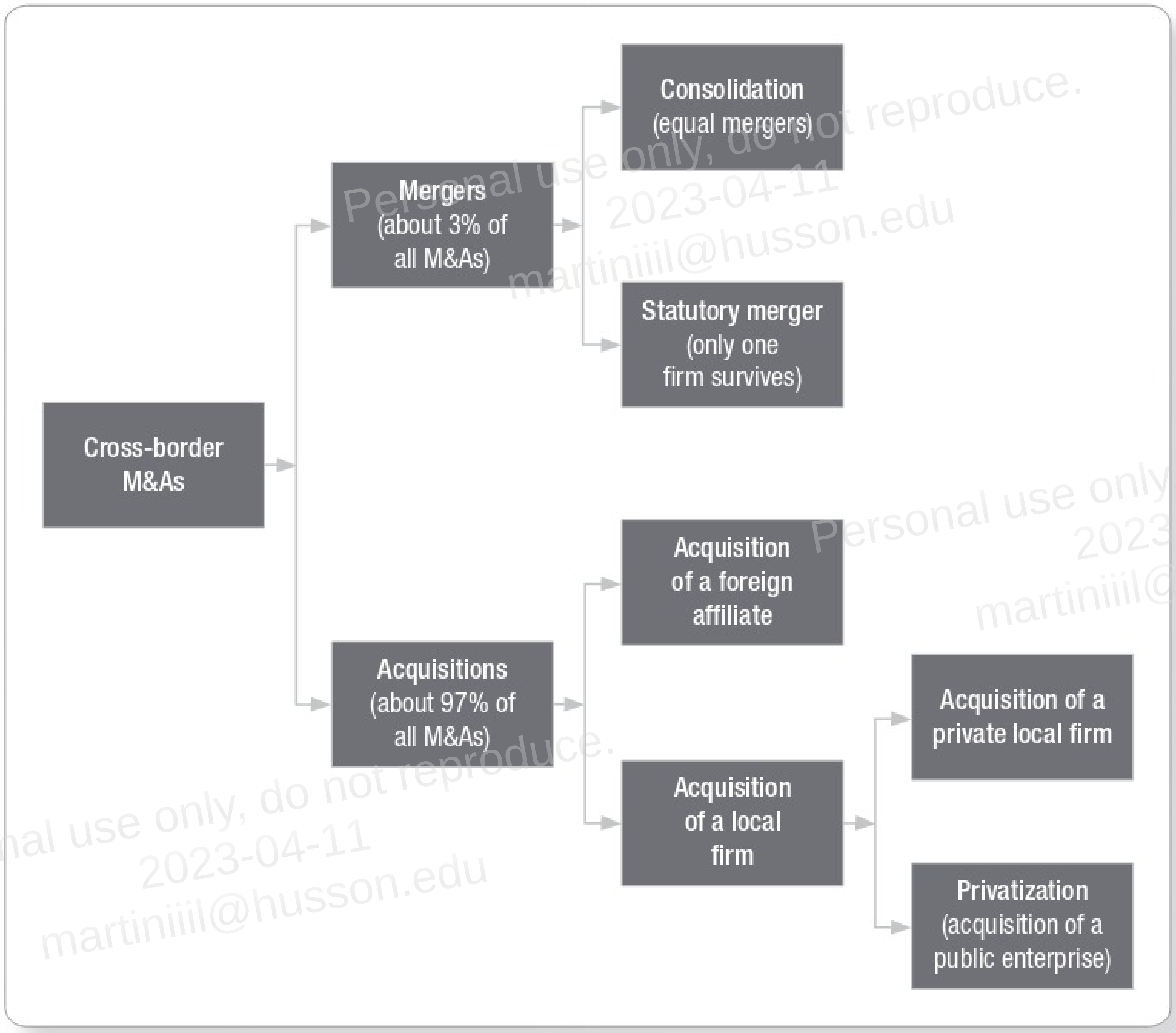
Although the term **"mergers and acquisitions" (M&As)** is often used, in reality, acquisitions dominate the scene. An **acquisition** is transfer of the control of assets, operations, and management from one firm (target) to another (acquirer), the former becoming a unit of the latter. For example, Volvo is now a unit of Geely. A **merger** is the combination of assets, operations, and management of two firms to establish a new legal entity. For instance, the merger of Fiat and Chrysler resulted in Fiat Chrysler Automobiles (FCA), a new entity.

Although the phrase "mergers and acquisitions" (M&As) is often used, in reality, acquisitions dominate the scene. In the 2010s, approximately 40% of M&As are cross-border deals. Twenty years ago, only about one-sixth were cross-border deals.[28] Of all cross-border M&As, only 3% are mergers. Even many so-called "mergers of equals" turn out to be one firm taking over another (such as DaimlerChrysler, 1998–2007). Because the number of "real" mergers is very low, for practical purposes, we can use the two terms, "M&As" and "acquisitions," interchangeably. Specifically, we focus on cross-border (international) M&As, whose various types are illustrated by Figure 9.8.

There are three primary categories of M&As: (1) horizontal, (2) vertical, and (3) conglomerate. **Horizontal M&As** refer to deals involving competing firms in the same industry (such as Nomura's acquisition of Lehman Brothers' assets).[29] Approximately 70% of the cross-border M&As are horizontal. **Vertical M&As**, another form of product-related diversification, are deals that allow the focal firms to acquire (upstream) suppliers and/or (downstream) buyers (such as Coca-Cola's acquisition of its bottler Coca-Cola Enterprises).[30] About 10% of cross-border M&As are vertical ones. **Conglomerate M&As** are transactions involving firms in product-unrelated industries (such as Siemens's acquisition of Denmark's Bonus Energy, which became Siemens Wind Power). Roughly 20% of cross-border M&As are conglomerate deals.

The terms of M&As can be friendly or hostile. In **friendly M&As**, the board and management of a target firm agree to the transaction. **Hostile M&As (also known as hostile takeovers)** are undertaken against the wishes of the target firm's board and management, who reject M&A offers. In the United States, hostile M&As are more frequent, reaching 14% of all deals in the 1980s (although the number went down to 4% in the 1990s). Internationally, hostile M&As are very rare, accounting for fewer than 0.2% of all deals and fewer than 5% of total value. The US$19 billion hostile takeover of Britain's Cadbury by America's Kraft in 2010 was a high-profile example of hostile cross-border M&A.

FIGURE 9.8 The Variety of Cross-Border Mergers and Acquisitions.



Motives for Mergers and Acquisitions

What drives M&A? Table 9.3 shows three drivers: (1) synergistic, (2) hubris, and (3) managerial motives, which can be illustrated by the three leading perspectives. In terms of synergistic motives, the most frequently mentioned industry-based rationale is to enhance and consolidate market power.[31] For example, the merger of United and Continental created the world's largest airline, which is called "United."

From a resource-based view, the most important synergistic rationale is to leverage superior resources.[32] Shown in the Opening Case, Indian firms' cross-border acquisitions have primarily targeted high-tech and computer services in order to leverage their superior resources in these industries. Finally, another motive is to gain access to complementary resources, as evidenced by Nomura's interest in Lehman Brothers' worldwide client base.[33]

In terms of synergistic motives, from an institution-based view, acquisitions are often a response to formal institutional constraints and transitions in search of synergy.[34] It is not a coincidence that the number of cross-border M&As has skyrocketed in the last two decades. This is the same period during which trade and investment barriers have gone down and FDI has risen.

While all the synergistic motives, in theory, add value, hubris and managerial motives reduce value. **Hubris** refers to managers' overconfidence in their

TABLE 9.3 Motives behind Mergers and Acquisitions.

	Industry-Based Issues	Resource-Based Issues	Institution-Based Issues
Synergistic motives	• Enhance and consolidate market power • Overcome entry barriers • Reduce risk • Leverage scope economies	• Leverage superior managerial capabilities • Access to complementary resources • Learning and developing new skills	• Respond to formal institutional constraints and transitions • Take advantage of market openings and globalization
Hubris motives		• Managers' overconfidence in their capabilities	• Herd behavior—following norms and chasing fads of M&As
Managerial motives			• Self-interested actions such as empire-building guided by informal norms and cognitions

capabilities.[35] Managers of acquiring firms make two very strong statements. The first is that "We can manage *your* assets better than you [target firm managers] can!" The second statement is even bolder, because acquirers of publicly listed firms always have to pay an **acquisition premium** (an above-the-market price to acquire another firm).[36] Acquirers of US firms on average pay a 20% to 30% premium, and acquirers of EU firms pay a slightly lower premium (about 18%).[37] This is essentially saying: "We are smarter than the market!"

To the extent that the capital market is (relatively) efficient and that market price of target firms reflects their intrinsic value,[38] there is simply no hope to profit from such acquisitions. Even when we assume the capital market to be inefficient, it is still apparent that when the premium is too high, acquiring firms must have overpaid. This is especially true when multiple firms bid for the same target, the winning acquirer may suffer from the "winner's curse" from auctions by overpaying. From an institution-based view, many managers join the acquisition "bandwagon," after some first-movers start doing deals in an industry. The fact that M&As come in "waves" speaks volumes about such a herd behavior.[39] Eager to catch up, late movers in such "waves" often rush in, prompted by a "Wow! Get it!" mentality. Not surprisingly, many deals go bust.

While the hubris motives suggest that managers may *unknowingly* overpay for targets, managerial motives posit that for self-interested reasons, some (although certainly not all) managers may have *knowingly* overpaid the acquisition premium for target firms. Driven by such norms and cognitions, some managers may have deliberately over-diversified their firms through M&As (see Chapter 11). After all, they use other people's (shareholders') money to fund acquisitions.

Overall, synergistic motives add value, and hubris and managerial motives destroy value. They may *simultaneously* coexist. The Opening Case uses emerging multinationals as a new breed of cross-border acquirers to illustrate these dynamics. Next, we discuss the performance of M&As.

Performance of Mergers and Acquisitions

Despite the popularity of M&As, their performance record is rather sobering.[40] As many as 70% of M&As reportedly fail. On average, the performance of acquiring firms does not improve after acquisitions.[41] Target firms, after being acquired and becoming internal units, often perform worse than when they were independent, standalone firms. The only identifiable group of winners is the shareholders of target firms, who may experience on average a 25% increase in their stock value—thanks to acquisition premium.[42] Shareholders of acquiring firms experience a 4% loss in their stock value during the same period. The combined wealth of shareholders of both acquiring and target firms is only marginally positive, less than 2%.[43] Unfortunately, many M&As destroy value.

Why do many acquisitions fail? Problems can be identified in both pre-acquisition and post-acquisition phases (Table 9.4).[44] During the pre-acquisition phase, because of executive hubris and/or managerial motives, acquiring firms may overpay targets—in other words, they fall into a "synergy trap." For example, in 1998, when Chrysler was profitable, Daimler-Benz paid US$40 billion, a 40% premium over its market value, to acquire it. Given that Chrysler's expected performance was already built into its existing share price, at a *zero* premium, Daimler-Benz's willingness to pay for such a high premium was indicative of (1) strong managerial capabilities to derive synergy, (2) high levels of hubris, (3) significant managerial self-interests, or (4) *all of the above*. As it turned out, by the time Chrysler was sold in 2007, it only fetched US$7.4 billion, destroying four-fifths of the value. In 2010, Microsoft paid US$8.5 billion to buy Skype, which was 400 times greater than Skype's income. Although practically every reader of this book has heard about Skype, Skype has remained an underachieving Internet icon—how many people have paid money to Skype each other? Not surprisingly, this acquisition, Microsoft's biggest, raised a lot of eyebrows.

Another primary pre-acquisition problem is inadequate screening and failure to achieve **strategic fit**, which is the effective matching of complementary strategic capabilities.[45] For example, Bank of America, in a hurry to make a deal, spent only 48 hours in September 2008 before agreeing to acquire Merrill Lynch for US$50 billion. Not surprisingly, failure to do adequate homework—technically, **due diligence** (thorough investigation prior to signing contracts)—led to numerous problems centered on the lack of strategic fit. Consequently, this acquisition was labeled by the *Wall Street Journal* as "a deal from hell."[46]

Acquiring international assets can be even more problematic because institutional and cultural distances can be even larger, and nationalistic concerns over foreign acquisitions may erupt (see the Opening Case). When Japanese firms acquired Rockefeller Center and movie studios in the 1980s and 1990s, the US media reacted with indignation. In the 2000s, when DP World from the United Arab Emirates and CNOOC from China attempted to acquire US assets, they had to back off due to political backlash.

Numerous integration problems may surface during the post-acquisition phase.[47] Defined as similarity in cultures, systems, and structures, **organizational fit** is just as important as strategic fit. Many acquiring firms do *not* bother to analyze organizational fit with targets. In 2008, when Nomura decided to acquire Lehman Brothers'

TABLE 9.4 Symptoms of Merger and Acquisition Failures.

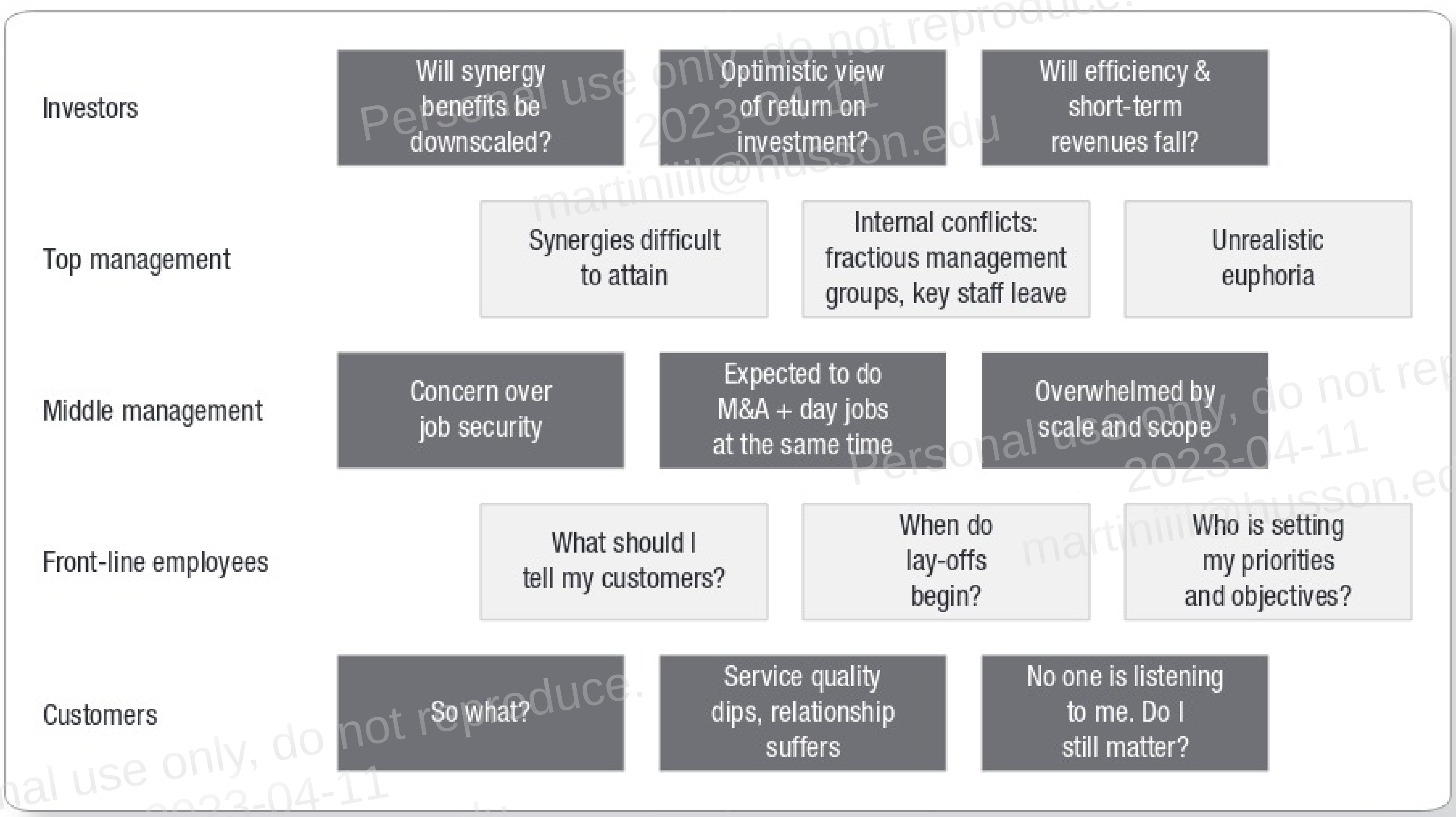
	Problems for All M&As	Particular Problems for Cross-Border M&As
Pre-acquisition: Overpayment for targets	• Managers overestimate their ability to create value • Inadequate pre-acquisition screening • Poor strategic fit	• Lack of familiarity with foreign cultures, institutions, and business systems • Inadequate number of worthy targets • Nationalistic concerns against foreign takeovers (political and media levels)
Post-acquisition: Failure in integration	• Poor organizational fit • Failure to address multiple stakeholder groups' concerns	• Clashes of organizational cultures compounded by clashes of national cultures • Nationalistic concerns against foreign takeovers (firm and employee levels)

assets in Asia and Europe in a lightning 24 hours, no consideration was given on the total lack of organizational fit between a hard-charging New York investment bank and a conservative, seniority-based Japanese firm still practicing lifetime employment. Firms may also fail to address the concerns of multiple stakeholders, including job losses and diminished power (see Figure 9.9). Most firms focus on task issues such as standardizing reporting and pay inadequate attention to people issues, which typically results in low morale and high turnover.[48]

In cross-border M&As, integration difficulties may be much worse because clashes of organizational cultures are compounded by clashes of national cultures.[49] Due to cultural differences, Chinese acquirers (such as Geely) often have a hard time integrating Western firms (such as Volvo). But even when both sides are from the West, cultural conflicts may still erupt. When Four Seasons acquired a hotel in Paris, the simple American request that employees *smile* at customers was resisted by French employees and laughed at by the local media as "la culture Mickey Mouse." After Alcatel acquired Lucent, the situation, in the words of *Bloomberg Businessweek*, became "almost comically dysfunctional."[50] At an all-hands gathering at an Alcatel-Lucent European facility, employees threw fruits and vegetables at executives announcing another round of restructuring.

Although acquisitions are often the largest capital expenditures most firms ever make, they frequently are the worst-planned and worst-executed activities of all.[51] Unfortunately, while merging firms are sorting out the mess, rivals are likely to launch aggressive attacks. When Daimler struggled first with the chaos associated with the marriage with Chrysler (1998) and then was engulfed in the divorce with Chrysler (2007), BMW overtook Mercedes-Benz to become the world's number-one luxury carmaker. Adding all of the above together, it is hardly surprising that most M&As fail.

FIGURE 9.9 Stakeholder Concerns during Mergers and Acquisitions.



Restructuring

Every acquisition deal entails at least two parties: an acquirer (buyer) and a seller. Why is the seller motivated to sell? A simple answer is that the seller is interested in restructuring by selling some of its units to an acquirer. Although the term "**restructuring**" normally refers to adjustments to firm size and scope through either diversification (expansion or entry), divestiture (contraction or exit), or both,[52] its most common definition is *reduction* of firm size and scope—we will adopt this more frequently used definition here. Using this definition, there are two primary ways of restructuring: (1) **downsizing** (reducing the number of employees through lay-offs, early retirements, and outsourcing), and (2) **downscoping** (reducing the scope of the firm through divestitures and spin-offs). The flipside of downscoping is **refocusing**, namely, narrowing the scope of the firm to focus on a few areas.

DEBATES AND EXTENSIONS

Diversification and acquisitions have no shortage of controversies. The two leading debates discussed here are (1) product relatedness versus other forms of relatedness, and (2) acquisitions versus alliances.

Product Relatedness versus Other Forms of Relatedness

What exactly is relatedness? While product relatedness (such as HondaJet) is seemingly straightforward, it has attracted at least three significant points of contention. First, how to actually measure product relatedness remains debatable. Starbucks sells music CDs in its coffee shops. Are coffee and music related? The answer would be both "yes" and "no," depending on how you measure relatedness. One interesting quiz is: How do we characterize Sony's product relatedness? Most of us think of Sony as a manufacturer of electronics hardware (such as TV) and software (such as games) as well as a producer of entertainment content (such as movies and music). But all of the above make little or lose money in recent years. What has sustained Sony is its seldom-reported and (almost totally) unrelated business in life insurance. So a sarcastic answer to the question, "What is Sony?" can be that Sony is a life insurer that makes TVs as a *hobby* (!).[53]

Second, beyond measurement issues, an important school of thought, known as the "**dominant logic**" school, argues that it is not the visible product linkages that can only count as product relatedness. Rather, it is a set of common underlying dominant logic that connects various businesses in a diversified firm.[54] Consider Britain's easyGroup, which operates easyJet (airline), easyCinema, and easyInternetcafe, among others. Underneath its conglomerate skin, a dominant logic is to actively manage supply and demand. Early and/or non-peak-hour customers get cheap deals (such as 20 cents a movie), and late and/or peak-hour customers pay a lot more. Charges at Internet cafés rise as seats fill up. While many firms (such as airlines) practice such "yield management," none has been so aggressive as the easyGroup. Thus, instead of treating the easyGroup as an "unrelated conglomerate," perhaps we may label it a "related yield management firm."

Finally, from an institution-based view, some "product-unrelated" conglomerates may be linked by **institutional relatedness**, defined as "a firm's informal linkages with dominant institutions in the environment that confer resources and legitimacy."[55] For example, sound informal relationships with government agencies, in countries (usually emerging economies) where such agencies control crucial resources such as licensing and financing, would encourage firms to leverage such relationships by entering multiple industries. In emerging economies, solid connections with banks—a crucial financial institution—may help raise financing to enter multiple industries, whereas stand-alone entrepreneurial start-ups without such connections often have a hard time securing financing. This idea helps explain why in developed economies, e-commerce is dominated by new start-ups (such as Amazon), whereas in emerging economies it is dominated by new units of old-line conglomerates (such as Hong Kong's Wharf). It seems that despite the Western advice to downscope, some conglomerates in emerging economies have recently *expanded* their scope by entering new industries such as solar panels. In other words, a firm, which is classified as a "product-unrelated" conglomerate, may actually enjoy a great deal of institutional relatedness.

Acquisitions versus Alliances

Despite the proliferation of acquisitions, their lackluster performance has led to a debate regarding whether they have been overused. Strategic alliances are an alternative to acquisitions (see Chapter 7). However, many firms seem to have plunged straight into "merger mania." HP, IBM, Microsoft, and Oracle are known as "rapid-fire" acquirers, often swallowing a dozen firms in any given year. Even when many firms pursue both M&As and alliances, they are often undertaken in isolation.[56] While many large MNEs have an M&A function and some have set up an alliance function, few firms have established a combined "mergers, acquisitions, *and* alliance" function. In practice, it may be advisable to explicitly compare and contrast acquisitions vis-à-vis alliances. Compared with acquisitions, alliances, despite their own problems, cost less and allow for opportunities to learn from working with each other before engaging in full-blown acquisitions. Many poor acquisitions (such as DaimlerChrysler) would probably have been better off had firms pursued alliances first. On the other hand, Fiat and Chrysler, having worked together as alliance partners, may have better odds to have an enduring relationship together as Fiat Chrysler Automobiles.

THE SAVVY STRATEGIST

Guided by the three leading perspectives underpinning the strategy tripod, the savvy strategist draws three important implications for action (Table 9.5). First, understand the nature of your industry that may call for diversification, acquisitions, and restructuring. In some "sunset" industries, diversifying out of them is a must. In new hot-growth industries and countries, new entrants often feel compelled to acquire in order to ensure a timely presence.

Second, you and your firm need to develop capabilities that facilitate successful diversification and acquisitions, by following the suggestions outlined in Table 9.6. These would include do not overpay for targets and focus on both strategic and organizational fit. Refusing to let the bidding war go out of hand and admitting failure in proposed deals by walking away are painful but courageous. Around the world, between 10% and 20% of the proposed deals collapse.[57] Despite the media hoopla about the "power" of emerging multinationals from China, in reality more than half of their announced deals end in tears. Indian multinationals do better, but still one-third of their deals cannot close (see the Opening Case). This is not a problem that only affects emerging acquirers. Experienced acquirers such as AT&T, News Corporation, and Pfizer, respectively, withdrew from their multi-billion dollar deals to acquire T-Mobile, Time Warner, and AstraZeneca recently. Given that 70% of

TABLE 9.5 Strategic Implications for Action.

- Understand the nature of your industry that may call for diversification and acquisitions.
- Develop capabilities that facilitate successful diversification and acquisitions.
- Master the rules of the game governing diversification and acquisitions around the world.

TABLE 9.6 Improving the Odds for Acquisition Success.

Areas	Do's and Don'ts
Pre-acquisition	• Do not overpay for targets and avoid a bidding war when premiums are too high. • Engage in thorough due diligence concerning both strategic fit and organizational fit.
Post-acquisition	• Address the concerns of multiple stakeholders and try to keep the best talents. • Be prepared to deal with roadblocks thrown out by people whose jobs and power may be jeopardized.

acquisitions fail and that integration challenges loom large down the road even if deals close, acquisitions that fail to close may sometimes be a blessing in disguise.

Finally, you need to master the rules of the game governing acquisitions around the world.[58] When negotiating its acquisition of IBM's PC assets, Lenovo clearly understood and tapped into the Chinese government's support for homegrown multinationals. IBM likewise understood the necessity for the new Lenovo to maintain an American image when it persuaded Lenovo to set up a second headquarters in the United States. This highly symbolic action made it easier to win approval from the US government. In contrast, GE and Honeywell proposed to merge and cleared US antitrust scrutiny, but failed to anticipate the EU antitrust authorities' incentive to kill the deal.[59] In the end, the EU torpedoed the deal. The upshot is that, in addition to the economics of diversification and acquisitions, managers must pay attention to the politics behind such high-stakes strategic moves.

In terms of the four most fundamental questions, this chapter directly answers Question 3: What determines the scope of the firm?[60] Industry conditions, resource repertoire, and institutional frameworks shape corporate scope. In addition, why firms differ (Question 1) and how firms behave (Question 2) boil down to why and how they choose different diversification strategies. Finally, what determines the international success and failure of firms? The answer lies in whether they can successfully overcome the challenges associated with diversification and acquisitions.

CHAPTER SUMMARY

1. Define product diversification and geographic diversification
   - Product-related diversification focuses on operational synergy and scale economies.
   - Product-unrelated diversification (conglomeration) stresses financial synergy and scope economies.
   - Geographically diversified firms can have a limited or extensive international scope.
   - Most firms pursue product and geographic diversification simultaneously.
2. Articulate a comprehensive model of diversification
   - The strategy tripod suggests industry-based, resource-based, and institution-based factors for diversification.
3. Gain insights into the motives and performance of acquisitions
   - Most M&As are acquisitions.
   - M&As are driven by (1) synergistic, (2) hubris, and/or (3) managerial motivations.
   - Restructuring involves downsizing, downscoping, and refocusing.

4. Participate in two leading debates concerning diversification and acquisitions
   - (1) Product relatedness versus other forms of relatedness and (2) acquisitions versus alliances.
5. Draw strategic implications for action
   - Understand the nature of your industry that may call for diversification and acquisitions.
   - Develop capabilities that facilitate successful diversification and acquisitions.
   - Master the rules of the game governing diversification and acquisitions around the world.

CRITICAL DISCUSSION QUESTIONS

1. M&As are a rare event for most firms. How can they enhance their capabilities for M&As?
2. ***ON ETHICS***: As a CEO leading an acquisition of a foreign firm (think of Anheuser-Busch or Cadbury), you are interviewed by a reporter from the host country. The reporter asks: "A lot of people in our country are mad about this foreign takeover of our iconic company. How would you alleviate their concerns?"
3. ***ON ETHICS***: CEOs' pay is typically linked to the size of their firms. Some argue that CEOs have an inherent bias in favor of undertaking M&As using shareholders' money. Do you agree or disagree with this view?

TOPICS FOR EXPANDED PROJECTS

1. Some argue that shareholders can diversify their stockholdings and that there is no need for corporate diversification to reduce risk. The upshot is that any excess earnings (known as "free cash flows") should be returned to shareholders as dividends. Do you agree or disagree with this statement? Why?
2. Unrelated product diversification (conglomeration) is widely discredited in developed economies. However, in some cases it still seems to add value in emerging economies—think of Samsung and Tata. Is this interest in conglomeration likely to hold or decrease in emerging economies over time? Why?
3. ***ON ETHICS:*** As a CEO, you are trying to decide whether to acquire a foreign firm. The size of your firm will double after this acquisition and it will become the largest in your industry. On the one hand, you are excited about the opportunities to be a leading captain of industry and the associated power, prestige, and income (you expect your income to double next year). On the other hand, you have just read this chapter and are troubled by the 70% M&A failure rate. How would you proceed?

CLOSING CASE 9.1

Emerging Markets: Emerging Acquirers from China and India

Multinational enterprises (MNEs) from emerging economies, especially China and India, have emerged as a new breed of acquirers around the world. Provoking "oohs" and "ahhs," they have grabbed media headlines and caused controversies. Anecdotes aside, what are the patterns of these new global acquirers? How do they differ? Only recently has rigorous academic research been conducted to allow for systematic comparison (Table 9.1).