Chapter 9

Corporate Strategy – Horizontal Integration, Vertical Integration, and Strategic Outsourcing
Strategy in Action

Oracle Strives to become biggest and best.

Corporate-Level Strategy

Corporate-Level Strategy should allow a company, or its business units, to perform the value-creation functions at lower cost or in a way that allows for differentiation and premium price.

Corporate strategy is used to identify:
1. Businesses or industries that the company should compete in
2. Value creation activities that the company should perform in those businesses
3. Method to enter or leave businesses or industries in order to maximize its long-run profitability

Companies must adopt a long-term perspective Consider how changes in the industry and its products, technology, customers, and competitors will affect its current business model and future strategies.

Repositioning and Redefining A Company's Business Model

Corporate-level strategies are primarily directed toward improving a company's competitive advantage and profitability in its present business or product line:

- Horizontal Integration
  • The process of acquiring or merging with industry competitors
- Vertical Integration
  • Expanding operations backward into an industry that produces inputs for the company or forward into an industry that distributes the company's products
- Strategic Outsourcing
  • Letting some value creation activities within a business be performed by an independent entity

Opening Case

News Corp. Forges Ahead
Overview

- **Horizontal integration**
  - The process of acquiring or merging with industry competitors
  - Acquisition and merger

- **Vertical integration**
  - Expanding operations backward into an industry that produces inputs for the company or forward into an industry that distributes the company's products

- **Strategic outsourcing**
  - Letting some value creation activities within a business be performed by an independent entity

Benefits of Horizontal Integration

**Profits and profitability increase when horizontal integration:**

1. **Reduces the cost structure**
   - Creates increasing economies of scale
   - Reduces the duplication of resources between two companies

2. **Increases product differentiation**
   - Product bundling — broader range at single combined price
   - Cross-selling — leveraging established customer relationships
   - Cross-selling

3. **Replicates the business model**
   - In new market segments within the same industry

4. **Reduces industry rivalry**
   - Eliminate excess capacity in an industry
   - Easier to implement tacit price coordination among rivals

5. **Increases bargaining power**
   - Increased market power over suppliers and buyers
   - Gain greater control

Drawbacks and Limits of Horizontal Integration

- Majority of mergers and acquisitions do not create value
- Implementing a horizontal integration strategy is not easy
- Mergers and acquisitions often fail to produce the anticipated gains
- Can bring the company into conflict with antitrust law

Increasing Profitability Through Vertical Integration

- Building barriers to entry
- Facilitating investments in specialized assets
- Protecting product quality
- Improved scheduling

Real World

- "Bombardier"
Film

- Domino's

Running Case

- Wal-mart's Chain of "Neighborhood Markets"

Strategy in Action

- McDonald's a Leader at Vertical Integration

Strategy in Action

- Specialized Assets and Vertical Integration in the Aluminum Industry

Benefits of Outsourcing

- Reducing costs
  - The specialist company is less than what it would cost to perform the activity internally
- Differentiation
  - The quality of the activity performed by the specialist is greater than if the activity were performed by the company
- Focus
  - Distractions are removed; the company can focus attention and resources on activities important for value creation and competitive advantage
Real World

△ Luxottica Agrees $400M Deal to Buy Cole National Chain of Stores

“Have Dealmakers Wised Up?”

Real World

△ “Buying Spree By China Firms is a Bet on Value of US Brands”

Closing Case

△ Beating Dell

End of Lecture 9
Oracle Strives to Become the Biggest and the Best

Oracle Corporation, based in Redwood City, California, is the world's largest maker of database software and the third-largest global software company after Microsoft and IBM. This commanding position is not enough for Oracle, however, which has set its sights on becoming the global leader in the corporate applications software market. In this market, Germany's SAP, with 45% of the market, is the acknowledged leader, and Oracle, with only 19%, is a distant second. Corporate applications is a fast growing and highly profitable market, however, and Oracle has been snapping up leading companies in this segment.

Its goal is to quickly build the distinctive competencies needed to expand the range of products that it can offer to its existing customers and attract new customers to compete with SAP. Beginning in 2005, Oracle's CEO Larry Ellison spent $19 billion to acquire 14 leading suppliers of corporate software, including two of the top five companies: PeopleSoft, a leading human resource management (HRM) software supplier it bought for $10 billion, and Siebel Systems, a leader in customer relationship management (CRM) software, which cost Oracle $5.8 billion.

Oracle expects several competitive advantages to result from its use of acquisitions to pursue the corporate strategy of horizontal integration. First, it is now able to meld or bundle the best software applications of these acquired companies—with Oracle's own first-class set of corporate and database software programs—to create a new integrated software suite that will allow companies to manage all their functional activities, such as accounting, marketing, sales, HRM, CRM, and supply-chain management. Second, through these acquisitions, Oracle obtained access to thousands of new customers—the companies that use the software of the companies it acquired. All these companies now become potential customers for all of Oracle's other database and corporate software offerings. Third, beyond increasing the range of its products and number of its customers, Oracle's acquisitions have consolidated the corporate software industry. By taking over some of its largest rivals, Oracle has become the second-largest supplier of corporate software and is better positioned to compete with leader SAP.
News Corp Forges Ahead

News Corp CEO Rupert Murdoch engineered acquisition or divestiture decisions for more than 50 years.

Murdoch has created one of the four largest and most powerful entertainment media companies in the world. What kinds of strategic decisions did Murdoch use to create his media empire? Murdoch was born into a news family; his father owned and published the Meacham News, a small, local newspaper in his hometown. When his father died in 1932, Murdoch took control. He quickly enlarged the customer base by acquiring more Australian newspapers. One of these had connections to a major British Rupert Murdoch newspaper and Murdoch used a sensational National Enquirer-like business model to establish his new newspaper, the Sun, as a leader in British tablons.
Murdoch’s reputation as an entrepreneur grew because he showed that he could create a much higher return (ROIC) on the media assets he controlled than his competitors. This enabled him to borrow increasing amounts of money, which he used to buy well-known newspapers such as the British Sunday Telegraph and then his first United States newspaper, the San Antonio Express. Pursuing his sensational business model further, he launched the National Star. His growing profits and reputation allowed him to continue to borrow money, and in 1977, he bought the New York Post. Four years later, in 1981, he engineered a new coup when he bought the Times and Sunday Times, Britain’s leading conservative publications—a far cry from the Sun tabloid.

Murdoch’s strategy of horizontal integration through mergers allowed him to create one of the world’s biggest newspaper empires. He realized, however, that industries in the entertainment and media sector can be divided into those that provide media content or “software” (newspapers, movies, and television programs) and those that provide the media channels or “hardware” necessary to bring software to customers (movie theaters, TV channels, TV cable, and satellite broadcasting). Murdoch decided that he could create the most profit by becoming involved in both the media software and hardware industries, that is, the entire value chain of the entertainment and media sector. This strategy of vertical integration gave him control over all the different industries, joined together like links in a chain that converted inputs such as stories into finished products like newspapers, books, TV shows, and movies.

In the 1980s, Murdoch began purchasing global media companies in both the software and hardware stages of the entertainment sector. He also launched new ventures of his own. For example, sensing the potential of satellite broadcasting, in 1983 he launched Sky, the first satellite TV channel in the United Kingdom. He also began a new strategy of horizontal integration by purchasing companies that owned television stations; for Metromedia, which owned seven stations that reached more than 20% of United States households, he paid $1.5 billion. He scored another major coup in 1985 when he bought Twentieth Century Fox Movie Studios, a premium content provider. As a result, he had Fox’s huge film library and its creative talents to make new films and TV programming.

In 1986, Murdoch decided to create the FOX Broadcasting Company and buy or create his own United States network of FOX affiliates that would show programming developed by his own FOX movie studios. After a slow start, the FOX network gained popularity with sensational shows like The Simpsons, which was FOX’s first blockbuster program. Then, in 1994, FOX purchased the sole rights to broadcast all NFL games for more than $1 billion, thereby shutting out NBC. FOX became the “fourth network,” which has forged and, with Murdoch’s sensational business model, was one of the first to create the “reality” programming that has proved so popular in the 2000s.

By 2005, Murdoch’s business model, based on strategies of horizontal and vertical integration, had created a global media empire. The company’s profitability has ebbed and flowed because of the massive debt needed to fund Murdoch’s acquisitions, debt that had frequently brought his company near to ruin. However, in 2009, his company is still a market leader because he engineered many new Internet acquisitions, such as MySpace, Renes Tomatoes, and other popular Web sites that he has used to create even more value from his media assets.  

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Bombardier is one of the great business success stories to come out of Canada in the second half of the twentieth century. A manufacturer of transportation equipment, including snowmobiles, railcars, and jet aircraft of seventy seats or less, the company has grown from sales of $10 million in the mid 1960s to around $7 billion in 1999, and it has posted consistent year-on-year growth in revenues and earnings. The key to this growth has been successful diversification.

Established in 1942 as a manufacturer of snowgoing equipment (tracked vehicles for crossing snow, such as snow cats), Bombardier expanded into the closely related market of snowmobiles in the 1960s. As oil prices surged in the early 1970s because of action by the Organization of Petroleum Exporting Countries (OPEC), demand for snowmobiles plummeted. Bombardier’s response was to diversify into the manufacture of railcars. Laurent Beaudoin, the company’s CEO for a thirty-three-year period that ended in 1999, reasoned that Bombardier’s engineering skills and manufacturing capacity could be quickly converted from the manufacture of snowmobiles to the manufacture of railcars.

In a make-or-break gamble, he purchased a French license for a subway car design and boldly bid on, and won, a huge contract to build cars for the Montreal subway system. This contract was followed by a 1982 deal to build 825 cars for the New York subway system. Today, Bombardier builds cars for mass-transit systems on four continents, ranking number two in the world railcar market. It also produces freight cars and locomotives. The railcar and locomotive business now accounts for around one-quarter of the company’s business.

The next diversification move came in 1986, when Bombardier purchased Canadair from the Canadian government for what many viewed as a bargain basement price. A struggling manufacturer of small regional aircraft, Canadair had been saved from total collapse when it was bought by the Canadian government. The key asset that interested Bombardier was the design and manufacturing
technology behind Canadair's small corporate jet, the Challenger. Shortly after the acquisition, Bombardier invested an amount equivalent to half the market capitalization of the company to develop a fifty-seat regional jet that just about everyone else thought the industry did not need. At the time, propeller-driven aircraft dominated the regional aircraft market. Just about everybody was wrong. The jet, and its successor aircraft, including a seventy-seat plane, have sold well. The Canadair acquisition was followed by several other purchases of troubled manufacturers of small aircraft, including Short Brother in Northern Ireland, de Havilland in Canada, and Learjet in the United States. In each case, Bombardier was able to purchase these companies for a relatively low price because of their financial troubles.

By imposing good management and tight financial discipline, and by developing a well-thought-out range of smaller jet aircraft in the twenty- to ninety-seat range, Bombardier has managed to weld this grab bag of companies into a coherent and significant force in the global aerospace market. Now the third largest civilian aerospace company in the world, behind Boeing and Airbus, Bombardier has thrived by focusing on a niche where Boeing and Airbus do not compete. In 1998, it received a record 200 orders for its small regional jet aircraft. In total, the units now account for more than half of Bombardier's revenues and profits.

Bombardier's management attributes much of the company's success with diversification to a number of factors. It has entered only those niches where it thought it had a good chance of being the number one or two player in the world, and it has acquired valuable technology at a relatively low cost. Furthermore, it has managed its different businesses within a decentralized organizational structure, which gives the managers of business units the freedom to pursue what they think are the appropriate competitive and operations strategies, subject of course to a detailed review from the top. The company has deliberately taken big risks in its diversification moves. According to the current CEO, Bob Brown, Bombardier's key values are boldness and energy. "When you take action," he says, "take bold action. And when you decide to do something, do it 150 percent."
Wal-Mart has long recognized that its huge supercenters and discount stores do not serve the needs of customers who want a quick and convenient shopping experience, for example, when they want to pick up food for an evening meal. It has also recognized that places like neighborhood supermarkets, drugstores, and convenience stores are a very lucrative segment of the food retailing market and that customers spend billions of dollars shopping in these locations. So, in the late 1990s, Wal-Mart decided to explore the concept of opening a chain of what it calls “neighborhood markets.” Each of these supermarkets is around 40,000 square feet, about a quarter of the size of a superstore, and stocks 20,000 to 30,000 items, as opposed to the over 100,000 items available in Wal-Mart’s larger stores. According to the plan, the neighborhood markets would be positioned to compete directly with supermarkets like Kroger and Albertsons and would be open twenty-four hours a day. They would also have a pharmacy and film-processing unit to draw off trade from drugstores, since customers could shop for food while they waited for their prescriptions to be filled or their film to be developed. In addition, the stores would have a large health and beauty products section, which is a high-profit-margin business that encourages impulse buying.

To test whether its cost-leadership model would work at this small scale of operations, Wal-Mart opened stores slowly in good locations. Margins are small in the supermarket business, often between 1 and 2 percent, which is lower than Wal-Mart is accustomed to. To keep costs low, it located its new stores in areas where it has an efficient warehouse food preparation and delivery system. Its plan is to prepare items like bakery goods and meat and deli items in a central location and then ship them to supermarkets in prepackaged containers. Each neighborhood market store is also tied in by satellite to Wal-Mart’s retail link network so that food service managers know what kind of food is selling and what is not. They can then adjust the food each store sells by changing the mix that is trucked fresh each day. In addition, because the stores have no butcher or baker, labor costs are reduced by 10 percent.

As a result of these measures, the sixty-plus U.S. stores that were opened by 2004 have been able to undercut the prices charged by supermarkets such as Publix, Winn-Dixie, Kroger, and Albertsons by 10 percent. A typical neighborhood market generates around $20 million a year in sales, has a staff of ninety, and obtains a 2.3 percent profit margin, which is significantly higher than average in the supermarket industry.

Wal-Mart has been opening stores in widely different locations, such as Manhattan, Dallas, Salt Lake City, Tampa, and Ogden, apparently to see if its business model for the new store will work in different kinds of urban settings. If it does, then it can roll out sixty to one hundred new stores each year and so build the neighborhood market chain in the way it has built its other chains. While Wal-Mart has been reticent to comment on how well its new chain is doing, perhaps for fear of alerting its competitors to the growing threat, there are reports that its new stores are even more profitable per square foot than its supercenters. If this is true, investing its capital to rapidly expand its chain will increase Wal-Mart’s ROIC and further contribute to its growth and profitability. At the same time, the weaker of its rivals, such as Winn-Dixie and Albertsons, will find their revenues and profits falling, so a continuing shakeout in the supermarket industry is likely in the years ahead. Indeed, it is possible that growing competition from Wal-Mart may induce these companies to agree to be acquired by Wal-Mart.
9.3 STRATEGY IN ACTION

McDonald's: A Leader at Vertical Integration

By the 1990s, McDonald's faced a problem: after decades of rapid growth, the fast food market was beginning to show signs of market saturation. McDonald's response to the slowdown was to expand abroad rapidly. In 1980, 26% of the chain's new restaurant openings were abroad; in 1990 it was 60%, and by 2000, 70% and today it has more than 12,000 restaurants in 110 countries outside the United States. One of the keys to McDonald's successful global expansion is to replicate the value-creation skills that spurred its growth in the countries and world regions in which it operates. McDonald's United States success was built on a formula of close relations with suppliers, nationwide marketing might, and tight control over store-level operating procedures.

McDonald's biggest global problem has been to replicate its United States supply chain in other countries. United States suppliers are fiercely loyal to McDonald's; they must be because their fortunes are closely linked to those of McDonald's. McDonald's maintains very rigorous specifications for all the raw ingredients it uses—key to its consistency and quality control. Outside of the United States, however, McDonald's has found suppliers far less willing to make the investments required to meet its specifications. In Great Britain, for example, McDonald's had problems getting local bakeries to produce the hamburger bun. After experiencing quality problems with two local bakeries, McDonald's had to vertically integrate backward and built its own bakeries to supply its British stores.

In a more extreme case, when McDonald's decided to operate in Russia, it found that local suppliers lacked the capability to produce ingredients of the quality it demanded. The firm was forced to vertically integrate through the local food industry on a heroic scale, importing potato seeds and bull semen and indirectly managing dairy farms, cattle ranches, and vegetable plots. It also had to construct the world's largest food-processing plant at a huge cost. In South America, McDonald's also bought huge ranches in Argentina to raise its own cattle. As a result, today, McDonald's is able to use vertical integration to protect product quality and reduce its global cost structure.

Specialized Assets and Vertical Integration in the Aluminum Industry

The metal content and chemical composition of bauxite ore, used to produce aluminum, vary from deposit to deposit, so each type of ore requires a specialized refinery—that is, the refinery must be designed for a particular type of ore. Running one type of bauxite through a refinery designed for another type reportedly increases production costs by 20 percent to 100 percent. Thus, the value of an investment in a specialized aluminum refinery and the cost of the output produced by that refinery depend on receiving the right kind of bauxite ore.

Imagine that an aluminum company has to decide whether to invest in an aluminum refinery designed to refine a certain type of ore. Also assume that this ore is extracted by a company that owns a single bauxite mine. Using a different type of ore would raise production costs by 50 percent. Therefore, the value of the aluminum company’s investment is dependent on the price it must pay the bauxite company for this bauxite. Recognizing this, once the aluminum company has made the investment in a new refinery, what is to stop the bauxite company from raising bauxite prices? Nothing. Once it has made the investment, the aluminum company is locked into its relationship with its bauxite supplier. The bauxite supplier can increase prices because it knows that as long as the increase in the total production costs of the aluminum company is less than 50 percent, the aluminum company will continue to buy its ore. Thus, once the aluminum company has made the investment, the bauxite supplier can hold up the aluminum company.

How can the aluminum company reduce the risk of holdup? The answer is by purchasing the bauxite supplier. If the aluminum company can purchase the bauxite supplier’s mine, it need no longer fear that bauxite prices will be increased after the investment in an aluminum refinery has been made. In other words, vertical integration, by eliminating the risk of holdup, makes the specialized investment worthwhile. In practice, it has been argued that these kinds of considerations have driven aluminum companies to pursue vertical integration to such a degree that, according to one study, 91 percent of the total volume of bauxite is transferred within vertically integrated aluminum companies.
Luxottica agrees $400m deal to buy Cole National chain of stores

By Mary Watkins in London

Luxottica yesterday agreed to acquire US retailer Cole National, taking the Italian eyewear group's spending above €2bn ($2.5bn) in the four years since it acquired the Ray-Ban sunglasses brand.

The $401m cash offer equates to $22.50 a share and comes seven months after Cole, which operates almost 3,000 eyewear and gift stores, received an unsolicited $19.65 a share offer from Luxottica.

Following that approach, Cole said it had considered other proposals, including one from HAL, a large shareholder in the group.

The Ohio-based company, the second-largest eyewear retailer in the US via its Pearle chain, will be added to a stable that includes the Sunglass Hut chain and Bausch & Lomb.

Leonardo Del Vecchio, Luxottica's founder and chairman, said the deal would enhance its North American presence "in product categories complementary to our LensCrafters and Sunglass Hut International operations".

Analysts said the deal was relatively expensive. However, it will help boost Luxottica's market share in the US by 6 per cent to about 19 per cent.

"It makes sense from both a strategic and financial perspective," said one analyst. Although, with 70 per cent of sales derived from the US, he admitted it was "a big bet on the US market recovery".

Luxottica will also offer to buy all outstanding options and similar equity rights at the same price per share, less their respective exercise prices. Luxottica said it would use cashflow and credit facilities to fund the deal, which is expected to close in the second half of 2004, subject to shareholder and regulatory approval.

The agreed deal adds another 2,197 locations - in the US, Canada, Puerto Rico and the Virgin Islands - to Luxottica's global retail network.


Last September, it boosted its presence in Asia by buying OPSM, Australia's biggest optical retailer, for A$550m (US$342m), making it the leader in the Australian prescription segment.

In 2002, Luxottica reported total sales of €3.13bn ($3.9bn) and net profit of €372.1m.

Luxottica was advised by Goldman Sachs, and Cole National by Lehman Brothers.
STRATEGIES

HAVE DEALMAKERS WISED UP?

Acquiring companies seem to be taking a closer look—and paying less

WITH BIG NAMES, big dollars, and big payouts, dealmaking is back on Wall Street. Following a runup of deals toward the end of last year, U.S. companies announced more than $144 billion worth of mergers and acquisitions in the first 40 days of 2005—the fastest start since 2001, according to Thomson Financial Inc. SBC Communications’ $16 billion deal for AT&T on Jan. 31 was followed just days later by Qwest Communications International’s $6.3 billion bid for MCI. The same week, MetLife Inc. said it will pay $11.5 billion in cash and stock for Travelers Life & Annuity, now owned by Citigroup. And Procter & Gamble Co. unveiled a deal to buy Gillette Co. for $57 billion in stock, with a $20 billion stock buyback to follow. As adrenaline-pumped CEOs face flashing cameras, it sure looks like deal fever is raging again.

Is it time for investors to worry? The list of failed deals from the late 1990s still resonates loudly in their collective memory. Daimler Benz’s $39 billion purchase of Chrysler and Conseco’s $7 billion deal for Greentree Financial were spectacular busts for their shareholders. And while America Online Inc.’s $166 billion acquisition of Time Warner Inc. saved AOL shareholders from the even worse losses suffered by other Internet stock holders, it proved an epic mismatch that wiped out tens of billions of dollars of wealth, including all of Time Warner’s takeover premium. The risks of the megadeal were underscored again on Feb. 9 when CEO Carleton S. Fiorina resigned under pressure from Hewlett-Packard Co. After pushing for the $19 billion acquisition of Compaq Computer Corp. in 2002, Fiorina failed to achieve the promised growth and profitability (page 34).

The latest round of dealmaking could be different. Many of today’s acquirers appear to have learned important lessons from the failures of the past. The recent spate of deals suggests that executives and directors are approaching takeover targets with a lot more care than in years past. They’re giving more thought to strategic fit, paying lower premiums, and spending more time and attention on integration. “We haven’t seen anything wild yet,” says Hugh “Skip” McGee, head of investment banking at Lehman Brothers Inc.

Of course, the odds are still against these mergers. Many studies over the past decade show that the majority of M&A deals result in worse returns for shareholders of acquiring companies than for their competitors. BusinessWeek investi-

New and Improved M&A

Stung by the failure of many late ’90s mergers, many companies are rethinking the playbook.

3LA: THE PREMIUM

Recent deals, including Procter & Gamble’s purchase of Gillette and Johnson & Johnson’s bid for Guidant, feature premiums of just 15%-20%—less than half the rate common during the boom. By paying less, they ease pressure from Wall Street and gain time to integrate their purchases.

STAY CLOSE TO HOME

Companies such as Citigroup and IBM are largely shunning huge deals that would move them into new fields, instead favoring small acquisitions and divestitures to concentrate on their core businesses. J&J’s purchase of Guidant, for example, builds its cardiac-device line.

PROCEED WITH CAUTION

With new accounting regulations requiring precise valuations, boards of directors are putting more time and effort into analyzing deals to ensure that they are worth pursuing. Some managers are privately talking to their targets’ customers and suppliers.

FOCUS ON INTEGRATION

Buyers are working to bolster morale, retain key execs, and keep customers happy at the companies they’ve snatched up. Cingular Wireless has done extensive outreach to AT&T Wireless customers, while Bank of America has moved slowly to integrate Fleet Financial.
by Congress and regulators have made corporate boards more mindful of their responsibilities, including the reviewing of deals. That has directors stepping up to challenge CEOs to prove that deals will pay off. “Boards are being much more careful,” says Mark L. Sirower, leader of the M&A strategy practice at PricewaterhouseCoopers.

So far, investors like what they’re seeing. SBC shares held their own as news leaked that it was looking to buy AT&T. MetLife stock slipped just a half of one percent when it said it was buying Travelers. And when Johnson & Johnson said on Dec. 16 that it was paying $25 billion for medical-device maker Guidant Corp., its stock rose 4%.

The big reason investors aren’t hammering buyers’ stocks: Most acquirers have become cautious about not overpaying. Gone are the 30% to 40% premiums regularly paid in the past, much less the 50%-plus premiums that were common in 1999 and 2000. SBC offered AT&T virtually no premium over its market price, while Exelon paid just a 16% premium for Public Service Enterprise Group. Exelon’s stock rose about 5% on the deal, a sign that investors figure it isn’t paying the sellers so much that it’s giving away all of the $400 million in annual cost savings it expects by combining the companies.

This new sense of moderation extends beyond the price of deals. Some companies are staying away from the deal market altogether if they don’t see a perfect fit. So far, Verizon Communications has held back as SBC snatches AT&T and Qwest pursues MCI (page 35). Some now follow the practice of private buyout firms that quietly interview a target company’s customers, suppliers, and lenders before agreeing to a price, says David Harding, a director at Bain & Co. and co-author of the book Mastering the Merger.

Dealmakers’ caution isn’t all internally driven. New accounting rules for acquisitions and director-independence provisions in the Sarbanes-Oxley Act of 2002 are prompting boards to question deals early. More directors are asking for detailed appraisals of individual assets that would be bought, says Paul Barnes, a managing director at Standard & Poor’s Corporate Value Consulting.

Another plus is that executives are often more intent on sticking with existing business strategies instead of chasing new markets. J&J’s purchase of Guidant, for instance, is part of a consistent strategy to build up its line of cardiac devices. And IBM hasn’t bought a company to make a big, bold entry into a new market since its 1995 purchase of Lotus Development Corp. Yet it has acquired 40 other companies since then in smaller deals to fill product gaps and consolidate weak rivals.

Other companies are adjusting their M&A tactics. General Electric Co. is cutting back on how many small deals it does. One reason: The costs and time required to integrate are high regardless of a deal’s size. “Integration doesn’t come naturally,” argues Pamela Daley, GE’s vice-president for corporate business development. Others are changing more dramatically. Citigroup’s strategy of building a financial supermarket through M&A was turned on its head when it announced on Jan. 31 that it will sell its Travelers insurance business to MetLife. Says Citigroup’s new CEO, Charles Prince: “The days of doing big consolidating transactions that completely transform the company are behind us.”

Buyers are also giving careful new attention to the critical issue of integration. A decade ago integration often meant slashing and burning, but these days managers are going to great lengths to keep the acquired company’s customers happy. Bank of America Corp. lost droves of customers in its 1997 buy of Barnett Banks Inc. when it quickly closed branches and rushed to combine computer systems. Now, BofA is taking an extra year to integrate the $47 billion purchase of FleetBoston Financial Corp. it closed in 2004. The payoff: BofA added 184,000 new checking accounts at Fleet in the first eight months after the merger.

Similarly, Cingular Wireless transformed 1,000 AT&T Wireless stores across the country to Cingular stores overnight late last year and gave AT&T customers instant access to Cingular’s gear and networks. That helped Cingular quickly reduce AT&T Wireless’ notoriously high churn rate.

As the latest round of mergers gains steam, many of these lessons may yet be forgotten by cocky corporate buyers. But for now these wheels and dealers don’t look as reckless as those of the past.

—By David Henry in New York, with Dean Foust in Atlanta, Emily Thornton in New York, and bureau reports
Buying Spree By China Firms Is a Bet on Value Of U.S. Brands

By GEOFFREY A. FOWLER

CAN THE MAYTAG REPAIRMAN learn Chinese?

Behind the $1.28 billion bid by China's Haier Group for American home appliance icon Maytag Corp. is the toughest challenge facing the Chinese companies that already make many of the world's appliances and electronics: how to transition from low-cost, often no-name manufacturers to respected global brands.

In recent months, a string of Asian electronics manufacturers with little international name recognition have attempted to vault into American and European homes by buying Western brands. Chinese TV maker TCL Corp. took control of the manufacturing operations of RCA-brand owner Thomson SA of France. Then computer maker Lenovo Group of China bought the personal-computer operations of International Business Machines Corp. This month, Taiwanese electronics maker BenQ Corp. took over the cellphone operations of Germany's Siemens AG.

Chinese companies are on a buying spree because they sense "it's now or never," says Paul Gao, a partner in Shanghai at McKinsey & Co. "They have reached a bottleneck in their next stage of development."

Foreign companies have used several strategies to expand into the U.S. Some purchased U.S. brands: BP PLC of the United Kingdom bought Amoco, slowly phasing in the BP name, and Philips Electronics NV of Amsterdam bought Magnavox. Others have built their U.S. customer base organically. Among these players are Japanese car makers Toyota Motor Corp. and Honda Motor Co., and electronics makers Sony Corp. of Japan and Samsung Electronics Co. of South Korea. But this path can take a long time and hit bumps along the way: Fifteen years ago, Korea's Hyundai Motor Co. was mocked in the U.S. for the shoddy craftsmanship of its cars; now it tops quality surveys and produces some of the most popular autos in the American market.

But Japanese and Korean manufacturers that moved to the U.S. enjoyed a boost their Chinese counterparts lack: a government-protected home market in the 1980s and '90s that allowed them to finance their international push with rich profits from domestic sales. China has largely opened up its consumer market to competition. "The Chinese companies simply cannot afford to wait until they dominate the domestic market and slowly grow their international presence," says McKinsey's Mr. Gao.

Yet wooing brand-conscious Americans shoppers is a slow process that almost no Chinese manufacturers, used to selling on price, have mastered. Almost a decade ago, Konka Group Ltd., then China's biggest TV maker, made a big push into the U.S. and seemed to make progress for a while with a low-cost line of sets. But it never gained the marketing savvy or name recognition it needed.

Please Turn to Page B6, Column 1
Chinese Buying Spree Is a Bet on U.S. Brand Names

Continued From Page B1

and has since retreated to its home market, where it has slipped to No. 3.

Buying an established company, on the other hand, offers Chinese companies immediate access to technology, experienced marketing executives and coveted distribution channels at a time when America's retail industry is consolidating.

But most of all, Haier wants the Maytag brand. Made famous in America through commercials since the 1960s featuring the lovable, lonely Maytag repairman, Maytag's emotional relationship with American consumers drives the company's business today as much as the technology in its appliances. Maytag also owns other well-known appliance brands, including Amana, Hoover and the upscale Jenn-Air.

Haier would be unlikely to put the Maytag repairman out of work. Madison Avenue executives say Haier would want to preserve Maytag's name and heritage—that is why it, along with partners Blackstone Group and Bain Capital, is offering a premium over an earlier bid for Maytag from an investment group led by Ripplewood Holdings LLC.

"Haier's target is Maytag's prestigious brand name as well as its mature sales channels," says Pan Chengli, an economist and independent director of Haier's Shanghai-listed subsidiary, Qingdao Haier.

Haier (pronounced HIGH-ER) is a descendent of a government-owned refrigerator factory that now is China's largest appliance manufacturer. It is one of the few Chinese brands, along with Tsingtao beer, that American consumers may recognize. Long a big seller of minifridges in the U.S., the company opened a factory in South Carolina in 1989. Its appliances now account for 2% of all full-size refrigerators sold in the U.S., 16% of window air conditioners and 8% of portable fans. Globally, the company had sales last year of $12.2 billion.

Haier plans to follow Lenovo's branding approach with IBM, Mr. Pan says, though Haier management has declined to comment on its marketing plans. The two computer makers agreed that Lenovo can use the IBM brand on its PCs for five years, though Lenovo is planning to shift to its own name in only 18 months. That means it will have to build up its own brand in a hurry. To do that, Lenovo has plunked down an estimated $55 million to associate itself with the Winter Olympic Games in Turin, Italy, next February and the Summer Games in Beijing in 2008. It also will start pairing IBM's ThinkPad name with its own.

The biggest challenge will be figuring out how to use the Maytag and Haier brands, says Michael Ip, the Asia-Pacific managing director of WPP Group brand consultancy Landor Associates, which is advising Lenovo on its transition. "What does Haier bring to Maytag? How do you position the two so there is no overlap and you maximize efficiencies?"

Part of the answer lies in how American consumers will respond to a Chinese brand. Despite problems in China with product counterfeiting, worker abuses and sometimes-poor quality control, it is increasingly clear that U.S. shoppers don't much care about the origins of brands.

A study conducted last fall for WPP's Ogilvy & Mather in the U.S., U.K., and France found that Western consumers are open to Chinese-brand products—if they offer something unique. While 36% of the American consumers in the survey associated Chinese brands with low-cost products, 26% also associated them with innovation, and 24% with advanced features and value for money.

Well beyond getting the branding right, China's new global players must pull off some ambitious marriages. In the case of TCL and RCA, executives say they have encountered more financial and operational difficulties than they had expected. Factory costs in Europe and North America are running higher than anticipated in the TV venture, forcing the company to delay its target for bringing the operations into the black.

The biggest hurdle, though, has been finding enough people who can bridge Chinese and Western business cultures. "Maybe Haier has the people," says Vincent Yan, a managing director of TCL. "We needed cross-cultural people with the right business experience. Those are very hard to accumulate."

—Qiu Haiyu and Evan Ramstad contributed to this article.
Running Case

Beating Dell: Why HP Wanted to Acquire Compaq

In 2001 Hewlett-Packard (HP) shocked the business world when its CEO, Carly Fiorina, announced that rival computer maker Compaq had agreed to be acquired by HP. This happened at the end of a year in which slumping demand and strong competition from Dell had buffeted both companies, which needed a way to fight back. The merged company would have annual revenues of about $87.4 billion, putting it in the same league as IBM, and would be able to provide customers with a full range of computer products and services. With the exception of the printer segment, in which HP is the market leader, there was significant product overlap between HP and Compaq.

To justify the acquisition, Fiorina claimed it would yield many benefits. First, there would be significant cost savings because eliminating redundant administrative functions and cutting 15,000 employees would reduce annual operating costs by $2.5 billion a year. Also, combining the PC businesses of HP and Compaq would enable the new HP to capture significant scale economies and compete more efficiently with Dell. The same would be true in the computer server and storage segments—segments in which Dell was gaining market share.

Critics, however, were quick to point out that Dell's competitive advantage was based on its strategy of cost leadership, which was the result of the efficient management of its supply chain. This was a functional competency in which both HP and Compaq lagged behind Dell. Achieving economies of scale is certainly desirable, but would the merger allow the new HP to reduce its operating costs enough? Would it result in major gains in supply chain efficiency, for example? If the new HP could not match Dell's low operating costs, then the merger would not provide any real benefits.

In addition to citing the cost advantages that would result from the merger, Fiorina argued that the acquisition would give HP a critical mass in the computer service and consultancy business, where it trailed leader IBM significantly. Fiorina insisted that by being able to offer customers a total solution to their IT hardware, software, and services needs, HP would gain new market share from corporate customers who would now buy HP PCs as part of their total "HP computer package." Also, HP would gain a greater share in the higher-margin IT services business. Here too, however, critics were quick to perceive flaws. They argued that HP would still be a minnow in the service and consultancy area, with under 3 percent of market share.

In 2004, HP announced that it had achieved its cost savings target and that it was continuing to find ways to decrease operating costs by reducing the duplication of resources in the merged company. However, it also announced that Dell's entry into the printer business had hurt its profit margins and that the profit margins on the sales of its PCs were still well below those obtained by Dell.

Thus HP had not been able to lower its costs to match Dell, while Dell had applied its cost-leadership model successfully to a growing number of computer and electronic products. In fact, in 2004 Dell announced record profits, while HP failed to meet its profit targets, and the result was that Dell's stock price soared while HP's sank. In March 2005, HP's board of directors decided that CEO Fiorino was not the right person to lead the company, and they replaced her with Mark Hurd, an IT executive who had spearheaded turnarounds in troubled electronics companies. By 2006 HP's performance had improved, but Apple Computer's resurgence, in large part due to the astonishing success of its iPods, now made it a new major competitor in the vital PC market!

Another example of the use of horizontal integration to reduce operating costs occurred in 2005 when Kmart and Sears shareholders approved the merger of these companies to improve the combined companies' competitive position against Wal-Mart. The idea was that the combined companies would be able to share common purchasing and distribution facilities and their HRM functions to reduce costs. In addition, some Kmart stores might be converted to Sears stores and vice versa, and in some areas the stores might be sold off to realize the value of the real estate. In addition, Kmart stores might carry some of the product lines for which Sears is well known, such as its appliances and Craftsman tools. In these ways, the merger may also result in the kinds of differentiation advantages discussed in this section.