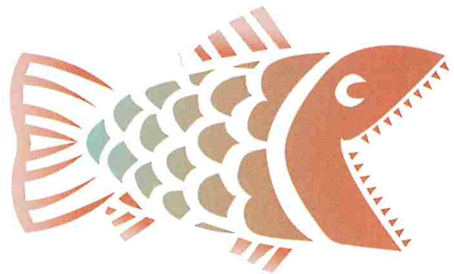
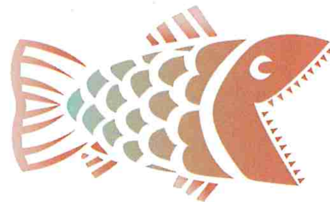
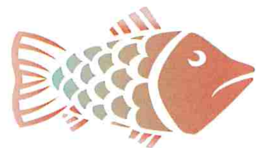

Growth by acquisition

*Textbooks outline many sound reasons why businesses pursue growth by acquisition. **David Rees** takes a more critical look at the motives involved*

All too often, companies seem to assume that to grow is to improve. If they are bigger than last year, then they have something positive to report to their shareholders. Since large businesses may look to shareholders for more **equity capital** when they need more funds from outside the company, what shareholders think of their management is very important to them. At the crudest level, if shareholders are pleased, then they will be a source of new capital if the company needs it. At worst, shareholders can remove executives who fail to give them the returns they demand. Sir Peter Bonfield's premature departure as chief executive from BT in October 2001, after a rapid 70% reduction in BT's stock-market value, was one such high-profile case.

Organic growth versus short-term demands

Shareholders could sit back and give the management time to deliver bigger returns by **organic growth**. This is where firms sell more of their own products by making and marketing them better and accumulating more productive capacity. But this takes time. Even big institutional shareholders, such as pension funds (which don't buy and sell shares as frequently as individual shareholders), might be frustrated at 5-year plans for growth. So, many businesses look for quicker ways to grow. One such way is through acquisitions, in which one company buys a controlling stake in another.

Vertical integration — a game of chess?

Apart from wanting to please shareholders' short-termist demands, there are other, more questionable reasons for wanting to expand through acquisitions.

Vodafone's £112 billion takeover of Mannesmann, in February 2000, was the first time that any German company had succumbed to a hostile foreign bid. It turned Vodafone into the fourth largest company in the world. Victorious Vodafone claimed that it was Mannesmann's technology it was after. In effect, this was an example of **vertical integration**. Mannesmann produced state-of-the-art equipment for the transmission and carriage of mobile phone services; Vodafone provided the service itself. Thus, it was guaranteeing a secure, economical supply of the technology it needed to do its business. The logic of this from a cost and operational point of view is clear.

However, look more closely and a more subtle motive becomes apparent. The fit between the two companies was not ideal, as Mannesmann also owned heavy engineering businesses of no use to Vodafone. But more importantly, Mannesmann had just bought one of Vodafone's most bitter rivals, Orange. So Vodafone bought Mannesmann. The competition authorities forced Vodafone to sell Orange after the deal, to prevent it acquiring monopoly power. This left Orange back at square one. Now, if Orange wants to use Mannesmann's technology, it has to effectively buy it from Vodafone.

Yet all this hasn't brought Vodafone the success many had hoped for. Its share price has slid to just over a quarter of its peak in March 2000 and the stock market is sceptical about whether it can recapture its previous growth rates. The company does seem to be increasing its profitability, but this is largely due to acquiring more customers and getting more revenue from each one — it could have done this without taking over Mannesmann.

This is all reminiscent of one of the worst corporate takeovers ever performed. When BMW took over the Rover Group in 1994, it claimed it wanted to get a share of the small car market. True, the marriage spawned the successful new Mini, but this was launched 7 years after the takeover. In 2002, when BMW sold Rover to the Phoenix Consortium for £10 (which apparently still hasn't been paid), Rover was losing £2 million a day. All told, BMW's mistake cost it £2,560 million. Great though the Mini may be, it definitely is not worth that much.

There were two reasons why the BMW/Rover deal failed:

(1) BMW didn't do its homework on the business culture and operational problems inside Rover

(2) BMW's motive was to stop Honda getting Rover

When corporate strategy begins to resemble a defensive game of chess, the players can take their eye off the real business of making exciting products efficiently that people want to buy — and then suffer the consequences.

TOPFOTO

The Chrysler Crossfire

Synergies — overcoming a culture clash

This is not to say that takeovers don't work. If there is an alignment between the two companies' products and markets, then most problems — even the dreaded culture clash — can be overcome. This relates well to Ansoff's matrix, which puts a business's products and markets as the two scales by which corporate strategy can be plotted.

Mercedes-Benz has given us a good case study of how this can be done. Since 1998, Mercedes (known as Daimler-Benz) has been gradually making its $38 billion takeover of America's Chrysler work. It did, of course, struggle to blend the two firms' contrasting business cultures. American managers were reportedly horrified at the Germans' habit of travelling first class to meetings and staying in top-class hotels on company expenses. They saw the Germans as rules-obsessed engineers who produced thick wads of paperwork at every meeting, while the Americans preferred verbal presentations followed by one-page summary memos. The Americans made decisions on hunches and liked to react quickly to market changes. German managers, on the other hand, were annoyed that their American colleagues could take home salaries two, three or even four times higher, even though Mercedes was in fact much more profitable. Indeed, in 2001, Chrysler in isolation made a $1.35 billion operating loss.

Chrysler's losses in 2001 included huge restructuring costs, but the company made over $300 million profit the previous year. Chrysler's business is fundamentally profitable, and likely to stay that way thanks to Mercedes. Development costs of new products are being slashed because DaimlerChrysler is developing new models just once, then using the technology in at least two different cars. Take the Chrysler Crossfire and the Mercedes CLK. Both are two-door coupés that share the same 3.2 litre petrol engine and an identical chassis. But the products don't compete directly with each other. One is a two-seater priced at $27,260, the other seats four and is priced at $34,590. Guess which is which…

Besides products, the two firms complement each other in their markets as well. Chrysler is bigger in the US market than Mercedes, while the German firm has much more presence in Europe and Asia. Even when both companies sit side-by-side in the same country's car market, they operate in different segments. Mercedes has long wanted to break into the lucrative and growing sports utility and mini-van segment of the American car market, for example, and Chrysler is a huge player there, with its Dodge brand and Voyager model. There is no reason why these products can't share Mercedes engineering.

DaimlerChrysler shows how two firms can come together and exploit **synergies** for their mutual benefit, i.e. they enjoy a greater benefit from operating together than they would have done separately. BMW never gave Rover full access to its technology. It stopped Rover making cars that were too sporty for fear of Rover treading on its toes. Mercedes isn't so squeamish. It knows that the two companies are not direct competitors, and they are too intertwined now to separate. It is too late to know which cost-savings are due to synergies and which are due to ordinary cost-cutting.

Glossary

Equity capital Share capital or, more specifically, ordinary share capital.

Organic growth Expansion from within the firm, i.e. not as a result of acquisitions. Organic growth is likely to be steady, even slow, but very secure.

Synergies When the whole is greater than the sum of the parts, i.e. when 2 + 2 = 5. This is often anticipated in takeover bids, when directors assert that the purchase of a rival will provide such economies of scale as to make the combined firm a world-beater. Research evidence suggests that synergy is achieved far less often than it is forecast.

Vertical integration When two firms that operate in the same industry join together, but at different stages in the production/supply chain. The integration might come about through merger or takeover.

Source: Lines, D., Martin, B., and Marcousé, I. (2003) *Complete A–Z Business Studies Handbook*, Hodder & Stoughton

Conclusion

Daimler-Benz shareholders now own a bigger company that can exert more power over its suppliers and retailers, can cut more costs and has the potential to make bigger profits. So maybe this takeover has worked. But Michael Porter's words must still be heeded, 'Acquisitions are difficult to integrate, and coordination among partners can prove troublesome.' He says he is hard-pushed to find any convincing cases of truly successful mergers. The big accountancy firm, KPMG, found in 199 that only 17% of mergers added anything t the value of shareholders' funds. This i from a company that advises others o how to conduct a takeover and profit hugely from it.

Sony and Bertelsmann have joine forces to combat internet music pirac Carlton and Granada plan to save £1 million a year with their merger by avoi ing duplication of services. British Ame can Tobacco (Benson & Hedges, Rothma and Dunhill) has sold out to R. J. Reynol of America (Camel and Winston) to get bigger share of the US market. These co panies had better remember that wh actually lines the pockets of shareholde in the long run is selling products to peo for a profit, not an overnight jump in t size of the business on the stock marke

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