Block

4

STRATEGIC CHANGE

Ref. No. BPS-SLM-IFHE – 042022 B4

For any clarification regarding this book, the students may please write to The ICFAI Foundation for Higher Education (IFHE), Hyderabad specifying the unit and page number.

While every possible care has been taken in type-setting and printing this book, The ICFAI Foundation for Higher Education (IFHE), Hyderabad welcomes suggestions from students for improvement in future editions.

Our E-mail id: cwfeedback@icfaiuniversity.in

Centre for Distance and Online Education (CDOE)
The ICFAI Foundation for Higher Education
(Deemed-to-be-University Under Section 3 of UGC Act, 1956)
Donthanapally, Shankarapalli Road, Hyderabad- 501203

BLOCK 4: STRATEGIC CHANGE

The fourth block of the course on Business Policy & Strategy deals with strategic change. The block contains five units. The first unit discusses about corporate restructuring. The second unit discusses joint ventures and strategic alliances. The third unit discusses mergers and acquisitions. The fourth unit discusses divestitures and anti-takeover defense. The fifth unit discusses managing strategic change, and the sixth unit discusses the challenges for the 21^{st} century.

The first unit, *Corporate Restructuring – An Overview*, discusses the classifications and forms of corporate restructuring. It discusses the alternatives of ‘numerator management’ and ‘denominator management’ that are open for management to adopt. The unit ends with a discussion on how organizations manage the turnaround process in an organization.

The second unit, *Joint Ventures and Strategic Alliances*, discusses the concept of a joint venture, the rationale for joint ventures, and the reasons for the failure of joint ventures. It describes the motives for and types of strategic alliances, and how to make strategic alliances work. The unit ends with a discussion on the advantages and disadvantages of a strategic alliance.

The third unit, *Mergers and Acquisitions*, discusses the types of mergers and the economic rationale for mergers and acquisitions. It discusses the influence of industry life cycle stages on mergers and acquisitions activity. The unit also discusses about cross-border mergers and acquisitions. The unit ends with a discussion on the reasons for success and failure of mergers and acquisitions.

The fourth unit, *Divestitures and Anti-Takeover Defense*, discusses the reasons why companies go in for divestitures. It discusses the various aspects of preparing for and executing a divestiture. The unit ends with a discussion on the factors influencing takeover, and various anti-takeover defense mechanisms.

The fifth unit, *Managing Strategic Change*, discusses the forces of change, the types of change, and the change process. It discusses the reasons for resistance to change and how these obstacles can be overcome. The unit also discusses the various approaches to implementing strategic change. The unit ends with a discussion on power and politics, and their influence on strategic change.

The sixth unit, *Challenges for the 21^{st} Century*, discusses the issues of global competitiveness in the new millennium. It discusses the considerations for strategists in the 21^{st} century. The unit also discusses emergence of the knowledge worker, and the challenge posed by e-business. The unit ends with a discussion on the role of the CEO in the new millennium.

Unit 15

Corporate Restructuring – An Overview

Structure

"If you want something new, you have to stop doing something old."

\- Peter F. Drucker

15.1 Introduction

Corporate restructuring takes place at the organization when it faces flaws or scope of improvement in the existing structure. Here, Drucker has put forth a statement that if a company wants to bring a good change in the existing structure then it has to forgo the old one.

In the last unit of the previous block, we have discussed organizational roles in strategic management. In this unit, we shall discuss about corporate restructuring.

This unit will first discuss the classifications and forms of corporate restructuring. We shall the move on to discuss the alternatives of 'numerator management' and 'denominator management' that are open for management to adopt. Finally, we shall discuss about how to manage the turnaround process in an organization.

15.2 Objectives

By the end of this unit, you should be able to:

- Discuss the classifications and forms of corporate restructuring.
- Explain the alternatives of 'numerator management' and 'denominator management' that are open for management to adopt, especially during an economic slowdown or recession.
- Find out how to manage the turnaround process in an organization.

15.3 Forms of Corporate Restructuring

Restructuring can be defined as a strategy by which a company changes its business or financial structure. It also involves making radical changes in the composition of the business. Firms use restructuring strategies in response to the changes in the external and internal environment. In light of the rapid environmental changes, restructuring is one of the best strategies for companies to create maximum value for their stakeholders.

Between the 1960s and the 1990s, diversification became a common phenomenon in the world of business. Many firms diversified to an extent that soon became unmanageable. Over-diversification led to an increase in bureaucratic inefficiencies, adversely affecting the performance of these companies. As a result, the stock prices of these companies fell drastically, making them soft targets for hostile takeovers. To minimize such risks, firms had to undertake restructuring activities.

The various types of corporate restructuring can be classified into four major forms: expansion (mergers and acquisitions, tender offers, and joint ventures), sell-offs (spin-offs, split-offs, split-ups, divestitures, and equity carve-outs), corporate control (premium buy-backs, standstill agreements, anti-takeover amendments, and proxy contests), and change in ownership structure (exchange offers, share repurchases, going private, and leveraged buy-outs).

15.3.1 Expansion

Firms can expand their operations through any of the following: mergers and acquisitions, tender offers, and joint ventures. A merger can be defined as any transaction through which two or more firms integrate their operations on a relatively co-equal basis. Thus, a merger refers to any transaction that forms one economic unit from two or more previous ones. Different firms have different resources and capabilities, and bringing them together can lead to the creation of competitive advantage.

Mergers can be classified as horizontal mergers, vertical mergers, or conglomerate mergers.

- A horizontal merger is a merger between two firms involved in the same kind of business activity, e.g., a merger between two steel companies or two automobile companies.
- A vertical merger takes place when one firm acquires another firm that is in the same industry but at a different stage of production. For example, an oil company engaged in exploration and production merging with another oil company engaged in refining and marketing is an example of a vertical merger.
- A conglomerate merger involves integration of firms from unrelated business activities. Conglomerate mergers can be classified as product-extension

mergers, geographic market-extension mergers, or pure conglomerate mergers.

- o A product-extension merger takes place when firms want to expand to broaden their product lines.
- o A geographic market-extension merger involves two firms having operations in different geographical areas.
- o A merger where two firms with unrelated business activities merge is known as pure conglomerate merger.

In a tender offer, a company which intends to acquire a controlling interest in another company asks the shareholders of the target company to submit or tender their shares of stock in the firm. If a company wants to have control over another company, it has to first take approval from the target company's management and the board of directors of the target company.

An alternate approach known as "Bear hug" can also be adopted. In this approach, a company communicates with the directors of the takeover target (in writing) regarding its acquisition proposal. The directors are required to make a quick decision on the proposal. If the acquiring company does not get the approval, it can directly appeal to the stockholders through tender offers. If the company obtains a favorable response to the tender offer, the acquiring company can gain control over the company and replace the directors who did not cooperate in the takeover effort. This type of gaining control is referred to as a hostile takeover.

A target company, in order to avoid being taken over, may join hands with another company with which it would like to form an association. The organization with which the target company wants to form an association is referred to as a *White Knight*. To avoid another company from taking it over, the target company can also go for some form of restructuring such as offering shareholders a large cash dividend financed by debt. Shareholders generally prefer this form of restructuring to an outside offer, making the target less financially attractive to the bidder.

In a joint venture, the participants continue to exist as separate firms with the joint venture representing a newly created entity. Partners share proportional capital, distinctive skills, personnel, and reporting systems and technologies to gain competitive advantage. Joint ventures result in a collaborative approach among the partners to create new value.

The following are the characteristics of a joint venture:

- Partners contribute money, property, effort, knowledge, skill or other assets to a common undertaking.
- Partners have the right to control and manage the venture.
- Partners come together in expectation of some profits and they have the right to share the profits.

The scope and duration of joint ventures is limited and involves only a small fraction of each participant's total activities. Each participant must contribute something unique which is of importance to the venture and at the same time, provide a source of advantage to the other partner.

Example

When Larsen and Toubro Ltd (L&T), the Indian infrastructure company, announced an open offer for a 31% stake of mid-tier IT company Mindtree at ₹ 980 per share, parallelly, it entered into a deal to buy Cafe Coffee Day owner V. G. Siddhartha's 20.32% stake in Mindtree and also placed an order with brokers to pick up another 15% of the company shares from the open market. Despite opposition from Mindtree's promoters, within four months, L&T managed to get the public shareholders of the company to tender their shares and raised its stake to 60%. By announcing the open offer, L&T wanted to have control over Mindtree and took calculated steps to get this 60% stake in the company (expansion).

Source: ICFAI Research Center

15.3.2 Sell-offs

There are two major types of sell-offs: spin-offs and divestitures.

A spin-off results in the creation of a separate legal entity; the shares are distributed among existing shareholders of the parent company on a pro-rata basis. It is a form of dividend to the existing shareholders. The new entity has the power to make independent decisions. It can also develop policies and strategies which are different from those of the parent company.

There are two types of spin-offs: split-offs and split-ups.

- In a split-off, some of the existing shareholders receive stocks in a subsidiary in exchange for the stocks of the parent company.
- In a split-up, the entire firm is fragmented into a series of spin-offs. This is done, to ensure that the parent firm no longer exists and the new company created as a result of split up survives in the long run.

Unlike spin-offs, where only shares are transferred or exchanged, divestiture involves the sale of a portion of the firm to a third party. Since the buyer is an existing firm, no new legal entity is created.

- *Equity carve-out* is a variation of divestiture. In this, a portion of the firm is sold to outsiders through an equity offering, giving them ownership of that portion of the previously existing firm.
- Equity carve-out also results in the creation of a new legal entity.

Example

Siemens AG, the German industrial conglomerate, outlined a plan to list its struggling power and gas division in the stock exchange under a new name, as a part of CEO Joe Kaeser's drive to dismantle the company's complex corporate structure and focus on profits. This plan included job cuts of 2,700 positions worldwide, including 1,400 in Germany. Gas and Power had the lowest profit margin of all divisions and this move was to save 500 million euros, improving the company's competitiveness and making existing shareholders happy. Siemens has decided that it will retain only less than 50 per cent of the new independent entity.

A sell-off like the one Siemens is deciding on results in the creation of a separate legal entity. Usually done as part of a restructuring, the new entity like the one planned by Siemens will have the power to make independent decisions. It can also develop policies and strategies which are different from those of the parent company. When the shares of the loss-making unit are re-distributed to new shareholders of the new company on a pro-rata basis, this results in profits for the existing shareholders.

Source: ICFAI Research Center

15.3.3 Corporate Control

Corporate control can be established through premium buy-backs, standstill agreements, anti-takeover amendments, and proxy contests.

- In ***premium buy-backs***, a substantial stockholder's ownership interest is re-purchased at a premium that is above the market price. In connection with such buy backs, often a standstill agreement is signed.
- A ***standstill agreement*** is a voluntary contract in which the stockholder whose shares have been purchased agrees that he or she will not make further attempts to take over the company in the future. If a buy-back is not involved in the standstill agreement, the stockholder with substantial influence agrees not to increase his/her ownership control.
- ***Anti-takeover amendment***s refer to the changes made in the corporate bylaws in an attempt being taken over. Some of them are: super majority voting provisions, which require a very high percentage of stockholders to approve the merger, unspecified service terms for directors which can delay change of control for a very long period, and golden parachutes wherein large termination payments have to be made to the existing management.
- In ***proxy contests***, a group which is external to the firm (often referred to as 'dissidents' or 'insurgents') tries to obtain representation on the company's board of directors. It tries to reduce the controlling power of the existing board of directors. As the management often controls the board of directors, proxy contests are seen as targeted towards the existing management.

15.3.4 Changes in Ownership Structure

This includes exchange offers, share repurchases, going private, and leveraged buy-outs.

- Exchange offers involve exchanging debt or preferred stock for common stock or exchanging common stock for debt or preferred stock. The first type of exchange increases leverage, while the second type decreases leverage.
- The ownership structure can also be changed by repurchasing shares, that is, a company can buy back some portion of its outstanding shares of common stock. The percentage of shares purchased may vary. If it is successful in purchasing a substantial percentage of shares, it can change the control structure of the company.
- A going-private transaction involves a small group of investors purchasing the entire equity interest in a public company. When the members of the incumbent management group initiates the transaction (purchasing substantial proportion of the equity ownership of the new private company), it is known as a management buy-out. A small group of outside investors may provide funds and secure representation on the private company's board of directors. They may also arrange finance from third party investors.
- When the private company borrows substantially from third parties, such transactions are called Leveraged buyouts (LBOs).

Example

Sotheby, one of the world's largest auction houses listed in the stock exchange, announced that it is being bought by a French-Israeli telecommunications entrepreneur Patrick Drahi, in a deal worth $3.7 billion. The purchase was made through Bid Fair USA, a company owned by Mr. Drahi and included $2.66 billion in cash with Sotheby's current shareholders getting $57 per share. Being publicly traded is challenging for auction houses as its business relies on fluctuating revenues and quality of consignments for making profits on any given sale. Under a private owner, the company no longer has to justify every business decision or explain every market fluctuation to shareholders on a quarterly basis. In this case, Mr. Drahi succeeded in purchasing a substantial percentage of shares from the public and converting it into a private company, effectively changing the ownership structure of the company.

Source: ICFAI Research Center

Activity 15.1

A spinoff can be an effective way to minimize the execution risk of a divestiture, either due to third-party negotiations or due to changing market conditions. Sometimes, spinoffs are taken up also as a part of an M&A deal.

With the help of a recent example, discuss how companies use spinoff as part of M&A activity. **Answer:**

Check Your Progress - 1

1. The various types of corporate restructuring can be classified into expansion, sell-offs, corporate control, and change in ownership structure. Match each type of restructuring listed here with its corresponding classification.

   Type of restructuring

   i. Premium buyback
   ii. Joint venture
   iii. Split-up
   iv. Going private

   Classification

   p. Expansion
   q. Sell-off
   r. Corporate control
   s. Change in ownership structure

   a. i/p, ii/s, iii/q, iv/r
   b. i/q, ii/s, iii/p, iv/r
   c. i/r, ii/p, iii/q, iv/s
   d. i/s, ii/p, iii/q, iv/r

2. Sell-off is one class of corporate restructuring measures. Which of the following is **false** with respect to this class?

   a. Spin-off and equity carve-out result in the creation of a separate legal entity.
   b. In a split-off, the entire firm is fragmented into a series of spin-offs.
   c. In a split-up, the parent firm no longer exists.
   d. A divestiture involves the sale of a portion of the firm to a third party.

3. Corporate control is one class of corporate restructuring measures. Which of the following is **false** with respect to this class?
   a. Golden parachutes abolish termination payments that have to be made to the existing management.
   b. Premium buy-backs are often accompanied by a standstill agreement.
   c. Anti-takeover amendments refer to the changes made in the corporate bylaws in an attempt to prevent mergers and acquisitions.
   d. In proxy contests, a group which is external to the firm tries to obtain representation on the company's board of directors.

Activity 15.2
Buy-back of shares is a good tool for management to counter hostile takeover attempts. It protects the management by consolidating the holdings and the promoter's stake in the company. Discuss how companies use buy-back of shares as a strategy to protect themselves from hostile takeovers. **Answer:**

15.4 Numerator and Denominator Management

In an economy that is contracting, an organization has two alternatives for maintaining profitability levels. It could reduce headcount and investment, and sell assets under a 'denominator-driven', belt-tightening program. This type of approach is called denominator management. Alternatively, it could attempt to increase profitability by improving productivity. This approach is referred to as 'numerator-focused' management. An organization can increase profitability by maximizing the components of the numerators, and minimizing the components of the denominators.

Reducing manpower and expenditure is relatively easy to do. Denominator management is nothing more than an accountant's shortcut to asset productivity. Some CEOs, however, adopt the more healthy numerator-focused management approach. They search for ways to preserve technological leadership with a comparatively small R&D budget, for means to increase sales without increasing expenditure on advertising and other marketing communication activities, and for cost effective methods for expanding distribution coverage and improving customer services.

Gary Hamel and C.K. Prahalad, authors of the book, “Competing for the Future” say, “Regardless of business cycle, talented CEOs are devoted to adopting numerator-driven business strategy, namely, seeking ways of increasing revenues and net profit, rather than the denominator-oriented management of cutting investment and head count.” They say that smart CEOs improve profitability by employing re-engineering, which involves removing needless work and focusing on every process in the company towards customer satisfaction, reduced cycle time, and total quality. They also say that mediocre CEOs are intent on pushing for restructuring, cutting manpower, and shutting down unprofitable units. They prefer reengineering to restructuring because reengineering offers at least the hope of getting better as well as getting smaller. Whereas, a company that attempts to only restructure itself may find itself getting smaller faster than getting better.

15.5 Turnaround Management

Turnaround is of considerable importance to strategic management. However, the process of turnaround (how firms move away from deterioration in performance to enduring success) has not received sufficient attention in management literature. Not enough literature is available on turnarounds because of the wide gap between empirical findings (which may be based on large samples or case studies) and the work done towards uncovering the causal structure of events from the start of a firm’s decline to its ultimate recovery or death. Here we will discuss the framework of the turnaround process developed by Shamsud Chowdhury (Chowdhury).

A turnaround occurs when “a firm perseveres through an existence-threatening performance decline; ends the threat with a combination of strategies, systems, skills, and capabilities; and achieves sustainable performance recovery. The obverse of performance recovery is failure and eventual death.” This definition identifies four key attributes of a turnaround. First, declining performance is the trigger for turnaround. Second, turnaround involves a series of activities. Third, a turnaround is undertaken with a definite purpose. And fourth, turnaround activities continue for a number of years.

According to Chowdhury, though external forces such as competitive strategies of immediate competitors and pressure from shareholders influence the outcomes of the turnaround, top management can still control the outcome to a great extent.

Chowdhury suggested the use of a stage theory to study the turnaround process. He identified four stages of the turnaround process: decline, response initiation, transition, and outcome.

- During the first stage (decline stage), decline starts from firm equilibrium and reaches a nadir.
- As the firm’s performance reaches its nadir, the management begins to take corrective actions — this is the second stage of the turnaround process.

- According to Chowdhury, the third stage of the turnaround process, the transition stage, is the most complex of all the stages. At this stage, the firm experiments with different strategies, structures, cultures, and technologies.
- During the fourth stage, the outcome stage, the outcome of the activities undertaken during the third stage is realized. The outcome could be either success or failure.

15.5.1 Stage 1: Decline

There are two theoretical perspectives that provide reasons for the decline of firms: K-extinction and R-extinction.

- The K-extinction perspective suggests that macro or external factors are responsible for the decline. According to this perspective, as the concerned firm is part of an industry, any decline in the industry will result in the decline of the firm.
- According to the R-extinction perspective, the decline in the firm is due to a reduction in resources within the firm, independent of the external environment.
- However, both internal and external factors will contribute to deterioration in financial performance and reduction in resources within the firm. But the magnitude of decline will vary depending on whether this is externally or internally induced.

Example

Barneys New York Inc, the 100-year-old American chain of luxury department stores, approached law firm Kirkland & Ellis LLP to look for turnaround moves or take the bankruptcy route. With expensive rentals especially in its flagship location in Manhattan eating into the profits of the retailer's business, changing customer tastes and heavy competition coming from online retailers like Amazon, Barneys' potential bankruptcy move underscores the fact that even luxury brands are vulnerable to online competition. Sadly, Barneys is taking the path of a long line of retailers like Sears, Toys “R” Us, Payless and Gymboree that have succumbed to the changing retail landscape. In the case of Barneys, despite the chain's success in the luxury retail business for nearly 100 years, it started facing problems due to external factors beyond its control. The growth of online retailers and ever-changing consumer choices have made the firm vulnerable and left with just two choices, either turnaround quickly or shut down.

Source: ICFAI Research Center

It is necessary to identify the various factors that contribute to each type of decline and the way the decline type approaches its nadir. It is also necessary to identify the sources of intervention that trigger action.

Usually more than one source of intervention or stimuli can be identified in a turnaround situation. Pressure from one or more triggers (banks, creditors, government, press, stockholders) can bring a change in management and even lead to the removal of the CEO of the firm.

15.5.2 Stage 2: Response Initiation

- Turnaround responses can be categorized into strategic and operating responses. Strategic responses involve changing or adjusting the businesses the firm is currently involved in. Some of the changes include diversification, vertical integration, and divestment.
- Operating responses focus on the way the firm conducts its businesses. These include short-run tactics aimed at cost cutting and revenue generation.

The type of turnaround response used depends on the cause of a firm's decline. If the decline is due to structural shifts in the market, a strategic response should be used; if the decline is due to inefficiency, an operating response should be initiated.

Example

When Jill Soltau became the CEO of J. C. Penney, the American department store chain, the company was in a bad shape with regular employee layoffs and repeated closure of distribution centres. The chain's sales declined by 7.1% to $11.6 billion, and the company had about $4 billion in debt to pay and was facing the risk of closing down. Jill decided that a drastic change in strategy would not help turnaround the company. To arrest the losses, Jill took steps to reduce the store's inventory levels and focused on the product categories that demonstrated profitable sales growth. Also, the retail chain's store processes were modified and discussions initiated on purchasing technology tools to help sales associates served customers better.

Operating responses focus on fixing the way a firm conducts its businesses. Short-run tactics like the one Jill Soltau is attempting at J.C. Penney's is aimed at arresting the losses and reduce further damage. Without making large strategic shifts, the company aims to reduce the inefficiencies in its inventory management and store processes in the hope of improving revenue and saving the company from extinction.

Source: ICFAI Research Center

15.5.3 Stage 3: Transition

According to Chowdhury, "a substantial amount of time has to pass before the results of turnaround strategies show." According to some researchers, on an average, performance improvement takes place after around 7 years.

Example

When Snapdeal, the Indian e-commerce company, posted a net loss of ₹ 46.47 billion, with no money left to survive, the founders Kunal Bahl and Rohit Bansal decided to revamp Snapdeal calling the project "Snapdeal 2.0". The idea was to go back to the energy and drive of a start-up culture, something that the firm had lost as it grew in size. Soon, the efforts started paying off with a four-fold increase in order volume. The very next year, the company became cash flow-positive and started calling back employees who had left the firm two years ago. While it will take some time before Snapdeal can start showing real profits, it seems to be on the right path. According to the framework of the turnaround process developed by Shamsud Chowdhury, a substantial amount of time has to pass before the results of turnaround strategies show up. One year has passed after the Snapdeal 2.0 turnaround, the company is in the transition stage and there are signs that it is overcoming the survival crisis.

Source: ICFAI Research Center

15.5.4 Stage 4: Outcome

The fourth stage involves determining whether a turnaround has been accomplished. According to Chowdhury, a cut off point of performance measures can be used to determine this. The measures used to determine the outcome are the same as those that are used to identify the decline at the first stage of the turnaround.

Check Your Progress - 2

4. Identify the statement that is **incorrect** with respect to the numerator-focused approach to management in an economy that is contracting.
   a. Reducing manpower and expenditure
   b. Preserving technological leadership while maintaining the existing R&D budget
   c. Increasing sales without increasing expenditure on marketing communications
   d. Expanding distribution coverage in a cost-effective manner
5. Shamsud Chowdhury suggested the use of a stage theory to understand the turnaround process. As per this theory, which of the following is the most complex of these stages?
   a. Denominator management
   b. Response initiation
   c. Transition
   d. Outcome

6. As per the stage theory of turnaround management, which of the following statements are true?

   i. In the response initiation stage, diversification, vertical integration, and divestment are examples of strategic responses.

   ii. In the response initiation stage, short-run tactics aimed at cost-cutting and revenue generation are examples of operating responses.

   iii. The R-extinction perspective suggests that macro or external factors are responsible for the decline.

   iv. The K-extinction perspective suggests that the decline in the firm is due to a reduction in resources within the firm, independent of the external environment.

   a. Only i and ii

   b. Only iii and iv

   c. Only i, ii, and iv

   d. i, ii, iii, and iv

Activity 15.3

Restructuring is a strategy by which a company changes its business or financial structure. Firms use it in response to changes in the external and internal environment. In the light of rapid changes, restructuring is one of the best strategies for companies to create maximum value for their stakeholders. Elaborate further, with an example, on what motivates an organization to restructure itself, and how the strategy may help it solve problems.

Answer:

15.6 Summary

- Firms use restructuring strategies in response to the changes in the external and internal environment. The four major forms of corporate restructuring are expansion, sell-offs, corporate control, and change in ownership structure.
- In an economy that is slowing down or contracting, CEOs have two alternatives -- numerator management and denominator management -- for maintaining profitability levels.

- Denominator management involves reducing headcount and investment, and selling assets under a 'denominator-driven' belt-tightening program. Numerator management involves increasing profitability by improving productivity.
- The turnaround process consists of four stages -- decline, response initiation, transition, and outcome.

15.7 Glossary

Conglomerate merger: A merger of two firms from unrelated business activities. Conglomerate mergers can be categorized into product extension merger (merger between two firms in a related business activity), geographic extension merger (merger between two firms operating in non-overlapping geographic areas), and pure conglomerate merger (merger between two firms from unrelated business activities).

Horizontal merger: A merger between two firms operating and competing in the same business activity. The merging of two competing business entities results in a larger firm and thus, greater economies of scale. Firms may also merge horizontally to share resources and skills, and to derive synergy.

Merger: The integration of two or more firms on a co-equal basis. In a merger, the merging firms pool all their resources together to create a sustainable competitive advantage. The merging firms believe that it is more advantageous to merge rather than to operate as independent entities. That is, they believe that there is a significant synergy in merging their businesses.

Numerator and denominator management: In an economy that is contracting, an organization has two alternatives for maintaining profitability levels. It could reduce headcount and investment, and sell assets under a 'denominator-driven', belt-tightening program. This type of approach is called denominator management. Alternatively, it could attempt to increase profitability by improving productivity. This approach is referred to as 'numerator-focused' management. An organization can increase profitability by maximizing the components of the numerators, and minimizing the components of the denominators.

Restructuring: Restructuring can be defined as a strategy by which a company changes its business or financial structure. It involves making radical changes in the composition of the business. The various types of corporate restructuring can be classified into four major forms: expansion, sell-offs, corporate control, and change in ownership structure.

Turnaround: A turnaround occurs when "a firm perseveres through an existence-threatening performance decline; ends the threat with a combination of strategies, systems, skills, and capabilities; and achieves sustainable performance recovery. The obverse of performance recovery is failure and eventual death." This definition identifies four key attributes of a turnaround -- (a) declining performance is the trigger for turnaround, (b) turnaround involves a series of activities, (c) a turnaround is undertaken with a definite purpose, and (d) turnaround activities continue for a number of years.

Vertical merger: A merger between two firms in the same industry but in different stages of the value chain.

15.8 Self-Assessment Test

1. Discuss the various classifications and forms of corporate restructuring.
2. Explain the alternatives of 'numerator management' and 'denominator management' that are open for management to adopt, especially during an economic slowdown or recession.
3. How can an organization manage the turnaround process?

15.9 Suggested Readings/Reference Material

1. Thomas L. Wheelen, et al., Strategic Management and Business Policy: Globalization, Innovation and Sustainability, Fifteenth Edition, Pearson Paperback – 30 July 2018
2. P.N. Srivastava, Business Policy and Strategy Hardcover, Horizon Press, January 2019
3. Joan Magretta, Emile Holmewood and Heinrich Zimmermann, What is Strategy?: An Illustrated Guide to Michael Porter Hardcover – Illustrated, 15 September 2020, Harvard Business Review Press
4. Shabbar Suterwala, Top 20 Business Strategies for your Business Growth, Notion Press; 1st edition Paperback – 27 May 2021
5. Brian Tracy, Business Strategy: The Brian Tracy Success Library Hardcover – 26 February 2018, Manjul Publishing House
6. Callie Daum, Business Strategy Essentials You Always Wanted to Know (Second Edition), January 2020, Vibrant Publishers

15.10 Answers to Check Your Progress Questions

1. (c) i/r, ii/p, iii/q, iv/s

Forms of Restructuring

Expansion	Sell-Offs	Corporate Control	Changes in Ownership Structure
• Mergers and Acquisitions • Tender Offers • Joint Ventures	• Spin-Offs • Split-Offs • Split-Ups • Divestitures • Equity Carve-outs	• Premium Buy-Backs • Standstill Agreements • Anti-takeover Amendments • Proxy Contests	• Exchange Offers • Share Repurchases • Going Private • Leveraged Buy-Outs

2. (b) **In a split-off, the entire firm is fragmented into a series of spin-offs.**

   In a split-up (and not split-off), the entire firm is fragmented into a series of spin-offs.

3. (a) **Golden parachutes abolish termination payments that have to be made to the existing management.**

   Golden parachutes involve large termination payments to be made to the existing management. It is a type of anti-takeover amendment that can be made to the corporate bylaws in an attempt to prevent mergers and acquisitions.

4. (a) **Reducing manpower and expenditure**

   Reducing manpower and expenditure is typical of the denominator-driven approach to management, also referred to as a 'belt-tightening' program.

5. (c) **Transition**

   The transition stage, the third stage of the turnaround process, is the most complex of the four stages. In this stage, the firm experiments with different strategies, structures, cultures, and technologies.

6. (a) **Only i and ii**

   Statements iii and iv are false. The K-extinction (and not the R-extinction) perspective suggests that macro or external factors are responsible for the decline. The R-extinction perspective suggests that the decline in the firm is due to a reduction in resources within the firm, independent of the external environment.

Unit 16

Joint Ventures and Strategic Alliances

Structure

Seek out strategic alliances; they are essential to growth and provide resistance to bigger competition.

- Richard Branson, (Founder, Virgin Group)

16.1 Introduction

Branson reveals the power of strategic alliance – Growth and resistance to bigger competition.

In the previous unit, we have discussed corporate restructuring. In this unit, we shall discuss joint ventures and strategic alliances.

A joint venture is an effort of two or more firms to create an enterprise for profit. The effort is reflected in terms of contributions to resources, skill, or knowledge. The enterprise so created is bigger and better than what each one of the contributing firms could have created in isolation or it is created for a specific purpose which either of the firms would not have considered in isolation. A strategic alliance is a cooperative agreement between potential or actual competitors.

This unit will first discuss the concept of a joint venture, the rationale for joint ventures, and the reasons for the failure of joint ventures. We shall then move on to discuss the motives for and types of strategic alliances, and how to make strategic alliances work. Finally, we shall discuss the advantages and disadvantages of a strategic alliance.

16.2 Objectives

By the end of this unit, you should be able to:

- Discuss the concept of a joint venture, the rationale for joint ventures, and the reasons for the failure of joint ventures.
- Find out the motives for and types of strategic alliances, and how to make strategic alliances work.
- Explain the advantages and disadvantages of a strategic alliance.

16.3 Introduction to Joint Ventures

Joint venture, as a strategy, is more complex and more formal than all other arrangements, such as a licensing arrangement.

- Joint ventures involve the creation of a third entity, representing the interests and capital of the partners involved.
- In a joint venture, both the partners contribute their own proportional amounts of capital, distinctive skills, managers, reporting systems, and technologies to the venture.
- The emphasis is on collaboration rather than mere exchange. While exchange simply involves obtaining something back for what you have put in, collaboration involves creation of new value.

A joint venture leads to the creation of a separate business enterprise. This, however, does not imply that the participants to the joint venture cease to exist. Joint venture participants continue to exist as separate firms. A joint venture may take the form of a partnership, a corporation, or any other form of business organization, the participating firms might choose to select.

The following characteristics are taken into account while describing joint ventures:

1. Contribution of money, property, effort, knowledge, skill, or any other asset to a common undertaking, by the partners involved.
2. Joint property interest in the subject matter of the venture.
3. Right of mutual control or management of the enterprise.
4. Expectation of profit, or the presence of "adventure".
5. Right to share in the profit.
6. Usual limitation of the objective to a single undertaking or ad hoc enterprise.

The scope and duration of joint ventures is, therefore, limited. Joint ventures involve only a small fraction of each participant's total activities. Each participant must contribute or offer something unique and of importance to the venture and, at the same time, provide a source of gain to the other participants to the venture.

16.4 The Rationale for Joint Ventures

The following are the rationale for joint ventures:

1. The primary motive for starting a joint venture is to share investment expenditure or to enable a large, cash rich company to collaborate with a smaller company having a product or production idea but lacking funds to pursue the opportunity.
2. The learning experience that may be obtained is the second strong motive for joint ventures.
3. A joint venture serves as a method for sharing the risks, even for a large company.
4. Anti-trust authorities may be more willing to permit joint ventures rather than mergers. This is because joint ventures result in an increase in the number of firms while mergers lead to a decrease in the number of firms. In a joint venture, parent firms continue their operations even after the new firm is created. The likelihood of receiving endorsement from government agencies is especially greater in case of joint ventures in research and development areas.
5. A firm when entering into a new market or a new country, may choose to enter into a joint venture with a domestic company in order to minimize the exposure to country risk. In some countries, foreign firms are allowed to operate in some sectors only if they have a domestic joint venture partner.
6. Another rationale for joint ventures could be that one firm brings technology to the venture and the other firm brings capital because the former does not have the capital and the latter does not have the technology.

Further, joint ventures may be used to acquire complementary or technological resources at a lower cost, or to derive benefits from economies of scale, critical mass, and learning experience.

Joint ventures may also be used as an element for long-range strategic planning by firms. Similar to a spider's web, a small firm in a highly concentrated industry acquires countervailing power among rivals in a product market and among rivals for a scarce resource by entering into joint ventures with several of the industry's dominant firms.

It thus forms around itself a self-protective network of counterbalancing forces. This strategy is feasible only when the small firm has something unique to offer to the industry leaders.

Example

When Starbucks Coffee Company, the international coffee brand, signed a 50-50 joint venture with Tata Global Beverages Limited, the Indian branded tea company, a new entity was named Tata Starbucks Limited for operating Starbucks cafés in India. Indian laws allowed up to 51% Foreign Direct Investment (FDI) in single-brand retail. Choosing a trusted brand like Tata helped Starbucks enter the Indian market with minimal regulatory hurdles. Tata was already supplying Indian Arabica coffee beans to Starbucks globally. Six years later, the JV had 138 stores, mostly in metro cities across India with 540,000 loyalty programme members. By tying up with a trusted company of the Tata Group and forming a new legal entity, Starbucks was able to manage the FDI restrictions and reduce its country risk exposure.

Source: ICFAI Research Center

16.4.1 Joint Ventures and Complex Learning

According to Berg, Duncan, and Friedman (1982), 50 percent of all joint ventures take place for the purpose of knowledge acquisition. The contractual relationship between the joint venture partners is determined on the basis of the complexity of the knowledge to be transferred. Learning-by-doing and teaching-by-doing (L/TBD) may be the most appropriate means of transfer in situations where the knowledge to be transferred is complex or embedded in a complicated set of technological and organizational circumstances.

Giving training in complex production tasks in a classroom situation may be very costly or even impossible. Simulation of the atmosphere (operations, machines, work group) may be essential to enable proper knowledge transfer. Further, to achieve efficiency in the process being taught, successive adaptations to changing internal and environmental events become necessary. Hence, job incumbents, however skilled, may be unable to describe job skills to trainees except in an operational context. L/TBD is, therefore, the most appropriate vehicle for knowledge transfer, more so in a joint venture setting.

Example

Japanese automaker Toyota and the German auto major BMW signed a joint venture agreement to co-develop a platform concept for a mid-size sports vehicle. Toyota made the move to tap into BMW’s expertise in making sports cars and for BMW, it wanted to gain insight on Toyota’s legendary quality and efficiency focused manufacturing process. After few years, the Toyota Supra with a BMW 3 litre 6-cylinder engine was launched and BMW decided to use the same platform to build its new range of sports cars. The venture created by Toyota and BMW was an effort by the two companies at gaining insights on each other’s expertise.

Source: ICFAI Research Center

Tax aspects of joint ventures

A significant aspect in joint ventures is tax advantages. The tax consequences may be less than on royalties earned through a licensing arrangement if a corporation contributes a patent or licensable technology to a joint venture. The use of joint ventures may be favored in many circumstances due to a number of other more technical tax advantages such as limitation on operating loss carry-over.

16.4.2 International Joint Ventures

The need to reduce the risk of expansion in a foreign environment also acts in favor of joint ventures. In some foreign countries, there may be a legal requirement for a local partner, who could contribute valuable information about the local conditions, which may be of vital importance to the success of the venture. The main reasons for international joint ventures are:

Learning a partner's skills

Firms often enter into joint ventures in order to learn the distinctive skills or capabilities of another firm. It is preferable to make use of skills such as proprietary technologies and specialized processes that may already be available in a potential partner than spending time and money on developing these. This is commonly observed in many high-technology industries.

Upgrading and improving skills

Firms with similar skills can also improve and augment each other's distinctive competencies through joint ventures. In spite of being competing rivals within the same industry, joint venture participants may still benefit from closely cooperating in developing cutting-edge technology, which can transform the industry.

Activity 16.1

Though companies enter into joint ventures for various reasons, many analysts feel that 50% of all joint ventures take place to acquire knowledge. Discuss, with the help of a suitable example, how companies acquire knowledge by entering into joint ventures.

Answer:

16.5 Reasons for the Failure of Joint Ventures

Joint ventures, like any other long-term contract, are prone to problems. According to independent studies conducted by McKinsey & Co. and Coopers & Lybrand, 70 percent of joint ventures are either disbanded or fall short of expectations. Other studies suggest that on an average, joint ventures do not even last as long as one half the term of years stated in the joint venture agreement. Following are some of the reasons for the failure of joint ventures.

- The contract may be too inflexible to permit required adjustments in the future.
- There may be a lack of commitment and time in implementing the project.
- There may be an inability or failure to develop the desired technology.
- There may be a lack of adequate pre-planning for the joint ventures.
- There could be a failure to reach an agreement on alternative approaches to achieve the basic objectives of the joint venture.
- Managers possessing expertise in one company may refuse to share knowledge with their counterparts in the joint venture.
- The parent companies may be unable to share control or compromise on difficult issues.
- Critical issues of business policy and long-term strategies of individual business firms may arise in certain joint ventures.

<u>Check Your Progress - 1</u>

1. Which of the following strategies is a combined undertaking or a partnership by two or more firms to create a separate business enterprise?
   a. Joint collaboration
   b. Merger
   c. Joint venture
   d. Leveraged buyout
2. Which of the following emphasizes on collaboration rather than mere exchange? While exchange simply involves obtaining something in return for what is put in, collaboration involves creating new value.
   a. Joint venture
   b. Merger
   c. Fair price amendment
   d. Golden parachute

3. Which of the following characteristics are taken into account while describing a joint venture?
   i. Contribution of asset to a common undertaking, by the partners involved
   ii. Joint property interest in the subject matter of the venture
   iii. Contribution of money, property, effort, skills, or other assets by the partners
   iv. Right of mutual control or management of the enterprise
   a. Only i, ii, and iii
   b. Only i, ii, and iv
   c. Only i, iii, and iv
   d. i, ii, iii, and iv
4. Which of the following characteristics is **not** found in a joint venture?
   a. Expectation of profit or presence of 'adventure'
   b. Right to share in the profit
   c. Usual limitation of the objective to a single undertaking or ad hoc enterprise
   d. The number of partners in any collaboration is confined to two.
5. The motives behind initiating a joint venture are:
   i. To share the investment expenses.
   ii. To obtain learning experience.
   iii. To increase the investment outlay.
   iv. Share the risk.
   a. Only i, ii, and iii
   b. Only i, ii, and iv
   c. Only i, iii, and iv
   d. i, ii, iii, and iv
6. Which of the following strategies that anti-trust authorities are more willing to permit rather than mergers?
   a. Joint ventures
   b. Acquisitions
   c. Takeovers
   d. Spinoffs
7. Shapur Refinery is a small-scale gold refinery company. It is planning to initiate gold mining operations in the southern part of the country and is looking for partners for this project. The Kolkata-based Tushar Group with diverse interests in jewelry stores, textiles, industrial chemicals, electronics,

and cosmetics has shown interest in entering into a joint venture with Shapur Refinery for starting new gold mining operations. What could be the probable reasons for Tushar Group's decision?

i. Tushar Group's other projects such as jewelry and electronics may benefit from this project.
ii. Tushar Group has surplus funds which can be invested in this venture.
iii. Tushar Group can, later on, carry out fully-owned backward integration
iv. Tushar Group has the specialized skill required in starting gold mines, gained from its other projects

a. Only ii and iv
b. Only i and ii
c. Only ii and iii
d. Only i, ii, and iii

8. Which of the following is **not** a reason for the failure of joint ventures?
   a. The contract may be too flexible and permits adjustments in the future
   b. Lack of commitment and time in implementing the project
   c. Inability or failure to develop the desired technology
   d. Lack of adequate pre-planning for the joint venture

Activity 16.2

A joint venture can be defined as a cooperative business agreement between two or more firms that want to attain similar objectives. Joint ventures, like any other long-term contracts, are prone to difficulties. With the help of an example, discuss the difficulties faced in joint ventures that may even result in their break-up.

Answer:

16.6 Introduction to Strategic Alliances

A strategic alliance is a cooperative agreement between potential or actual competitors.

16.6.1 Generic Motives for a Strategic Alliance

Firms are entering into strategic alliances with their rivals, suppliers, and customers. Today, groups of companies are competing with other groups of companies, leading to the redistribution of economic power in society. There are obvious reasons for entering into such agreements.

- Strategic alliances enable firms to design new products, minimize costs, enter new markets, preempt competitors, and generate higher revenues.
- Alliances also enable the transfer of technology and further organizational learning.
- Companies that wish to expand their geographic reach take the strategic alliance route.

Thus strategic alliances can be a powerful source of strength in these changing times.

The benefits of a strategic alliance go beyond satisfying the immediate needs of the participants in the alliance; they also open avenues to new opportunities. Strategic alliance can also improve a firm's strategic position in the market significantly, and can sometimes even transform a company.

16.6.3 Types of Strategic Alliances

There are different bases for the classification of strategic alliances. In this section, we will discuss two such classification schemes.

Classification by Bleeke and Ernst

Joel Bleeke and David Ernst have classified strategic alliances according to the power of the companies that enter into the alliance and the possibility that the alliance might end in the sale of one or more of the participants. On this basis, they have classified strategic alliances into six types.

- *Collision between two partners*: This is an alliance between two strong firms that are in direct competition with each other. Such alliances are short-lived and usually end in dissolution or a merger/acquisition.
- *Evolution to a sale*: Two strong and compatible partners enter into an alliance but competitive tensions develop. In the end, one partner sells out to the other.
- *Alliance of complementary equals*: This is an alliance of two strong and complementary partners that remains strong during the course of the alliance.
- *Disguised sale*: This is a short-lived alliance between a weak firm and a strong firm. The weaker partner remains weak during the course of the alliance and is eventually acquired by the stronger partner.
- *Bootstrap alliance*: This is an alliance between a weak firm and a strong firm. The weaker firm uses the alliance to improve its competencies, but it remains relatively weak and is acquired by the stronger firm in the end.
- *Alliance of the weak*: In this, two weak firms join hands to improve their positions but both the firms usually grow weaker and the alliance fails.

Example

A strategic alliance was announced between technology major Google and NASA, the American aerospace research agency. The alliance on the Haughton-Mars Project (HMP) was to conduct cutting-edge research in human Mars exploration. Google will supply its data storage platform to NASA and analyse Earth, life and space science discoveries using supercomputing and data mining. Google in return gets access to valuable inputs on the terrain of Mars and deploy its range of tools to map the landscape of the planet. The relationship between Google and NASA revolves around areas of common interest, namely, terrain mapping and data analytics.

Source: ICFAI Research Center

Classification by Hamel, Doz, and Prahalad

Another classification of strategic alliances is based on the framework provided by Gary Hamel, Yves L. Doz, and C. K. Prahalad. According to them, there are three types of strategic alliances:

- One is an alliance between potential competitors to neutralize rivalry. An example of such an alliance is the Airbus Consortium, formed by the governments of European countries to create an entity which could be a formidable competitor to Boeing.
- The second type of strategic alliance is between companies that have separate specialized resources. Companies combine these resources to create value. For example, Hitachi tied up with Texas Instruments for the development of a 265 megabit DRAM chip and with GE for gas turbines.
- The third type of strategic alliance involves acquisition of new knowledge by working together or observing each other. For example, by forming an alliance with Toyota, General Motors hoped to learn about Toyota’s lean manufacturing system and Toyota about General Motors’ superior designs.

Example

The internet search giant, Google, announced a partnership with Milan-based premium eyewear company Luxottica Group - makers of famous brands like Ray-Ban to create innovative wearable devices for its headset product called Glass. Google had earlier worked on Glass using its R&D team, but with its lack of knowledge in the eyewear space had failed to create and market the right product. This time, Google had decided to have a team of experts from both the companies jointly working on the design, development, tooling and engineering of Glass products. Google's expertise in connected internet devices will be shared with Luxottica and in return, gets access to the best practices of eyewear manufacturing and marketing.

Source: ICFAI Research Center

16.7 Making Alliances Work

The success of an alliance depends on three main factors -- partner selection, alliance structure, and the manner in which the alliance is managed.

16.7.1 Selecting the Right Partner

It is important to select the right kind of partner to make the strategic alliance work. A good partner has three principal characteristics.

- First, a good partner helps the firm achieve its strategic goals, be it access to the market, sharing costs and risks of new product development, or gaining access to core competencies.
- Second, a good partner shares the vision of the firm for the purpose of the alliance. If two firms have different agendas then the chances are that the alliance will not be successful.
- Third, a good partner will not exploit the alliance for selfish ends such as acquiring the partner's technological know-how while giving very little in return.

It is important for the firm to get to know the potential partner before committing itself to an alliance. Before selecting a partner, a firm should collect information on potential allies and collect information from firms that have had alliances with them in the past.

16.7.2 Structuring the Alliance

While structuring the alliance, some issues that need to be discussed in detail are percentage of ownership; the mix of financing, technology, and machinery to be contributed by each partner, division; and sharing of activities, staffing, location, and control.

The alliance should be designed in such a way that there is reasonable consistency with the strategic objectives of the partners and there is potential for value addition. The success of an alliance depends on its ability to address as early as possible questions like:

- How can the alliance create value?
- How can this value be maximized for all partners?
- What mechanisms are needed to resolve conflicts?

The alliance should be structured in such a way that the firm's risk of giving too much away to the partner is reduced to an acceptable level. The alliance should be designed in such a way that it is difficult to transfer technology that is not meant to be transferred. The design, development, manufacture, and servicing of a product manufactured by an alliance can be structured in such a way as to "wall off" sensitive technologies to prevent them from leaking to the other participant.

Contractual safeguards should be included in the alliance to guard against the risk of opportunism by a partner. To ensure equitable gain from the alliance, both parties can agree to swap skills and technologies. One way is to have a cross-licensing agreement.

The risk of opportunism by an alliance partner can also be reduced if the firm gets credible commitment from the partner in advance.

16.7.3 Managing the Alliance

After selecting a partner and putting an appropriate alliance structure in place, the next task is to maximize the benefits from the alliance. For this, the partners need to build trust and learn from each other and build interpersonal relationships between the firm's managers.

Hamel, Doz, and Prahalad studied 15 strategic alliances for a period of five years and concluded that a major determinant of how a company gains from an alliance is its ability to learn from its alliance partner.

- The researchers focused on a number of alliances between Japanese companies and their western partners.
- They concluded that in each case, the Japanese company emerged stronger than its western partner from an alliance and that it made greater efforts to learn.
- Few western companies seemed to have made efforts to learn from their Japanese partners. They considered the alliance as purely a cost-sharing or risk-sharing device and not as an opportunity to learn how a potential competitor does business.

Hamel, Doz, and Prahalad felt that most learning takes place at lower levels of an alliance. Operating employees play an important role in acquiring knowledge and therefore, they must be well informed of the partner's strengths and weaknesses. They must understand how acquiring particular skills will improve their company's competitive position.

According to the researchers, to maximize the learning benefits of an alliance, a firm must try to learn from its partner and apply the knowledge within its own organization. They felt that this was a standard practice among Japanese companies. The collaborations manager at one Japanese company made the rounds of all employees involved in alliances. The idea was to identify what information had been collected by whom and then pass it on to appropriate departments.

16.8 The Advantages and Disadvantages of a Strategic Alliance

According to Hamel, Doz, and Prahalad, firms form alliances with actual or potential competitors for various strategic purposes.

- Strategic alliances facilitate entry into foreign markets.

- Firms also enter into strategic alliances to share the costs and risks associated with developing new products or processes.
- Companies can combine skills and assets that neither can develop on their own.
- Strategic alliances also help firms establish technological standards for the industry that ultimately benefit the firms. Though strategic alliances are highly beneficial, some critics have argued that they give competitors a low cost route to new technology and markets.

Check Your Progress - 2

9. As per the classification scheme proposed by Bleeke and Ernst, which of the following types of strategic alliances (between two organizations) is expected to be successful and long-lived instead of resulting in an early dissolution or acquisition of one partner by the other?
   a. Collision between two partners
   b. Alliance of complementary equals
   c. Bootstrap alliance
   d. Alliance of the weak
10. The success of an alliance depends on three main factors: partner selection, alliance structure, and the manner in which the alliance is managed. From the following options, identify a set of guidelines for structuring the alliance effectively.
    i. The alliance should be designed in such a way that there is reasonable consistency with the strategic objectives of the partners and there is potential for value addition.
    ii. Issues such as 'the mechanisms required to resolve conflicts' should be addressed when structuring the alliance.
    iii. A firm's risk of giving too much away to the partner should be reduced to an acceptable level.
    iv. The risk of opportunism by a partner should be guarded against by including contractual safeguards and/or getting credible commitment in advance from the partner.
    a. Only i and iii
    b. Only i, iii, and iv
    c. Only ii, iii, and iv
    d. i, ii, iii, and iv

Activity 16.3

Joint ventures allow companies to own a stake and play a role in the management of the joint operation. They require more direct investment and training, management assistance, and technology transfer. The basic motive for starting a joint venture is sharing investment. Learning is the second biggest motive. Elaborate further, by giving an example, why firms enter into joint ventures and why they come out of them?

Answer:

16.9 Summary

- A joint venture can be defined as a new corporate entity that is created as an outcome of a cooperative business agreement between two or more firms that want to attain similar objectives and fulfill their mutual needs.
- The basic motive for starting a joint venture is sharing investment. The main reasons for international joint ventures are: learning a partner's skills, and upgrading and improving skills.
- There are many managerial reasons for the failure of joint ventures.
- A strategic alliance is a cooperative agreement between potential or actual competitors. Strategic alliances enable firms to design new products, minimize costs, enter new markets, preempt competitors, and generate higher revenues.
- According to one classification scheme, the different types of strategic alliances are: collision between two partners, evolution to a sale, alliance of complementary equals, disguised sale, bootstrap alliance, and alliance of the weak.
- According to another classification scheme, the different types of strategic alliances are: alliance between potential competitors to neutralize rivalry, alliance between firms that have separate specialized resources, and alliances that involve acquisition of new knowledge by working together or observing each other.
- The success of an alliance depends on three main factors: partner selection, alliance structure, and the manner in which the alliance is managed.
- Strategic alliances may facilitate companies to enter into foreign markets, share costs and risk in developing new products or processes, combine skills and assets that neither can develop on their own.
- The drawback of strategic alliances is that they may give competitors a low cost route to new technology and markets.

16.10 Glossary

Bootstrap alliance: A strategic alliance between a weak firm and a strong firm.

Buy-out: When the members of the incumbent management group initiates the transaction (purchasing substantial proportion of the equity ownership of the new private company), it is known as a management buy-out.

Joint venture: An effort of two or more firms to create an enterprise for profit. The effort is reflected in terms of contributions to resources, skill, or knowledge. The enterprise so created is bigger and better than what each one of the contributing firms could have created in isolation or it is created for a specific purpose which either of the firms would not have considered in isolation.

Leveraged buyouts (LBOs): When the private company borrows substantially from third parties, such transactions are called Leveraged buyouts (LBOs).

Merger: Any transaction through which two or more firms integrate their operations on a relatively co-equal basis

Strategic alliance: A cooperative agreement between potential or actual competitors.

16.11 Self-Assessment Test

1. Explain the concept of a joint venture. What is the rationale behind companies entering into joint ventures? Describe the reasons why these fail.
2. Describe the motives for entering into strategic alliances. What are the various types of strategic alliances?
3. How can company make strategic alliances work? What are the advantages and disadvantages of a strategic alliance?

16.12 Suggested Readings/Reference Material

1. Thomas L. Wheelen, et al., Strategic Management and Business Policy: Globalization, Innovation and Sustainability, Fifteenth Edition, Pearson Paperback – 30 July 2018
2. P.N. Srivastava, Business Policy and Strategy Hardcover, Horizon Press, January 2019
3. Joan Magretta, Emile Holmewood and Heinrich Zimmermann, What is Strategy?: An Illustrated Guide to Michael Porter Hardcover – Illustrated, 15 September 2020, Harvard Business Review Press
4. Shabbar Suterwala, Top 20 Business Strategies for your Business Growth, Notion Press; 1st edition Paperback – 27 May 2021
5. Brian Tracy, Business Strategy: The Brian Tracy Success Library Hardcover – 26 February 2018, Manjul Publishing House
6. Callie Daum, Business Strategy Essentials You Always Wanted to Know (Second Edition), January 2020, Vibrant Publishers

16.13 Answers to Check Your Progress Questions

1. (c) Joint venture

A combined undertaking or partnership by two or more firms to create a separate business enterprise is known as a joint venture. A joint venture can be taken up for a variety of reasons. An example of a joint venture is NTPC-ALSTOM Power Services Pvt. Ltd. This joint venture was undertaken by NTPC and ALSTOM for renovation and modernization of power stations in India and other SAARC countries. Both promoters contributed equally to the promoters' equity.

2. (a) Joint venture

The emphasis of a joint venture is on collaboration rather than mere exchange. While exchange simply involves getting something in return for what is put in, collaboration involves the creation of new value. A joint venture aims at making use of the distinct capabilities or resources of the two firms (in a synergistic way) to create new value. For example, Aditya Birla Group and Sun Life of Canada have entered into a joint venture to serve the Indian market with insurance solutions, mutual funds, and investment planning services. Aditya Birla group alone would not have the expertise to offer these solutions and Sun Life on its own would be an unknown entity in the Indian market. Accordingly, the two companies came together to take advantage of each other's capabilities in a synergistic manner and created new value for the Indian investors.

3. (d) i, ii, iii, and iv

Characteristics that are taken into account while describing joint ventures are: contribution of money, property, effort, knowledge, skill, or other assets to a common undertaking by the partners involved; joint property interest in the subject matter of the venture; and the right of mutual control or management of the enterprise.

4. (d) The number of partners in any collaboration is confined to two.

Characteristics found in a joint venture include: expectation of profit or presence of "adventure"; right to share in the profit; and usual limitation of the objective to a single undertaking or ad hoc enterprise. There can be any number of partners in a joint venture; it is not confined to only two. For example, in a joint venture to set up and run a five star hotel, one partner may contribute by bringing in land, another may offer the franchise name, and the third partner may look after the operations of the hotel.

5. (b) Only i, ii, and iv

Joint ventures are stimulated for a number of motives. The primary motive for starting a joint venture is to share investment expenses or to enable a large company rich in cash to invest and collaborate with a smaller company that has a product or production idea but lacks funds to pursue the opportunity. The learning experience that may be obtained is a second strong motive for joint ventures. Further, a joint venture serves as a method for reducing the investment outlay and sharing the risks, even for a large company.

6. **(a) Joint ventures, mergers**

   Anti-trust authorities are more willing to permit joint ventures rather than mergers. This is because joint ventures result in an increase in the number of firms while mergers lead to a decrease in the number of firms which may reduce competitiveness in an industry. Further, joint ventures enable partners to pool their resources, share risk, and take up large projects, which they would be hesitant to take up individually.

7. **(d) Only i, ii, and iii**

   Tushar Group might be interested in the venture to enable it to source gold at a low cost for its jewelry stores and electronics. They may also have surplus funds and find the venture a good route for investment. Once Tushar Group gains the expertise in gold mining through this venture, it may itself get into gold mining as a fully-owned venture to enable backward integration for its jewelry stores. Statement (iv) is not correct because Tushar Group's other projects, namely textiles, jewelry stores, electronics, industrial chemicals, and cosmetics do not contribute to the skill required for gold mining operations.

8. **(a) The contract may be too flexible and permits adjustments in the future**

   Reasons for the failure of joint ventures are: the contract may be too **inflexible and does not** permit required adjustments in the future; lack of commitment and time in implementing the project; inability or failure to develop the desired technology; and the lack of adequate pre-planning for the joint venture.

9. **(b) Alliance of complementary equals**

   A strategic alliance between two strong and complementary partners remains strong during the course of the alliance. The collision between two partners alliance is expected to be short-lived. A bootstrap alliance usually results in the acquisition of the weaker company by the stronger company. An alliance of the weak usually results in further weakening of both the companies and the alliance fails.

10. **(d) i, ii, iii, and iv**

    The four statements describe various guidelines for structuring an alliance effectively to increase its probability of success.

Unit 17

Mergers and Acquisitions

Structure

"Apple doesn't buy competitors — it buys companies which have products or other technology that Apple can turn into features."

- Tim Cook (CEO, Apple)

17.1 Introduction

Tim Cook is talking about how Apple is unlocking the business advantages that acquisition strategy offers.

In the previous unit, we have discussed joint ventures and strategic alliances. In this unit, we shall discuss about mergers and acquisitions.

Mergers can be defined as the integration of two or more firms on a co-equal basis. In mergers, firms pool all their resources together to create a sustainable competitive advantage. The two merging firms believe that it is more advantageous to merge rather than to operate as independent entities. That is, they believe that there is a significant synergy in merging their businesses.

An acquisition refers to the process of one company gaining partial or complete control of another for some strategic reasons. Unlike mergers, acquisitions can sometimes be unfriendly. For example, a firm may attempt to acquire, that is, take over another, by adopting hostile measures which may not be in the interest of the firm that is to be acquired.

This unit will first discuss the types of mergers and the economic rationale for mergers and acquisitions. We shall then move on to discuss the influence of industry life cycle stages on mergers and acquisitions activity. We shall also discuss about cross-border mergers and acquisitions. Finally, we shall discuss the reasons for success and failure of mergers and acquisitions.

17.2 Objectives

By the end of this unit, you should be able to:

- Discuss the types of mergers and the economic rationale for mergers and acquisitions.
- Explain the influence of industry life cycle stages on mergers and acquisitions activity.
- Discuss about cross-border mergers and acquisitions.
- Identify the reasons for success and failure of mergers and acquisitions.

17.3 Types of Mergers

Mergers and acquisitions (M&As) enable a firm to pursue an inorganic growth strategy. In order to expand the size of the firm through mergers, firms go in for horizontal, vertical, and conglomerate mergers.

17.3.1 Horizontal Mergers

If two firms operating and competing in the same business activity merge, it is known as a horizontal merger. For example, a series of horizontal mergers resulted in the consolidation of the global steel industry. The merging of two competing business entities results in a larger firm and thus, greater economies of scale. But this is not the only reason for the popularity of horizontal mergers.

Though horizontal mergers benefit from large-scale operations, not all firms merge horizontally to achieve economies of scale. Firms may merge horizontally to share resources and skills, and to derive synergy.

By decreasing the number of firms in an industry, a horizontal merger may create a monopoly market and the consumer suffers. As horizontal mergers can reduce competition, governments take efforts to regulate such mergers.

Example

United Bank of India (UBI) and Oriental Bank of Commerce (OBC) were merged with India’s third-largest PSU lender Punjab National Bank (PNB). The new entity estimated that PNB-UBI-OBC combined will have a collective business volume of about ₹ 18 lakh crore. The merged entity would become the second-largest public sector lender surpassing the second-largest PSB Bank of Baroda. In the above case, UBI, OBC, and PNB operate in the same business. Hence, the merger of UBI, OBC, and PNB is an example of horizontal merger.

Source: ICFAI Research Center

3.1 Vertical Mergers

When two firms in the same industry but in different stages of the value chain, merge, it is called a vertical merger.

There are different reasons for companies entering into vertical mergers. They include: reducing costs of communication, coordinating production, and better planning for inventory and production.

Activity 17.1

Most mergers and acquisitions aim at increasing market power, target competitors, suppliers, distributors, or businesses in related industries. There are three types of mergers: Horizontal, Vertical, and Conglomerate. With the help of an example, discuss how a vertical merger benefits the merged entity.

Answer:

17.3.2 Conglomerate Mergers

When two firms from unrelated business activities merge, it is known as a conglomerate merger. Conglomerate mergers can be categorized into three different types: product extension merger, geographic extension merger, and pure conglomerate merger.

- When two firms in a related business activity merge, it is called a product extension merger. It helps broaden the product line of firms.
- When two firms operating in non-overlapping geographic areas merge, it is known as geographic extension merger.
- When two firms from unrelated business activities merge, it is known as a pure conglomerate merger.

Example

Reliance Industries Limited, an Indian multinational conglomerate company, operates different businesses like energy, petrochemicals, textiles, natural resources, retail, and telecommunications. In 2018, Reliance Industries signed a pact with Saavn music app (India based music company) for $104 million in cash and rest in stock, to merge it with its own digital music service JioMusic, valuing the combined music platform at about $1 billion. In the cash and stock deal for Saavn, JioMusic would hold implied valuation of $670 million.

Contd….

In addition to the merger, Reliance is also investing up to Rupee equivalent of $100 million for growth and expansion of the platform into one of the largest streaming services in the world. The above case of Reliance shows product extension conglomerate merger.

Source: ICFAI Research Center

Check Your Progress - 1

1. In which of the following strategies, two or more firms integrate on a co-equal basis?
   a. Acquisition
   b. Merger
   c. Spin-off
   d. Takeover
2. A merger between two or more firms can be called a horizontal merger if
   a. They are operating and competing in the same business environment and are producing the same product.
   b. They have unrelated business activities.
   c. They are in the same industry but at a different stage of the value chain.
   d. The intent is only to acquire a controlling interest in the other company.
3. Two or more business entities undergo a horizontal merger in order to
   i. Benefit from large scale operations.
   ii. Share resources and skills.
   iii. Gain corporate control.
   iv. Derive synergy.
   a. Only i and ii
   b. Only i, ii, and iv
   c. Only ii, iii, and iv
   d. i, ii, iii, and iv
4. Which of the following is true when Governments make efforts to regulate horizontal mergers?
   a. Create a monopoly market
   b. Increase competition in the market
   c. Increase the number of firms in the market
   d. Increase new product development

5. Which of the following is **not** a reason for undertaking a vertical merger?
   a. To reduce costs of communication
   b. To coordinate production
   c. To achieve greater economies of scale
   d. For better planning of inventory and production
6. Which of the following is a merger between a firm manufacturing two-wheelers and a firm manufacturing cars?
   a. Horizontal merger
   b. Vertical merger
   c. Product extension conglomerate merger
   d. Pure conglomerate merger
7. Akash Enterprises Ltd is a south India-based soap manufacturing firm with no foothold in the northern part of India. It has decided to undergo a merger with Ajay Ltd that enjoys a dominant position in the soaps industry in northern India. Which of the following is correct for the given scenario?
   a. Geographic extension conglomerate merger
   b. Horizontal merger
   c. Product extension conglomerate merger
   d. Vertical merger

Activity 17.2

The primary reason for firms opting for mergers and acquisitions is their desire to increase their market power through synergies. One type of merger through which firms can increase their market power is geographic extension merger. Explain, with the help of an example, a geographic extension merger, and how it leads to increased market power.

Answer:

17.4 The Economic Rationale for Mergers and Acquisitions

Firms opt for M&As due to various reasons such as increased market power, overcoming entry barriers, avoiding the cost of new product development, increased speed to market, lower risk, increased diversification, and reshaping the firm’s competitive scope.

17.4.1 Increased Market Power

The primary reason for firms going in for M&As is their desire to increase their market power. A firm gains market power when it is able to sell its goods or services at a price lower than its competitors or when the cost of producing the product or service is much less than it is in the case of its competitors.

A firm may have core competencies but may lack the required resources and size to compete in the market. In order to gain the required resources, the firm may go in for a merger with another company that is rich in resources. Economies of scale also result in increased bargaining power during negotiations with suppliers.

17.4.2 Overcoming Entry Barriers

When firms try to enter new markets, they often face many problems, some of which may act as barriers to their entry.

- Well-established firms in a market may sell their products and services in large volumes, thereby gaining economies of scale. Economies of scale become a barrier to entry.
- Another barrier that a new entrant in the market faces is customer loyalty to existing products and services.
- Creating enduring relationships with customers leads to customer loyalty which a new entrant may find difficult to overcome.
- Moreover, a new entrant has to spend huge amounts on promotional activities. The cost of advertising increases further when a new entrant to the market prefers differentiating its products from those of its competitors.

Thus economies of scale, customer loyalty, and high promotional expenditure act as barriers for a firm trying to enter a new market. The greater the barriers to entry, the more the likelihood that firms will resort to M&As to overcome these barriers.

17.4.3 Avoiding the Cost of New Product Development

Developing new products and launching them successfully in the market requires commitment of the firm’s resources. The return on investment may take a long time. Moreover, the market acceptance of the new product is also unpredictable. According to a study, 88 percent of the new products fail to achieve expected results. And 60 percent of innovative products are copied within four years being patented.

Firms prefer to go in for M&As to avoid the internal costs of developing new products. Moreover, M&As also reduce the risks associated with the launch of a new product, as the product has already been tested in the market. If a company acquires another that already has an established product in the market, the acquiring company can enter the market more quickly.

For example, pharmaceutical companies use M&As to gain a quick entry into the market and overcome the high costs of product development. As patents on many key drugs expire after a certain period, firms which do not have a strong R&D center are likely to be left behind. Thus, M&As are the preferred option for such companies.

17.4.4 Increased Speed to Market

As discussed earlier, M&As lead to faster market entry when compared to the time taken for new product development. Research has shown that M&As are the quickest route to new markets and new capabilities.

The new capabilities can be used to introduce new products and enter markets, and this can create an advantageous market position. However, how long the advantage may last depends upon the counter-strategies adopted by competitors.

17.4.5 Lower Risk

As we have seen earlier, developing a new product involves a lot of risk. Managers view M&As as a risk-free method of gaining an entry into new markets. Research shows that M&As have become a means of avoiding risky internal ventures. Many firms would not like to incur heavy expenses on developing new products, as acquisitions often seem to provide an economically more viable option.

But one major drawback associated with increasing M&As activities is that they prevent investments in new product development.

17.4.6 Increased Diversification

Firms find it easy to develop and introduce new products in markets in which they have some experience. On the contrary, if a firm launches a product that has no relation to its existing portfolio of the products, there are lower chances of its success. Thus, in order to diversify, firms would prefer the M&A route.

M&As can be used for both related as well as unrelated diversification. They are more common when firms want to diversify on a global level.

17.4.7 Reshaping the Firm’s Competitive Scope

The intensity of competition affects the profitability of a firm. To reduce the negative effect of competition, and reduce their dependence on a single or a few products, firms acquire other firms. If a firm is dependent on a single product and market for all its revenues and profits, the competitive scope of the company is likely to be reduced. To avoid such dependence, many firms venture into new industries and markets through acquisitions.

17.5 Industry Life Cycle Stages and M&A Activity

There is a close link between the various stages in the industry life cycle and the nature of M&A activity. All the four stages -- introduction, exploitation, maturity, and decline -- have distinct roles to play in influencing the nature of M&A activity.

- In the introduction and exploitation stages of the industry life cycle, new or small firms are the targets for related or conglomerate mergers.
- The process of mergers is initiated by larger firms in mature or declining industries. The larger firms provide managerial and financial efficiencies through mergers.
- Horizontal mergers between smaller firms take place for the acquisition of managerial and financial resources. The purpose behind horizontal and related mergers in the maturity stage is to match the low cost and price performance of other firms -- both domestic and foreign -- by achieving economies of scale in research, marketing, and production.
- In the decline stage, horizontal mergers take place to ensure survival; vertical mergers to increase efficiency and profit margins; acquisitions in related industries to obtain opportunities for synergy and carry-over of managerial capabilities; and conglomerate acquisitions to utilize financial slack of mature firms in declining industries.

Example

Intel—known for its chips, data centers and computing capabilities—acquired Israel-based 'Mobileye', for a huge $15 billion. Mobileye develops and supplies sensors and cameras for ADAS (Advanced Driver Assisted System). Mobileye is also known for its computer vision and machine learning technology. The $15 billion deal gives Intel a huge advantage in the growing self-driving car industry, market the company estimates, will grow to $70 billion annually by 2030. In the introduction stage, smaller and highly profitable companies of new industries are targets and big and established companies like Intel buy them.

Source: ICFAI Research Center

Table 1 relates the various stages of industry life cycle with the nature of M&A activity.

Table 1: Industry Life Cycle Stages and M&A Activity

Stage of Industry Life Cycle	Nature of M&A Activity
Introduction stage	Newly created firms may sell to outside larger firms in a mature or declining industry, thereby enabling the latter to enter a new growth industry. These result in related or conglomerate mergers. The smaller firms may wish to sell because the owners may prefer to 'cash out' rather than to place large

Stage of Industry Life Cycle	Nature of M&A Activity
	investments in the hands of managers who do not have a long record of success. Horizontal mergers between smaller firms may also occur, enabling such firms to pool management and capital resources.
Exploitation stage	Mergers during the exploitation stage are similar to mergers during the introductory stage. The impetus for such mergers is reinforced by the more visible indications of prospective growth and profit and by the large capital requirements of a higher growth rate.
Maturity stage	Mergers are undertaken to achieve economies of scale in research, production, and marketing in order to match the low cost and price performance of other firms, domestic or foreign. Some acquisitions of smaller firms by larger firms take place for the purposes of rounding out the management skills of the smaller firms and providing them with a broader financial base.
Decline stage	Horizontal mergers are undertaken to ensure survival. Vertical mergers are carried out to increase efficiency and profit margins. Mergers involving firms in related industries provide opportunities for synergy and carry-over of managerial capabilities. Conglomerate acquisitions of firms in growth industries are undertaken to utilize the accumulating cash position of mature firms in declining industries whose internal flow of funds exceeds the investment requirements of their traditional lines of business.

Adapted from Weston, J. Fred, Kwang S. Chung, and Susan E. Hoag. Mergers Restructuring, and Corporate Control. Pearson, 2015.

17.6 Cross-border Mergers and Acquisitions

Though cross-border M&As are common, they involve a fair amount of risk, are more complex and quite expensive, and may require debt financing. Dealing with a new legal and regulatory environment in the host country often creates problems for the acquirer. Cross-border M&As have increased in number due to various reasons such as growth, technology, government policy, differential labor costs and productivity, and source of raw materials.

17.6.1 Growth

Growth is one of the primary motivating factors for cross-border M&As. M&As provide an opportunity for firms to grow quickly.

- A firm making profits in an ailing economy would not like to make additional investments in the same country. It makes perfect business sense for the firm to invest in an economy which promises faster growth.
- Firms which have operations in a single country may not have a cost advantage because of limited sales. If the operations are expanded to other countries, the firm can gain cost advantage due to the economies of scale.

Example

India's third largest software company, Wipro, completed the acquisition of Brazilian IT firm 'InfoSERVER' which mainly focuses on Brazilian market, provides software deployment services to its clients. The acquisition is in line with Wipro's aim to expand its presence in the Latin American market. After the merger proposal was announced, Ankur Prakash, Senior Management Personnel, Wipro said in a press conference "This acquisition will provide Wipro with scale and key client relationships, especially in the banking, financial services and insurance domains, which are the largest and fastest growing sectors in the region." Wipro went ahead with the cross-border acquisition of InfoSERVER because of the growth prospects it enables in one major consumer segment, i.e. the banking sector.

Source: ICFAI Research Center

17.6.2 Technology

A technologically superior firm may go in for M&As to exploit its technological advantage. On the other hand, a firm which lacks technological advantage may opt for M&As to gain access to superior technology. By using the advanced technology of the acquired firm, the acquirer can improve its competitive position and profitability both at home and abroad.

17.6.3 Government Policy

Environmental and other regulations can increase the time and cost required to build facilities abroad for entry. In such situations, acquiring a company with facilities in place makes good business sense. Government policies and regulations relating to tariffs and quotas can also influence cross-border M&As.

17.6.4 Differential Labor Costs and Productivity

Many multinational companies go in for M&As to take advantage of the availability of cheap labor. It is because of this reason that many multinational companies are heading toward developing countries like India and China to set up their manufacturing bases there. Higher productivity of labor also influences cross-border M&As.

17.6.5 Source of Raw Materials

This factor plays an important role in the growth of vertical mergers, more so for acquiring firms from resource-poor countries. This approach may not be feasible in the case of some strategic raw materials as many countries have restrictions on foreign ownership of such assets.

17.7 M&A – Success and Failure

According to a research study conducted by the Boston Consulting Group – a global general management consulting firm with a leading position in strategic management practice,

"Successful acquirers choose acquisitive (inorganic) growth only when it is an inherent part of their strategy and they are confident that they can use it to create sustainable competitive advantage and so deliver above-average returns. They develop a detailed understanding of the role of M&As in achieving their growth strategy – far in advance of bidding on any particular deal. They are unusually rigorous when it comes to valuing and pricing potential deals. They pay at least as much attention to the details of post-merger integration (PMI) as they do the deal itself and work hard to strike a balance between speed and thoroughness in the PMI process."

According to Peter F. Drucker, financial factors provide the stimulus for M&A activity. In his opinion, M&As should conform to the following five rules, in order to be economically viable.

- The acquirer must contribute something to the acquired company.
- A common core of unity is required.
- The acquirer must respect the business of the acquired company.
- Within a year or so, the acquiring company must be able to provide top management to the acquired company.
- Within the first year of the merger, the managements of both companies should receive promotions across the entities.

17.7.1 Reasons for Merger Failure

Mergers often fail because companies do not accord sufficient time in analyzing and anticipating current and future market trends and post-merger integration issues. Lack of a clear vision and communication, inadequate leadership, improper management, and cultural differences also lead to merger failure. The occurrence of merger failure is highest during the post-merger integration phase.

The absence of a clear vision for the merger is an important reason for the failure of a merger. The top management's failure to articulate the reasons for the merger and to take the initiative and drive the merger leads to the failure of the merger.

Fearing the dysfunctional aspects of the merger like the exodus of key employees and reduced productivity, top management may delay the communication of merger. This, in turn, leads to suspicion and distrust, and the employees may turn hostile toward the merger and not contribute to the merged firm to the best of their abilities.

During the post-merger period, leadership issues gain predominance. The merged firm needs a leader who can guide the combined entity and provide a sense of purpose and direction to the firm. The absence of such a leader leads to the failure of the merger. It is the top management which should be accountable for value generation post merger.

However, the top management's involvement is high only for negotiation and deal closure whereas the middle management is entrusted with the responsibility of post-merger integration. This leads to problems if the middle management is not empowered to make important decisions or if the resources allocated to achieving strategic objectives are insufficient for the purpose. This results in an uncertain environment which is characterized by an increase in stress levels and decrease in commitment and loyalty levels.

The top management teams of the merged firms may ignore each other's priorities. If communication channels are not appropriately developed, workers in the merged enterprise may find themselves out of tune with their managers. Lack of managerial experience in dealing with mergers could reduce the probability of success. At the same time, it is important to accept the fact that each merger is unique.

Post merger, during the integration stage, the employees of the merged firm may fear loss of power and/or loss of jobs. In such an atmosphere of insecurity, conflicts and disagreements would be more frequent and more difficult to resolve.

Working with a new set of people who might have a different outlook, values, and beliefs, could lead to a situation where the efforts of all employees are not aligned with the organization's vision and strategy. On the contrary, the actions of one group of employees may oppose those of another group, to the detriment of the firm as a whole. As a result, the benefits of synergy may not accrue to the merged firm.

Cultural differences between the merging firms are among the most important factors of a merger failure. These get reflected in the philosophies, values, style, and mission of the two merged firms and in creation of a work environment post merger. Incompatibility between cultures leads to many behavioral problems in the merged firm, which could result in the failure of the merger.

Example

Morgan Stanley reported in February 2019 that Walmart may consider exiting Flipkart due to the Indian Government's latest e-commerce norms that bars online retailers from operating an inventory-led model. The new rules that came into effect in February 2019 mandates online e-commerce giants like Amazon, Walmart-owned Flipkart from stocking a quarter or 25 per cent of their inventory from a single vendor. As per the new rule, Flipkart may need to remove approximately 25% of its products from its site. Smartphones and electronics have historically driven Flipkart's gross sales, meaning Flipkart could face meaningful disruption and top-line pressure because of this rule. In Walmart's case, the new regulatory norms that came into effect since February 2019 became unfavorable for the acquired company Flipkart. Flipkart which was already making losses would also lose out on sales after the rules come into effect.

Source: ICFAI Research Center

Check Your Progress - 2

8. A firm in the declining stage of the industry life cycle may undergo a merger
   - i. To ensure survival.
   - ii. To increase efficiency and profit margins.
   - iii. For synergy.
   - iv. To focus on core business.
   - a. Only i, ii, and iii
   - b. Only i, ii, and iv
   - c. Only ii, iii, and iv
   - d. Only i, iii, and iv
9. Which of the following is **not** a reason for undergoing cross border mergers and acquisitions?
   - a. Positive government policy
   - b. Cultural differences
   - c. Differential labor cost
   - d. Good source of raw materials

Activity 17.3

Very often, mergers and acquisitions do not yield the desired results due to problems that crop up after the merger. Managing such problems is a difficult task. Discuss, with the help of an example, the problems faced by a merged entity.

Answer:

17.8 Summary

- Mergers can be defined as the integration of two or more firms on a co-equal basis. An acquisition refers to the process of one company gaining partial or complete control of another for some strategic reasons.
- In order to expand the size of the firm through mergers, firms go in for horizontal, vertical, and conglomerate mergers.
- Firms opt for M&As due to various reasons such as: increased market power, overcoming entry barriers, avoiding the cost of new product development, increased speed to market, lower risk, increased diversification, and reshaping the firm's competitive scope.
- All the four stages of the industry life cycle -- introduction, exploitation, maturity, and decline -- have distinct roles to play in influencing the nature of M&A activity.
- The reasons for the growth in the number of cross-border M&As include growth, technology, government policy, differential labor costs, productivity, and source of raw materials.
- For M&A activity to be successful, it should be an integral part of the firm's strategy and due care should be taken for valuation of the deal and managing post-merger integration.
- Mergers often fail because companies do not accord sufficient time in analyzing and anticipating current and future market trends, and due to post-merger integration issues. Lack of a clear vision and communication, inadequate leadership, improper management, and cultural differences also lead to merger failure.

17.9 Glossary

Acquisition: An acquisition refers to the process of one company gaining partial or complete control of another for some strategic reasons. Unlike mergers, acquisitions can sometimes be unfriendly. For example, a firm may attempt to acquire, that is, take over another, by adopting hostile measures which may not be in the interest of the firm that is to be acquired.

Conglomerate merger: A merger of two firms from unrelated business activities. Conglomerate mergers can be categorized into product extension merger (merger between two firms in a related business activity), geographic extension merger (merger between two firms operating in non-overlapping geographic areas), and pure conglomerate merger (merger between two firms from unrelated business activities).

Horizontal merger: A merger between two firms operating and competing in the same business activity. The merging of two competing business entities results in a larger firm and thus, greater economies of scale. Firms may also merge horizontally to share resources and skills, and to derive synergy.

Merger: The integration of two or more firms on a co-equal basis. In a merger, the merging firms pool all their resources together to create a sustainable competitive advantage. The merging firms believe that it is more advantageous to merge rather than to operate as independent entities. That is, they believe that there is a significant synergy in merging their businesses.

Vertical merger: A merger between two firms in the same industry but in different stages of the value chain.

17.10 Self-Assessment Test

1. What are the different types of mergers? What is the economic rationale behind mergers and acquisitions?
2. In what way do the industry life cycle stages influence the mergers and acquisitions activity?
3. Describe about cross-border mergers and acquisitions.
4. What are the reasons for the success and failure of mergers and acquisitions?

17.11 Suggested Readings/Reference Material

1. Thomas L. Wheelen, et al., Strategic Management and Business Policy: Globalization, Innovation and Sustainability, Fifteenth Edition, Pearson Paperback – 30 July 2018
2. P.N. Srivastava, Business Policy and Strategy Hardcover, Horizon Press, January 2019
3. Joan Magretta, Emile Holmewood and Heinrich Zimmermann, What is Strategy?: An Illustrated Guide to Michael Porter Hardcover – Illustrated, 15 September 2020, Harvard Business Review Press

4. Shabbar Suterwala, Top 20 Business Strategies for your Business Growth, Notion Press; 1st edition Paperback – 27 May 2021
5. Brian Tracy, Business Strategy: The Brian Tracy Success Library Hardcover – 26 February 2018, Manjul Publishing House
6. Callie Daum, Business Strategy Essentials You Always Wanted to Know (Second Edition), January 2020, Vibrant Publishers

17.12 Answers to Check Your Progress Questions

1. (b) Merger

Mergers can be defined as the integration of two or more firms on a co-equal basis. In mergers, firms pool all their resources together to create a sustainable competitive advantage. In a merger, one of the firms may lose its existence. Unlike mergers, takeovers / acquisitions can be unfriendly and may not be in the interest of the acquired firm. Spin-off is the formation of a new entity by a split from a larger one.

2. (a) They are operating and competing in the same business environment and are producing the same product.

Horizontal mergers take place where the two merging companies produce similar products in the same industry. For example, before Compaq merged with Hewlett Packard, they were two distinct companies operating in the same industry, viz., computers, and the same markets, and offering similar products and services. This kind of merger is known as a horizontal merger.

3. (b) Only i, ii, and iv

A horizontal merger results in a larger firm and thus, greater economies of scale. They may also share resources, skills, and derive synergy. For example, the merger of an Indian pharmaceutical firm and a Canadian pharmaceutical company will give the merged entity access to unexplored markets and scale economies. As any two firms undergo merger on a **co-equal** basis and form a new entity, the need for one to gain corporate control over the other **does not** arise.

4. (a) Create a monopoly market

When two or more companies undergo a horizontal merger, it results in a decrease in the number of firms in an industry. As a result, competition is reduced and a monopoly market may be created, due to which the consumer may suffer. Hence, governments make efforts to regulate horizontal mergers.

5. (c) To achieve greater economies of scale

There are different reasons for which companies enter into vertical mergers. They are: reducing costs of communication, coordinating production, better planning of inventory and production, and achieving better control over the source of inputs and their quality or to be closer to the customer. Greater economies of scale result from horizontal mergers.

6. (c) Product extension conglomerate merger

A product-extension merger takes place when firms want to expand to broaden their product lines. Two wheelers and cars are a part of the automobile industry and represent two distinct product lines requiring different manufacturing facilities. The objective of a product extension merger is to expand the product portfolio of the merged firm and exploit synergistic effects through the merger.

7. (a) Geographic extension conglomerate merger

A geographic extension conglomerate merger involves two firms having operations in different geographical areas. The objective is for the merged firm to exploit the distribution and marketing strengths of the two firms in different geographical areas. In the example just seen, Ajay Ltd. can make use of the distribution network and marketing activities of Akash Enterprises Ltd. in the southern part of the country, and Akash Enterprises Ltd. can take advantage of the distribution and marketing network of Ajay Ltd. in the northern part of India once the two firms merge.

8. (a) Only i, ii, and iii

A firm in the declining stage of the industry life cycle undertakes horizontal mergers to ensure survival. Vertical mergers in this stage are carried out to increase efficiency and profit margins, while concentric mergers involving firms in related industries in the declining stage of industry life cycle provide opportunities for synergy and carry-over of managerial capabilities.

9. (b) Cultural differences

There are various reasons for the growth of cross border mergers and acquisitions. Some of these reasons are growth, technology, government policy, differential labor costs, productivity, and source of raw materials. However, opposing cultures and different management styles across borders often act as barriers in the realization of cross border M&As. For example, a merger between a French company and a Chinese company will involve understanding of two very different cultures and may act as a deterrent to the merger.

Unit 18

Divestitures and Anti-Takeover Defense

Structure

"If the forces are intense, (..) almost no company earns attractive returns on investment."

- Michael Porter

18.1 Introduction

A company operating in an environment where the external and/or internal forces are intense, cannot make a good ROI and has to do divestiture on time to prevent from huge losses. Here Michael Porter recalling the time to take divestiture strategic decision.

In the previous unit, we have discussed mergers and acquisitions. In this unit, we shall discuss divestitures and anti-takeover defense.

Divestiture is defined as the sale of a segment of a company (assets, a product line, a subsidiary) to a third party for cash and/or securities. Large companies with diversified business interests may divest themselves of some of their businesses to focus completely on their core businesses. Firms often divest themselves of businesses which are not of strategic importance and which do not contribute much to their total revenues.

Divestments of such businesses bring in resources that can be used to reduce debt and to support existing businesses. Multinational companies often use divestments to restructure their businesses.

A company can divest itself of a part of it or the entire company can be sold by various voluntary liquidation/sell-off methods. An involuntary divestiture usually is the result of an antitrust (anti-monopoly) ruling by the government or regulatory authorities, whereas a voluntary divestiture is a willful decision by management to divest. A takeover is the acquisition, often in a hostile manner, of one company by another.

This unit will first discuss the reasons why companies go in for divestitures. We shall then move on to discuss the various aspects of preparing for and executing a divestiture. Finally, we shall discuss the factors influencing takeover, and various anti-takeover defense mechanisms.

18.2 Objectives

By the end of this unit, you should be able to:

- Identify the reasons why companies go in for divestitures.
- Explain the various aspects of preparing for and executing a divestiture.
- Discuss the factors influencing takeover, and various anti-takeover defense mechanisms.

18.3 Motives for Divestitures

A divestiture is the sale of a part or a division of a company to a third party. The division may include assets, product lines, or subsidiaries. These are sold for cash or securities or a combination of both.

There are various reasons for the growth of divestitures.

- Companies often claim that they divest businesses to raise working capital or to pay back the debts of the organization. This claim is questionable since financing needs can be fulfilled by methods other than divestiture.
- A study published by Scott C. Linn and Michael S. Rozeff in 1984 highlighted two main reasons for divestitures -- the assets are worth more as part of the buyer’s organization than as part of the seller’s and the assets are actively interfering with other profitable operations of the seller.
- The need to get rid of a loss-making subsidiary is often cited as a reason for divestiture. However, divestiture will not yield any gains, unless the subsidiary is sold for more than its present value. In some cases, it is advisable to sell a subsidiary even if the sale fails to generate more than its present value. For example, subsidiaries that hinder the efficient functioning of other units should be sold even if the sale does not lead to any monetary gain.

According to James C. Van Horne, some of the main reasons that force companies to divest are: efficiency gains and refocus, information effect, wealth transfers, and tax reasons.

Example
TATA Steel announced that it started searching for buyers of five of its loss-making business units in Europe. These loss-making units which totally employ over 1,000 people are spread over different European countries like Sweden, UK, Germany, Turkey, and Canada. The proposed sale would enable TATA Steel Europe to divert resources from loss-making units to core businesses. Thus, TATA Steel can focus its financial and management resources on its strip product business and other strategic markets. In the above case, TATA Steel Europe proposes to sell five of its loss-making units and focus on its core strip product business.

Source: ICFAI Research Center

18.3.1 Efficiency Gains and Refocus

While M&As lead to synergy, divestures can result in reverse synergy. A particular business may be more valuable to someone for generating cash flows and that someone will be paying a higher price for the business than its present value. Divestiture is also used to enable a company to make certain strategic changes.

The competitive advantage that a company has may change over time due to changing market conditions, and as a result, a company may have to divest a particular business. In some cases, the past diversification programs of a company may have lost value, making it necessary for a company to refocus on its core competencies.

A divestiture helps in bringing back a company on to its core competencies.

18.3.2 Information Effects

The information that a divestiture conveys to investors is another reason for divestiture. If the information given by management is not known to investors, the announcement of divestiture can be seen as a change in investment strategy or in operating efficiency. This may be taken in a positive sense and boost share price.

However, if the divestiture announcement is perceived as the firm’s attempt to dispose off a marketable subsidiary to deal with adversities in other businesses, it will send a wrong signal to investors. Whether the divestiture is seen as a good or bad signal depends on the circumstances.

18.3.3 Wealth Transfers

Divestiture results in the transfer of wealth from debt holders to stock holders. This transfer takes place when a company divests a particular division and distributes the resulting proceeds of the sale among stockholders. As a result of this transaction, there is less likelihood of repayment of debt and it will have lesser value. If the total value of the firm remains unchanged, its equity value is expected to rise.

18.3.4 Tax Reasons

As in the case of mergers, divestitures also provide a considerable tax advantage. When a company is losing money and is unable to use a tax-loss carry forward, it is better to divest wholly or in part to realize a tax benefit. When there is increased leverage due to restructuring, a firm can have a tax shield advantage due to interest payments being tax deductible.

Check Your Progress - 1

1. Of the following, which are the two main reasons for divestitures, according to the study done by Linn and Rozeff in 1984?
   i. The assets are worth more as part of the buyer's organization than as part of the seller's
   ii. The firm needs to raise working capital or funds to pay back the debts of the organization
   iii. The assets are actively interfering with other profitable operations of the seller
   a. Only i and ii
   b. Only i and iii
   c. Only ii and iii
   d. None of the above
2. According to James C. Van Horne, some of the main reasons that force companies to divest are:
   i. to gain efficiency.
   ii. to refocus on their core business.
   iii. financial losses
   iv. tax reasons
   a. Only i, ii, and iii
   b. Only i, ii, and iv
   c. Only i, iii, and iv
   d. i, ii, iii, and iv
3. When does an involuntary divestiture usually take place?
   a. When the market is saturated
   b. When the regulatory authority passes an anti-trust ruling
   c. When there is a poor business fit
   d. When there is market inefficiency

Activity 18.1

The competitive advantage that a company has may change over time due to changing market conditions, and, as a result, a company may have to drop a particular business. In some cases, past diversification programs of a company may have lost value, making it necessary for a company to refocus on its core competencies. Sometimes, divestitures are taken up to get rid of a loss-making unit. Thus, various reasons prompt companies to resort to divestitures. In the light of this statement, explain a divestiture program taken up by an Indian company.

Answer:

18.4 Assembling the Divestiture Team

Divestment of a business requires a team of functional experts under the direction of an experienced project manager. The first and foremost action that is to be taken after reaching the decision to divest pertains to the selection of the project manager. Along with general management skills, the project manager must also be knowledgeable in the tasks and techniques necessary to bring about a successful divestiture. People possessing these types of skills usually reside in the corporate development function.

Corporations devoid of a formal corporate development activity may find qualified divestiture managers within the financial, legal, or corporate planning departments. The appointment of an internal project manager and core team is absolutely critical even in those instances where an investment banker or some other intermediary is engaged by the corporation to assist in the divestiture.

Assembling the core team is the first task of the project manager.

- The composition of the core team will vary depending on the specific nature of the divestiture and generally includes someone who is extremely knowledgeable about the business being sold and from the corporate financial function.
- Where practical, close association of a member of the corporate legal staff with the activities of the core team from the very beginning of the project will facilitate preparation of the offering memorandum, the negotiations, and writing of the letter of intent and definitive purchase agreement.
- The core team will also need assistance from time to time during the project from other functional areas of the corporation, which may include the tax department, human resources, corporate communications, and the corporate controller.

After having assembled the core team, the project manager should formulate a definitive project plan and obtain approval of the intended approach from the corporate management. The project plan should include:

1. Identification of the core team and supplementary internal resources that are required.
2. Specific tasks and responsibilities of each project participant.
3. Identification of outside resources required, such as investment bankers, their specific tasks, and anticipated costs for their services.
4. Timetable for each major phase of the project.
5. An overall budget of the project.

The decision regarding the use of outside resources is a critical element in assembling the project team and preparation of the project plan. Some corporations may not possess the resources and talent internally to effect a successful divestiture. So, they turn to investment bankers, outside law firms, or other intermediaries for professional assistance.

This decision of the corporation is perfectly appropriate because selling a business is a highly specialized activity, and investment bankers, in addition to providing the necessary professional expertise that may be lacking in a selling corporation, can be particularly helpful in a number of other areas important to a successful divestiture. These are: identification of potential purchasers, approaching potential buyers on an anonymous basis, assisting in the structuring of the deal, and assisting in the negotiating process.

The process of engaging outside resources requires careful planning and execution. Both investment bankers as well as outside law firms receive substantial compensation for their services.

18.5 Preparing for the Divestiture

No two divestitures are exactly alike and one of the foremost tasks of the project team is to determine precisely what is to be sold. While some divestitures involve the sale of assets, others involve sale of legal corporate entities. When determining specifically what is to be sold, tax, legal as well as business implications are required to be considered from both the buyer's and seller's perspective.

Example

Since 1991, the Government of India had been focusing on privatization of loss-making public sector units (PSU). In 2018, the Government of India mandated NITI Aayog (a policy think tank to achieve sustainable development goals) to prepare a list of PSUs for divestiture and for which suitable buyers need to be identified.

Contd….

NITI Aayog recommended 23 PSUs for strategic divestment to the Department of Investment and Public Assets Management (DIPAM). The list contained loss-making PSUs and some profitable PSUs that are no longer relevant to the Government. DIPAM issues guidelines for disinvestment and also takes necessary steps to expedite divestiture of PSUs targeted for divestiture. Based on the details given above, NITI Aayog and DIPAM have undertaken the preparatory steps for divestiture.

Source: ICFAI Research Center

18.5.1 Common Issues in Preparing for Divestitures

A number of other issues, in addition to the form of the transaction, are to be considered in preparing for the divestiture. Divestitures involving stand-alone businesses that have no ongoing relationship with the selling corporation after the sale are the cleanest divestitures.

Divestitures, however, often involve some sort of continuing business relationship.

- The selling corporation may be the supplier of products and / or services to the business being sold, which are critical to the future success of the business.
- The purchaser will, therefore, expect to negotiate some sort of a service agreement as part of the transaction. In other words, there may exist marketing or distribution dependencies between the selling corporation and the business being divested.
- Further, the purchaser would prefer to develop operationally viable and economically feasible agency agreements as a part of the transaction. It is, therefore, essential to carefully analyze these types of interdependencies at the very outset of the divestiture project.

Major problems can often arise in the successful completion of the divestiture due to failure to understand these interdependencies and to prepare for their resolution as part of the overall transaction. The least that can happen is that discovery of critical interdependencies late in the negotiating process can seriously impact the selling price or deal structure, and may cause the buyer to relinquish the deal.

The resolution of management and human resources issues is another important matter to be considered in preparing for the divestiture, and may affect the nature, timing, and valuation of the business. If key members of the management or if staff expertise are valuable assets critical to the future success of the business, these people should be retained and motivated to assure a successful sale. It is necessary to understand and address the needs and desires of these people early in the divestiture process.

Special compensation and employment contracts are useful tools to be considered in some instances in order to assure management and staff cooperation in the divestiture process. The manner in which employees are handled influences the price a buyer is willing to pay for the business and the net value of the deal to the seller.

Most of the effort in preparing for the divestiture goes into gathering data and information necessary to present the business to prospective purchasers. Several purposes are served by this data-gathering exercise, such as:

- It enables the selling corporation to make some policy-type decisions.
- It forms the basis on which the initial selling document or offering memorandum is developed.
- It serves as the foundation for business reviews to be held with serious prospective buyers later in the selling process.

Thus, as a result of preparing a business for sale, the project team, often, ends up knowing more about the business being sold than either the management of the business or the selling corporation. In other words, successful divestitures depend upon careful preparation and intimate knowledge of the business being sold.

In preparing for a divestiture, it may be helpful to review the requirements of types of data and information in the context of a typical offering memorandum. Although the preparation of a formal offering memorandum is not required for all divestitures, the data and information necessary to initiate the selling process tend to be the same. The type of selling process decides whether or not to prepare a formal offering memorandum.

A formal offering memorandum is essential if the business being sold is to be offered, to a number of potential buyers, either sequentially or on a competitive bidding basis. The formality of an offering memorandum may not be necessary if the selling corporation is highly confident of knowing the buyer and that the deal will be done with that one party; however, the prospective buyer has to be provided with the same level of information.

18.5.2 Contents of the Offering Memorandum

The offering memorandum must provide sufficient detail to the prospective buyers to ascertain their genuine interest in acquiring the business. It should be accurate in every respect. Errors or misstatements about the business can cause serious difficulties in consummating the transaction and may cause discussions to be terminated completely. The offering memorandum should emphasize the strengths of the business and, where possible, position these in alliance with the strategies or potential strategies of prospective buyers.

The offering memorandum may have the following components: executive summary; buyer procedure; background; the market; products / services; facilities and fixed assets; systems and operations; organization, management, and personnel; and key financial information.

Example

Government of India came out with a memorandum for strategic sale of Pawan Hans, a helicopter service company. This PSU (public sector unit) helicopter service company is based in New Delhi, India. Pawan Hans, a Mini Ratna-Category-1 PSU has a fleet of 46 choppers. It has cumulatively flown more than 1 million hours and has had 2.5 million landings on its fleet since its formation. Other than providing helicopter services to ONGC (Oil and Natural Gas Commission) and to its off-shore locations, this public sector company is often engaged in providing services to various state governments in India. Government of India issued an 'Information Memorandum' (with all details about Pawan Hans) seeking 'EOI' (Expression of Interest) from interested bidders. In the above case, the Government of India provided details about the various services performed by Pawan Hans and also its fleet size, in order to invite EOI from interested bidders.

Source: ICFAI Research Center

Executive summary

It constitutes one of the most important parts of the document and is a key selling point. It should emphasize the strengths and advantages of the business in addition to summarizing the business' key points, specifically including what is for sale and the reasons for sale of the business.

Buyer procedure

The rules as specified by the selling corporation are given, which indicate whether competitive bidding or some other process is being used. Dates for indications of serious interest and for initial bid submission are specified. Apart from stipulating when and where detailed business reviews will be held, it also sets the date for submission of final bids.

In addition to describing the method of payment that the seller would accept, and outlining both acceptable and unacceptable deal structures, it also specifically indicates the persons in the selling corporations whom the prospective purchasers are authorized to contact.

Example

All-Wood Fibre Ltd. was one of the leading portable chips company in Western Canada. KPMG, Canada which was performing various tasks of selling the bankrupt company, All-Wood, sent out the following notification to prospective buyers:

Contd….

"Upon review of the Document, a prospective purchaser wishing to acquire certain or all of the Assets of All-Wood Fibre is invited to submit an offer in writing to KPMG Inc. An offer should be executed by an authorized officer of the prospective purchaser and received by KPMG Inc., no later than 5:00 p.m. Pacific Standard Time, Monday, May 4, 2015. The offer must be submitted in the form provided under Appendix M."

The notification sent out by KPMG, which is acting on behalf of All-Wood, outlines the procedure to make a bid for All-Wood's assets which are for sale. It has details like the last date of submission, the form that needs to be submitted, etc.

Source: ICFAI Research Center

Background

The business is introduced by means of historical perspective and highlighting key evolutionary events till date. The key elements of this section include history of the business; date of founding or acquisition; past and present strategic objectives; background as to why the business is being sold; and background of key officers and employees.

The market

A comprehensive picture of the industry in which the business is participating is provided in this unit. It also provides information that emphasizes the strengths of the business being sold. The following types of data and information are used for this purpose:

- Market size, major products / services, historic growth rates
- Industry's current position in its lifecycle
- Product / service life cycle position
- Projected growth rate of market and major segments
- Customer concentration
- Market share of business being sold and market saturation
- Major competitors and their market shares
- Business strengths and weaknesses
- Domestic and international factors, etc.

Products / services

Prospective buyers find the following types of information -- quality objectives; pricing policies and schedules; technical specifications of the product / service; and operating and / or production processes -- helpful in describing the products /services of the business being sold.

Facilities and fixed assets

There should be separate exhibits made to show the specific facilities and fixed assets that are to be included as part of the sale. The facilities and fixed assets should be categorized in terms of owned or leased, by location, and by key activities. This part includes an analysis of adequacy of both facilities and equipment for future growth, and contractual obligations are also indicated.

Systems and operations

A detailed description of the business systems and operations is included. A distinction of those systems and operations capabilities included as part of the sale and those not included in the sale is made. The section also addresses adequacy of the systems and operations, included as part of the sale, for both current and future production and delivery of products / services.

Organization, management, and personnel

Apart from describing the key human resource elements of the transaction process, this section also states who among the management and/or personnel are believed to be critical to the business, lists the numbers and employee categories to be made available, and describes all employee benefits.

Key financial information

Sufficient financial information will be expected to be received by prospective purchasers to enable them to make a preliminary judgment regarding their interest in acquiring the business. Generally, financial history of the business pertaining to the last 5 years is provided and is shown in proforma terms so as to reflect accurately the specific nature of the business being sold.

Items such as intercompany charges for services that the selling corporation no longer intends to provide, overhead allocations from the selling corporation, and federal and state taxes, are often omitted from the profit-and-loss statement. Prospective purchasers are advised of these adjustments and instructed to insert their own estimates regarding these expenses while valuing the business. The balance sheet, also, is similarly adjusted to reflect specifically what is being sold.

The types of data and information that might be included are balance sheet and income statement for the past five years; revenues analysis (by product / service, seasonality factors, and sales policies); expense analysis (by business segment, by product / service, fixed vs. variable cost, etc); and other specific financial items (loans, receivables analysis, prepaid expenses and deferred charges, and purchase contracts).

18.5.3 Valuing the Business

There are several valuation techniques available, one or more of which, can be utilized by the prospective purchasers in determining their offering price for the business. A similar analysis should be conducted by the divestiture team which will serve a number of purposes such as:

- Provides the selling corporation an estimate of the market value of the business.
- Assists in identification of prospective buyers.
- Assists in comparing values of different offers in cases where more than one offer is received.
- Provides foundation for price negotiation later in the selling process.

A few of the basic valuation techniques that might be used are book value, comparables, discounted cash flow (net present value), payback, and replacement cost method.

The valuation methodologies must be modified to reflect the special circumstances of each prospective purchaser such as considerations of market forces, competition, and effect of the acquisition on the buyer's base business.

The outcome of activities pertaining to the valuation and pricing of a business is thus influenced by business, market, financial, and other assumptions. The seller's knowledge and understanding of these with regard to specific purchasers decides the success of a divestiture.

Check Your Progress - 2

4. The composition of the core divestiture team will vary depending on the specific nature of the divestiture. From which of the following functions someone will generally be included in the divestiture team?
   a. Divisional finance
   b. Functional planning
   c. Divisional marketing
   d. Corporate finance
5. The project plan of a divestiture should include:
   i. Identification of the core team and the details of the required supplementary internal resources.
   ii. Specific tasks and responsibilities of each project participant.
   iii. Timetable for each major phase of the project.
   iv. Identification of outside resources required, such as investment bankers, their specific tasks, and anticipated costs for their services.

   a. Only i, ii, and iii
   b. Only i, iii, and iv
   c. Only ii, iii, and iv
   d. i, ii, iii, and iv

6. The offering memorandum of a divestiture includes buyer procedures which comprise:
   i. Rules as specified by the selling corporation.
   ii. Dates for indications of serious interest and for initial bid submission.
   iii. Stipulation about when and where detailed business reviews will be held.
   a. Only i and ii
   b. Only i and iii
   c. Only ii and iii
   d. i, ii, and iii

18.6 The Selling Process

The four key elements that constitute the selling process are: (1) identification of prospective buyers, (2) selection of the type of selling process to be utilized, (3) business reviews, and (4) negotiation of the transaction and closing the deal.

18.6.1 Identifying Potential Buyers

Identification of potential buyers by the project team initiates the selling process. All activities prior to this step such as the divestment decision, organization of the project team, and preliminary work in preparing for the divestiture, are internal to the selling corporation. The external process begins with the identification of the potential buyers.

The decision to engage or not to engage an investment banker or some other intermediary to identify prospective buyers is considered or reconsidered at this stage in the divestiture process. The decision to use an intermediary depends on the selling corporation's experience with divestitures, the confidence it has in its divestiture team, and the in-house knowledge it has regarding potentially interested buyers.

Investment bankers, similarly, can help in the identification of prospective buyers by knowing the types of businesses their clients and their competitors are seeking to acquire, and by having the capability to identify potential acquirers who have not been active in the market, but for whom a particular business may be a good strategic fit. Investment bankers can also qualify potential leads anonymously since usually the selling corporations do not like the prospect of having the business they are divesting characterized as having been widely "shopped".

Potential buyers, in general, can be categorized into direct competitors, companies in similar types of businesses, buyers who want to broaden their product lines, buyers looking for operational economies of scale, suppliers and customers, and others such as companies seeking diversification, holding companies, investment groups, and venture capitalists.

18.6.2 Selecting the Selling Process

There are, basically, four different methods of selling a business, each having its own advantages and disadvantages. The selection of the selling process depends on the nature of the business being sold and the objectives of the selling corporation. The four methods are as given under:

Competitive bidding

This process helps produce the highest bidder and the best deal structure for the selling corporation, if correctly managed. The process of competitive bidding is most effective when 5 to 10 potential buyers have been identified and when the potential buyer list contains diverse strategic objectives.

Disadvantages of utilizing competitive bidding include the unlikely possibility of an unsuccessful sale that can adversely affect the value and near term viability of the business. Customers as well as the employees view it as a lack of commitment to the business on the part of the selling corporation. Competitors stand to gain significant advantage in such a circumstance. If a competitor has been a potential buyer, it gains significant knowledge about the business, which it can use against the business in the marketplace. Divestitures usually fail due to poor initial planning of the divestiture or due to a badly managed selling process.

Sequential selling

This method involves establishing a priority list of potential buyers after the identification of prospective purchasers. The selling corporation offers the business to what it believes to be the most likely potential buyer and, if unsuccessful, moves down the pre-established priority list. If successful with the very first potential buyer, this process is obviously a much easier process to manage than competitive bidding.

However, there is no market frame of reference available for the price and deal structure that is negotiated and the seller can never know if a better deal could have been struck with someone else. This is an acceptable selling method, if the primary objective is to get out of business with secondary importance being attached to the price and deal structure. However, if the pre-established priority list itself is faulty, it requires the business to be offered to a number of prospective buyers, in sequence, giving the business an image of having been widely "shopped" and rejected. This seriously impairs the potential value of the business.

One buyer

If, in the process of identifying potential buyers, only one prospective purchaser can be identified, the seller is left with little negotiating leverage. The resulting transaction is hence not likely to meet all of the seller's objectives. In cases where there is a known anxious buyer, the seller should ascertain the value that this buyer sees in the business, and should try and identify other buyers who might see the same value as well. If successful in doing so, a one-buyer divestiture might be transformed into a competitive bidding transaction thereby resulting in significantly better price and terms than could have been possible in a one-buyer transaction.

Going public

Divestiture of a business through an initial public offering is completely different from selling it through a private transaction. In order to go public, the entity to be sold must have an established history of profits and growth or a proprietary product or service on which a public market price can be based. Also, there should be existing favorable market conditions in terms of appetite for initial public offerings. When considering the divestiture of a business through an initial public offering, even the most sophisticated selling corporations require the assistance of investment bankers.

18.6.3 Business Reviews

In the competitive bidding type of selling process, business reviews are held only for serious prospective buyers after receipt of initial bids and clarifying discussions. In a sequential sale, the business review is held only for the prospective buyer enjoying top most priority and only when discussions are terminated with that buyer, the process is started all over again with the buyer who figures next on the priority list. Similar is the case with one-buyer transaction, however, if the discussions terminate, the selling corporation has only two options – either to keep the business or to turn the transaction into a competitive bidding deal by identifying other buyers who can be shown the same value in the business as was seen by the initial one buyer.

Business reviews generally last for one or two days during which prospective buyers are given detailed presentations on all aspects of the business, and are also, often, given the opportunity to visit the company’s facilities.

The primary objective of business reviews is to provide sufficient information to prospective purchasers, which is necessary for the preparation of firm offers for the business. In case of competitive bidding, business reviews enable prospective purchasers to refine their initial bid after the review.

In case of sequential selling, business reviews either reinforce the interest of the priority purchaser, thus increasing the probability of consummating the transaction, or lessen the interest, causing the selling corporation to move on to the next potential purchaser on the priority list. In a one-buyer type of selling process, business reviews tend to blend with the negotiating process since both the parties are aware of the fact that there is only one potential buyer. Information exchange, therefore, invariably includes discussions about the deal structure and the purchase price.

18.6.4 Negotiating and Closing the Transaction

A diverse set of skills and very thorough preparation is required for negotiating and closing a divestiture transaction. Facts and information alone are not sufficient for the purpose. A good negotiator knows when to be tough and when to be flexible on a specific point. The objective of good negotiators is to maximize price and optimize the deal structure.

Preparing for negotiations

Prior to initiating negotiations, the negotiating team should identify all the major points that are to be discussed and should evaluate these in the context of the overall objective of the divestiture. The team should prepare the opening position, preferred position, fallback position, and the deal breakers for each point in the negotiation.

Before beginning the negotiations, a role-play of the forthcoming negotiations will facilitate identifying the weaknesses in the positions established for each point and enable the members of the negotiating team to polish their roles.

Conducting the negotiations

There are several steps involved in actual negotiations. The first step of the negotiation deals with reaching an agreement in principle. This process may result in a term sheet, which is used as a basis for negotiation and preparation of the definitive purchase agreement, or may simply result in the parties agreeing to sign a formal agreement in principle once all major points pertaining to the negotiation are believed to be resolved.

Due diligence examinations

After having reached and documenting agreement on the major points of the transaction, the purchaser expects to conduct a due diligence examination of appropriate books, records, and facilities of the business for verifying the financial statement and other information. Any kind of misrepresentation, if discovered by the purchaser, can void the agreement or cause renegotiations of the price and deal structure.

The purchase agreement

The next step in the conduct of negotiations involves the preparation of the definitive purchase agreement and any supplementary agreements that may be required. The process involves numerous drafts and revisions prior to the closing. Preparation of agreements and the closing documents is greatly facilitated if the divestiture was planned well by the selling corporation and both the parties in good faith negotiated the business issues.

Example

Walmart acquired a controlling stake of 77% in India's largest online retailer Flipkart for a price of USD 16 billion. For Walmart, Flipkart was the best route to enter India and hence, Walmart was bent on acquiring Flipkart, notwithstanding the slow growth of the company and its accumulated losses. When discussions between the two sides began, Walmart was initially looking to pick up a minority stake. The nature of the talks shifted toward acquisition, a direction that was championed by Greg Penner, chairman of the Walmart Board. Then, top Walmart executives met the Board members of Flipkart in Bengaluru. While rival Amazon also made a bid to acquire Flipkart, Walmart was able to clinch the deal. Walmart, which was desirous of acquiring Flipkart, focused on discussions at various levels to negotiate the price and acquire a controlling stake of 77% in Flipkart.

Source: ICFAI Research Center

Closing the transaction

Usually, closing of a transaction involves signing of agreements, and exchanging of the proceeds of the transaction. It is however essential to observe caution. Simply speaking, a seller can never relax until the documents are signed and proceeds change hands. A high level of confidence after reaching an agreement in principle is a sure signal for disaster. A feeling of comfort about the last draft of the purchase agreement can result in great disappointment, and if there is insufficient attention to detail while preparing the closing documents, it can lead to deferred closing of the deal, or worse, no closing at all.

18.7 Takeover

A takeover is the acquisition of one company by another. The factors that make a firm a desirable candidate for acquisition and vulnerable to a takeover include:

- A low stock price compared to asset replacement cost or their potential earning power.
- A highly liquid balance sheet with large amounts of excess cash, a valuable securities portfolio, and a significantly unused debt capacity.
- Good cash flow relative to current stock prices.
- Subsidiaries or properties that can be sold off without significantly affecting the cash flow.
- Relatively small stock holdings under the control of incumbent management.

These factors in combination serve to simultaneously make a firm an attractive investment opportunity as well as facilitate its financing. The firm's assets provide collateral security for an acquirer's borrowings and the target's cash flows from operations and divestitures facilitates repayment of loans.

Activity 18.2

A takeover refers to acquisition of a certain block of paid-up equity capital of a company to acquire control over the affairs of the company. In a friendly or negotiated takeover, the management decides to give away control of the company to another group on terms and conditions mutually agreed upon. In an open market or hostile takeover, a person or a group acquires shares of a company from the open market to take control of the company. Explain, with the help of an example, what prompts companies to attempt takeovers.

Answer:

18.8 Anti-Takeover Defense Mechanisms

When faced with a potential takeover situation, the prospective target can employ a number of anti-takeover defense mechanisms such as anti-takeover amendments, poison pill defense, and targeted share repurchase and standstill agreements.

18.8.1 Anti-Takeover Amendments

Anti-takeover amendments are amendments to the firm's corporate charter, which are intended to make it more difficult for an unwanted acquirer to take over the firm. These are popularly called shark repellents. As is the case for all charter amendments, anti-takeover amendments must be voted on and approved by shareholders. There are various types of anti-takeover amendments:

Super majority amendments

Under such amendments, shareholder approval by at least a two-thirds vote and sometimes even 90 percent of the voting power of outstanding capital stock is required for change of control. In many cases, a board-out clause is introduced, which empowers the board to determine when and if the supermajority provisions will be in effect. The management's flexibility in takeover negotiations gets limited as a result of pure supermajority provisions.

Fair price amendments

The corporate charter may be amended to require supermajority provisions with a board-out clause, and an additional clause which waives the requirement of supermajority if a fair price is paid for all the shares purchased. Fair price is defined as the highest price paid by the bidder during a specified period, and is sometimes required to exceed the book value of the target, or an amount determined relative to accounting earnings.

Classified boards

Staggered or classified boards of directors are another major type of anti-takeover initiative. The rationale behind proposing a staggered board or classified board is to ensure continuity of policy and experience. For example, if a board has nine members, it will be divided into three classes with only three members standing for election for a three-year term each year. A new shareholder would have to wait at least two annual general meetings to gain control of the board of directors.

Authorization of preferred stock

The board of directors has the discretion to create a new class of securities with special voting rights. In a control contest, these securities are offered to friendly parties. Though this method has been traditionally used as a tool to give the board of directors flexibility in financing under dynamic economic conditions, it is basically a defensive measure against hostile takeover bids.

18.8.2 Poison Pill Defense

Poison pill defense is a popular but controversial defense mechanism against hostile takeover bids. The process involves creation of securities known as poison pills. These securities provide their holders with special rights to be exercised only some days after a takeover attempt. The takeover attempt could be either a tender offer for control or accumulation of a specified percentage of target shares. The exercise of the rights makes the takeover more difficult and/or costly for an acquirer.

Usually, shareholders' approval is not sought for adoption of poison pills by the board of directors. The rights provided by a poison pill plan can be quickly altered by the board or redeemed by the firm any time before their exercise, following the occurrence of the triggering event.

Example

Micron Technology's Board of Directors introduced a shareholder rights plan as a defense against a possible takeover. There was speculation that there could be a takeover attempt from a Chinese company or Intel. By adopting this defense mechanism, Micron could go for a rights issue in the event of an individual or group acquiring more than 4.99% of its outstanding stock. The rights issue defense technique would make a potential takeover very expensive and thus ward off any such overtures. Poison pill defense mechanism was adopted by Micron Technology to avert a possible takeover bid.

Source: ICFAI Research Center

18.8.3 Targeted Share Repurchase and Standstill Agreements

Targeted repurchase, also known as greenmail, is a process in which a target firm indulges in private negotiations and repurchases a large block of its stock from an individual shareholder or a subset of shareholders at a premium. The purpose of premium buy-back is to put an end to the threat of a hostile takeover by the large blockholder or greenmailer.

As greenmail is a type of blackmail, both the payers and buyers of greenmail are not seen with respect. According to opponents of greenmail, greenmailers are responsible for causing damage to shareholders. According to them, the large block investors are corporate 'raiders' who snatch corporate assets, causing harm to other shareholders.

A standstill agreement is a voluntary contract in which the stockholder who is bought out, agrees to abstain from making further investments in the target company for a specified time period. If the standstill agreement is made without a repurchase, the large blockholder agrees to refrain from increasing his/her ownership, as this may give him/her a controlling position in the company.

Check Your Progress - 3

7. Arrange the elements constituting the selling process of a divesting firm in the correct order.
   i. Holding detailed business reviews with the potential purchasers
   ii. Selecting the type of selling process to be utilized
   iii. Negotiating the transaction
   iv. Identifying prospective buyers
   a. i, ii, iii, iv
   b. iv, ii, i, iii
   c. iii, i, iv, ii
   d. ii, iv, iii, i
8. Which of the following is **not** a method of divestiture of a business?
   a. Competitive bidding
   b. Sequential selling
   c. Acquisition
   d. Initial public offering
9. If correctly managed, which of the following processes helps produce the highest bidder and the best deal structure for the selling firm?
   a. Competitive bidding
   b. Sequential selling
   c. Fair price amendment
   d. Initial public offering

10. Which of the following is **not** an anti-takeover amendment?
    a. Fair price amendments
    b. Authorization of preferred stock
    c. Standstill agreement
    d. Classified boards

Activity 18.3

Hostile takeover bids are often resisted by the promoters, the management, and the shareholders. Explain, with the help of an example, how a hostile takeover bid was resisted in the Indian corporate world and what the outcome of the takeover battle was.

Answer:

18.9 Summary

- Divestitures are undertaken for two main reasons: the assets are worth more as part of the buyer's organization than as part of the seller's; or the assets are actively interfering with other profitable operations of the seller.
- The reasons for divestitures can also be classified as: efficiency gains and refocus, information effects, wealth transfers, and tax reasons.
- Divestment of a business requires a team of functional experts under the direction of an experienced project manager. Corporations devoid of a formal corporate development activity may find qualified divestiture managers within the financial, legal or corporate planning departments. After having assembled the core team, the project manager should formulate a definitive project plan and obtain approval of the intended approach from the corporate management.
- In the stage of preparing for the divestiture, a formal offering memorandum may be prepared.
- The offering memorandum may have the following components: executive summary; buyer procedure; background; the market; products / services; facilities and fixed assets; systems and operations; organization, management, and personnel; and key financial information.

- Valuation techniques such as book value, comparables, discounted cash flow (net present value), payback, or replacement cost method may be used for valuing the business.
- The selling process consists of four key elements, namely, identification of potential buyers, selection of the type of selling process, business reviews, and negotiating and closing of the deal.
- Selling processes may be of four types – competitive bidding, sequential selling, one-buyer, and going public.
- A takeover is the acquisition of one company by another.
- Anti-takeover amendments deal with the amendments to the corporate charter of a firm which are intended to make it more difficult for an undesirable acquirer to take over the firm. The four types of anti-takeover amendments are: super majority amendments, fair-price amendments, classified boards, and authorization of preferred stock.
- Other anti-takeover measures include poison pill defense, targeted share repurchase, and standstill agreements.

18.10 Glossary

Takeover: A takeover is the acquisition of one company by another.

Standstill agreement: A voluntary contract in which the stockholder whose shares have been purchased agrees that he or she will not make further attempts to take over the company in the future.

Sequential selling: This method involves establishing a priority list of potential buyers after the identification of prospective purchasers.

Offering memorandum: The initial selling document drafted in preparation for a divestiture. The offering memorandum may have the following components: executive summary; buyer procedure; background; the market; products/services; facilities and fixed assets; systems and operations; organization, management, and personnel; and key financial information.

Initial Public Offer: Companies which are not being publicly traded offer stock to the general public thereby diluting the ownership rights of the promoters.

Divestiture: The sale of a segment of a company (assets, a product line, a subsidiary) to a third party for cash and/or securities. Firms often divest themselves of businesses which are not of strategic importance and which do not contribute much to their total revenues, and to focus completely on their core businesses.

Competitive bidding: Buyers compete on the price being offered for the firm's assets or business division.

18.11 Self-Assessment Test

1. Why do companies go for divestitures?
2. What are the aspects that need to be considered by companies to prepare for and execute a divestiture?
3. Discuss the factors that influence takeovers. What are the anti-takeover defense mechanisms that organizations may adopt?

18.12 Suggested Readings/Reference Material

1. Thomas L. Wheelen, et al., Strategic Management and Business Policy: Globalization, Innovation and Sustainability, Fifteenth Edition, Pearson Paperback – 30 July 2018
2. P.N. Srivastava, Business Policy and Strategy Hardcover, Horizon Press, January 2019
3. Joan Magretta, Emile Holmewood and Heinrich Zimmermann, What is Strategy?: An Illustrated Guide to Michael Porter Hardcover – Illustrated, 15 September 2020, Harvard Business Review Press
4. Shabbar Suterwala, Top 20 Business Strategies for your Business Growth, Notion Press; 1st edition Paperback – 27 May 2021
5. Brian Tracy, Business Strategy: The Brian Tracy Success Library Hardcover – 26 February 2018, Manjul Publishing House
6. Callie Daum, Business Strategy Essentials You Always Wanted to Know (Second Edition), January 2020, Vibrant Publishers

18.13 Answers to Check Your Progress Questions

1. (b) Only i and iii

A study done by Linn and Rozeff in 1984 revealed two main reasons for divestitures, i.e., the assets are worth more as part of the buyer's organization than as part of the seller's and also that the assets are actively interfering with other profitable operations of the seller. For example, one of the business units of a firm is a state of the art leather tannery. This unit might be more valuable to a firm like Bata or Liberty shoes and hence they may pay a very good price for it. Or a firm may have a milk processing company, a rubber company, a plastic company, and a textile company in its corporate portfolio. If the rubber company is drawing more attention from the managers because of the increased competitive pressures in the rubber industry, the firm may decide to sell it off.

2. (b) Only i, ii, and iv

According to James C. Van Horne, some of the main reasons that force companies to divest are: efficiency gains and refocus, information effect, wealth transfers, and tax reasons. When a chemical firm enters a range of industries like the ink industry, the detergents industry, the paints industry, the paper industry, and the snack foods industry, it may result in a loss of focus on the core business. In such an event, it may decide to sell off its paper unit and snack foods unit to refocus on the chemicals line.

3. (b) When the regulatory authority passes an anti-trust ruling

An involuntary divestiture is usually the result of an anti-trust ruling by the government or regulatory authorities, whereas a voluntary divestiture is a willful decision by management to divest. An anti-trust ruling is passed against a firm when it is found that the firm's practices are providing it with an unfair advantage in its industry or that it is betraying the common interest of the consumer.

4. (d) Corporate finance

The composition of the core team will vary depending on the specific nature of the divestiture and the team will generally include someone who is extremely knowledgeable about the business being sold and someone from the corporate finance function. If the asset being divested is a sophisticated plant and machinery, then one of those in charge of production will form part of the core divestiture team. On the other hand, if a branch office is being sold, then the property manager will be in the core divestiture team. The corporate finance manager will know about the monetary cost (after depreciation) of the assets being divested and their market value. Hence he or she is generally included in the core divestiture team.

5. (d) i, ii, iii, and iv

The project plan of a divestiture should include: identification of the core team and supplementary internal resources that are required; specific tasks and responsibilities of each project participant; identification of outside resources required such as investment bankers, their specific tasks, and anticipated costs for their services; the timetable for each major phase of the project; and an overall budget for the project.

6. (d) i, ii, and iii

The offering memorandum of a divestiture includes buyer procedures which comprise the rules as specified by the selling corporation like the selling process to be used, which indicates whether competitive bidding or some other process is being used. Dates for indications of serious interest and for initial bid submission are specified. Apart from stipulating when and where detailed business reviews will be held, it also sets the date for submission of final bids.

7. (b) **iv, ii, i, iii**

The four key elements that constitute the selling process of a divesting firm are: identifying prospective buyers, selecting the type of selling process to be utilized, holding business reviews with the potential purchasers, and negotiating the transaction and closing of the deal.

8. (c) **Acquisition**

Acquisition is a **method of buying** a firm and **not** of divestiture. There are basically four different methods of selling a business such as: competitive bidding, sequential selling, one buyer, and going public (initial public offering). In competitive bidding, buyers compete on the price being offered for the firm's assets or business division. Sequential selling involves first exploring the route of selling to a known buyer and, if that fails, resorting to competitive bidding or any other mechanism of sale. Initial Public Offer means that companies which are not being publicly traded offer stock to the general public thereby diluting the ownership rights of the promoters.

9. (a) **Competitive bidding**

The process of competitive bidding helps produce the highest bidder and the best deal structure for the selling corporation, if correctly managed. In competitive bidding, buyers compete with each other to acquire the assets that the selling firm is divesting itself of and they try to outbid each other. This results in high prices for the assets.

10. (c) **Standstill agreement**

Anti-takeover amendments are amendments to the firm's corporate charter. The various types of anti-takeover amendments are: super majority amendments; fair price amendments; authorization of preferred stock; and classified boards. A standstill agreement is a voluntary contract in which the stockholder whose shares have been purchased agrees that he or she will not make further attempts to take over the company in the future. It is a mechanism for establishing corporate control and is not an anti-takeover amendment.

Unit 19

Managing Strategic Change

Structure

"If you can't measure it, you can't change it."

- Peter F. Drucker

19.1 Introduction

Drucker is emphasizing the importance of measuring (efficiency, productivity, effectiveness, etc.) in managing strategic change.

In the previous unit, we have discussed divestitures and anti-takeover defenses. In this unit, we shall discuss managing strategic change.

In today's global environment, change rather than stability is the order of the day. Rapid changes in technology, competition, and customer demands have increased the rate at which companies need to alter their strategies and structures to survive in the marketplace. Organization change means any substantive modification to some part of the organization. The change could be strategic or operational in nature.

Organizations and management face change on a continuous basis, especially in volatile environments. Some changes are reactions to threats, whereas others are proactive attempts to seize opportunities. Organizations that seek to create and sustain competitive advantage should be ready to change and implement the proposed changes. When strategies change, there are accompanying changes in structures and responsibilities, and people are clearly affected. In such organizations, managers and employees should be supportive rather than resistant or hostile.

This unit will first discuss the forces of change, the types of change, and the change process. We shall then move on to discuss the reasons for resistance to change and how these obstacles can be overcome. We shall also discuss the various approaches to implementing strategic change. Finally, we shall discuss about power and politics, and their influence on strategic change.

19.2 Objectives

By the end of this unit, you should be able to:

- Explain the forces of change, the types of change, and the change process.
- Identify the reasons for resistance to change and how these obstacles can be overcome.
- Find out the various approaches to implementing strategic change.
- Discuss about power and politics, and their influence on strategic change.

19.3 Forces for Change

Why do organizations change? The basic answer to that is that either something relevant to the organization has changed or is going to change. Consequently, the organization too has to change. The major forces for change are as follows:

Technical obsolescence and technical improvements

A need for technical change arises when competitors come up with some new developments. Another reason could be that the strategy team wishes to harness new technologies. Internal research and development ideas can generate technical change internally. In high technology industries, this is a significant issue because the product life cycles are short.

Political, economic, and social events

The socio-cultural dimension reflecting societal values, determines what kind of products will be accepted in the market. Generally, political and social events are beyond the control of organizations, but they are forced to respond to such events. Similarly, policy level changes in the economic environment force an organization to change its practices. For example, the introduction of the product patent regime in India has forced pharmaceutical companies to change their strategies for growth and success.

Example

When Satya Nadella assumed the position of CEO of Microsoft, he faced a tough job of reviving the fortunes of the company. He initiated changes by shifting business strategy, business practices, which in turn required an overhaul of the company culture. "We used to hang on to our past success too much and our industry doesn't care about past success," he says. "It's all about the future and every industry is like that nowadays. Being successful in the past means nothing."

Few years after taking over as CEO, Microsoft's share price has tripled compared to what it was five years ago. Microsoft is considered as one of the most valuable companies of the world next only to Apple. Satya Nadella had revived the fortunes of the company. Thus, driven by 'Economic Factor', Satya Nadella initiated changes in the company.

Source: ICFAI Research Center

Globalization

Globalization has provided opportunities for many organizations and allowed them to grow. But many organizations are forced to change so as to respond to the competitive conditions.

Example

The International Monetary Fund forecasted that by 2025, emerging economies would represent half of the world's consumption. In 2007, David Lessar, CEO of Halliburton (a US-based oil-field services firm), in a press conference informed company stakeholders that Halliburton was moving its corporate headquarters from Houston to Dubai. Lessar said "My office will be in Dubai, and I will run our entire worldwide operations from that office.

The Eastern Hemisphere is a market that is more heavily weighted toward oil exploration and production opportunities. Growing our business here will bring more balance to Halliburton's overall portfolio." Managing the diversity of markets, allocation of resources, understanding local culture, customer buying behavior, and buying channels is a difficult task for companies that globalize their operations. To manage these challenges, it is important to change headquarters and also make other related changes like change in organization structure.

Source: ICFAI Research Center

Increase in organizational size, complexity, and specialization

The growth of organizations creates pressure for further changes. Large organizations have started using information technology in their operations, introducing automation and streamlining their business processes. These create a need for greater specialist expertise, training, and changes in the jobs of managers and employees.

Greater strategic awareness and skills of managers and employees

Able and ambitious employees need opportunities for growth within the organization for job satisfaction. This could be in the form of promotion or changes in the scope of the job. Such changes require strategic development and growth by the organization as well.

After considering these general change forces, we will mention issues that have a significant impact on the competitive activity of organizations.

Competitive dynamics

The competitive forces acting on an organization determine how proactive and change-oriented it must be if it is to be effective. There are several factors that require organizations to be receptive to the need for change. Such factors are:

- The general dynamics and uncertainty of economies
- Time horizons. As product life cycles shorten, the development time for new products must be cut and this requires change.
- Quality, design, and service. These must be responsive to customer perceptions if organizations are to gain a competitive advantage.

Though certain common factors are illustrated here, these forces and their relative intensity vary between organizations and industries.

Activity 19.1

In today's competitive environment, change rather than stability is the order of the day. Rapid changes in technology, competition, and customer demands have increased the rate at which companies need to alter their strategies and structures to survive in the marketplace. With the help of a suitable example, explain why change is necessary and how organizations manage change.

Answer:

19.4 Types of Change

Strategic change is the movement of an organization away from its present state toward some desired future state to increase its competitive advantage. Three important types of change are re-engineering, restructuring, and innovation.

19.4.1 Re-engineering

Re-engineering is defined as the fundamental rethinking and radical redesign of business processes to achieve dramatic improvements in critical, contemporary measures of performance such as cost, quality, service, and speed. The strategists who use re-engineering must do a complete rethink on how their organization goes about in its business.

In re-engineering, the strategic managers make business processes the focus of attention. A business process is any activity that is vital to delivering goods and services to customers quickly or at low cost. Some examples of business processes are order processing, inventory control, or product design.

The organizations that take up re-engineering ignore the existing arrangement of work activities. Such organizations start the change process by asking the customers "How can we reorganize the way we do our work to provide the best quality and the lowest cost goods?" Such companies realize that there are more effective ways to reorganize their activities. Often individual jobs (that become increasingly complex) and people are grouped into business processes that are executed by cross-functional teams and are re-engineered to reduce costs and increase quality.

Therefore, re-engineering adopts a different approach in optimizing its activities. This may be because of drastic unexpected changes in the environment such as emergence of aggressive new competitors or technological breakthroughs.

Example

Karur Vysya Bank, a leading South India-based private-sector bank, launched 'KVB Next', a tab-based digital initiative. Through this service, eligible retail and business customers could get loans sanctioned in about 15 minutes. Business customers can visit a self-service web portal and complete the loan application process. Subsequently, they could take the help of sales team and after scrutiny of the application, the loan gets disbursed in 2 or 3 days. Customers can get home, personal, vehicle, property, and working capital loan through this tab-based application.

KVB launched many such digital services for the benefit of the customers. Commenting on this change, KVB's CEO, P. R. Seshadri said in an interview to *Business Line*, "This is the technology transformation that KVB has embarked upon. The 102-year-old organization has combined modernity to stay in business". In the KVB example, digitalization of processes and technology transformation aims at providing superior, high quality and speedy service to customers. These measures have been initiated by KVB to gain competitive advantage.

Source: ICFAI Research Center

19.4.2 Restructuring

Business-level restructuring programs involve changes in the relationships between divisions and functions. There are two basic steps to restructuring. In the first step, the organization reduces its level of differentiation and integration by eliminating divisions, departments, or levels in the hierarchy. Next, it downsizes by reducing the number of employees so as to reduce operating costs.

There are many reasons why organizations go in for restructuring.

- Sometimes, unforeseen changes might occur in the business environment. For example, worldwide recession can reduce the demand for the organization's products.
- Sometimes, organizations have excess capacity because customers do not want its products. At times, leading organizations restructure to build and improve their competitive position and sustain their leadership positions.
- Also, organizations downsize because over time they have grown too tall and bureaucratic, due to which operating costs have increased to a large extent.
- Sometimes, companies are forced to downsize because they have not paid attention to the need to re-engineer themselves. In such a situation, restructuring becomes the only way they can survive and compete in an increasingly competitive environment.

19.4.3 Innovation

Innovation involves the use of a new idea or method. An organization that brings out an innovative product usually enjoys the 'first mover' advantage. This advantage can help it to gain market share and later, economies of scale. Thus, an innovation correctly exploited, can create a strategic advantage for an organization.

Innovation need not always be dramatic to bring success to the organization. Even incremental improvements can add significant value to the organization. Launching a new product, entering a different industry, or operating through a new distribution channel, can all be considered innovative.

Innovation depends on the collective enterprise and expertise of employees. Though organizations are well aware of the need for innovation, their ability to innovate is limited by many obstacles. Complacency over past successes comes in the way of potential innovations. Complacent people prefer predictability and conformity. This preference discourages different ways of thinking.

The personal priorities of managers may discourage innovations. Arrogance, a short-term mentality, and the 'expert' syndrome are also blocks to innovation. Some managers are intolerant of mavericks and significantly averse to risk — this too discourages innovation in an organization.

Managers in organizations have to focus on long-term opportunities, and expect and accept contributions from employees at all levels. They should encourage those who have new ideas, accept bigger risks, and set ambitious goals. Corporate control systems often establish convergent thinking in preference to lateral thinking in their decision-making. Convergent thinking focuses on well-defined problems and suggests time-tested and well-known solutions immediately. This approach has great advantages. However, its use in areas requiring innovation is limited.

Lateral thinking, on the other hand, stresses the importance of change, and movement in a non-linear direction. Convergent thinking or vertical thinking moves step by step; by taking the right step each time, a solution is reached. In contrast, lateral thinking takes into consideration a lot of information that appears irrelevant to the problem at hand. This approach is similar to that employed in brainstorming sessions. In brainstorming sessions, irrational ideas are never discouraged because even these can lead to brilliant ideas. Innovations demand such a flexible approach.

Creativity and risk taking are important prerequisites for any innovation. Creativity needs paradigm shifts. Shifts in thinking are difficult to achieve as changing the pattern of thinking involves risk. In some cases, management's inflexibility is an obstacle to changing the way people think.

Innovation is a result of creative action or thought or both. Creativity is the ability to develop new ideas. However, in organizations, creative ideas are hardly ever encouraged because these ideas threaten the *status quo*. A concerted effort should therefore be made to encourage creativity.

Coordination, productivity requirements, and control systems may also undermine creativity in an organization. Organizations should establish systems that encourage creativity in the workplace. The employee's intrinsic motivation should also be kept alive.

Example

Google's 20% policy encourages employees to spend 20% of their time on any project that they would like to work on, as long as it is business related. This policy has helped Google create some great products like Google Maps, Gmail, Adsense, Google News, etc. Google offers a good work-life balance and stress free work environment for its employees. Google's People's Operation Team (HR) uses HR Data Analytics to make improvements in different aspects of people processes and align them with the work culture so that employee performance on creating and developing new ideas and new products is optimized. In this case, Google is trying to bring about innovation culture and gain competitive advantage.

Contd….

Corporates like Google encourage those who have new ideas, accept bigger risks, and set ambitious goals. To do this, they must create an innovation culture in the organization and Google makes changes in the policies to create this environment.

Source: ICFAI Research Center

Check Your Progress - 1

1. Which of the following statements is **false**?
   a. Organizations that seek to create and sustain competitive advantage should be ready to change and implement the proposed changes.
   b. Some changes are reactions to threats, whereas others are proactive attempts to seize opportunities.
   c. The socio-cultural dimension, reflecting societal values, determines what kind of products will be accepted in the market.
   d. Generally, political and social events are beyond the control of the firms, therefore they need not respond to such events.
2. There are several factors that require organizations to be receptive to the need for change. Which of the following are such factors?
   i. The general dynamics and uncertainty of economies.
   ii. Stable technology.
   iii. Time horizons.
   iv. Quality, design, and service.
   a. Only i, ii, and iii
   b. Only i, ii, and iv
   c. Only i, iii, and iv
   d. i, ii, iii, and iv
3. Which of the following aspects need change with reference to different ways of doing things will require a change in values, culture, and style of management, and is executed through organizational development?
   a. Mission
   b. Vision
   c. Goal
   d. Policy
4. Which of the following are required for Innovation by employees?
   a. Individual efforts, knowledge
   b. Individual efforts, experience
   c. Collective enterprise, expertise
   d. Collective enterprise, beliefs

Activity 19.2

Organizations have to be receptive to the need for change. Factors such as general dynamics and uncertainty of economies, time horizon, quality, design, and service influence the level of change in the industry. Strategic change is the movement of a company from its existing state to a desired future state. Describe such a strategic change with the help of an example.

Answer:

19.5 The Change Process

Change frequently disrupts normality. If the organization is facing strong external pressures, it is unrealistic to expect managers and employees not to query or resist the need to change. The change process becomes difficult when individuals perceive that they are losing out rather than benefiting or are not being rewarded for cooperating.

Change involves actions based on a carefully thought-out process that anticipates future difficulties, threats, and opportunities. The various steps in the change process are:

19.5.1 Recognition of Need for Change

In the first step, the senior management must develop an early awareness of the need for change. Information leading to such awareness can come from the various stakeholders of the organization. Another source of information is scientific associations, which may know more about developments in product and manufacturing technologies. Moreover, examining the actions of competitors gives an additional lens to managers through which they can monitor the environment.

19.5.2 Building Awareness of Need to Change

Once senior managers have gained a general idea of the kind of change required, they must build awareness of this need among employees in the organization. Awareness can be built among employees during routine contacts with them. These conversations will stimulate people's thoughts about possible change without raising anxieties too quickly. Thus, sharing information and establishing trust are critical in building support for change.

Example

In an interview to *Wall Street Journal*, John Flannery, chairman of General Electric, very clearly and confidently announced GE's major strategic change of spinning off its healthcare unit and selling its stake in Baker Hughes (GE's oil company). Through this interview, GE chairman informed employees, shareholders, and the financial media that he was doing the right thing by streamlining GE into a company that focuses on power, aviation and renewable energy. The changes to GE's business portfolio designed to stimulate growth and generate more value for shareholders. GE's Aviation, Power and Renewable Energy units will form a new core of the company. GE planned to turn GE Healthcare into a standalone business, distributing 80 percent to GE shareholders and monetizing the remaining 20 percent. In the above case, GE chairman is using the press interview to build awareness for change to establish trust and support for the move.

Source: ICFAI Research Center

19.5.3 Fostering Debate

A stimulating debate about alternative solutions and a diversity of perspectives is essential. Diversity of ideas raises the chances that both the best and worst aspects of each alternative are brought to light. The debates and various perspectives contribute to building a commitment to new goals.

19.5.4 Creating Consensus

Evidence will accumulate in favor of a particular approach when the outcomes of debates are analyzed. This evidence helps in creating a consensus about the direction change should take. In this process, opposition is likely and retaining entrenched opponents to a change initiative can result in trouble. In this stage, continuous training and management development can reap big dividends in implementing change. By teaching new skills to employees, the management can eliminate fear, the major source of resistance to transformation.

19.5.6 Assigning Responsibility

Once the appropriate response to change has been determined, responsibility for carrying it out must be assigned. In this context, a new effort toward change can be placed within an existing department. Also, the organization can set up a new autonomous unit. To ensure that an initiative receives proper attention, it may need to be established as a separate unit headed by someone who has only its welfare in mind.

19.5.6 Allocating Resources

A variety of resources may be needed to carry out a new initiative. Management must ensure that sufficient resources are available for sustaining the initiative. Otherwise, the initiative will atrophy for lack of sustenance.

19.6 Resistance to Change

Managers promoting change often possess insufficient knowledge to determine how the organization should respond to change. A senior manager interested in bringing about change must rely on employees to implement the new response once it has been developed. Therefore, he/she needs the support of managers and employees in designing a change initiative and implementing it.

19.6.1 Reasons for Resistance

Various reasons for resistance to change are outlined here.

Lack of awareness

Change requires a broad view of both the competitive and general environment. Managers (at the middle and lower level) and employees are often too focused on current activities to develop this kind of perspective. They become so narrowly focused that they are unaware of potential changes over the horizon. They fail to appreciate the need for change, especially if change means learning new methods, processes, or techniques.

Lack of interest

Even when managers and employees recognize the need for change, they often perceive it with lack of interest. This kind of reaction is common even with new developments.

Incompatibility with cherished values

Organizations most often develop their own sense of shared values and corporate cultures. Managers and employees oppose new strategies, products, or approaches that appear to conflict with established practices. Therefore, strongly held values and corporate cultures can become significant obstacles to change.

Fear of cannibalization

Developing new products that are distinct from those of the organization's current lineup means admitting the possibility that alternative or substitute products exist. Facing the threat of substitute products is hard for any organization. Thus, cannibalization is one of the main reasons that prevent organizations from investing in new technologies/products before competitors compel them to do so.

Fear of personal loss

The fear of restructuring that would eliminate entire divisions or businesses, along with the people involved in it, makes corporate change painful. Moreover, change may reduce the career opportunities for employees and may even cost them their jobs.

Different perception

A manager may make a decision and recommend change based on his/her own assessment of a situation. Others may resist the change because they may perceive the situation differently. As a result of a different perception, it becomes difficult for organizations to implement change.

19.6.2 Overcoming Resistance to Change

The opposition to change must be overcome, if it is to be implemented successfully. Casualties are possible and sometimes inevitable. Moreover, some people will leave because they are uncomfortable with the changes. Organizations in difficulty often appoint a new strategic leader to introduce fresh ideas and implement the changes. Changes need to be planned and everyone must be reassured that these changes will be for the betterment of the organization and its stakeholders.

There are several techniques to overcome resistance to change. They are -- education and communication, participation and involvement, facilitation and support, negotiation and agreement, manipulation and co-option, and explicit and implicit coercion. Use of these techniques can be associated with the concept of power.

Example

Stephen Friedman, the former managing partner of investment bank, Goldman Sachs, relates an interesting story as to how he realigned rewards to promote change. When the bank's leadership team initially decided that the organization had to expand internationally to stay competitive, there were few volunteers for its foreign offices. "It was just not valued as an attractive career opportunity by most of the US employees, and their spouses didn't necessarily want to go, and their dogs couldn't possibly endure living in Tokyo." Friedman recalls that he took an exceptionally talented young banker and promoted him to partner two years ahead of his class because he went to Asia at great personal sacrifice. Here, Mr. Friedman is overcoming the resistance to change by tactically rewarding a junior manager who was willing to accept a foreign assignment.

Source: ICFAI Research Center

Refreezing

Refreezing takes place when the intended change is realized and the new patterns of behavior are institutionalized in the organization. Often, rewards are influential in ensuring that refreezing takes place.

19.7 Implementing Strategic Change

Implementation is an activity in which structures and systems are changed to accommodate changes in strategy. Implementation of a strategy should be considered in depth before final decisions are made regarding strategy formulation.

There are five distinct approaches to strategy implementation and strategic change, which are:

- The strategic leader defines the changes of strategy and then hands it over to management for implementation. In this sense, he/she is a planner/thinker rather than a doer.
- The strategic leader decides on major changes of strategy, and also considers the appropriate changes required in structure, personnel, reward systems, etc. for the strategy to be implemented effectively.
- The strategic leader and senior managers meet for lengthy discussions with a view to formulating proposed strategic changes. The managers are briefed and the aim is to reach decisions to which they will all be committed. Managers who have been instrumental in their formulation then implement the strategies.
- The strategic leader concentrates on establishing and communicating a clear mission for the organization. He/she pursues this through a decentralized structure by developing an appropriate organization culture. The strategic leader retains the responsibility for changes in strategic perspective. The decisions concerning functional strategy are decentralized, but constrained by the mission, culture, and policies established by the strategic leader.
- In this approach, managers throughout the organization are encouraged to be innovative and come up with proposals. The strategic leader establishes a framework for evaluating these proposals. The accepted and resourced proposals result in raising the status of the manager concerned.

19.7.1 Top-Down Strategic Change

There can be a number of approaches in drawing strategic plans for the organization, but such plans are ultimately centralized decisions. This approach is viable as long as the strategies are implemented effectively. For formulation of top-down strategic change, capable managers are needed throughout the organization to deal with operational issues. This approach is attractive to strategic leaders who are inclined more toward the analytical aspects of strategy than they are toward behavioral issues.

19.7.2 Quinn's Incremental Model

The management of change in any organization generally fails for one reason, that is, an inadequate understanding on the part of top management. James Brian Quinn proposed a model of strategic change that is primarily a top-down approach. According to Quinn, the hardest part of strategic management is implementation of change. The role of a strategic leader is critical in the process because he/she is responsible for the proposed changes in strategy.

Moreover, the strategic leader is responsible for establishing the structure and processes within the organization. Quinn's approach can be described as follows.

- The strategic leaders will develop their information channels, both within and external to the organization, and will draw on this by using the formal systems.
- The strategic leader should then generate awareness of the desired change within the organization.
- The strategic leader will seek to legitimize the new strategies by lending authority to them; thus he/she will gather key supporters for the strategy.
- The strategy may be floated as a minor change to minimize resistance. If this is done, the ultimate aim is kept unclear. Alternatively, the strategy may be floated as an experiment.
- Steps are taken to remove or minimize opposition. For example, opponents can be moved to other parts of the organization.
- In the initial period, the strategy will be flexible, so that changes can be made in light of trials. The principle of learning by doing is practiced by strategic leaders.
- Finally, the proposed changes will be formalized and ideally accepted within the organization. It is important to look ahead and consider how the new strategy might be developed further in the future.

Quinn's approach incorporated the likely impact upon people and the organizational culture. This approach pragmatically searches for a better way of doing things, once the decision to change has been made.

19.7.3 Organizational Development

The basic theme of organizational development is that developing an appropriate organization culture will generate desirable changes in strategy. Organizational development is an effort that is planned and managed from the top. It is designed to increase organizational effectiveness and health through planned interventions in the organization's process. In essence, it means planned cultural change to establish mechanisms that encourage managers to be more open and cooperative when dealing with problems.

The objectives of organizational development are: improved organizational effectiveness; better customer service and higher profits; effective decision making; increased innovation; reduced conflict and destructive political activity; and greater trust and collaboration between managers and business units.

The thinking behind organizational development is that when managers learn more about the problems that face the organization as a whole, they become more aware of the impact of the decisions they make. The organizational development programs are not a response to specific problems but are a general approach to the management of change in the long run.

Organization development programs involve activities such as team building, collaborative decision making, bringing managers together, and encouraging them to share and discuss problems and issues. Organizational development helps the strategic leader to develop the appropriate culture for the mission he/she wishes to pursue.

Check Your Progress - 2

5. Arrange the steps of the change process in the correct sequence:
   i. Strengthening consensus for a preferred approach
   ii. Recognition of the need for change
   iii. Allocating resources to sustain the change effort
   iv. Stimulating debate about alternative solutions to effect change
   a. i, ii, iii, iv
   b. iii, i, iv, ii
   c. ii, iv, i, iii
   d. iv, ii, i, iii
6. Employees should support managers in designing a change initiative and implementing it, but in certain organizations employees withhold such support because of:
   i. Lack of awareness.
   ii. Lack of interest.
   iii. Incompatibility with cherished values.
   iv. Recognition of need for change.
   a. Only i, ii, and iii
   b. Only i, ii, and iv
   c. Only ii, iii, and iv
   d. i, ii, iii, and iv
7. In the change process, which of the following processes takes place when the intended change is realized and the new patterns of behavior are institutionalized in the organization?
   a. Refreezing
   b. Freezing
   c. Vertical integration
   d. Horizontal integration

8. When the strategic leader assumes the planner/thinker role rather than the doer role for strategy implementation, which of the following statements is true?
   a. The strategic leader decides on major changes of strategy and then considers the appropriate changes in structure, personnel, reward systems, etc., for effectively implementing the strategy.
   b. The strategic leader defines the changes of strategy and then hands it over to managers for implementation.
   c. The strategic leader concentrates on establishing and communicating a clear mission for the organization.
   d. The strategic leader and senior managers meet for lengthy discussions with a view to formulate proposed strategic changes.

Activity 19.3

Change involves actions based on a carefully thought-out process that anticipates future difficulties, threats, and opportunities. The various steps in the change process are recognizing need for change, building awareness of need to change, fostering debate, creating consensus, assigning responsibility, and allocating resources. With the help of an example, explain how a company can bring about change.

Answer:

19.8 Power

The management of change requires that managers have the requisite power to implement decisions and that they are able to exert influence. Managers who regularly attempt to get things done through other people have the problem of generating an agreement. Generally, the perspective of such managers differs from that of employees. Disagreements can range from polite and friendly to those involving threat and coercion.

The relative power and influence of stakeholders affect the need for change. For example, powerful customers and powerful suppliers may represent potential threats and they can demand change. Also, the management of change is affected by the relative power of the organization. For example, a change in strategies could be adopted because the organization possesses the power to implement and withstand the change in strategies.

Moreover, the decisions taken within organizations concerning changes of corporate and functional strategies are influenced by the disposition of relative power between functions and business units, and the ways in which managers seek to use power and influence.

19.8.1 The Bases of Power

There are many bases of power. The extent to which managers and employees in organizations use each of these bases is a major determinant of corporate culture.

Reward and coercive power

Reward and coercive power are strategically significant because they are the major determinants of employee motivation. Effective management involves two aspects, that is, establishing clear objectives for employees and rewarding/punishing them for the performance of these activities. Coercive power is generally effective when the organization is experiencing a decline and major changes in strategy are urgently required.

Legitimate power

Legitimate power is determined by the organization structure. Therefore, changes in structure will affect the power and significance of different functions and managers.

Example

Jeff Bezos, CEO of Amazon, is said to have once remarked, "Do I have to go down to the front office and get that sign that says I'm the CEO for you to stop arguing with me?" In this case, as the CEO of the organization, Jeff Bezos holds the highest position in the organization hierarchy and therefore, he can get work done from his subordinates by exercising legitimate power.

Source: ICFAI Research Center

Personal power

Personal power can lead to the commitment of others to the power holder. Managers who are supported and trusted by their colleagues/subordinates will find it easier to introduce and implement changes.

Expert power

Expertise is job related. Therefore, it is important to ensure that those managers who are perceived to be experts in the function concerned are supportive of the proposed changes.

Information and connection power

Information and connection power becomes significant as the importance of information technology grows.

The bases of power just mentioned are visible sources. Besides these, there is invisible power that exists in organizations. For example, the way in which an issue is presented can influence the way in which it is dealt with. Also, membership of managers in informal groups can be a source of power, particularly if the people involved feel dependent on each other. Likewise, there could be several sources of invisible power. The use of such power by individuals can inhibit changes that might be in the best interests of the organization.

19.8.2 Uses of Power and Influence

When a change agent wishes to exercise control over the behavior of other people, he/she has two options.

- First, the change agent can structure the situation so that others comply with his/her wishes.
- Second, he/she can change the perceptions of people by communicating with them. In this situation, people see things differently and decide to do as per the change agent's suggestion.

Both these options are categorized as strategies of manipulation.

- The change agent is using certain power bases in the first option and is seeking to use influence in the second.
- The outcome of both these situational and intentional approaches can be positive or negative.
- When the effect is positive, the people (influenced by change) feel that they are better off. The impact would be vice versa if the effect is negative.

Four tactics are related to these uses of power and influence. They are:

Inducement

Inducement implies an ability to control the situation. Other people who are involved in it perceive the outcome of inducement as beneficial. For example, an organization requires its employees to be mobile and it rewards them with salary increases or relocation expenses every time they move. In this context, the situation is controlled and the employees feel positive about the moves.

Coercion

Coercion implies an ability to control the situation but the outcome is perceived negatively. Taking the same example of the organization requiring its employees to be mobile, in the case of coercion, the employees would be threatened with no further promotions unless they agree to certain moves within the organization.

Persuasion

Here, the manager does not try to change the situation, but argues that people will benefit by behaving in certain ways. For example, people might be persuaded to agree to a change that is not immediately desirable. The outcome is generally positive.

Obligation

Obligation is an intentional tactic, the outcome of which is negative. People are persuaded to behave in a certain way by being made to feel that they are under an obligation to do so. For example, the organization might suggest that employees owe a particular manager a favor for something which has happened in the past.

Tactics that have positive outcomes are preferable to those which cause negative feelings. But in certain circumstances, the power bases of managers may be limited and speedy results may be required. In such cases, the managers have little option but to coerce and obligate people. Therefore, it is very important for managers to be skillful in managing change as they implement the detailed strategies. Also, strategic leaders should ensure that they have support from both the line and staff managers for changing the overall corporate strategy.

Example

Taxi and auto-rickshaw drivers across major Indian cities once took turns to protest against cab aggregators, Uber and Ola. Their complaint was that Ola and Uber have become a threat to their livelihood. The new cab hailing app has caught the attention of commuters, because of the convenience and lower charges. The traditional taxi drivers called it an uneven playing field and wanted better rules to ensure that the cab app operators do not intrude into their livelihood. During that time, over 90,000 auto-rickshaws and 15,000 yellow top taxis went on an indefinite strike making life difficult for daily commuters. Through the indefinite strike, coercive power was used and exerted by traditional taxi operators to block the entry of cab operators and prevent change. In this case, traditional taxis that are in a majority can bring the urban cities to a standstill by withdrawing their services and going on strike. The government and public would take notice and attention will be diverted to their issues. Cab aggregators like Ola and Uber too would feel threatened and might go slow on deploying aggressive pricing policies or expansion plans. Thus, coercive power is put to use here.

Source: ICFAI Research Center

19.9 Politics

Organizational politics are tactics that strategic managers engage in order to obtain and use power to influence organizational goals. In other words, organizational politics is the process by which differing interests reach accommodation. These accommodations relate to the behavior that is not prescribed by the policies established within the organization. Politics can be positive and legitimate but at times it is negative and illegitimate.

Political activity can be described in terms of three dimensions: legitimate or illegitimate, vertical or lateral, and internal or external to the organization. For instance, a suggestion/complaint by an employee to a senior manager, bypassing an immediate superior, would be classified as legitimate, vertical, and internal. On the other hand, threats and sabotage attempts are illegitimate.

In considering the feasibility of changes and how to implement them, it is important to examine the underlying political abilities and behavior within the organization. Without taking this into account, the implementation of change is likely to be hazardous. Politics is a key aspect of strategy implementation because it enables managers to be proactive and to influence their environment rather than being manipulated and dominated by external events.

19.9.1 Political Effectiveness

Effective managers clearly indicate what kind of support they need from other people and what they will offer in return, if proposed changes are to be implemented. Agreements are reached and such agreements provide mutual advantages. General and functional managers should be politically competent if personal objectives and undesirable changes of individuals are to be restrained and prevented.

Personal power is essential for managers who are politically effective and are able to influence others. If managers are to exercise political effectiveness, they should have a reputation built on past experience. In this context, external credibility (depending on the relative power of outside stakeholders) can prove valuable. Moreover, in order to exercise political effectiveness, managers should have access to information about the organization and individual employees.

Managers who are successful and effective politically, and can implement the proposed changes, generally understand the organizational processes and are sensitive to the needs of the people in the organization. Therefore, it is extremely useful if the strategic leader is an able politician.

The type and incidence of incremental changes in strategies (throughout the organization) are affected by the political ability of the managers. This implies that managers with political ability will be instrumental in introducing changes. Political ability relates to the use of power and influence in the most appropriate way in particular circumstances. In cases where the strategic leader encourages managers to be innovative and adaptive, he/she should consider the political ability of the manager concerned.

Some political tactics that may be used to obtain results are:

- Developing liaisons with other managers within and across functions and divisions, especially with managers who are more powerful
- Following a ‘divide and rule’ approach when faced with opposition
- Demonstrating willingness to compromise in order to accommodate the interests of powerful people whose support is required to implement change

19.9.2 Machiavellianism

Machiavellianism is the term used to describe coercive management tactics. It means the ruthless use of power, particularly coercive power and manipulation to attain personal goals. Sometimes, coercive power is used effectively by managers but it is not easy to justify coercive power especially if other alternatives are available. Moreover, coercion is not practical if used on a repeat basis and any fear of a threat not carried out recedes quickly.

19.10 Effects of Power and Politics on Strategic Change

Power and politics strongly influence an organization's choice of strategy and structure, if it is responsive to the aspirations of various divisions, functions, managers, and changes in the external environment. The problem faced by the companies is that the internal structure of power lags behind changes in the environment because in general, the environment changes faster than companies can respond.

To use politics to promote effective change, the organization must create a power balance among the various divisions/functions so that no single person dominates the enterprise. If a power balance does not exist, the divisions compete to maximize their own returns. In such situations, exchanging resources among divisions becomes expensive. This in turn lowers the organization's profitability and reduces organizational growth. Politics pervades all organizations but the CEO and top level managers can shape its character.

To design an organizational structure to create a power balance that facilitates change, senior managers can use the tools of implementation.

- First, they must create the right mix of integrating mechanisms so that functions can share information and ideas.
- The organization can then develop norms and values that emphasize corporate mission rather than divisional interests.
- Finally, strong hierarchical control by the CEO can create the organizational context in which politics can facilitate the change process.

Thus, the strategic manager should learn how to manage politics and power to further corporate interests, because politics is an essential part of the process of strategic change.

Check Your Progress - 3

9. Which of the following tactics implies an ability to control the situation. People affected by it perceive its outcome as beneficial?
   a. Obligation
   b. Persuasion
   c. Coercion
   d. Inducement

10. In an organizational context, which of the following dimensions can be used to describe political activity?
    i. Legitimate or illegitimate
    ii. Vertical or lateral
    iii. Internal or external to the organization
    a. Only i and ii
    b. Only i and iii
    c. Only ii and iii
    d. i, ii, and iii

19.11 Summary

- Organizations that seek to create and sustain competitive advantage should be ready to change and implement the proposed changes.
- The major forces for change are: technical obsolescence and technical improvements; political, economic, and social events; globalization; increase in organizational size, complexity, and specialization; greater strategic awareness and skills of managers and employees; and competitive dynamics.
- The level of change could be at values, culture, or styles of management; objectives, corporate strategy, or organization structure; competitive strategies, systems, and management roles; and functional strategies or organization of tasks. It is crucial to clarify the level of change and tackle needs and problems appropriately.
- The major types of strategic change are re-engineering, restructuring, and innovation.
- The strategic change process involves the following steps: recognition of need for change, building awareness of need to change, fostering debate, creating consensus, assigning responsibility, and allocating resources.
- There are various reasons for resistance to change and various techniques available for overcoming resistance to change.
- Refreezing takes place when the intended change is realized and the new patterns of behavior are institutionalized in the organization.
- Top-down strategic change, Quinn’s incremental model, and organization development are three techniques of implementing strategic change.
- Managing strategic change requires an understanding of the role of power or politics and using it appropriately to benefit the organization.
- To use politics to promote effective change, the organization must create a power balance among the various divisions/functions so that no single person dominates the enterprise.

19.12 Glossary

Innovation: Innovation involves the use of a new idea or method. An organization that brings out an innovative product usually enjoys the 'first mover' advantage. This advantage can help it to gain market share and later, economies of scale. Thus, an innovation correctly exploited, can create a strategic advantage for an organization.

Machiavellianism: It is a term used to describe coercive management tactics. It means the ruthless use of power, particularly coercive power and manipulation to attain personal goals.

Organizational politics: These are tactics that strategic managers engage in order to obtain and use power to influence organizational goals. In other words, organizational politics is the process by which differing interests reach accommodation.

Re-engineering: Re-engineering or business process re-engineering is an improvement philosophy that can be applied at the level of the individual process or at the level of the organization. Re-engineering achieves performance improvements by redesigning operational processes and maximizing value-added content.

Restructuring: Restructuring can be defined as a strategy by which a company changes its business or financial structure. It involves making radical changes in the composition of the business. The various types of corporate restructuring can be classified into four major forms: expansion, sell-offs, corporate control, and change in ownership structure.

19.13 Self-Assessment Test

1. Explain the forces of change. What are the various types of types of change? Describe the change process in detail.
2. Identify the reasons for resistance to change. How can organizations overcome these obstacles?
3. What are the various approaches to implementing strategic change?
4. What is power and politics? In what way do they influence on strategic change?

19.14 Suggested Readings/Reference Material

1. Thomas L. Wheelen, et al., Strategic Management and Business Policy: Globalization, Innovation and Sustainability, Fifteenth Edition, Pearson Paperback – 30 July 2018
2. P.N. Srivastava, Business Policy and Strategy Hardcover, Horizon Press, January 2019

3. Joan Magretta, Emile Holmewood and Heinrich Zimmermann, What is Strategy?: An Illustrated Guide to Michael Porter Hardcover – Illustrated, 15 September 2020, Harvard Business Review Press
4. Shabbar Suterwala, Top 20 Business Strategies for your Business Growth, Notion Press; 1st edition Paperback – 27 May 2021
5. Brian Tracy, Business Strategy: The Brian Tracy Success Library Hardcover – 26 February 2018, Manjul Publishing House
6. Callie Daum, Business Strategy Essentials You Always Wanted to Know (Second Edition), January 2020, Vibrant Publishers

19.15 Answers to Check Your Progress Questions

1. (d) Generally, political and social events are beyond the control of the firms, therefore they need not respond to such events.

Generally, while political and social events are beyond the control of firms, **they cannot afford to ignore such events**. For example, the Indian government's decision to become a signatory to the WTO (World Trade Organization) has led to Indian pharmaceutical firms investing substantially in research and development activities. Similarly, vegetarianism among particular sections of Indian society has led to McDonald's using vegetable oil in its product offerings.

2. (c) Only i, iii, and iv

Factors that require organizations to be receptive to the need for change are: the general dynamics and uncertainty of economies; time horizons – as product life cycles shorten, the development time for new products must shorten which requires change; and quality, design, and service, which must be responsive to customer perceptions if firms have to gain competitive advantage. If technology conditions are stable and not witnessing new developments, organizations would not be receptive to the need for change, as was witnessed in the electronics industry before the liberalization process started in India. Most of the older TV companies like Crown TV, Televista, Weston, Bestavision, and Texla, which were major companies when television technology was stable and were not receptive to the need for change, are now minor players or have been completely eliminated.

3. (a) Mission

The need for a change in the mission of an organization with reference to different ways of doing things will require a change in values, culture, and style of management, and is executed through organizational development. Organization development makes use of techniques like performance management, workforce remodeling, creating communities of practice, and other collaborative techniques of learning.

4. (c) **Collective enterprise, expertise**

Innovation depends on the collective enterprise and expertise of employees. Innovation is a result of a creative process and involves recognition of needs. The recognition of a need may be a collective or individual process/ act but the ability to create an innovative product which satisfies the need is a result of the collective enterprise and expertise of the employees. For example, the need for an LCD color TV might have been felt by a single individual but creating that product would have involved the efforts and expertise of a specialized team of employees.

5. (c) **ii, iv, i, iii**

The various steps in the change process are: recognition of the need for change; building organizational awareness for this need; stimulating debate about alternative solutions to effect change; strengthening consensus for a preferred approach; assigning responsibility; and finally, allocation of resources to sustain the change effort.

6. (a) **Only i, ii, and iii**

Reasons for withholding support to a change initiative by employees are: lack of awareness; lack of interest; and incompatibility with cherished values. A general lack of awareness about either the changing environmental factors or the benefits of the proposed change will prevent employees from lending support to the change initiative. If employees are not involved in organization survival and growth, they will lack interest in the proposed change initiative as they have become accustomed to the existing state of affairs. Or, if the proposed change is not compatible with the cherished values of the employees, they will not support the change initiative.

7. (a) **Refreezing**

In the change process, the first requirement is to defreeze, whereby employees are trained to unlearn existing practices and methods. Once they have unlearned these and are open to change, employees are taught new methods and practices and change takes place. Once the changed patterns are accepted and followed willingly, they are formalized and employees are expected to adhere to the new practices and methods. This is known as refreezing.

8. (b) **The strategic leader defines the changes of strategy and then hands it over to managers for implementation.**

The strategic leader who assumes the planner/thinker role rather than the doer role limits his/her role to defining the changes of strategy and hands over the implementation responsibility to managers.

9. (d) **Inducement**

Inducement implies an ability to control the situation. People who are affected by it perceive the outcome of the inducement as beneficial. For example, an organization requires its employees to be mobile and rewards them with salary increases or reimburses relocation expenses every time they move. In this context, the situation is controlled and the employees feel positive about the moves.

10. (d) **i, ii, and iii**

Political activity can be described in terms of the following dimensions: legitimate or illegitimate; vertical or lateral; and internal or external to the organization. For instance, a suggestion/complaint by an employee to a senior manager, bypassing an immediate superior, would be classified as legitimate, vertical, and internal. Threats and attempts of sabotage as a result of political activity are illegitimate.

Unit 20

Challenges for the 21st Century

Structure

"The only skill that will be important in the 21st century is the skill of learning new skills. Everything else will become obsolete over time."

- Peter F. Drucker

20.1 Introduction

Learning is the lifelong journey. One should not stop learning. According to Drucker, in the 21st century skill of learning new skills is important for the survival in the market, which poses a challenge for the 21st organizations.

In the previous unit, we have discussed managing strategic change. In this unit, we shall discuss the challenges faced by managers in the 21st century.

One cannot predict with certainty what lies in the future in the areas of international business and economic relationships. But one can determine the hazy outlines of future trends when one looks at the several factors that shape international business and social relationships. Global socio-political, technological, and economic forces that are under no one's control but affect everyone, constitute one set of factors.

Further, business and social relations will be affected by the decisions and actions of sovereign nation-states and international organizations. In addition, the perceptions, choices, and actions of individual managers and their business organizations will shape the future. International managers must equip themselves with an understanding of the interactive power of global trends, national actions, organizational and individual choices, and prepare to face this uncertain future.

This unit will first discuss the issues of global competitiveness in the new millennium. We shall then move on to discuss the considerations for strategists in the 21st century. We shall also discuss the emergence of the knowledge worker, and the challenge posed by e-business. Finally, we shall discuss the role of the CEO in the new millennium.

20.2 Objectives

By the end of this unit, you should be able to:

- Identify the issues of global competitiveness in the new millennium.
- Explain the considerations for strategists in the 21st century.
- Discuss the emergence of the knowledge worker.
- Recognize the challenge posed by e-business.
- Assess the role of the CEO in the new millennium.

20.3 Global Competitiveness in the New Millennium

The global marketplace has developed an account of factors such as:

- Explosive growth in world gross domestic product
- Even more rapid expansion in merchandise trade (exports and imports) reflecting a new demand for goods from affluent customers.
- Cost cutting and improvement of product quality by organizations seeking competitive advantage, resulted in the growth of large corporations with worldwide operations. A revolution in manufacturing, distribution, and product quality control, further enhanced the competitive positions of these large corporations.
- A revolution in communications technology.

Other significant forces, which have also been responsible for facilitating the rise of great global corporations, are:

- Growth of large pools of liquid funds and more efficient capital markets to deploy them quickly.
- Improved financial, logistics, and business management techniques.

The ease with which technology is transferred globally and introduced into new products increases the intensity of global competition.

20.3.1 Competitive Strengths of Major Industrialized Countries

Companies from United States, Europe, and Japan are the leading players in the global market. Companies in these geographic regions possess enormous competitive strengths. For example, GE (USA), Toyota Motors (Japan), Siemens (Germany) electronics, Philips (Netherlands) electronics, Nestlé (Switzerland) food products and so on are some of the largest players in their respective industries.

United States is leading in IT related products. Japan’s strength lies in its transportation equipment and cameras. British companies are strong in the areas of publishing, consumer goods, and banking. Chemicals, machinery, and optics are the strong points of Germany. However, companies from all of these countries including the United States are handicapped by fluctuations in currency rates, government restraints on such matters as employment, and general domestic economic conditions.

20.3.2 What should be done to meet the Global Competitive Challenges?

Although the global competitive position of many leading companies of the world has strengthened significantly in recent years, there are still weaknesses that require correction. It is a challenge for both private and public sector companies to maintain and strengthen their competitive positions and to rectify their weaknesses. Certain policies and practices to move in this direction are suggested here.

20.3.3 What Should Corporations Do?

According to Michael E. Porter, organizations should seek long-term investors and give them a voice in governance. A manager’s compensation should be linked to the organization’s competitive position. Improving worker-training programs in the organization, collaborating with local educational institutions to advance worker-training programs, promoting managers with skills in dealing with global markets, increasing funding for basic research, and taking a special interest in adherence to international codes of social responsibility and ethics are other recommendations.

20.3.4 What Should Governments Do?

Steps that should be taken by governments include:

Technology policy

- Urgent national priority to be given to technology leadership.
- Greater emphasis on R&D allocations to improve transfer of basic research to new products and processes. Setting up of technology centers, dissemination of technology to industry, and assistance to companies to transfer new technology more quickly into products and processes.

- Better coordination among government agencies in policy setting and allocation of funds to R&D.
- Increased tax credits for R&D investments in industry.
- Encouragement to industries to form consortia for developing new technology.

Industrial policy

Those who favor government support for specific technologies say that technological strength is critical to economic strength and the government should help industry strengthen its technological muscle. They add that many governments subsidize technological development by private companies.

Critics of such policies, however, caution against government involvement in picking technological winners and losers. They say that governments are simply inept in making such decisions, because political considerations will override economic and technical factors. In reality, government policies supporting commercial technological growth have been in existence for many years.

Strengthening education programs

Reform and improvement of the present education system should occupy top most priority and include revitalizing elementary and secondary schools in order to improve both general learning and technical knowledge. The greater the excellence in technical skills, greater the generation of new ideas, and the more advanced a nation’s knowledge base, stronger will be its economy and higher the standards of living of its people. Business people also recommend that universities should place more emphasis on manufacturing, engineering, product innovation, and international management.

Financial reforms

Financial reforms could include a change in tax laws to stimulate a higher rate of savings, change in capital gains laws to provide incentives for entrepreneurs and long-term investments, permission to banks to invest in equities with safeguards assuring long-term rather than short-term trading, and, finally, removal of incentives for financial manipulation in buying and selling corporations.

Example

Hyundai Motor India Ltd., a subsidiary of Hyundai Motor Company, set up its first factory in Chennai, Tamil Nadu (TN) in May 1996. Like Hyundai, many other multinational companies like Nokia, Nissan, Ford, and Saint Gobain also have production centers in TN.

Contd….

Successive TN Governments created necessary infrastructure like industrial parks that offer ready to use plots to set up production facilities. The city rarely faces major labor strikes and the availability of qualified manpower is an added advantage.

In the 'Investor Meet' organized by the TN Government in January 2019, Hyundai India signed an MOU (Memorandum of Understanding) with Tamil Nadu to take up ₹ 7,000 crores expansion work in its Chennai facility. The TN Government promised considering tax concessions to the company. Based on the information provided in the case, TN Government's pro-industry policy can be gauged from their setting up of industrial parks and related support infrastructure for businesses. The entry of many other MNCs also point to the pro-investor and industry-friendly policy of the State Government. Organizing 'Investors' Meet-2019' also points to the investor-friendly policy of the Government.

Source: ICFAI Research Center

Check Your Progress - 1

1. Which of the following factors have played a positive role in the development of a global marketplace?
   i. Political and cultural rigidity of countries
   ii. Rapid expansion in merchandise trade
   iii. Cost-cutting efforts by firms seeking competitive advantage
   iv. Revolution in the communications technology
   a. Only i, ii, and iii
   b. Only i, ii, and iv
   c. Only ii, iii, and iv
   d. i, ii, iii, and iv
2. Forces responsible for facilitating the rise of global corporations are:
   i. Growth of large pools of liquid funds.
   ii. Efficient capital markets.
   iii. Improved financial, logistics, and business management techniques.
   e. Only i and ii
   f. Only i and iii
   g. Only ii and iii
   h. i, ii, and iii

3. Which of the following are policies and practices that companies can follow in order to strengthen their competitive position and rectify their weaknesses?

   i. Promoting managers with skills in dealing with global markets

   ii. Decrease funding for basic research

   iii. Taking a special interest in adherence to international codes of social responsibility and ethics

   a. Only i and ii

   b. Only i and iii

   c. Only ii and iii

   d. i, ii, and iii

4. In order to strengthen the global competitive position of business firms, government policies on technology should:

   i. Give national priority to technology leadership.

   ii. Increase tax credits for R&D investments in industry.

   iii. Encourage industries to form consortia for developing new technology.

   iv. Provide incentives for entrepreneurs by making changes in capital gain tax laws.

   a. Only i, ii, and iii

   b. Only i, ii, and iv

   c. Only ii, iii, and iv

   d. i, ii, iii, and iv

Activity 20.1

With the 21st century witnessing an increasing pace of change, managers are facing conditions that they have never faced before. Describe with the help of an example, in the context of new challenges of 21st century, how an organization's performance can be influenced by such factors. How can an organization overcome those problems?

Answer:

20.4 Considerations for Strategists in the 21st Century

Going forward in the 21st century, we find that there is an increasing need for managers who understand their role under conditions of rapid change. In certain situations, there are forces which are beyond the control of managers. These situations require managers who can adjust to new developments. Managers are also themselves involved in initiating and directing change. Some of the challenges that managers face in the 21st century are described here.

20.4.1 Corporate Strategy

The last decade of the 20th and the first decade of the 21st century are likely to be viewed by historians as an era in which a remarkable redefinition of business took place. Many companies reengineered operations in order to become more efficient, but often less dependent on people than in the past. Massive dislocation of people from all levels of companies has taken place as a result of waves of restructuring, during the past decade.

As a result of restructuring many of the middle- and senior-level managers lost their jobs, and upon failing to find comparable jobs in other large organizations, these managers were instrumental in founding new companies. The 1990s thus saw a great burst of new business formation. The effects of restructuring and layoffs also affected a new generation of employees. Many talented people who might have once strived to join large companies began to view better opportunities and more happiness in smaller, independent businesses of their own.

It has become necessary for managers to consider whether, and how, their companies can integrate commitments towards their employees with the changing needs and demands of customers for products and services. Further, the need for high-performance workplace environments has made it essential for companies to invest in education of its employees, development of their skills, and process changes to effectively empower employees.

Although some companies have made significant efforts in creating an environment encouraging excellent performance in the workplace, others have been excessively cautious in this regard. The trade-off between the benefits of initiating these changes relative to the costs, is one of the key strategic issues managers have to face.

20.4.2 Ethics, Public Values, and Social Responsibility

The ever-changing conditions in which business is conducted test the ability of companies to adhere to core values and principles. Technological changes, for example, are throwing up a host of new issues regarding the ownership, use, and distribution of intellectual property.

Managers can expect further complications in ethical issues, many of which will relate to global business activity. These issues will culminate in one central question for strategic managers – how can business be conducted within a framework of ethical ideals, norms, and standards that are understood and accepted by people globally? Social responsibility and environmentalism are important related issues in this context.

20.4.3 Global Challenges

Strategic managers in the 21st century are likely to face one central question: How can businesses operate in a global environment in ways that serve societal objectives by meeting real needs, yet accommodate the diverse demands and often conflicting interests of stakeholders?

20.4.4 Role of the Government

Governments around the world are in the process of redefining and reinventing their role in the global economy of the 21st century. The choices of individual nations will be influenced by many factors, including the new reality of global financial markets that react instantaneously to financial news in any part of the world.

20.4.5 Ecological Challenges

In the 21st century, ecological challenges have emerged as the most important vector of change. Understanding the interconnectedness of economic and demographic variables will be crucial in this century.

20.4.6 Quality and Productivity

Another challenge faced by strategy managers in recent years has been issues of quality, productivity, and their relationships. Companies in the US have come to understand that the success of the Japanese and German firms lies in the edge in quality of their products. As a result, US firms are moving towards the enhancement of the quality of their products and services. Products of higher quality using fewer resources are developed by globally competitive companies. More and more interest is, therefore, being shown by US managers on ways to improve the productivity of American workers.

20.4.7 Workforce Diversity

Workforce diversity is another issue that managers today must learn to deal with. Various factors such as globalization, aging population, influx of workers into new careers and occupations, and influx of women into organizations, have made the workforce much more heterogeneous than at any time in the past. The workplace, likewise, is very different from what it was in the past. It has, therefore, become important for managers in every organization to become more sensitive to the needs, perceptions, and aspirations of many different kinds of workers. Managers of today must also be in a position to utilize the talents of all their employees.

Example

Facebook (FB) has changed its hiring process to enable people from various walks of life get opportunities to be a part of their workforce. Further, it has implemented a program called Facebook University to ensure that women and people from minority groups learn programming and develop greater interest in computer science. Based on the initiatives taken discussed above, we can infer that Facebook's 'workforce diversity' policy is implemented through the changed hiring process. Further, to manage the policy of workforce diversity, FB has set up 'Facebook University'. This initiative will ensure that people from differing backgrounds have equal opportunities to learn and compete.

Source: ICFAI Research Center

20.4.8 Change

Managers of today face more change than their predecessors did. The requirements, demands, and expectations from managers and their organizations, as well as the complexity of the competitive environment, is far greater than was the case in the past. In the past, managers viewed change as something to be addressed periodically, whereas it has become a fact of everyday life for present day managers.

20.4.9 Empowerment

Issues dealing with empowerment of the organization's human resources are another challenge for managers in the 21st century. The various techniques and methods of empowerment range from increased participation in decision making to the use of integrated work teams.

20.5 Emergence of the Knowledge Worker

According to Peter F. Drucker (Drucker), what we refer to as the information revolution is in fact a knowledge revolution. This suggests that organizations which want to maintain leadership in the economy and the technologies that are going to emerge in the future need to give enough consideration to the social position of the knowledge professionals and their values.

Traditionally, capital has been treated as the key resource, the financier as the owner, and knowledge workers as employees who would be content with bonuses and stock options. Drucker says that this attitude will work only as long as the stock-markets are booming. The major industries are likely to grow more like traditional industries — slowly, painfully, and laboriously — unlike Internet companies. These major industries are going to depend on knowledge workers. These workers won't be content with fringe benefits such as stock options and bonuses. Financial incentives won't prevent people from leaving.

Running an organization with "shareholder value" as its goal and justification can become counterproductive, because the performance of these knowledge-based organizations will depend to a large extent on how they can attract, hold, and motivate knowledge workers. Since these people can't be satisfied with money, they should be offered recognition and power within the organization. This is possible only when subordinates are treated as fellow executives, and employees as partners.

20.5.1 Role of a Knowledge Worker

It is through the means of formal education that a knowledge worker gains access to work, job, and social position. A fairly limited amount of knowledge may be required in some kinds of knowledge work, for example, some paramedical technicians such as an X-ray machine operator, a clinical laboratory technician, or a pulmonary technologist. On the contrary, far more advanced theoretical knowledge is required for some other kinds of knowledge work such as market research, product planning, and advertising and promotion.

Since knowledge workers work in teams and since knowledge work is more effective when it is more specialized, the team rather than the individual becomes the actual work unit. Further, the effectiveness of a knowledge worker will depend upon the manager's ability to diagnose what kind of team is required for full effectiveness of a certain kind of knowledge work, and the ability to organize such a team and to integrate the worker into it.

Knowledge, unlike any of the traditional key resources like land, labor, and capital, is not tied to any country but is transnational, portable, and can be created everywhere, fast, and cheap. Knowledge is forever changing and makes itself obsolete within a short period of time. The only thing that can be predicted about a competitive advantage of a country, an industry, an institution, or an individual, based on knowledge, is that the advantage will soon be challenged, possibly by a total newcomer.

Acquisition of knowledge, or learning, therefore, can no longer stop at any age. Life-long learning or continuous learning during one's working life will increasingly be a requirement for all knowledge workers.

Also, while it is possible to define what productivity is with respect to the manual worker, it is not so in the case of a knowledge worker. The measurements of productivity for a manual worker such as number of pieces turned out per hour or per dollar wage prove to be irrelevant if applied to the knowledge worker. Productivity in case of a knowledge worker is primarily in terms of quality.

Example

Google's People Operations Team studied various teams at Google to find out 'What makes a Google team effective?' After studying hundreds of Google teams and after analyzing, 'why some teams stumbled and some soared', they identified five key dynamics that set successful teams apart from the rest:

Contd….

i. Team members feel safe to take risks without feeling insecure or embarrassed
ii. Team members can count on each other to do high quality work on time
iii. Goals, roles and execution plans are pretty much clear
iv. People feel a sense of purpose in their work
v. Have clear understanding of how one's work is contributing to organization's goals

Source: ICFAI Research Center

Much of the work done in companies like Google that employs knowledge workers is done collaboratively in teams. To optimize the performance of knowledge workers who work as a team, companies like Google invest much time and money to study what factors optimize team performance.

Activity 20.2

Knowledge Management (KM) is a process through which organizations generate value from their intellectual and knowledge-based assets. With the help of an example, explain the KM initiatives that can be taken by a company?

Answer:

20.6 E-Business: The Central Challenge

E-Business will, in time, kill traditional multinationals. In future, the delivery of goods, services, and spare parts will be done by completely different organizations. E-business needs a different mindset. Different yardsticks will be required to measure the performance of e-business organizations. In traditional businesses, delivery is regarded as a 'support' function. This function is treated as a part of routine work, which is taken for granted unless something goes drastically wrong. But with e-business, organizations can create competitive advantage through this function. They can transform delivery into their 'core competence'. The speed and quality of delivery can become competitive factors for the organization.

E-business does not simply master the distance: it eliminates the distance. Any organization that can organize delivery can operate in any market without maintaining its physical presence there.

E-Business separates selling and purchase. Under e-business, selling is over when the order is received and paid for. But purchasing is said to be over only when the good has been delivered and purchaser's want has been satisfied. Similarly, e-business separates manufacturing and selling: production becomes procurement and a firm need not limit itself to marketing and selling of one manufacturer's products. In fact, this ability to provide customers with a whole range of products has been the greatest strength of companies such as Amazon.com. In traditional organizations, selling is still dependent on production, as it 'sells what production makes'. In the e-business context, this might well be 'sell what we can deliver'.

Example

'Swiggy App' is an on-demand food ordering and delivery platform. Customers can browse, search for their favorite food from their favorite restaurant and get it delivered in less than 30 minutes. The entire act of ordering food just takes a few minutes. Anxious customers can also track the order to know how long it would take for the food to be delivered. E-commerce models operate on their ability to provide customers with a range of products and better delivery solutions. E-commerce models operate with the help of an 'app'.

Source: ICFAI Research Center

Activity 20.3

Organizations and management face change on a continuous basis. Some changes are reactions to threats, whereas others are proactive attempts to seize opportunities. A recent change in many organizations is a foray into e-business. Do you think e-business is here to stay? Substantiate with an example.

Answer:

20.7 The CEO in the New Millennium

In the 21st century, the CEOs have to live up to the demands of better corporate governance and they need to adopt an approach toward information that will help the organization exploit the enormous potential of information technology and systems for creating and sustaining a competitive advantage.

20.7.1 Corporate Governance

In future, the governance of corporations will be significantly different from what it is now. Fundamental change in the corporate ownership structure will, in all probability, lead to changes in corporate governance. All over the world, particularly in developed countries, financial considerations are determining ownership interests. In most developed countries, the population is aging. Consequently more people are worried about their future financial resources. This makes the investment of pension funds an important issue. Factors such as these will have an impact on corporate owners.

CEOs must try to find ways to strike the right balance. With their experience, CEOs can do what needs to be done even when it is difficult to do so, and even when they are prone to committing mistakes. It is unfortunate that many CEOs try to avoid the issue of governance and manage the organization in the short-term interest of the shareholder. This neglect has harmed organizations such as WorldCom and Enron.

20.7.2 Approach to Information

It was widely believed that new information storage-cum-processing capacities would completely change the way businesses are run. But, this has not been evident anywhere, except in military organizations. The impact of new information capacities has been significant only on the way organizations manage their operations. For example, using software, a single architect today can draw building designs that earlier required the efforts of hundreds of individuals. Similarly, young surgeons can learn and practice surgical techniques with virtual reality equipment without endangering the health of patients.

Though information technology has had an impact on all types of businesses, it has hardly had any influence over strategy and innovation. Till now, a CEO rarely benefited from the new information available for decision making. This will change. Organizations are changing basic record-keeping to accommodate present economic reality. Simultaneously, they are merging the record-keeping function with the data producing function to create an information system that is entirely different from the existing one. Even this system will not provide CEOs with the complete information necessary for making decisions.

Organizations do not know completely what is happening in the external environment. Even when an organization is a leader in a particular product category, most of the people who buy that product may not be its customers. A firm is generally considered a giant if it has a 30 percent market share. But 70 percent of the customers do not buy that firm’s product, and the firm does not have any information on these customers. The firm should take this 70 percent seriously because it can provide the information that will help the firm understand the changes that affect the industry. Irrespective of the business they are in, senior managers should spend some time outside their organization to know about the culture of the society in which they are operating.

Example

Amazon is a pioneer in using technology to track customer buying habits, purchase frequency, history, spending habits, and other details and uses these insights to gain a 360 degree understanding of each customer. Based on its understanding of customers, it sends custom content, personalized offers to increase sales and gain customer loyalty. Amazon gathers customer data and uses it to understand customers. These customer insights are used to gain sales and build relationship with customers. Thus, its approach to data gathering and use of information gathered has given it a competitive advantage.

Source: ICFAI Research Center

Check Your Progress - 2

5. Challenges faced by managers at the start of the new century are:
   i. Ecological challenges.
   ii. Issues of quality, productivity, and their relationships.
   iii. Issues dealing with empowerment of the organization's human resources.
   a. Only i and ii
   b. Only i and iii
   c. Only ii and iii
   d. i, ii, and iii
6. Which of the following resources is transnational, portable, and can be created everywhere, fast, and cheap?
   a. Land
   b. Labor
   c. Knowledge
   d. Capital

20.8 Summary

- The global marketplace has developed because of factors such as explosive growth in world GDP, rapid expansion in merchandise trade, cost cutting and improvement of product quality by firms seeking competitive advantage, and a revolution in communication technology.
- The rise of great global corporations has also been influenced by the growth of large pools of liquid funds and more efficient capital markets to deploy them quickly; and improved financial, logistics, and business management

techniques. Both corporations and governments have their respective roles to play in order to meet the global competitive challenges.

- Considerations for strategists in the 21st century are many. These include corporate strategy; ethics, public values, and social responsibility; global challenges; the role of the government; ecological challenges; quality and productivity; workforce diversity; change; and empowerment.
- Organizations that want to maintain leadership in the economy and the technologies that are going to emerge in the future need to give enough consideration to the social position of the knowledge professionals and their values.
- With e-business, the speed and quality of delivery can become competitive factors for an organization. Any organization that can organize delivery can operate in any market without maintaining its physical presence there.
- In the 21st century, the CEOs have to live up to the demands of better corporate governance, and they need to adopt an approach toward information that will help the organization exploit the enormous potential of information technology and systems for creating and sustaining a competitive advantage.

20.9 Glossary

Core competence: The collective learning in an organization, especially how to coordinate diverse production skills and integrate multiple streams of technologies.

Corporate governance: A system of rules and processes by which companies are directed and controlled.

Corporate Governance: It is the system by which business corporations are directed and controlled. It specifies the distribution of rights and responsibilities among different participants in the corporation such as, the board, managers, shareholders and other stakeholders, and spells out the rules and procedures for making decisions on corporate affairs.

E-business: A term that was coined and popularized by IBM to emphasize the importance of Internet technology in automating business functions.

Financial reforms: Include a change in tax laws to stimulate a higher rate of savings, change in capital gains laws to provide incentives for entrepreneurs and long-term investments, permission to banks to invest in equities with safeguards assuring long-term rather than short-term trading, and, finally, removal of incentives for financial manipulation in buying and selling corporations.

Knowledge management: It refers to a process in which advanced information systems are deployed in organizations to capture the knowledge and disseminate it so as to be leveraged by employees to achieve organizational objectives.

20.10 Self-Assessment Test

1. Discuss the issues of global competitiveness in the new millennium. What aspects should the strategists consider in the 21st century?
2. How did the knowledge worker emerge in the 21st century? Explain their role.
3. What are the challenges posed by e-business?
4. Discuss the role of the CEO in the new millennium.

20.11 Suggested Readings/Reference Material

1. "Global Marketplace" http://www.consumerpsychologist.com/intl_Global_Marketplace.html (Accessed on 5th April 2022)
2. Ricard Sébastien, "The Year Of The Knowledge Worker", https://www.forbes.com/sites/forbestechcouncil/2020/12/10/the-year-of-the-knowledge-worker/?sh=5764f0687fbb, December 10, 2020 (Accesses on 5th April 2022)
3. Danijela Jerković, "Knowledge Workers & Knowledge Society", https://www.linkedin.com/pulse/knowledge-workers-society-danijela-jerkovi%C4%87?trk=pulse-article_more-articles_related-content-card, February 20, 2022 (Accessed on 5th April 2022)
4. "Knowledge Workers" <https://corporatefinanceinstitute.com/resources/knowledge/other/knowledge-workers/> (Accessed on 5th April 2022)
5. "Addressing the challenge of growing e-commerce businesses", https://www.thehindubusinessline.com/opinion/addressing-the-challenge-of-growing-e-commerce-businesses/article36827521.ece, October 4th 2021 (Accessed on 5th April 2022)
6. "6 Biggest Ecommerce Challenges in 2021", https://www.europeanbusinessreview.com/6-biggest-ecommerce-challenges-in-2021/, May 13, 2021 (Accessed on 5th April 2022)
7. Thomas L. Wheelen, et al., Strategic Management and Business Policy: Globalization, Innovation and Sustainability, Fifteenth Edition, Pearson Paperback – 30 July 2018
8. P.N. Srivastava, Business Policy and Strategy Hardcover, Horizon Press, January 2019
9. Joan Magretta, Emile Holmewood and Heinrich Zimmermann, What is Strategy?: An Illustrated Guide to Michael Porter Hardcover – Illustrated, 15 September 2020, Harvard Business Review Press

10. Shabbar Suterwala, Top 20 Business Strategies for your Business Growth, Notion Press; 1st edition Paperback – 27 May 2021
11. Brian Tracy, Business Strategy: The Brian Tracy Success Library Hardcover – 26 February 2018, Manjul Publishing House
12. Callie Daum, Business Strategy Essentials You Always Wanted to Know (Second Edition), January 2020, Vibrant Publishers

20.12 Answers to Check Your Progress Questions

1. (c) Only ii, iii, and iv

The global marketplace has developed because of factors such as growth in world domestic product, rapid expansion in merchandise trade, cost cutting and increasing product quality by firms seeking competitive advantage, and revolution in the communications technology. Political and cultural rigidity of countries, whereby foreign firms are viewed unfavorably, acts as a constraint in the development of the global marketplace.

2. (d) i, ii, and iii

Forces responsible for facilitating the rise of global corporations are: growth of large pools of liquid funds; efficient capital markets to employ funds quickly; and improved financial, logistics, and business management techniques.

3. (b) Only i and iii

Any firm which aims at improving its competitive position by eliminating weaknesses should increase funding for basic research. Basic research often leads to new inventions and paradigm shifts in the functionality of the product which provides a strategic advantage to the firm. Sony, for instance, engages in basic research and hence has been able to come out with products which are state-of-the-art. Allocating resources for basic research helps in building a quality-conscious and technologically advanced company.

4. (a) Only i, ii and iii

Giving national priority to technology leadership and announcing awards and giving recognition for the same, help in advancement of technology. Increasing tax credits for R&D investments in industry enable and encourage companies to engage in R&D activities which they might not have otherwise considered. Encouraging industries to form consortia for developing new technology in order to strengthen the global competitive position of the companies is an important element of technology policy. Government policy on capital gain tax laws is a financial reform and is not an aspect of technological policy.

5. (d) i, ii, and iii

Challenges faced by managers at the start of the new century include ecological challenges, i.e., the impact of industrial activity on air, water, and land, global warming, etc.; issues of quality, productivity, and their relationships; and issues dealing with empowerment of the organization’s human resources.

6. (c) Knowledge

Knowledge, unlike any of the traditional key resources like land, labor, and capital, is not tied to any country but is transnational, portable, and can be created everywhere, fast and cheap. The developments and advancements in information and communications technologies have helped in integrating widespread and remote locations and have enabled free flow of knowledge from one location to another quickly and cheaply.

Business Policy & Strategy

Course Structure

Block 1: Overview of Strategic Management	
Unit 1	Introduction to Strategy
Unit 2	Strategic Management
Unit 3	Vision, Mission, and Social Responsibility
Block 2: Strategic Analysis and Strategy Formulation	
Unit 4	External Environment Analysis
Unit 5	Internal Environment Analysis
Unit 6	Objectives, Grand Strategies, and Functional Strategies
Unit 7	Generic Competitive Strategies
Unit 8	Strategic Analysis and Choice
Block 3: Strategy Execution and Control	
Unit 9	The Value Chain and Competitive Scope
Unit 10	The Value Chain and Generic Strategies
Unit 11	Strategy and Structure
Unit 12	Strategy Execution and Organizational Culture
Unit 13	Strategic and Operational Control
Unit 14	Organizational Roles in Strategic Management
Block 4: Strategic Change	
Unit 15	Corporate Restructuring – An Overview
Unit 16	Joint Ventures and Strategic Alliances
Unit 17	Mergers and Acquisitions
Unit 18	Divestitures and Anti-Takeover Defense
Unit 19	Managing Strategic Change
Unit 20	Challenges for the 21st Century