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An Inorganic Approach
to Globalization
*The Marriage of
Geely and Volvo*



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EXECUTIVE SUMMARY

In The Path to Globalization of China's Automotive Industry, we described the motivation and steps to be taken for China's automotive companies to go global. Zhejiang Geely Automotive Group's \$1.8 billion acquisition of Volvo from Ford represents the most ambitious action to date for a Chinese vehicle manufacturer to accelerate the process of transforming into a global automotive player.

By announcing the sale of the Volvo car brand, Ford has nearly completed the process of shedding its portfolio of loss-making brands that previously comprised its Premier Automotive Group. In doing so, Ford fulfills its objective of sharpening its focus down to its core mass-market brands. This represents a clear and sound strategy for Ford to focus its management attention and investments in the area of the business it understands best. But how does this deal benefit Volvo and its new suitor, Geely?

RATIONALE FOR THE ACQUISITION OF VOLVO

The roots of the deal require understanding of the how Geely's Chairman Li Shufu views the auto business. Founded in 1986, as a manufacturer of refrigerators, Geely in the early 1990's expanded into motorcycle parts and eventually motorcycles and scooters. After rapidly expanding volume and scale, Geely began producing automobiles in 1998.

Admittedly, Chairman Li's initial view of automobiles was previously quite simplistic. His initial view of a car was essentially "a sofa with 4 wheels". However, Li has quickly become an expert in the car business and increasingly demonstrates an understanding of what needs to be done to become a competitive car company. He has already become quite critical of his initial understanding of the complexities of the automobile and the ingredients behind building global brands.

Specifically, Li recognizes the importance of technology and the capability of developing technology to an automotive company. He also has grown in his appreciation for how multi-national companies must be capable of self-development of technologies of the products they sell.

China and its car companies believe that the country that produces and consumes the most automobiles must be competitive on the world stage. However, leaders like Li Shufu understand that selling cars in China is not the same as in developed countries. Selling affordably priced cars to the vast number of entry-level Chinese consumers is a significant step away from the goal of selling Chinese-branded cars to experienced consumers in mature markets.

Geely's acquisition of Volvo is intended to accelerate the process of achieving this goal.

GEELY'S APPROACH TO INTEGRATION

The industrial revolution started late in China, and is happening on a much shorter time schedule. Chinese car companies are trying to achieve what took many decades for Japanese and Korean companies in a much shorter time frame. Geely will take the approach of “standing next to partners and learning from them”. They must find companies to associate with and transfer knowledge from them. Their recent partnership with Manganese Bronze to produce London Taxi parts and vehicles, along with the acquisition of Australian gearbox maker Drivetrain Systems International were examples of this approach.

However, just taking pieces is not sufficient. The approach Geely is taking in the acquisition of Volvo is to study the entire “eco-system” and integrate this into Geely’s global strategy.

Geely is based in Zhejiang province, which is a haven for export-oriented companies. Chairman Li is adapting this mindset to into Geely’s strategy: a fundamental belief that a viable business must eventually become global and achieve the capability to sell its products around the world.

Geely’s approach can be summarized:

1. Learn the Volvo “eco-system” and get in the global game

2. Use this opportunity to promote the corporate Geely name world-wide
3. Learn to manage a high-end car brand: essential skills for a global car company.

Geely describes itself as the “poor boy from the countryside”, while Volvo is the “rich girl from the city”. Geely believes that for the marriage to be successful, certain commitments must be made. Geely therefore strives to preserve Volvo’s:

1. Brand Equity
2. Culture
3. Manufacturing and R&D in Europe (to preserve “European-ness”)
4. Relationships with Suppliers and Distributors
5. Management Team (use Volvo management to run Volvo, similar in approach to Hong Kong integration: “One Country, Two Systems”)
6. Relationship with Labor Union

STRATEGIC FIT

While the viability of Volvo's global business may be challenging in the near-term, Geely believes:

1. Volvo is a small percentage of Ford's overall business, and is not core to Ford's global strategy. Volvo is simply not a priority to Ford.
2. In contrast, Volvo will be core to Geely's global strategy and will be therefore more highly valued.
3. Ford has not placed sufficient emphasis on Volvo in the emerging growth markets—especially China.

Volvo today suffers from a lack of scale across their product portfolio. Volumes are evenly distributed across the portfolio, which creates a cost structure disadvantage versus other global players. By having a number of low-volume products burdens Volvo with high investment with limited scale, which is problematic for a brand trying to compete internationally.

Geely believes there is significant upside potential for Volvo in the China market. Simply put, it is believed that If BMW and Mercedes-Benz can sell over 50,000 cars and Audi can sell over 100,000 cars, then Volvo has the opportunity to grow significantly as a European luxury brand in China. To achieve this, Volvo must be understood in China as a European brand, not just a Scandinavian brand.

There will be very little conflict with Geely's brands, therefore very little brand tension among the parents. In addition, Ford very likely did not leverage low-cost global sourcing to achieve a more competitive cost structure for Volvo. Geely will seek to achieve sourcing efficiencies and cost benefits through further localization in China.

Geely will likely use Volvo to challenge Audi's position as the "government official's car". While Volvo and Geely should have their own strategies as well as management, core business processes (such as Sourcing and Product Development) can be shared. However technology sharing will likely require legal/IP clearance. The partners will also need to align key Volvo and Geely strategies including how to address New Energy/Low Carbon initiatives.

While marrying Volvo appears to be quite ambitious for a "poor boy from the countryside" with only a little more than a decade of automotive experience, the industrial logic appears to be quite pragmatic and sound. With proper attention to the process of post-acquisition integration, Geely can indeed use the Volvo acquisition to accelerate the process of transforming itself into a global automotive player.

SHARING THE SAME BED, HAVING DIFFERENT DREAMS

It is a marriage of two automotive companies with very dissimilar backgrounds and histories. The Chinese describe partners with different agendas as “sharing the same bed, but having different dreams”. The sound industrial logic for this deal only provides the foundation. Building a successful partnership between Volvo and Geely will require a solid plan for post-acquisition integration.

It should be noted that the Volvo acquisition is not Geely’s first cross-border deal. In 2006, Geely partnered with Manganese Bronze to produce components for and assemble London

Taxi vehicles. On March 17, 2010 Geely announced plans to become the majority shareholder of Manganese Bronze. In May 2009, Geely acquired the Australian gearbox maker Drivetrain Systems International.

Geely is clearly using an “inorganic” approach to accelerate its development and to improve its ability to compete in the China auto market. The learning applied here could also accelerate its emergence as a global automotive player. However, it is well known that cross-border deals rarely deliver on their initial promise.

LESSONS LEARNED FROM FAILED AUTOMOTIVE MARRIAGES

We are witnessing a historic period in the development of the global automotive industry. The global financial crisis has dramatically weakened the “triad” markets (Western Europe, North America and Japan), and has highlighted the resilience of the emerging markets, led by China. The resultant economic “imbalance” creates opportunities for structural realignment of the industry as assets shift to the higher growth markets.

Clearly there is a need, on the part of the European and North American vehicle manufacturers and suppliers, to find additional sources of funding in order to keep their operations going, while the rapid growth of China’s auto market in recent years has provided Chinese companies with more capacity to invest. However, there are real challenges in making cross-border deals work.

For example, SAIC’s recent acquisition of Ssangyong was fraught with difficulty. The two companies had “different dreams” in terms of what they wanted out of a partnership, and they were not successful. SAIC was: unable to secure concessions from Ssangyong’s labor union to lower costs, unwilling to inject billions of RMB incremental capital to fund the business, and unable to manage the loss of leadership at Ssangyong. Ultimately, SAIC decided to dissolve the deal.

Even the more successful partnerships have had mixed results: by all measures, the Ford alliance with Mazda has been a very good example of a successful cross-border alliance. Ford benefited from access to Mazda’s fuel-efficient technologies and platforms, and both sides benefited from a shared global production and distribution footprint. However, Ford recently made the decision to liquidate its shares in Mazda in order to raise much-needed cash.

One of the most famous cases was the failed 9-year marriage of Daimler-Benz and Chrysler. Announced to the world in 1998 as a \$38 billion “merger of equals”, the deal was ultimately dissolved in 2007. The causes of failure for the DaimlerChrysler marriage are noteworthy:

1. **Strategic Mis-Alignment:** While each company had a sound rationale for partnership, there was a lack of alignment between the architects of the deal and the organizations they led. Juergen Schrempp was seeking to build scale and elevate the prominence of the automotive business in the Daimler-Benz portfolio of companies. Bob Eaton was seeking to expand Chrysler’s global reach beyond its core North American market. While on the surface it appeared compatible, this vision lacked sufficient top-down direction needed to build a globally

integrated automotive enterprise. The target for achieving “synergy” resulting from achievement of a cost-savings target became the sole objective of the post-merger integration team, and meaningful integration of the core automotive business was never established as a concrete target.

2. **Brand Tension:** The brands of Daimler and Chrysler do not overlap, however the struggle over brands cut to the heart of the merger integration challenge. In many ways, the brands of a company define the image and aspirations of both its customers as well as its companies. For this reason, the idea of sharing any product, technology, or even resources used in the development or distribution of the product was viewed as a risk of compromising the value proposition of the brands. Daimler was concerned that a direct association with Chrysler would damage the Mercedes-Benz “premium” image. Chrysler was concerned that Daimler’s higher cost structure would make Chrysler’s mass-market brands less cost competitive.
3. **Lack of Core Business Integration:** The “Chrysler Group” essentially became a division within Daimler-Benz, which was renamed “DaimlerChrysler AG” in November 1998. The only

functions that were integrated were the Financial Services division and several corporate staffs including Human Resources, IT, and Corporate Finance. Staff reductions in these functions accounted for much of the “Synergy” of the merger. The core business functions were left unchanged. As a result, the complex decisions of how to share development costs, develop new technologies, share product platforms, cross-load manufacturing plants, and combine marketing and sales functions were completely avoided. As a result, the automotive businesses failed to realize any benefits from the partnership.

4. **Brain Drain:** It is often stated that the majority of senior leaders of an acquired company leave within a two-year period after the merger. While efforts were made to retain Chrysler’s top leadership, it became very difficult once it became clear that this was never actually a “merger of equals”. Starting with Bob Eaton’s decision to step down as co-CEO, the leadership “flight” at Chrysler accelerated. Within two years, a significant percentage of Chrysler’s top 100 managers had left the company. While it may be difficult to avoid completely, it is critical to plan for the retention of the key leadership, or company performance and employee morale will suffer.

5. **Culture Shock:** This issue is often mistakenly attributed to differences in language, culture between Germans and Americans. However, this is not the root cause. The challenge is to achieve a true understanding of the respective needs of each partner. This tends to get oversimplified by assuming that language and culture are the problems. Language and cultural misunderstanding creates “resistance” and adds friction among the partners – which makes it difficult to develop a common understanding, but this is not the most fundamentally challenging issue. If this were the case, it would be impossible to explain why similar problems occur when companies merge within the same country. The most difficult issue is to establish a common understanding of what each partner wants out of the relationship – and finding a way to work with that.

Businesses hoping to grow “inorganically” would be wise to learn the lessons from the causes of the failed DaimlerChrysler merger.

LIVING THE DREAM: THE IMMEDIATE CHALLENGES

As a result of the shift of the automotive center of gravity to the east, there is a need to make these cross-border marriages work. A Chinese company investing in foreign assets must understand how to align the interests of the partner in the transaction with their own, or they will likely end up owning assets without the technological development know-how that went into creating those assets.

It all should start with a comprehensive risk-assessment and plan for post-acquisition integration. The key elements of this plan were noted in the article *The Path to Globalization of China's Automotive Industry*.

Beyond this, Geely must overcome several other challenges in order to

turn around Volvo's operations. Geely must address the following issues:

- 1. Strategic Alignment and Governance.** Bridging the huge gap between Volvo's traditional European (and some would argue "Scandinavian") management mode and Geely's dynamic family business mode. This may be the largest challenge for Li Shufu in achieving "synergy" among the automotive units. This will be particularly challenging as Chairman Li has committed to keep independence of Volvo operations.
- 2. Cost Structure.** Since Volvo maintains their current business structure, processes and supply base, it is impossible for Geely to realize the highest benefits of

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localization for Volvo cars even if they build a new production base in China in the near future. Geely may need to subsidize the Volvo global operation with the very thin margins generated from Geely's local brand operations, which poses high risk and places pressure on Geely's working capital.

3. **Market Positioning.** Geely faces a number of product portfolio and platform decisions regarding Volvo product offerings for China and the global markets. The manufacturing agreement with Chang'An Ford for the Volvo S40 and S80's will need to be addressed and Geely has already stated an objective of building a 300,000-unit production base in China. To achieve this, Volvo products would need to be repositioned in order

to serve a mass-market instead of merely following the luxury-market leader Audi.

Marrying Volvo was an ambitious move for a "poor boy from the countryside" with only a little more than a decade of automotive experience. The automotive world is now closely watching to see if they can make it work.

With proper attention to the process of post-acquisition integration, and by addressing the immediate challenges noted here, Geely could indeed use the Volvo acquisition to accelerate the process of transforming itself into a global automotive player.

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