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Buying Right
In Asia

*Successful M&As in a
Challenging Market*



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Buying Right in Asia

Successful M&As in a Challenging Market

Acquiring and integrating companies is a risky business anywhere in the world. Booz Allen Hamilton, in its various studies of mergers and acquisitions (M&As), has consistently found at best a 50 percent success rate.¹

In Asia, buying companies can be trickier than elsewhere: Potential deals are often a lot less transparent than in Europe or North America; the quality of financial and other data is often worse; and capital markets in most of the region remain underdeveloped. Frequently companies are buying other businesses for intangible qualities, such as their relationships with other companies or governments. Official interference can, in some places, be a concern. Combined, these factors make conducting in-depth due diligence studies even more critical than elsewhere while simultaneously making them harder to carry out.

Once a deal is completed, post-purchase integration needs to be handled with an acknowledgement of the different cultures involved, a task often made more difficult by the lack of history of M&As in various parts of the region. As a result, staff are often nervous or suspicious of becoming part of another organization and the changes this might bring.

There are also questions as to which deals can actually be carried out – including on occasion what exactly can be bought. In China, for example, markets have been opening over the last 15 years, particularly since China's accession to the World Trade Organization in 2001. However, the process of acquiring a company

can still be a cumbersome one, requiring multiple levels of approval, not all of them rooted in regulations.

All the same, neither the difficulty nor the high proportion of failures should put companies off from considering acquisitions. The large body of knowledge surrounding M&As also provides a lot of information on what companies need to do, first, to identify the right kind of target and then to manage the acquisition process successfully. Some of this know-how remains counterintuitive. In particular, success is not dependent on the specific aspects of any deal. Among the main points that stand out are:

- **The price doesn't need to be (exactly) right.**

Perhaps most surprisingly, there is no correlation between the purchase premium paid—the cost of a company compared with its market capitalization—and deal success. Of course, no company wants to pay more than it needs to acquire another, but buying a company at a bargain price doesn't make success more likely, nor does paying over the odds increase the likelihood of failure. What does count is whether the additional cost can be justified by the value likely to be gained. Often this potential is not visible to outsiders, but if a company can see a way by which acquiring another business will lay the foundation for sustained growth, then paying a high premium for that initial purchase should not be a cause for concern in itself.

- **The relative size of the acquirer and the target doesn't matter.** No excess returns are found in acquisitions of small companies versus that of big

¹ Typical of these studies is "Post-Merger Integration: What Makes Mergers Work?" (Booz Allen Hamilton, 1999). It found that only 49 percent of companies that undertook mergers gained value compared with their peers.

companies. While it might seem more likely that buying a series of small companies would contain more likelihood of acquiring a seed capable of growing from acorn to oak, larger companies have just as much chance of bringing the same kind of growth.

- **Industrial relatedness is irrelevant.** There is no correlation between excess returns and buying a company in the purchaser's sector or industry. Vertical and horizontal mergers are equally likely to succeed or fail. Companies looking to grow should look as much outside their own sector as within.
- **Haste doesn't pay off.** The time taken from the announcement of a deal to its completion does not directly influence the results. Consequently, it is vital that this period is used to conduct thorough due diligence and double-check the vision, strategy, and numbers underlying the purchase. It's a big mistake to skimp on these processes in the belief that completing the deal quickly is more important.

In short, instead of focusing on the price, size, or sector of a purchase target, companies should first concentrate on its potential for value creation; second, take the time to work out the correct strategy to manage its integration into their current operations; and third, constantly check that it fits all the criteria which originally motivated the buying decision.

Driving Success

To ensure a company's acquisitions are among the half of all mergers that succeed rather than in the half that fail, a buyer has to focus on two things: how well a target fits with its overall strategy, and how well the process of acquisition is managed pre- and post-deal.

The right fit. Successful companies know where acquisitions fit into their overall business strategy. When considering a purchase, they carefully screen and approach potential targets, scrutinizing their assets and capabilities and the potential value they could add to the company. They look, wherever possible, to execute a deal on friendly terms—remembering, of course, that friendliness is not a value in its own right. Some purchases will require tough treatment to succeed. In fact, it may be the buyer's ability to deliver such tough treatment—which for one reason or another its

previous management had been unable to deliver—that makes the purchase worthwhile in the first place.

This vision has to include knowing exactly what is going to be done with the new business—from deciding whether to put a new management team in place if the company is being run badly to having a clear picture of how the various parts of an acquisition will be merged (or not) into the buyer's existing structure. It also has to include understanding the context in which the deal is taking place. This obviously means taking into account market evolution—where a target company has come from and how its products and services will meet future demand. But it also calls for knowing what motivates the target has for being acquired and how this can help it meet its needs. And in some markets, especially China, buyers must be aware of the view regulators and politicians will take of an acquisition: What might appear to make commercial sense may not be viewed the same way by an official who regards a potential purchase as a key source of national or local pride.

Plan ahead. Ultimately, successful acquisitions turn less on a vision of potential and far more on what happens during the integration period—in particular, whether managing the integration can be done quickly. To do this requires that planning work starts sufficiently early that by the time a deal is closed, it has more or less been completed. Of course, no plan can be perfect, especially in emerging markets such as those of Asia and elsewhere, but if there is a critical moment, it comes just before the announcement of any deal. At this time, the team charged with handling the deal must be setting targets and drawing up detailed schedules so that the integration process can start the day a deal is closed.

With such a plan in place, as soon as a purchase is completed, the acquirer's management team can communicate its objectives clearly with the goal of achieving consensus and so be placed to manage the integration of their new business as smoothly—and as quickly—as possible.

Additionally, while the integration process must have a strong leader, both sides should have input into the process, and communication between the buying company and its new acquisition should be open and

frequent. This in turn means the plan must be flexible enough to absorb useful suggestions and can be changed where necessary as the integration moves forward.

Within the plan, two features stand out as particularly important—timetabling, to ensure that the post-deal process is conducted as quickly as possible, and getting the people part right. Obviously, any purchaser wants to keep all the good people in its new acquisition; but at this time of uncertainty, staff in the acquired company can feel very unsettled, wondering whether they will have a future in the new business or not.

The acquirer therefore has to have a clear idea of which people it wants to retain in which roles—and must implement its plans very quickly. Ideally, its plan should be communicated and implemented within 30 days, and certainly no longer than 90 days.

Two other aspects that should also be covered in any acquisition plan are customer retention and information technology (IT). The period after a takeover is often a time when the focus of both the buyer and acquired company is principally on internal matters, leading to a loss of attention to the marketplace. Competitors know this, and often use it as an opportunity to try and lure customers away. IT can suffer precisely because getting it right is usually not as crucial as retaining the right staff and keeping customers, but in far too many instances companies take too long to decide on which systems to install and develop—sometimes even two years after a deal is completed, nothing is in place.

To overcome these problems, it is essential that any company searching for acquisitions put a dedicated project team in place with a clear mandate to manage issues around human resources and customer retention, and for that team to execute their plan extremely quickly once a purchase goes ahead. In turn, the team has to have very clear criteria in place to measure implementation—to be able to monitor that all the right things are happening at the right time. And finally, just in case things don't work out, companies also need to have an exit plan—to know what to do if conditions change, making previous assumptions unviable or if an acquisition simply cannot be made to work with its existing business.

Two Ways to Grow

When companies look to grow through acquisitions, they are essentially faced with two choices: buying companies in the business area in which they already operate, or buying companies in different business areas. In both cases, the urge to acquire can be driven by various reasons. Sometimes companies find their ambitions for growth cannot be fulfilled by organic growth; sometimes they want to extend their products or their markets; sometimes they are in search of new capabilities for sustainable growth; and sometimes they hope to achieve scale for better efficiency. While the motives for buying a business in the area in which a company already operates are usually aimed at augmenting its current operations in one way or another, venturing into entirely new areas can be done for a host of reasons. At one extreme, a company's existing business may be mature with little prospect for further growth, meaning it has to look elsewhere for major new opportunities, while at the other it may simply see what it takes to be an entirely new and untapped market that it should enter as quickly as possible—the view many companies took of the Internet in the late 1990s and early 2000s. The examples that follow represent companies that have attempted to grow their business through acquisition, first by looking at examples of growth through acquisition aimed at developing existing businesses and then at growth via acquisitions in unrelated business areas.

1. Growing Within the Industry

In the late 1990s, Techtronic Industries (TTI), a Hong Kong-based manufacturer of power tools and floor-care products, and Li & Fung, a major trading and sourcing company, also based in Hong Kong, found themselves facing a similar problem—how to sustain growth when working with what had become commoditized products in mature markets. TTI's challenge was exacerbated by its position as an original equipment manufacturer, producing tools for other brand-name companies, which further limited its ability to add value to its products. For Li & Fung, the garment sourcing industry—its major product line—was not only highly fragmented, but was undergoing a worldwide process of disintermediation while showing generally slow market growth.

Both companies used acquisitions to bring growth to their business. In both cases, it is possible to identify a “strategic intent” that sets the direction for their pursuit of new businesses, and a series of selection criteria that allowed them to pick the right kind of targets to buy.

For TTI, the strategic intent lay in a combination of expanding its geographical markets and moving away from its traditional position as an OEM manufacturer with no public name recognition. The key goals driving its hunt were:

- To find companies that would generate rapid top-line growth through market extension;
- To become a “brand owner” for better sustainability; and
- To increase scale in order to improve efficiency.

Bearing these objectives in mind, target companies had to:

- Be well-established;
- Have strong brands with good channel access;
- Be underperforming; and
- Be in or serving mature markets.

Size was not a concern for TTI: If a company met the above criteria, then it didn’t matter whether it was big, small, or somewhere in the middle.

Li & Fung’s strategic intent focused on developing and refining its pre-existing strengths in sourcing by:

- Expanding its sourcing range to allow it to meet more demands from its customers;
- Extending its capabilities into manufacturing and design; and
- Building its own brands in the medium term.

Its target companies had to:

- Have a strong client base;
- Be well-established and profitable; and
- Not be serving mature markets.

Owning strong brands was of less importance for Li &

Fung and it, like TTI, was not concerned about the size of possible acquisitions.

Both companies have seen successful outcomes to these focused acquisition programs. TTI bought the U.S. arms of Japan’s Ryobi Limited for US\$95 million in 2000, securing exclusive manufacturing and distribution rights for the brand in North America. It added Ryobi Europe in 2001, and Australia and New Zealand two years after that. In 2001, it bought John Deere’s Homelite brand of outdoor power equipment. In 2003 it bought Royal Appliance Manufacturing’s floor care business for US\$105 million. And then 2005 it spent US\$626 million buying the power tools division of Sweden’s Atlas Copco. From 2002-05, TTI’s revenues grew by 38 percent per year and its net income grew by 49 percent. Its acquisitions played a key role, contributing 20 percent of total revenue in 2005.

Li & Fung saw its revenue grow nearly 14 percent annually from 2001-05, while its net income rose 26 percent. The main reason for this was acquisitions in the sourcing business, where it completed 10 deals in 10 years, and along its value chain, where it realized seven deals in three years. Purchases were geographically diverse—ranging from Germany and the Netherlands to Mexico and Indonesia—and included service providers as well as manufacturers. As a result, whereas in the mid-1990s the company had been primarily focused on servicing the US market, it was now able to increase its exports to European and other markets, diversify its product range away from its previous reliance largely on apparel, and acquire design and production capabilities that allowed it expand its service offering along the supply chain. Acquisitions came in all sizes—from US\$4 million to US\$260 million, pushing its total spending on buying companies to US\$640 million since 1994.

The key feature shared by these two companies was that they both treated making an acquisition as a process, not an event. They factored purchases into their overall strategies and business plans, putting in place the capabilities needed actively to identify potential targets, then assess and approach them, and finally—if the decision to buy was taken—to integrate them and monitor their performance. As a result, they were both well equipped to recognize a

likely acquisition candidate when they saw one, then handle the acquisition process smoothly and quickly, simultaneously impressing and reassuring their targets with their routines and professionalism as they integrated their purchases into their existing business rapidly and efficiently.

2. *Branching Out of the Business*

While companies tend to buy businesses close to their main line of operation for fairly obvious and usually quite narrow reasons, the same cannot be said for those that hunt for acquisitions outside their core line of operations. Some see possibilities for extending their capabilities into new but related areas in order to sustain their growth; some see new opportunities emerging that they feel they have the skills to take advantage of; and some simply see what they believe to be a good deal. Whatever the motive, all reap the major benefit of gaining immediate access to new markets, a factor that can be of particular importance in industries that have high barriers to entry, such as requiring a major investment in infrastructure or a large-scale presence to be viable.

Li & Fung, as well as acquiring companies in its traditional sourcing business, has more recently been buying companies that allow it to acquire customer relationships and augment its capabilities up and down the value chain beyond sourcing. For example, in the last three years in the US it has bought:

- Ralsey Group, a branded knitwear producer, to acquire its brands and gain access to a higher-margin clothing business;
- Briefly Stated Holding, an apparel supplier, to strengthen its portfolio of licensed brands; and
- Young Stuff Apparel, a private-label supplier, to improve its capabilities to serve major retailers such as Wal-Mart.

India's Tata Group, which operates businesses in industries ranging from hotels to steel, offers an example of a conglomerate that built new businesses outside of its core due to new market trends or major market discontinuities. Its strategic intent for acquisitions centres on expanding both its geographic and business coverage.

Its goals were to:

- Strengthen core businesses by increasing their scale or capability along the value chain;
- Reach into new lines of business and new geographic markets; and
- Improve Tata's ability to serve new customers, especially in rapidly growing business areas.

With such broad goals, specific criteria were less well defined than in the examples above. Target companies had to:

- Allow Tata to establish a position in a new market;
- Rapidly increase competence in such a market;
- Be readily integratable into the company's pre-existing culture.

The company can date its interest in telecom services to 1994, when India first allowed private fixed-line operators to enter the market; the Tata Group set up Tata Teleservice in 1996 to provide basic telephony services. In 2001, the government announced its intention of privatizing state-owned VSNL, and then, a year later, that it would be ending the company's monopoly of international long-distance calls in and out of the country. In response, the Tata Group acquired VSNL in 2002, then two years later started acquiring one company after another in new, high-growth, telecom-related businesses to become India's first global telecom operator.

Malaysian conglomerate Sime Darby, an investment holding company principally focused on plantations, property, heavy equipment, motor vehicles, and energy and utilities, similarly took advantage of government deregulation. In 1993, the Malaysian government decided to open up the Malaysian electricity market to allow private ownership. Due to its longstanding relationship with the government, Sime Darby became one of the first five companies to win an independent power provider (IPP) license, setting up Sime Darby Power Generation. In 1994 it bought 40 percent of Port Dickson Power to gain immediate access to the market and the necessary capabilities to do business, then continued to buy additional shares in the company, until by 2004 it held 75 percent. In 2002, it expanded

into Thailand by acquiring Laem Chabang Power. And in 2003, encouraged by a government initiative to develop renewable energy, it started Malaysia's first biomass power plant.

Sime Darby's other major venture into a new line of business, however, proved far less successful. In 1995, it acquired a 60 percent stake in United Malayan Banking Corp, the country's fourth-largest bank, renaming it Sime Bank and its related brokerage arm Sime Securities. The new operations had a successful first few years, accounting for 30 percent of pretax earnings in the first half of 1997. The Asian financial crisis, however, turned this success on its head: In the second half of 1997, Sime Bank posted a loss of US\$431 million, the largest loss in Malaysian banking history.

Sime Darby Power Generation has proved far more reliable: revenues and profits at both its power operations have continued to grow steadily despite the downturn of both the Thai and Malaysian markets in the Asian financial crisis. And the company was able to withdraw from its one problematic scheme, the Island Power project in Singapore, after this encountered significant delays.

Tata's telecom business has fallen between the extremes of Sime Darby's two acquisitions. Ongoing deregulation has intensified competition, pushing down prices and with them VSNL's revenues and profits. While Tata Teleservice has managed to keep its top line growing overall, its earnings have not been enough to cover the costs of its major investments in network expansion.

Clearly companies need to be extremely cautious when entering a new business area via an acquisition—even when a new business appears to have been integrated successfully, as the experience of Sime Darby's banking purchase highlights. Sime Darby failed in its banking business largely due to poor internal risk management. Its bank-funded expansion through inter-bank borrowing left it with a loan-deposit ratio of more than 120%, one of the highest in the industry, while its securities arm consistently breached trading limits for single customers and put the bank under great risk. The Asian financial crisis caused a sharp depreciation

in the value of the Malaysian ringgit and a steep decline in the stock market, resulting in the accumulation of US\$500 million in non-performing loans. "Even if we had a lot of spare cash, we'd never go back to financial services," says ex-group chief executive Nik Mohamed. He continues to remind his managers that Sime Bank caused so much trouble because nobody in the group realized that running a bank and running a trading or plantation company required vastly different skills. Failure, however, did not mean simply plowing on. The company developed an exit plan, and in 1998 it sold 90% of Sime Bank, saying it would not go into banking again.

Tata Group's investments in a range of core businesses, which it develops and grows over time, look to be a far better example of how to grow through a combination of acquisitions and organic growth that allows it to utilize the existing capabilities of its corporate model and core competences, as do the disciplined acquisitions of Li & Fung.

In Tata's case, its strong commitment to making telecom one of its core businesses has been of critical importance. Accompanying its investment in VNSL, it has also:

- Continuously lobbied the government on deregulation and pricing of telecom services;
- Emphasized its expertise and service orientation in the market to maintain subscriptions despite having to lower its charges;
- Continuously launched new products and services; and
- Constantly monitored the environment for potential acquisitions that would strengthen either VSNL or Tata Teleservice up and down the value chain.

The Key Success Factors

In summary, four factors stand out as critical to making the right acquisition decisions.

1. Have a clear objective for any acquisition.

Clearly this was the case in the purchases made by Li & Fung and TTI. Both companies looked to expand their existing businesses by extending their capabilities

into new areas of their value chains or acquire new capabilities such as brands they felt they could develop in partnership with their existing operations. The same can be said for Tata's telecom business and, at least in retrospect, for Sime Derby's power projects.

2. Have a detailed understanding of the desired and feasible profile of any likely acquisition target.

Again, the success of Li & Fung and TTI points to just how important this is. The failure of Sime Bank highlights what can happen when a company lacks the management capabilities and operating model for a business very different from those that it already operates. Listing the criteria by which a deal will be assessed is far more important than worrying about the exact price. Moreover, a company that knows what it wants but can't find anything that it is quite right is in a better position to identify a possible target that meets some of its criteria, even if it is not the perfect solution.

3. Select and negotiate deal terms and structure based on the value-creation potential of an acquisition.

As noted above, it is the potential for value creation that counts for most when assessing a possible purchase. At the same time having a good understanding of how much money a business is likely to make from an acquisition allows it to calculate what it will be willing to pay far better than simply attempting to negotiate the price down. Concentrating on the value-creation potential is also important when a company is only buying part of another business: If it is establishing a joint venture to introduce new products, then it must ensure it is responsible for new products with the other party taking care of other matters such as sales. In other instances, such as in the purchase of a bank, an acquirer might want to include a put-back provision in its deal so that if, say, non-performing loans turn out to be worse than expected it receives compensation.

4. Have a complete plan in place—with clear accountability—to realize value creation for any acquisition before any deal is completed.

Again, as the successful track records of Li & Fung and TTI underline, acquisitions are a process, not an event. A company must put people in charge of making

sure its post-deal plan is prepared in advance and then implemented properly: There is never time enough to plan after an acquisition has been completed. Indeed, getting the implementation of integration right remains the most crucial aspect of any deal. It doesn't matter how low the purchase price, or how great the potential; if a newly acquired company cannot be brought smoothly into the fold of its buyer, than it might as well not have been bought in the first place.

Extra Attention in Asia

While these four factors hold true universally, in Asia they are especially critical. A lack of familiarity with mergers and acquisitions, as mentioned earlier, can cause problems—as is being witnessed currently in China with the backlash against foreign purchases of various companies and minority stakes in banks. Potential buyers need to be careful not to be sending the message, “We've got the money—we're buying you.” Far better is to suggest that any deal will be realized through a process of mutual seduction, with a potential target being made to feel it is selling itself to the right buyer as much as the buyer thinking it is making a smart purchase. Such an approach can be helped by demonstrating the additional resources that will be made available if the deal goes ahead, or the new markets its products will be able to reach.

Acquirers also need to pay attention to the possible reaction of governments. While the benefits of a purchase may look all too clear to a foreign buyer, the buyer shouldn't assume that acquiring a company and helping it to grow and become part of a bigger organization will necessarily be viewed in the same way by officials. In China, various buy-outs by foreign companies have been halted after opposition from government officials, often backed by public sentiment. The American Carlyle Group in late 2005 reached an agreement to pay US\$375 million for 85 percent of a leading Chinese machinery business, Xugong Group Construction Machinery Co. The deal was then delayed for 15 months after the central government indicated it didn't want control of what it viewed as an important company to fall into foreign hands. So far, the deal has not been approved even though Carlyle agreed to lower its equity stake to 45 percent.

Acquisition Pitfalls

During the early stages of acquisition, especially for first-timers, companies often underestimate exactly what is needed to allow the process of buying another business to go ahead. Six shortcomings stand out:

1. Believing that success in one business can be easily extended to another business.
2. Misunderstanding how a new market or sector operates, so misunderstanding how value can be created in that sector or market.
3. Being too limited in scope in selecting targets.
4. Not being involved enough in due diligence—there is far more to this process than just its technical aspects.
5. Being overly optimistic in assessing the growth prospects of a potential acquisition, and so over-valuing it.
6. Not committing enough attention or resources to the acquisition process, leading to delays or even bringing it to a halt.

If acquisitions in Asia, especially China, demand more attention than in some other parts of the world, the potential for deals more than merits this extra effort. Industries in many countries in the region are ripe for consolidation. Firms which have grown rapidly in the last couple of decades are looking for partners to help them sustain their growth as part of a bigger unit. And at numerous locations—in China's Shenzhen, India's Bangalore, or Taiwan's Hsinchu, to name but three —there are high-tech start-ups with products and ideas that need capital and expertise to realize their potential. For those who pick the right targets, then successfully integrate and manage them, the reward will be sustainable long-term growth.

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