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How emerging giants are rewriting the rules of M&A

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How Emerging Giants Are Rewriting the Rules of M&A

By Nirmalya Kumar

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MERGERS AND ACQUISITIONS, the stuff of newspaper headlines, quite often fail. Around 50% of mergers don't achieve their business objectives, and takeovers cause the shareholders of most acquirers to lose money, according to several studies conducted over the past four decades. Yet, in an ironic twist, companies from developing countries such as China, India, Malaysia, Russia, and South Africa are using M&A as their main globalization strategy today.

Even after the economic crisis engulfed the world in the last quarter of 2008, the Indian technology major Tata Consultancy Services picked up Citigroup Global Services (the North American bank's India-based outsourcing division) for \$505 million in October 2008; another Indian technology company, HCL, bought Britain's Axon Group for \$672 million in December 2008; and China's Minmetals made a \$1.7 billion bid for the Australian company OZ Minerals in February 2009. In fact, emerging giants clinched 26% of the previous year's takeover deals between developed countries and developing ones, a recent A.T. Kearney study shows.

Fueling the trend is the fact that many emerging giants are cash rich. Economies like China and India grew at near double-digit rates over the past 15 years, and that, along with corporations' restructuring, resulted in profit margins of 10%, twice those in the developed world. Reflecting those companies' bloated balance sheets, a survey conducted by HBR and the World Economic Forum in 2008 found that 50% of CEOs from developing economies plan to finance their bids with internal resources and 46% by issuing fresh equity. They aren't worried about diluting shareholdings: Business families or founder-promoters hold large stakes in companies in developing nations. Those majority shareholdings also ensure that CEOs won't lose control if stock prices fall, so smart ones can focus on generating long-term value. Moreover, suitors from developing countries are finding the valuations of companies more attractive after the recent stock market crashes in the United States and Europe.

Cash isn't the only factor behind the M&A wave. My research indicates that emerging giants can also create value from takeovers more easily than corporations from developed countries. U.S. and European companies, inhibited by slow-growing home markets, acquire rivals primarily to become bigger and thus create economies of scale. After every merger, executives try to identify synergies, fashion efficient processes, and reduce head count so that costs will fall. In a slow-growing market, lowering costs to enhance margins is the only way to boost profits. This storyline is easy to sell to investors; a CEO can describe a merger's benefits beforehand and demonstrate some of them soon afterward.

IDEA IN BRIEF

- Half of mergers don't deliver their hoped-for business value. Yet companies from developing countries are defying that statistic, using M&A as their main globalization strategy and generating more value from takeovers than their counterparts from developed nations.
- Unlike Western companies, which use M&A primarily to increase size and efficiency, emerging giants acquire firms to obtain competencies, technology, and knowledge essential to their strategy. They avoid overturning acquisitions' management structures and people, ensuring smoother integration. And they have a clear long-term vision guiding their actions; they are willing to wait for a takeover to pay off.
- By applying these M&A principles, Indian aluminum producer Hindalco became one of the world's largest aluminum manufacturers.

By contrast, when emerging giants pursue cross-border acquisitions in particular, they don't search for traditional synergies or try to lower their costs. They buy Western companies to gain complementary competencies – that is, to learn to deploy assets such as technologies and brands, and capabilities such as new business models and innovation skills – that will help them become global leaders. Operating costs aren't an issue; the emerging giant knows it can transform an acquisition's economics simply by switching to the low-cost resources and business processes in its home country. In addition, developing countries will increasingly absorb Western companies' output of technologically superior products. Many slow-growing companies with low margins can be turned into fast-growing, high-margin enterprises by their acquirers in developing countries, the logic of "reverse" M&A suggests.

To realize their objectives, companies from developing countries are using new techniques to identify targets and integrate them. They acquire only to meet strategic goals; they don't completely assimilate acquisitions; and CEOs focus on the long term while planning takeovers and evaluating results. One company showing the way is India's Hindalco, which has used M&A to become one of the world's largest manufacturers of aluminum. In the process, the Indian commodities player turned into an integrated global major and boosted revenues by 30 times, from \$500 million to \$15 billion, in just seven years. Although the current recession is hurting Hindalco, its strategies are a harbinger of how emerging giants will increasingly approach M&A in the global market and gain an advantage over companies that use more traditional acquisition strategies.

Hindalco's Global Ambitions

Unknown outside India until recently, Hindalco is the flagship company of the \$28 billion Aditya Birla Group, one of the country's oldest and most diversified family business houses. Set up in 1857, the group went overseas in the 1970s when the founder's great-great-grandson, Aditya Birla, established 19 joint ventures in Egypt, Indonesia, Malaysia, the Philippines, and Thailand. It was unusual for Indian entrepreneurs to operate abroad in those days, and the experience laid the foundations of the group's global ambitions. After Aditya's death, in 1995, son Kumar Birla continued to focus on growth; by 1999, the group was one of the world's biggest manufacturers of cement, carbon black, and viscose staple fiber.

By then, Hindalco had grown into India's largest aluminum producer, with a nearly 40% share of the market. It had built a dozen processing plants and also captive power plants and coal mines, and the organization concentrated on upstream operations such as bauxite mining, alumina refining, and aluminum smelting. It was a commodity manufacturer predominantly focused on the Indian market, although it exported a fifth of its output. Senior executives in the group, like Debu Bhattacharya, who became Hindalco's CEO in July 2003, were dissatisfied with that. Hindalco could do better, they believed, because India had large reserves of bauxite and the company boasted low processing costs.

A turn-of-the-century strategy review convinced top management that Hindalco could become a global leader by expanding the aluminum business, manufacturing more value-added products, and selling both aluminum and aluminum products all over the world. However, success factors in upstream and downstream businesses differ, so Hindalco decided to pursue a two-pronged strategy: It would generate economies of scale in the aluminum manufacturing business by setting up projects in India, and it would use cross-border acquisitions to break into the product market. The latter would be risky; Hindalco had never before acquired a company. It would therefore have to learn to integrate acquisitions and, at the same time, absorb new capabilities.

Climbing the M&A Competency Stairway

Hindalco didn't immediately cast about for targets overseas. Instead, it patiently executed small takeovers, first in India and later abroad, before making a big global play. Each of the initial acquisitions, my research suggests, taught the company something new and served as a stepping-stone toward another acquisition (see the exhibit "Lessons Learned from Each Acquisition"). Combined, those moves created an M&A competency stairway, as I call it, which the company steadily climbed over a period of eight years.

The process started in 2000. Canada's Alcan, one of the aluminum industry's global leaders, wanted to merge with France's Pechiney and Switzerland's Alusuisse to focus on the upstream business. It decided to pull out of India, where it had only a downstream operation, and put its 55% equity stake in Indal – the longtime leader in the Indian market – on the block. A bidding war ensued, and in July 2000, Hindalco, which had long coveted Indal, managed to land the prize catch for a total of \$230 million.

This takeover enabled Hindalco to straddle the length of the industry's value chain. Over the past nine years, the company has become adept at developing aluminum products such as sheets, foils, and extrusions, and manufacturing them cost-effectively. It has developed the ability to brand products, distribute them to retailers and other business customers, and cultivate customer relationships. From Indal, Hindalco inherited a small company, Annapurna Foils, which had gone into receivership. Hindalco's executives, who had never had to nurse a company back to health, joined the team dealing with the situation. By installing cutting-edge equipment, reengineering processes, and fostering demand for packaging foils, such as lid foil and confectionery wrap, they helped turn around Annapurna.

Hindalco also learned to cope with touchy postmerger integration issues. For example, Alcan had operated in India since 1938, and its Indian managers prided themselves on their values and processes. Indal's managers worried that after the merger, Hindalco's "family business" ways would drive out their "professional management" culture. To reassure them, Hindalco decided to retain all of Indal's senior managers. Kumar Birla made it a point to send out the message, internally and externally, that the group "acquires talent, not just assets" and that it would always deploy the best person for the job. Hindalco has tried to live up to that claim. For instance, Indal's CFO, S. Talukdar, continued in that role until 2005, when the two companies formally merged, and then stepped in as Hindalco's CFO – a rare postmerger occurrence. Hindalco's approach helped turn Indal into a growth machine: Its profits were five times as big in 2006 as they were in 1999.

Three years after picking up the majority stake in Indal, Hindalco felt it could tackle cross-border acquisitions. A nascent copper division took over the Nifty and Mount Gordon mines, two Australian companies, one of which was in receivership and the other was heading there. The companies were small, but the takeovers forced Hindalco to cut its teeth in a developed country, where, among other challenges, labor costs were high and regulations were strict. It used the opportunity to create an overseas company. After merging the two acquisitions, Hindalco made a public offering and listed Aditya Birla Minerals – the first Indian company to trade publicly in Australia – on the Australian Securities Exchange.

Hindalco's growing confidence in its ability to take over and turn around companies spread throughout the Aditya Birla Group. In 2005 the group picked up a pulp mill in Canada to feed its fiber plants in China, India, Indonesia, and Thailand. The deal allowed the group's managers to cope with the dynamics of a global supply chain from the perspectives of both sellers and buyers, and to understand the intricacies of hedging foreign exchange and price risks in different countries. The next year, the group's outsourcing services unit, TransWorks Information, bought a Canadian company, Minacs Worldwide, to create a global player in that field.

The experience the Aditya Birla Group gained through all these takeovers convinced Hindalco that it was time to go after the big one. In December 2006, after the group had scooped up six companies in six years, Hindalco

made a bid for Novelis, one of the world's largest producers of flat-rolled aluminum and aluminum products. The Atlanta-headquartered company's facilities were new; it had earned a reputation for technological innovation; and its customers included Anheuser-Busch, Coca-Cola, Ford, Tetra Pak, and ThyssenKrupp. Novelis had reported a 2005 profit of \$90 million, but for fiscal 2006 it was projecting a loss of between \$240 million and \$285 million. That's because it had been born with a large amount of debt on its books. In addition, the company had entered into fixed-price long-term contracts with four major customers, and when raw materials prices rose sharply in 2005, Novelis started losing money on those deals.

Hindalco's unsolicited offer took Novelis's board by surprise. The board later warmed to the idea of a sale and initiated a competitive bidding process. In May 2007, Hindalco succeeded in picking up Novelis for \$6 billion – the second-largest takeover by an Indian company in the United States. If Hindalco hadn't gained a wealth of M&A experience, it probably wouldn't have overcome the diffidence of many emerging-market companies and made a bid for a North American corporation more than twice its size.

Sticking to Strategic Acquisitions

It may appear as though Hindalco acquired firms willy-nilly, as most Western enterprises do. However, it pursued companies such as Indal and Novelis only after it had carefully figured out what it would achieve by buying them. Hindalco identified its weaknesses and targeted only those corporations whose purchase would offset them, as I shall demonstrate next. So far, it hasn't shown much interest in using M&A to grow quickly or to deal with overcapacity.

Three years before the Novelis bid, Hindalco identified four types of companies in the aluminum industry: Miners like Rio Tinto and BHP Billiton mainly extract bauxite and convert it into aluminum. Aluminum producers such as Dubal and Rusal make aluminum because they have inexpensive access to energy, which accounts for 40% of production costs. Downstream producers such as Novelis and Sapa buy aluminum on the London Metal Exchange and convert it into aluminum products. And integrated giants like Alcoa and Alcan combine upstream and downstream operations.

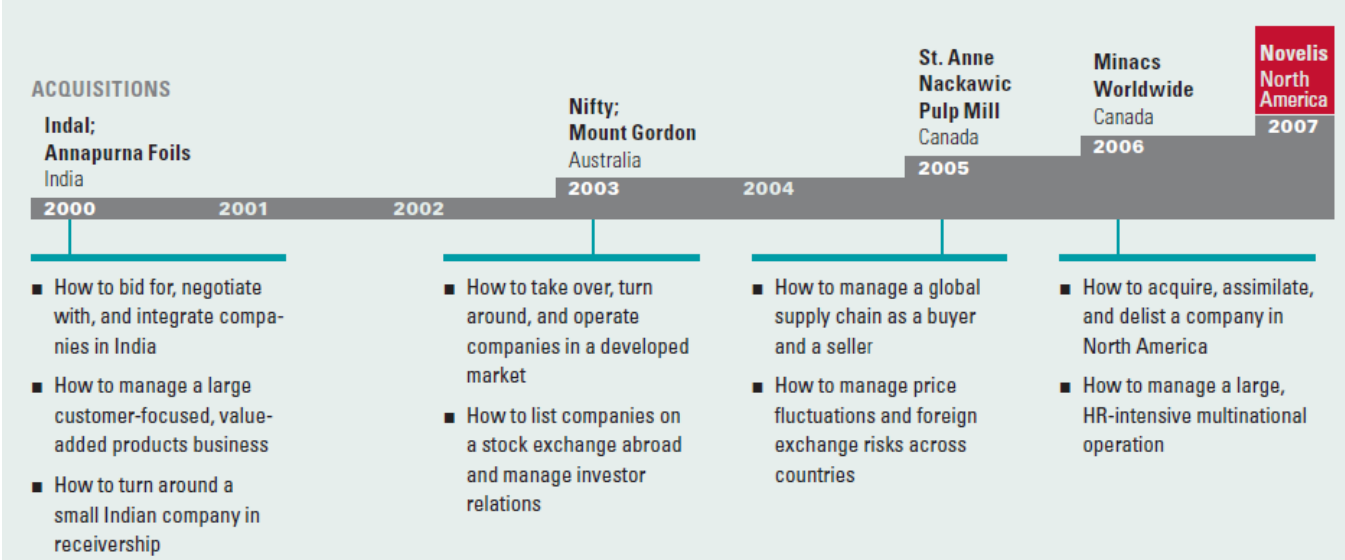
There are good companies of all four kinds, so no single business model is preferable. Enterprises that focus on upstream rather than downstream operations are more profitable, but their profits fluctuate more. That's because speculators on commodity exchanges influence aluminum prices, whereas consumer demand mostly determines product prices.

Hindalco was then an upstream player, so its profits varied every year. It decided to add downstream operations for a few reasons: First, the company wanted to steady the profit stream. Second, it realized it had to be globally competitive at home since India wasn't a protected market anymore. And third, to move away from the commodity business, Hindalco had to manufacture value-added products. Making aluminum at competitive prices requires economies of scale, process skills, and cheap raw materials. Selling value-added aluminum products demands attention to quality, service, and brands; product development skills; and a knack for forging customer relationships – capabilities that Hindalco didn't possess. To learn them, it decided to acquire the leading downstream companies: Indal in India and Novelis overseas. The objective was to gain new competencies – not to get big fast or to reduce costs.

Once it has identified a target, Hindalco doesn't worry much about the stock market's reaction. The day after it announced the Novelis deal, for instance, Hindalco's scrip price fell (on February 11, 2007) by 13% and its market capitalization declined by \$600 million. In the 2006–2007 annual report, Birla acknowledged the adverse impact of the takeover on Hindalco's bottom line. He asked shareholders to be patient: "I do realize that in the short-term

[the acquisition] does cause a strain on your Company's Balance Sheet. However, if you look at the bigger picture, this is one of the most striking acquisitions and over the long-term will undeniably create enormous shareholder value."

This philosophy, which will stand Birla in good stead as Hindalco battles the current recession, is one of the distinguishing features of takeovers by emerging giants. Unlike the many Western companies that merely pay lip service to the idea of generating value in the long run, smart emerging giants are content to reap the benefits from takeovers over time. In an interview for this article, Birla told me: "I'm not worried. Investors may have a short-term perspective, but my vision is to build a world-class company that is still the leader four decades from now." One downside of this approach is that if the logic driving an acquisition is flawed, it will be too late before the company realizes its mistake. Companies like Hindalco can conceal a multitude of sins by telling investors, "We know best; trust us."



Allowing Integration to Evolve

Hindalco's management doesn't believe in the 30-day or 100-day integration plan; it allows the postmerger process to evolve naturally and rarely intervenes. By the time the company bid for Novelis, it had developed a simple, four-step process to help meet its initial postmerger objectives. The steps are standard ones, relating to finance, organizational issues, business processes, and markets, but the Indian company prioritizes them in a unique way. Most Western and Asian companies spend a lot of time after a merger tackling knotty organizational issues – that is, who's going to get what job – as well as financial ones. Hindalco resolves those issues quickly and then focuses on integrating business processes to score immediate wins and combining markets to create long-term value.

Financial integration. Instead of centralizing the financial operations after taking over a company, Hindalco tackles only the reporting systems at first. Senior executives want the acquirer and the acquired to speak the same financial language, see the same reports, and set similar benchmarks – as soon as possible. Managers from Novelis and Hindalco worked side by side to get their reporting periods aligned. Prior to June 2007, Hindalco's financial year ended on March 31 whereas Novelis's ended on December 31, so standardization was essential. Other teams took up the consolidation of quarterly results and ensured that both entities met the guidelines of regulators such as the Securities and Exchange Board of India and the U.S. Securities and Exchange Commission. Taxation too required an integration team; Hindalco and Novelis had to meet the tax laws in all the countries in which they operated, but they wanted to optimize the tax bill as well. In none of these cases did Hindalco insist on

doing things its way; it shared best practices with Novelis, and vice versa, so that they could find common ground.

Organizational integration. Hindalco doesn't disturb an acquisition's management structure, systems, or people unless necessary. For example, it kept Novelis people in all the top management jobs there – including COO Martha Finn Brooks, who has held her position since 2005. Moreover, in the first six months after the takeover, Hindalco deputed just two of its own executives to Novelis: It sent an expert from its copper division to institutionalize a risk-management process and installed a senior executive in Novelis's logistics department to help improve its global supply chain. This dampened the fears at Novelis that "the Indians were coming." By sending two of its best people, Hindalco was able to impress Novelis's executives, who now routinely check with the Indian company before going outside the group for ideas or people.

Business process integration. Hindalco looks for easy and painless business wins in the short term. For instance, it has set up a company in India to manage Novelis's information technology systems because of the availability of inexpensive engineers there. Hindalco didn't lay off Novelis employees, but it stopped the hiring of consultants. By 2010 the IT project will reduce the merged entity's costs by \$40 million a year. Similarly, Hindalco noticed that Novelis's stock turns – the number of times inventory sells – were six a year, compared with its own 20. If stock turns at Novelis were to increase by just one, the company reckons, that would free \$50 million to \$70 million in working capital. Hindalco has set Novelis a target of seven to 12 stock turns a year by 2010, which could free about \$300 million in working capital. Novelis has started overhauling its supply chain management and inventory control practices, but it's too early to say what the results will be. Besides, the company's sales are falling in the current slowdown, so its stock turns are unlikely to rise.

Wherever Hindalco has felt that Novelis had superior processes, the acquirer has learned from the acquired. For instance, the U.S. company relies on value-based management systems, so Hindalco has enlisted Novelis's managers to develop similar processes in all its units in India. On the basis of analyses of competitors, markets, plants, financials, and customer data, they are developing planning models that will enable Hindalco to craft better strategies for the future.

Market integration. Despite the competition in the Indian market, Hindalco can easily stoke demand in India for the products of companies it acquires. This type of integration is peculiar to emerging giants, which have fast-growing home markets. For example, India's demand for aluminum products is projected to almost double from 1 million tons in 2007 to 1.9 million tons in 2012, and half of that increase in demand will be for the kind of flat-rolled products Novelis produces. Thus, India could absorb a third of the North American company's output in three years' time. Even then, India's per capita consumption of aluminum will be one kilogram compared with China's 9 kilograms and the United States' 25. If Hindalco can grow India's consumption to 2.25 kilograms – a quarter of China's current consumption – India will consume everything that Novelis produces today. The first signs of change are visible. Two years before the Novelis deal, Hindalco sounded out the world's majors about setting up can-making operations in India. None were interested, but after the Novelis takeover, five entered India. Hindalco is supplying all of them with flat-rolled aluminum from a Novelis plant in South Korea. When the volumes become bigger, the company will set up a plant in India to manufacture flat-rolled aluminum.

The future of these investment plans will of course depend on how well Hindalco weathers the global recession, which has shrunk the demand for aluminum and aluminum products. Although the price of aluminum fell by about one-third in the last three months of 2008, the Indian company's revenues grew by 1.8% and it reported a profit of \$395 million for the period from April to December 2008. By contrast, Novelis's performance suffered: Sales fell by 1.7% in the nine months leading up to December 31, 2008; in the last quarter of the calendar year, they tumbled by 20%. The company realized a huge net loss of \$1.9 billion from April to December. This included a onetime financial charge of \$1.5 billion, which Novelis, like several other North American companies,

incurred because its value fell by that amount in 2008, and the SEC required that the sum be written off. Excluding all the financial charges, Novelis recorded a pretax loss of \$32 million for the quarter, compared with a loss of \$22 million for the same period in 2007.

Hindalco believed that Novelis's steady earnings would help offset the fluctuations in its profits from year to year. It did not anticipate a meltdown of the market, with demand all along the value chain falling so dramatically. Hindalco has faced other problems at Novelis as well. For instance, Hindalco has not been able to commercialize Novelis's technologies quickly. It has several products in its innovation funnel, but their development is moving at a very slow pace. As with most acquisitions, Hindalco took over Novelis when the stock market was at its peak. When booms become busts, acquirers often run into problems as interest costs rise and debt repayments come due. Not only will it take Hindalco longer than it expected to realize the benefits of the Novelis acquisition, but the Indian company will have to invest a lot of money to ride out this storm. What will help, though, is the fact that Hindalco developed a clear long-term strategy and adhered to it while making acquisitions.

Traditionally, the desire to consolidate has driven acquisitions. However, emerging giants are taking over companies abroad to connect sophisticated technologies and brands with low costs and relatively high growth rates at home. Western multinational companies can fight back by giving global mandates to their overseas subsidiaries. But that will happen only when the locus of M&A shifts from the corporate headquarters in the developed world to regional headquarters in emerging markets.

Lessons Learned from Each Acquisition

Indian aluminum producer Hindalco acquired several companies before it picked up Atlanta-headquartered giant Novelis in 2007. From each takeover, the Indian enterprise learned new industry-related skills and M&A techniques. It needed to cultivate both kinds of capabilities to acquire a North American company more than twice its size.

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Two Approaches to M&A

Emerging giants have different reasons from Western corporations for acquiring companies abroad. They also use novel integration techniques and measure performance in light of long-term goals. It's too early to tell if their approach will work – but if it does, it will take cross-border M&A to new heights.

	Traditional Approach to M&A	Emerging Giants' Approach to M&A
RATIONALE	The aim of a takeover is usually to lower costs, though some companies use acquisitions to obtain technologies, enter niches, or break into new countries.	The aim is to obtain new technologies, brands, and consumers in foreign countries.
SYNERGY LEVELS	The acquirer and the acquisition usually have the same business model. Even when a company takes over a start-up, the approach to market is the same.	The acquirer is often a low-cost commodity player, while the acquisition is a value-added branded-products company.
INTEGRATION SPEED	The buyer makes several changes in the acquisition soon after the takeover. It slows the quest for synergies thereafter.	Integration is slow-moving at first. After a while, the buyer starts pulling the acquisition closer.
ORGANIZATIONAL FALLOUT	High executive turnover and head-count reduction are likely at first. Culture clashes occur and productivity declines, but things settle down over time.	Little interference, executive turnover, or head-count reduction occurs right after the acquisition. Although it's too soon to tell as of now, tensions could simmer over the long run and blow up.
GOALS	The buyer has clear short-term aims but may not have thought through long-term goals.	The acquirer's short-term objectives may be fuzzy, but its long-term vision for the acquisition is clear.