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**A STRATEGIC FOCUS ON THE
STRUCTURING OF BUSINESS COMBINATIONS**

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Thesis presented for the Degree of

DOCTOR OF PHILOSOPHY

in the Faculty of Commerce

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Anton Snyman
May 2004, Cape Town

DECLARATION

I, Anton Morkel Snyman, do hereby declare that this thesis titled
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is my own unaided work, save to the extent indicated in the acknowledgements, reference list and
comments included in the body of the thesis.

I further declare that this thesis, or any part of it, has not been, or is being, or is to be, submitted to
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Signed by candidate

Anton Morkel Snyman

27th day of May, 2004

ABSTRACT

1. Purpose of the research

The purpose of the research is to develop a strategic planning approach apropos the structuring of business combinations on the basis of empirical research as well as relevant strategy approaches and concepts. Business combination with other firms through mergers and acquisitions (M&A), joint ventures and strategic alliances represents the major external versus internal organic growth route and provides the firm intent on external growth with a considerable range of combination vehicles, through which it can implement specific combination strategies to achieve its defined corporate vision and objectives.

2. Review of corporate combination activity in South Africa within a macroeconomic context

The research has, as a first focus, a review of corporate combination activity in South Africa within a macroeconomic context through mergers, acquisitions and other combination vehicles during the period, 1991 to 2001. This review highlights the trend towards unbundling of corporate combination structures that occurred in South Africa from 1993 onwards as well as the internationalisation or offshore moves by large South African corporate firms in the later part of the period.

The key economic and business drivers affecting the level of combination activity over the period are identified, as well as the various combination vehicles that were utilised to implement corporate strategies. The relevant characteristics of the South African economy as a context affecting combination activity are highlighted as well as certain relevant economic factors, which are directly affecting the level and nature of contemporary business combination activity. The total M&A activity in South Africa is compared and related to world-wide combination activity and consolidation.

3. Descriptive role in respect of the business combination decision-making process

The research has, as a second focus, a descriptive role in assessing the state-of-the-art in the combination decision-making process within South African acquiring firms. This decision-making process encompasses in scope the motivation or intent to structure business combinations with other firms in the corporate strategy of the firm, the formulation of a specific combination strategy, the organisation of the combination function in the firm to manage and accomplish external combination, as well as the eventual integration and post-combination management of the combining firms. Activities such as the selection of the suitable combination vehicles to be utilised,

the decision on the desired level of control, the appropriate structural fit with the corporate body, the definition of an ideal combination profile, the screening and selection of combination or acquisition targets, the subsequent negotiations with the target firm and, if successful, followed by the integration of the merger or the acquired firm, are other key elements of this process.

Grounded theory is used as the most appropriate research strategy to assess the research phenomenon, given the qualitative nature of the phenomenon and the utility of grounded theory as a scientific research method to both describe the phenomenon and utilise the result as a basis to develop valid prescriptive theory. The descriptive research explains the nature and functionality of the various constituent activities in this process within the South African context based on interviewing in large South African combination active firms.

The result of the interview research is summarised in two empirical research models describing specifically how acquiring firms manage their business combination decision-making processes. Two broad situations were encountered in practice that represented the two ends of the combination process continuum. At one end of the continuum was a truly planned combination by the acquiring firm and at the other end an opportunistic situation where an opportunity was presented to the acquiring firm. The planned business combination was characterised by the systematic development and implementation of a well defined corporate and combination strategy that was aiming to expand the business in selected business sectors, a specific global area and through a specific form of combination such as through acquisition of relatively large firms. The particular combination strategy was then implemented through the definition of a profile outlining key desired criteria of a combination target in line with the strategy and then searching and screening alternative candidates to find a target best fitting this profile. The planned and opportunistic business combination decision-making processes are in line with the prescriptive and emergent modes of strategy formulation.

4. Prescriptive contribution in terms of a strategic planning approach to the structuring of business combinations

The third thrust of the study is a prescriptive contribution in terms of formulating a systemic strategic framework for the planning and structuring of business combinations. The business combination decision-making process in the strategic framework has been divided into four distinct phases to explain the process flow of key activities. The combination decision-making process should be initiated in a planning phase formulating corporate and combination strategy by the combination-intent firm followed by an implementation phase where strategic decisions are implemented through locating, approaching, negotiating the ideal combination target and then finalising the transaction. The

consummation of the combination should be effected with the optimal integration of the target in line with the strategy, structure and operations of the acquiring firm. Finally, in a follow-through post-combination phase the combined firm should be managed as part of the acquirer's group to achieve corporate objectives in line with the strategic direction set as corporate strategy.

This strategic approach to combination decision-making emphasises that the combination strategy of a firm intent on pursuing external growth through this mode may be defined in terms of the specific capabilities sought by the combination-intent firm, the suitable combination vehicles to be used, the ideal combination profile defining criteria such as the size and profitability of a target acquisition, the level of control the acquiring firm would like to exercise, and the specific approach to integration of the target firms with the corporate structure of the acquirer.

The prescriptive contribution of this research is insistent that firms, which plan to expand through external combination, should carefully consider the range of alternative combination vehicles and implement their strategy through the most suitable and fitting of these vehicles as a means to achieve corporate and combination specific objectives. The strategic framework outlined in this thesis provides corporate management and other role-players with systemic and systematic insights enabling them to more efficaciously execute their planning, evaluation and structuring of a specific combination or a programme of business combinations.

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GLOSSARY OF TERMS

The following terms constitute stipulative definitions of key research phenomena in this thesis and should be understood in the relevant context in which they are used. The various forms of business combinations as defined by experts in the discipline are fully defined in the first chapter.

Business combination: The process and result of the merging or linking of two or more firms through mergers, acquisitions, amalgamations, consortia, joint ventures and strategic alliances in a close business relationship.

Combination vehicle: The specific organisational form utilised to accomplish the combination of two or more firms such as the acquisition of a majority shareholding and establishing the acquired firm as a subsidiary, a minority shareholding interest, a merger of equals, an equity joint venture or a contractual strategic alliance. The combination vehicle serves as a means of implementing corporate strategy and achieving the strategic objectives of the firm intent on expanding through combination.

Combination structure: The end result of an acquiring firm effecting a series of combinations through stock acquisitions and establishing a holding company – subsidiary relationship with acquired firms.

Combination-intent firm: A firm intent on growing through business combination with other firms, that may possibly utilise any of the combination vehicles in its combination programme. The word is defined in contrast to 'acquiring firm', which technically only denotes the intention and execution of growth through acquisitions and merger through absorption.

PREFACE

External business combination through vehicles such as mergers and acquisitions (M&A), joint ventures and strategic alliances has been a popular growth route for firms intent on expanding their business. Most research studies, however, have indicated that external combination has a poor performance record in meeting strategic and financial expectations with roughly a 50% failure rate. The opportunity costs of unsuccessful mergers and acquisitions are enormous in terms of investment as well as the unproductive employment of capital and human resources in such combinations.

This research had, as a first focus, a *review of business combination activity in South Africa within a macroeconomic context* highlighting the various *combination vehicles* utilised during the period, 1991 to 2001, by large South African acquiring firms inter alia to implement their internationalisation strategies and offshore moves. In their internationalisation drive some large corporates listed offshore to gain improved access to international capital, diversify their investor base, improve share ratings and in the process, some relocated headquarters during the later part of the period. In the outward internationalisation by South African acquiring firms, the acquisition of relatively large firms as platform acquisitions was amongst the first combination vehicles to be used. These combinations were largely the acquisition of stock, either 100% or a controlling stake, and establishing the acquired firms as subsidiaries. Later these acquired operations were managed by divisional geographic management structures or regional hubs in the specific global area, for example North America, Europe, Asia or Australia. A few acquiring firms embarked on aggressive world-wide acquisition programmes to globalise operations and one was noted as amongst the most active acquirers world-wide. Joint ventures as a combination vehicle for expansion was extensively utilised in capital intensive industries such as in natural resource mining, fuel and chemicals as well as the beverages industry. Joint ventures were used for both upstream as well as downstream expansion. A large merger of equals as a combination vehicle was effected in the mining sector with the South African and Australian business combination, BHP Billiton, which represented the largest transaction to date in these two countries.

Given that most literature on M&A activity in South Africa emanates from annual reports by auditing firms, the review of business combination activity in this thesis highlighted the vehicles utilised by South African acquiring firms from an academic perspective. An analysis of how total combination activity is affected by economic growth, stock exchange performance and the cost of capital (interest rates) has indicated the correlating relationship between these factors and has made a valuable contribution to how the level of combination activity may be anticipated on the basis of the movement in these economic factors.

The second focus of this research was a descriptive role in *assessing the state-of-the-art in the combination decision-making process of acquiring firms*, which encompassed in scope the motivations for a combination strategy through to the eventual integration and review activities. Through interviews in large acquiring firms, using a grounded theory study approach it became evident that the combination decision-making process was fundamentally different depending on whether a combination was a planned or an opportunistic situation. The planned business combination was characterised by the systematic development and implementation of a well defined corporate and combination strategy, that was aiming to expand the business in selected business sectors, a specific global area and through a specific form of combination such as through acquisition of relatively large firms. The particular combination strategy was then implemented through the definition of a profile outlining key desired criteria of a combination target in line with the strategy and then searching and screening alternative candidates to find a target best fitting this profile. The planned combination decision-making model was clearly in line with the *prescriptive strategy mode* in that the corporate strategy was planned in a rational and co-ordinated fashion on the basis of current resources as well as environmental and industry opportunities followed by the definition of combination criteria on the basis of the corporate growth direction and objectives. The opportunistic decision-making model represented an *emergent strategy mode* in that the combination opportunities taken influenced corporate growth in terms of the business focus and products. The combination opportunities utilised in this mode determined the firm's business focus and its market positioning in terms of its product line.

The third thrust of the study was a *prescriptive contribution to existing knowledge in terms of a systemic strategic framework for the efficacious planning and structuring of business combinations*. The business combination decision-making process in the strategic framework was divided into four distinct phases to explain the process flow of key activities. The combination decision-making process is initiated by the *planning* of corporate and specific combination strategy by the combination-intent firm, followed by an implementation phase where strategic decisions are *implemented* through locating, approaching, negotiating with the combination target and then finalising the transaction. The consummation of the combination is effected with the *integration* of the target in line with the strategy, structure and operations of the acquiring firm. Finally, in a follow-through *post-combination* phase, after *reviewing* the success of the combination, the combined firm is managed as part of the acquirer's group to achieve corporate objectives in line with the strategic direction set in the particular corporate strategy.

The strategic approach here is insistent that the combination-intent firm should consider the full range of alternative combination vehicles and *implement the vehicles most fitting its corporate and specific combination strategy*. Specific advantages and risks attendant in the various combination vehicles, that are valid in general

terms, have been identified in this research as gained from empirical observation. Combination strategy should be defined in terms of the following dimensions: the specific *combination objectives*, the *capabilities* that the expanding firm would like to acquire, an *ideal profile* of the target firm outlining *key criteria*, the *level of control* it would like to exercise as well as the *approach to integration* of the combining/ acquired firms.

This thesis represents a conceptual refinement of the combination decision-making process providing a series of stipulative definitions of combination phenomena hitherto absent in the literature and thus refining the description and explanation of the business combination process. It furthermore enriched the generic literature by mining down into the South African experience, describing how acquiring firms manage their decision-making processes in this context and using this empirical base in developing prescriptive theory for the planning and structuring of business combinations.

CHAPTER 1

INTRODUCTION TO THE STRUCTURING OF BUSINESS COMBINATIONS, KEY STRATEGY APPROACHES AND CONCEPTS

1.1 PURPOSE OF THIS RESEARCH

The purpose of this research is to describe the business combination phenomenon as practised by South African acquiring firms and develop a strategic planning approach apropos the formation of business combinations. The structuring of business combinations with other firms through mergers and acquisitions (M&A), amalgamations, joint ventures and strategic alliances is the major external growth route versus internal organic growth and offers the firm intent on growth with the strategic opportunities and combination vehicles to realise its defined corporate vision and objectives through the implementation of specific combination strategies. This thesis provides a strategic planning framework for the structuring of business combinations based on empirical research of the combination decision-making process in South African acquiring firms as well as relevant principles in strategy theory.

1.1.1 Review of business combination activity in South Africa within a macroeconomic context during the period, 1991-2001

The research has, as a first focus, a review of corporate combination activity in South Africa within a macroeconomic context, which takes a long-term view of business combination activity through mergers, acquisitions and other combination vehicles over the period, 1991 to 2001. The relevant characteristics of the South African economy as a background context affecting combination activity are indicated as well as selected economic factors, which are directly and indirectly affecting the nature and level of combination activity. The relationship dynamics of these economic factors with business combination activity is statistically examined. The review highlights the trend of refocusing by large corporates and the concomitant unbundling of corporate combination structures that occurred in South Africa from 1993 onwards as well as the internationalisation or offshore expansion by large South African acquiring firms during the second half of the period under review. The key economic and business drivers affecting the level of combination activity over the period are identified and the specific combination vehicles that were utilised to effect business combinations are highlighted.

1.1.2 Descriptive role in respect of the business combination decision-making process

The research has, as a second focus, a descriptive role in respect of the decision-making process within the acquiring firm facilitating the structuring of business combinations. This decision-making process

encompasses in scope the motivation or intent to structure business combinations with other firms in the corporate strategy of the firm, the formulation of a specific combination strategy, the organisation of the combination function in the firm to manage and accomplish external combination, as well as the eventual integration and post-combination management of the combining firms. Activities such as the selection of the suitable combination vehicles to be utilised, the decision on the desired level of control, the appropriate structural fit with the corporate body, the definition of an ideal combination profile, the screening and selection of combination or acquisition targets, the subsequent negotiations with the target firm and, if successful, followed by the integration of the merger of the acquired firm, are other key elements of this process.

In most acquiring firms the corporate combination decision is not a sudden ad hoc decision, but is part of a process that entails considerable management deliberation, planning and analysis. Each acquiring firm has an approach to this combination decision-making that provides the rationale for organising its combination activities in a certain way. The business combination decision-making process is unique to each firm's management style, corporate culture and strategy. The descriptive research explains the nature and functionality of the various constituent activities in this process based on interviewing in South African combination-active firms, that is summarised in empirical research models describing specifically how acquiring firms manage their business combination decision-making processes.

1.1.3 Prescriptive contribution in terms of a strategic planning approach to the structuring of business combinations

The third thrust of the study is a prescriptive contribution in terms of a strategic framework for the planning and structuring of business combinations. This strategic approach emphasises the crucial role of setting corporate direction through a vision defining the desired future, a mission statement describing the business growth direction and defining the business focus, as well as the consideration of alternative combination strategies that may be implemented through the utilisation of the suitable combination vehicle, the right level of control, and the appropriate integration with the acquiring firm.

This strategic framework provides the various role-players in the planning, analysis and consummation of a business combination with an overall systemic context within which they can plan and fulfil their own function more efficaciously and effectively. Researchers (Jemison and Sitkin, 1991) with a process approach to business combinations have indicated that a range of role-players such as management from diverse functions in the firm and a variety of specialists, some external and from different expert fields, are involved in this decision-making process. This often results in fragmented and ambiguous perspectives amongst the participants. The strategic framework outlined in this thesis provides corporate management and other role-players with systemic and systematic insights enabling

them to efficaciously execute their planning, evaluation and structuring of a specific combination or a programme of business combinations.

1.2 OBJECTIVES OF THIS CHAPTER

This first chapter serves as an introduction to the structuring of business combinations, strategy approaches and concepts as well as the decision-making process facilitating business combinations in the acquiring firm at the corporate level. The first objective is to introduce the various structural vehicles and their definitions through which business combination can be accomplished. The second objective is to indicate the significance of the combination decision-making process and to highlight the contribution of the process perspective.

To make a sound contribution in respect of a strategic planning approach to the business combination decision-making process, it was considered essential to introduce some of the central approaches and concepts in strategy formulation. The strategic motivation of business combinations in the acquiring firm is a key driving determinant in combination decision-making and therefore another objective is to provide a brief description of the generic corporate strategies practised, that were previously highlighted in the strategic management literature. Finally, a few special roles of business combinations in corporate strategy are indicated.

1.3 DEFINITION OF BUSINESS COMBINATION TERMINOLOGY

In this thesis 'business combinations' and 'the structuring of business combinations' are preferred as the descriptors to describe the result and process respectively of the linking of two or more firms through mergers, acquisitions, amalgamations, consortiums, joint ventures and strategic alliances in a close relationship. Business combination may result in a 'combination structure', which is a combination of two or more firms characterised by a holding company and subsidiary relationship. There may be more than one tier of holding companies, and usually there is more than one subsidiary firm linked up in the structure. Forms of combination structures are generally referred to as 'groups' and also 'alliances' in academic and business literature (Kantor, 1998:70). These business combination phenomena are characterised by an equity holding relationship between the combined firms. The following are established forms of business combinations:

Merger. This refers to the combination of two firms that may comprise the absorption of one firm by another. The acquiring firm retains its name and identity and it acquires all the assets and liabilities of the acquired firm. The acquired firm ceases to exist. Stock may be issued directly to the owners of the absorbed firm through a negotiated exchange agreement (Ross, Westerfield and Jaffe, 1990:768). This definition is in line with a definition later by Gaughan (2002:7) describing a merger as a combination of

two firms in which only one corporation survives and the merged firm goes out of existence. A subsidiary merger is a merger of two companies in which the target firm becomes a subsidiary or part of a subsidiary of the parent firm.

In respect of a merger, a distinction may be made between a merger through absorption and a merger of equals as occurred in the 1980s and 1990s through the large-scale combination of two firms of about equal size. In a merger through absorption the acquired firm loses its entity in the acquired firm. In a merger of equals the name of both firms are retained in the new entity, there is equal representation on the new board of directors, and an arrangement of equality as far as possible in terms of the position of chief executive officer and top management is negotiated.

Amalgamation. ('Consolidation' in American combination terminology). In this case two or more firms combine assets and liabilities in an entirely new firm and the combining firms cease to exist as individual corporate legal entities. The new firm becomes a legal entity in its own right (Ross, et al, 1990:768). This definition is still valid as confirmed by Gaughan (2002:7) describing a consolidation as a business combination whereby two or more firms join to form an entirely new firm.

The difference between a merger, a merger of equals, and an amalgamation may be described in the following terms: a merger is $A + B = A$, a merger of equals $A + B = AB$, and an amalgamation $A + B = C$, where C is an entirely new firm. Despite the differences between these terms, merger and amalgamation are sometimes used interchangeably. The term, merger, remains the more frequently used term to indicate a combination of business organisations as well as the combination of internal organisational units in a combined entity.

Holding company - subsidiary relationship through the acquisition of stock. The acquisition of stock in another firm may result in the following equity holding relationships representing the following forms of business combination:

- (i) *Subsidiary.* According to the South African Companies Act a company is deemed to be a subsidiary of another company if that other company is a member of it; and a) holds a majority of the voting rights in it; or b) has the right to appoint or remove directors holding a majority of the voting rights at meetings of the board; or c) has the sole control of a majority of the voting rights in it (Strydom, 2002:6).
- (ii) *Holding company.* According to the Companies Act a company is deemed to be a holding company of another company if that other company is its subsidiary (Strydom, 2002:6).
- (iii) *Pyramid company.* A pyramid company is one whose major or only asset consists of a controlling (that is more than 50%) shareholding in another company. If the holding

company owns 50% or more of another company, it can exercise full control over its subsidiary company. Thus a shareholder with 50% of the votes in a holding company that owns 50% of another company has effective control of both. Control of the second, or subsidiary firm, can be exercised with 50%, or just 25%, of the claims to the cash distributed by the subsidiary (Barr, Gerson and Kantor, 1995: 23-24). This form of control later became unpopular in the market and was prohibited by the rules of the Johannesburg Stock Exchange.

The acquiring firm may in terms of the above definitions choose to purchase only a portion of the target's stock and act as a holding company, which is a company that owns sufficient stock to have a controlling interest in the target through the voting rights. Holding companies trace their origins back to 1889 in the United States when New Jersey became the first state to pass a law that allowed companies to be formed for the express purpose of owning stock in other firms. If an acquirer buys 100% of the target, the acquired firm is called a wholly owned subsidiary. It is possible to acquire effective control with as little as 10% to 20% of the outstanding common stock of the target firm when it has a widely distributed equity base (Gaughan, 2002:18).

Consortium. In the case of a partnership between two or more firms this type of business combination is described as a consortium. The most common form of this practice is where two or more firms act together to acquire a joint shareholding in another existing firm or establish a joint shareholding in a new firm (Cilliers and Benade, 1992: 34).

Joint venture. Two or more firms that combine resources in a joint project for a limited time period accomplish a joint venture. Firms commit complementary resources to the project; for example, the one firm could supply a range of quality products and the other the marketing expertise to distribute the products through its distribution channels. In another situation one firm could provide the financing while another firm contributes physical assets or technological expertise (Gaughan, 2002:19). A distinction in business is made between project joint ventures (such as joint construction ventures) and equity or company joint ventures. In a company joint venture two firms combine resources and establish a joint shareholding in a newly formed company.

Strategic alliance. In this form of business combination two firms at the parent or holding company level acquire a cross holding of equity in each other (usually a minority shareholding) and effect mutual cooperation in possible areas such as research and development, production, distribution of products and improved marketing, for example, by sharing information about each other's client base (Lynch, 2000: 505). The term is mostly used to denote other forms of collaboration between two firms. In this meaning it is a more flexible concept than a joint venture and refers to a myriad of arrangements

between firms whereby they work together for varying periods of time to accomplish a specific goal. This is a weaker contractual agreement and usually falls short of the formation of a separate subsidiary. An organisational entity is not created with a strategic alliance, whereas it is in a joint venture (Gaughan, 2002:21).

There are other forms of combining firms that do not in most situations result in an equity relationship between separate entities, but a combination of firms or merging of resources is effectively utilised in the implementation of corporate objectives and strategies. These other forms of business combination include the following:

Partnership. A partnership is a legal relationship arising from an agreement between two or more persons, not exceeding twenty, each to contribute to an enterprise with the objective of making profits and to divide such profits. The contribution may be money, or rights, or labour, or skill. One firm may enter into partnership with natural persons or legal persons. A partnership can be affected between independent firms, and also between full subsidiaries within a group (Cilliers and Benade, 1992: 34).

Acquisition of assets. This is accomplished by the outright purchase of all or part of the assets of another firm. The acquisition of assets involves transferring the title to assets, and a formal vote of the shareholders of the selling firm is required. The assets are absorbed in an existing firm (Ross et. al., 1990: 769).

Acquisition of a block of business. This involves the buying of a piece of existing business from another firm. This may be existing contracts with established clients and does not include any physical assets. There is also no transfer of liabilities.

Licensing. Licensing refers to the granting of another firm the right to produce and distribute a product or trade name to which the licensing firm has the sole right. It may involve the provision of technology and other assets of the licensing firm under license (Lynch, 2000: 585).

Franchising. Franchising refers to a contractual license granted by one firm (the franchiser) to another (the franchisee) which permits or requires the franchisee to carry on a particular business under or using a specific name belonging to or associated with the franchiser. It may include a brand name, technical service expertise and some advertising assistance (Lynch, 2000: 583).

1.4 THE BUSINESS COMBINATION DECISION-MAKING PROCESS

The decision to structure a business combination is generally not a sudden ad hoc decision, but involves in most cases a process that entails considerable deliberation and analysis by management.

A number of organisational factors add to the complexity of this process. Large corporate firms are generally highly structured with a chain of command spanning different organisational levels that functions on a formal and informal basis. The combination decision-making process requires participants from different levels in this organisation to work together towards this specific purpose. This may involve the board of directors, chief executives at corporate level, operating executives of business units, specialist corporate staff and outside participants such as accountants, lawyers and merchant bankers.

Most combination decisions require a significant amount of information gathering and effective communication to all participants. To complicate matters further a given combination requires not just one decision, but a set of decisions made over a period of time. The merger or acquisition situation sometimes requires decision-makers to make prompt decisions without the luxury of time to gather necessary information to reduce the risk. The decisions call for approval at different executive levels, such as corporate and divisional executive levels, and by management responsible for different functions such as finance, strategic planning and business development. Since the nature and structure of a decision-making process significantly affect the outcome and given the complexity of the business combination decision-making process, the eventual combination decision is likely to be considerably determined by the way in which this process is organised and managed in a specific firm.

Each specific firm has an approach to this decision-making process that is unique to its management style, corporate strategy, organisational structure and culture. Scholars such as Jemison and Sitkin (1986) have put forward the view that precisely this process can be the cause of the poor performance record of combinations. Firms that fail to perform vital tasks such as adequate corporate resource analysis, accurate synergy potential assessment as well as integration planning and management may not make a successful combination.

1.5 THE PROCESS PERSPECTIVE TO THE STRUCTURING OF BUSINESS COMBINATIONS

Haspeslagh and Jemison (1991) have indicated that the quality of the combination decision-making process has a substantial impact on the eventual decision and the subsequent results of the combination. These authors advocated a process perspective that represents a clear contrast to the conventional view of combinations.

The conventional view of combinations sees combination decision-making as a sequential, segmented process in which the key elements are financial evaluation and the pre-combination analysis of strategic fit. The corporate manager is portrayed as a rational decision-maker surveying an efficient market place for strategically advantageous combination opportunities and analysing these

opportunities in a systematic manner. Most combination research has employed such a rational choice perspective. Such research has had two emphases: a narrow focus on strategic fit and an expanded focus that includes both strategic and organisational fit. Research concerning strategic fit has emphasised strategic analysis and negotiation during the pre-acquisition period, focusing on the analysis of strategic fit between acquiring and target firms in the light of general industry and market or technology-related issues (Rappaport 1979; Salter and Weinhold, 1981). Issues such as organisational fit and post-combination integration have received considerably less attention. Most research on corporate combinations before the 1980s has been prescriptive in simply asserting the importance of considering strategic and organisational fit, the relevance of involving key people in the process and focusing on successful and unsuccessful practices.

The process perspective argued by scholars Jemison and Sitkin (1986) has recognised that the combination process itself is a potentially important determinant of combination activities and outcomes. They demonstrated this argument by indicating four impediments present in the process that can result in the inadequate or misuse of strategic and organisational issues, indirectly affecting combination outcomes. These identified factors are problems of fragmented perspectives amongst the various role-players, escalating momentum to get the transaction done, expectation ambiguity and multiple management motives involved in the combination decision-making process. The process perspective emphasises the importance of the organisational processes through which corporate managers consider combination opportunities. It argues that the organisational structures and routines the firm employs in facilitating the combination decision-making affect the quality of the combination decision and the outcome of the combination. For example, whether a firm employs a full-time department with acquisition specialists or contracting the services of outside specialists, it requires different management approaches influencing the eventual selection and performance of the combination. The organisational structures employed in integrating the acquired firm within the current structure of the acquiring firm may also significantly affect the outcome or combination success.

Haspeslagh and Jemison (1991) have asserted that adopting a process perspective shifts the focus from a combination's results to the drivers that cause these results such as the transfer of capabilities from the acquirer to the target to build competitive advantage. In this process perspective combinations are not seen as independent one-off deals. The transactions themselves are not seen as bringing the expected benefits; instead the actions and activities of the managers after the agreement determine the results. In contrast with the conventional view that presumed that the value of a combination can be understood and predicted accurately at the time of the agreement, the process perspective emphasises the role that the dynamics of the combination decision-making process plays in helping corporate management understand how value will be created.

Combination decision-making and integration processes present separate unique problems and opportunities. Their interactive nature requires that issues arising during these processes be considered together. Practitioners of the conventional view often delegated post-combination decision-making and integration to managers who were excluded from the pre-combination decision process for reasons of secrecy or lack of status. The process perspective recognises that the problems that acquiring firms experience with combinations are not always to be attributed to individuals or to a lack of insight into what should be done. Instead, these problems are seen to be embedded in the organisational processes by which managers handle these issues. In many firms the decision-making approaches and techniques through which combinations are examined, as well as the organisational mechanisms used to integrate them, were not developed for making decisions about combinations in the first place. Structuring combinations with external firms is indeed a severe test of a firm's organisational capabilities.

This emphasis on the process in strategy formation is in line with a distinction made by scholars Pettigrew and Whipp (1991:26), who argued that in most situations corporate strategy is not simply a matter of taking a strategic decision and implementing it. It often takes a considerable time to make the decision and then another delay before it comes into effect. People at different organisational levels are involved and they may choose to apply their own business judgement to implement a chosen corporate strategy. They may influence both the initial decision and the subsequent actions that will implement it. For this reason these authors made a distinction between process, content and context in strategy formulation and implementation.

In strategy formulation every strategic decision involves these three elements, which must be considered separately, as well as together:

- *Process.* How the decisions and actions link together or interact with each other as strategy is formulated and unfolds against what may be a changing environment.
- *Content.* The main decisions and actions of the proposed strategy form the content. This includes the setting of strategic directions, particular strategic thrusts and the programming of the strategies.
- *Context.* This refers to the environmental context within which the strategy operates and in relation to which the strategy is developed.

Lynch (2000:23) agrees with this emphasis on the process and pointed out that in most corporate strategy situations the context and content are reasonably clear. It is the way in which strategy is developed and enacted – the process – that causes the problems. Processes are often vague and

quixotic because they involve people. The strategic framework and concepts used to guide the process of strategy development have a significant effect on the content of strategy. The process that is followed or facilitated in acquiring firms often determines the strategy, for example, the strategy facilitators or corporate advising firm would influence the content of acquiring strategy adopted. These considerations underline the need for the careful organisation of the combination decision-making process to maximise the achievement of the desired results.

1.6 APPROACHES AND CONCEPTS OF STRATEGY

This section describes some of the core approaches and concepts advanced in the strategy literature. It is essential that the most relevant approaches and concepts be positioned in the foreground here in order to provide a sound contribution to the strategic approach apropos the structuring of business combinations. This is not attempted comprehensively or in detail since it is not the primary focus of this study. Firstly, different strategy formulation approaches are discussed and then a few central approaches to the process of strategy formulation itself are highlighted. Then several key activities in a strategic planning process as well as alternative strategic planning techniques are indicated. Thereafter the different levels that strategy formulation and implementation is practised in an organisation are identified, and lastly, a few relevant concepts of corporate strategy are provided.

These concepts and principles of strategy are applied in chapter five presenting the strategic framework for the business combination decision-making process. A few finer strategic planning techniques that may be utilised in the strategic planning of business combinations are also indicated in the same chapter.

1.6.1 Strategy Formulation Approaches

1.6.1.1 The design school

A vast and diverse range of literature on strategy formulation has been generated since the middle 1960s. A good deal of this literature naturally divided itself into distinct schools of thought. The most common and entrenched of these schools is known as the design school. This constituted the dominant view of the strategy process at least into the 1970s. Its basic principles underlie almost all prescription in the field of strategy formulation and accordingly had enormous impact on how strategy and the strategy-making process are conceived in practice as well as in research. The design school's best-known proponents described the essential concept of strategy formulation as that of congruence or match: "The strategic alternative which results from matching opportunity and corporate capability at an acceptable level of risk is what we may call an economic strategy" (Bower, Bartlett, Christensen, Pearson and Andrews, 1991:109).

—The design school model placed primary emphasis on the appraisals of the external and internal situations, the former uncovering opportunities and threats in the environment, the latter revealing strengths and weaknesses of the organisation. Secondary emphasis was placed on understanding both the values of management and its social responsibilities. The match between these elements leads to the creation of strategies, which are then evaluated, with the chosen one implemented. The actual generation of strategies is thus a creative process of utilising distinctive capabilities to take the best advantage of opportunities.

1.6.1.2 The planning school

The planning school grew in parallel with the design school, but in sheer volume of publication, predominated by the mid-1970s and though it faltered in the 1980s, continues to be an important influence today. The planning school reflects most of the design school's assumptions, except that the process was not just cerebral but formal, decomposable into distinct steps, delineated by checklists, and supported by techniques with regard to objectives, budgets, programs, and operating plans. This meant that staff planners replaced senior managers de facto as the key players in the process (Mintzberg, Ahlstrand and Lampel, 2000:11).

1.6.1.3 The positioning school

The third of the prescriptive schools, commonly labelled the positioning school, was the dominant view of strategy formation in the 1980s. It was given impetus especially by Michael Porter in 1980, following earlier work on strategic positioning in academia and in consulting by the Boston Consulting Group (BCG) as well as the Profit Impact Marketing Strategy (PIMS) project, all preceded by a long literature on military strategy, dating back to 400 BC and that of Sun-tzu, author of 'The Art of War' (Mintzberg, Ahlstrand and Lampel, 2000:11). In this view strategy is reduced to generic positions selected through formalised analysis of industry situations. The positioning literature grew in all directions to include strategic groups, value chains, game theories, and other ideas, but always with an analytical bent.

BCG has presented three analytical frameworks: the experience curve, the product life cycle, and the portfolio matrix. Analysis on the basis of these frameworks leads to the development of suitable strategies. The experience curve represents a volume-cost relationship. It is argued that as cumulative historical volume of output increases, unit costs will fall at a geometric rate. This is asserted to result from specialisation, standardisation, learning and scale effects. The firm with the largest cumulative output will therefore have lower costs suggesting a strategy of early entry and price policies to develop volume. The product life cycle holds that every product or line of business proceeds through four phases: development, growth, maturity and decline. During the first two phases sales growth is rapid

and entry into an industry is easy. As individual firms gain experience and as growth follows in the last two stages, entry becomes difficult because of the cost advantages of the incumbent firms. In the decline phase sales and prices decline and firms, which have not achieved a favourable position on the experience curve, become profitable and either merge or exist from the industry.

Related to the product life cycle is the concept of portfolio balance. In the early stages of the product life cycle, rapid growth may require substantial investments. Such business segments are likely to require more investment funds than are generated by current profitability levels. As growth requirements diminish, profits may generate more funds than required for current investment requirements. Portfolio balance seeks to combine attractive investment segments (stars) with cash-generating segments (cash cows), eliminating segments with unattractive prospects (dogs). Overall the purpose is to balance corporate cash inflows with total corporate investments (Henderson, 1998:35).

1.6.1.4 Adaptive processes

Other writers such as Ansoff (1987), Steiner (1979) and Rumelt (1974) viewed strategy more as an adaptive process or way of thinking. They argued that a firm's competitive position is defined by a bundle of unique resources and relationships and that the task of general management is to adjust and review these resources and relationships as time, competition, and change erode their value. In general the orientation of adaptive processes involves matching resources to investment opportunities under environmental uncertainty compounded with uncertain competitor's actions and reactions. The methodology for dealing with these kinds of 'ill-structured problems' requires an iterative solution process. This is performed through undertaking iterative checklist procedures. It involves processes rather than closed form mathematical solutions. It involves ways of thinking, which assess competitors' actions and reactions as well as the changing environment.

The adaptive process methodologies emphasised the use of checklists to stimulate insights, as did the BCG and Porter approaches, which relied heavily on similar techniques. The process of strategic planning thus includes the art of making checklists, going around the loop iteratively, with the expectation that the thinking stimulated will lead to useful insights and sound strategies and decisions.

1.6.1.5 Logical incrementalism

After extensive field interviews studying the change processes in major organisations Quinn (Quinn and Voyer, 1996:96) concluded that effective strategies tend to emerge incrementally and opportunistically, as subsystems of organisational activity, for example, acquisitions, divestitures, major reorganisations, even formal plans, are blended into a coherent pattern.

1.6.1.6 Muddling through

This represented another form of the incremental approach. Lindblom (1979:517) called the approach 'muddling through'. He also used the term 'disjointed incrementalism' to describe the process. The basic prescription is that instead of attempting an evaluation of a wide range of alternatives, decision-makers should focus only on those policy alternatives that differ incrementally from existing policies. An iterative process is then employed to formulate and implement decisions.

1.6.1.7 The Porter approach to strategy

Porter has elaborated his approach in a number of writings (Porter, 1980, 1985, 1987). His approach to strategy development can be summarised as follows: select an attractive industry, develop competitive advantage through cost leadership or product differentiation, and develop attractive value chains to develop and sustain the competitive advantage.

Porter defined an attractive industry or strategic group as one where entry barriers are high, suppliers and buyers have only modest bargaining power, substitute products or services are few and the rivalry among competitors is stable. Secondly, Porter formulated a matrix for developing generic strategies. According to this the development of competitive advantage may be based on cost leadership or on product differentiation. Cost advantage may be achieved by consideration of a wide range of checklist factors including BCG's learning curve theory. The focus of developing cost advantage or product differentiation may be on narrow market segments or niches, broader market groups or across all segments.

Porter's third key concept was the 'value chain'. A matrix relates support activities such as infrastructure, human resource management, technology development and procurement to the primary activities viz. inbound logistics, operations, outbound logistics, marketing/sales and service. The aim is to minimise outlays in adding characteristics valued by customers and thus achieve the desired profit margin.

1.6.1.8 Core competence and strategic architecture

In 1990 Prahalad and Hamel (1990:79) introduced the enormously influential concepts of core competence and strategic architecture to the field of strategy. Core competence was described as "the collective learning in the organization, especially how to co-ordinate production skills and integrate multiple streams of technologies". Although this collective learning across the levels and functions of a firm incorporates a technology component, it also involves the governance process inside the organisation – the quality of relationships across functions within a business unit or across business units within a multi-business firm. Competence can thus be conceptualised as: Competence =

(Technology × Governance process × Collective learning). Prahalad and Hamel (1994:263) asserted that the corporation should be modelled as a portfolio of competencies with a strategic architecture that serve as a road map of the future and identifies which core competencies and core products to cultivate and build – the essence of the firm's long run competitiveness.

These authors pointed out the importance of articulating the firm's aspirations in a 'strategic intent' that will stretch the imagination of the total organisation. Strategic intent provides a way of creating an obsession with winning in the marketplace that should be translated into a shared competitive agenda that is sustained over a long period of time. The Apollo program's goal of putting a man on the moon by the end of the decade was a good example of the power of defined strategic intent.

1.6.1.9 The resource-based view of the firm

With the insight of the core competency framework corporate managers started to view their firms as a portfolio of competencies and not just portfolios of businesses. Their role was to nurture these competencies and deploy them into the businesses as a source of value creation. However, the meaningful application of the core competence concept was difficult because of the generality of its level of analysis and the absence of specific prescriptions. As a result advances in corporate strategy in the nineties shifted back in the academic arena to the articulation of the resource-based view of the firm. The proponents of the resource-based view emphasised that there is 'no one right strategy'. Instead, an effective corporate strategy is a consistent set of the five elements – resources, businesses, structure, systems and processes – which are the foundations of corporate strategy. When aligned in pursuit of a vision, and motivated by appropriate goals and objectives, this system can produce a corporate advantage, which justifies the firm's existence as a multi-business entity (Collis and Montgomery, 1997:7).

The resource-based approach to strategy formulation advocated that strategy development should be driven by the nature of the firm's special resources in its assets, skills and capabilities. It may range from highly specialised to very general. According to this approach a firm's location on the continuum constrains the sets of businesses it should compete in and should therefore be the key consideration in selecting new businesses rather than similarities in products (Collis and Montgomery, 1998:72).

1.6.2 Different approaches to the process of strategy formulation

A fundamental disagreement exists among strategy authors and commentators over the way that strategy may be developed. These different views on the process, content and nature of strategy have arisen because of the breadth and complexity of the subject as well as the fact that strategy in practice is influenced by constraints in resources and the environment in which it is operating. The overall

distinctions have been summarised by Lynch (2000:22) as representing two main process approaches to strategy development:

- *The prescriptive approach:* Some commentators have judged strategy to be essentially a linear and rational process, starting with where-we-are-now and then developing new strategies for the future. A prescriptive strategy is thus one whose objective has been defined in advance and whose main elements have been developed before the strategy commences. The design school proponents fit in this category.
- *The emergent approach:* Other commentators have taken the view that strategy emerges, adapting to human needs and continuing to develop over time. It is evolving, incremental and continuous, and therefore cannot be easily or fully summarised in a plan, which then requires being implemented. Emergent strategy is thus a strategy whose final objective is unclear and whose elements are developed during the course of its life, as the strategy proceeds.

The strategic planning guru, Mintzberg (1994:401), saw merit in both approaches. He thought that both approaches can make a contribution and are not mutually exclusive. In many respects, they can be said to be like the human brain, which has both a rational left side and an emotional right side. Both sides are needed for the brain to function properly. It can be argued that the same is true for the strategy formulation approach. It remains, however, essential to develop strategies and written plans to have a consistent framework for the various players who need to implement these strategies and plans. These may later be updated to adapt to changing external conditions and internal situations. The prescriptive approach is especially relevant to expansion through the structuring of business combinations. The acquiring firm needs to have a definite view on the strategic direction, objectives, suitable combination vehicles and strategies that will be utilised to make business combination successful.

1.6.3 Key activities in strategic planning

Many different theories and approaches to strategy formulation and planning have thus been presented in the literature. As is evident from the preceding section there is wide diversity in these strategic planning approaches. Some common elements required for a strategic planning process in general could, however, be identified. The following are a number of different activities and aspects common to strategic planning approaches:

Scanning external environments. A key activity in all approaches to strategic planning is the need for the continuous scanning and monitoring of the external environment. Environmental scanning should

encompass both domestic and international dimensions and include analysis of the macro and microenvironments of the organisation. The macro environment refers to external political, economic, social, technological, demographic, regulatory/legal, and physical factors. The microenvironment is specific to the organisation and includes the relevant industry, competitors, suppliers, markets and clients of the firm. Business organisations give different emphasis and weight to each of these categories depending on their business nature and scope.

The objective in scanning all relevant environments is to observe and identify pertinent changes in these environments, which could potentially impact on the firm's operations and performance. These changes are recognised as significant and described as an opportunity or threat depending on whether it could potentially influence the firm's performance positively or negatively. The deployment of resources to achieve strategic objectives should be aligned to take advantage of environmental opportunities and counter negative forces.

Internal resource analysis. The internal analysis of the resources and capabilities of the firm is an essential step in analysing the current position of the firm. This self-analysis usually includes all relevant elements in the firm's make-up such as the financial, marketing, technological, production, distribution, as well as management capacities and capabilities. This evaluates the relative strengths and weaknesses of the firm versus its competitors. The results of an internal self-analysis of resources are crucial information for strategy formulation, since they provide the basis for the development of the required human competencies and needed organisational capabilities. This usually receives considerable management focus, since these variables are within the direct control of management. External environmental factors on the other hand are predominantly uncontrollable.

Strategic fit. This refers to the extent to which the resources and distinct capabilities of the firm are equipped and aligned to exploit market opportunities and overcome negative forces in the environment. Realising this fit necessitates adaptive processes with appropriate resource leverage to ensure that maximum advantage is taken of opportunities and that threats are countered optimally by utilising the firm's specific strengths and eliminating weaknesses.

Formulation of vision, mission, objectives and policies. The vision statement is a formulation of the desired future state of the organisation. This usually long-term sketch of where the organisation wants to go and what needs to be achieved is outlined in broad terms and described in more detail in long-term strategic objectives. The mission statement defines the *raison d'être* or the business the firm wants to be in. Policies that will guide decisions in respect of the efficacious implementation of the strategies that are to be employed to achieve the identified desired future, are accordingly formulated.

provides a useful starting point for developing a strategic thinking process and to enhance strategic planning in an organisation. In practice it involves the risk that it may remain a static identification of SWOT factors without continuing to consider the dynamic leverage of strengths and the elimination of weaknesses to take advantage of opportunities.

Competitive analysis. A number of approaches to competitive analysis have been developed, most notably by Porter (1980). He laid the analytical foundation for the development of competitive strategy, built on the analysis of industry structure and competitors based on industrial organisation theory. The concept of structural analysis is utilised as a framework for understanding the five fundamental forces of competition in an industry. The five competitive forces – threat of new entrants, threat of substitution, bargaining power of buyers, bargaining power of suppliers and rivalry among current competitors – jointly determine the intensity of industry competition and profitability. Once the forces affecting competition in an industry and their underlying causes have been diagnosed, the acquiring firm is in a position to identify its strengths and weaknesses relative to the industry opportunities.

Scenario planning. Scenario planning is the process of constructing alternate futures of an organisation's external environment. The goal is to learn to use these alternative features to test the resilience of current strategies. The basic idea in scenario-construction is to identify existing trends and key uncertainties about the future and combine them into a few future worlds that are internally consistent and within the realm of the possible. The purpose of scenarios is not to cover all eventualities but to discover the boundaries of future outcomes. Organisations confronted with major uncertainties, life-threatening competition or sudden discontinuities find the scenario method especially useful. The development of scenarios stimulates managers to think together in systematic and disciplined ways.

Synergy. Ansoff (1987:79) described synergy as one of the major components of the business organisation's product-market strategy: "It is concerned with the desired characteristics of fit between the firm and its new product-market entries. In business literature it is frequently described as the '2+2 = 5' effect to denote the fact that the firm seeks a product-market posture with a combined performance that is greater than the sum of its parts". Business combinations are often motivated by the scope for synergy, referring to the combined revenues, resources and product-markets of two or more firms presenting opportunities for economies of scale, scope and market power.

Comparative histories. This methodology is widely used by many organisations in monitoring the competitive behaviour of their rivals. Chandler (1962) used it in a fundamental research mode in an analysis of the interrelationships among the economic environments of firms, their strategies, and their

organisation structure. Chandler compared the history of organisational changes among fifty large firms in the United States. From his studies he developed theories about the relationship between a firm's strategy and its organisation structure at various stages of development. Individual firms continuously monitor the strategies, actions and reactions of rivals.

Delphi technique. The technique involves the development of a questionnaire to obtain information on problems or issues from informed individuals. The responses are summarised into a feedback report and returned with a second questionnaire designed to probe more deeply into the ideas generated by the first questionnaire. Several iterations can be performed to develop key conclusions about the subject focus.

Computer models. Computer models provide the opportunity for considerable detail and complexity in analysing financial scenarios of alternative strategies. However, the models must reflect a theory or logic to guide their content. Otherwise, there is a great risk that the methodology will be overwhelmed by the resulting complexity.

Discussion group technique. In a discussion group situation the group leader begins with a statement of the problem. An unstructured group discussion ensues for the purpose of generating ideas. Information and judgements are generated. The goal is to reach a consensus decision or to make a decision on the basis of a majority voting procedure. It is popularly called brainstorming.

Top-down versus bottom-up forecasts. Management sets objectives on the basis of planning premises formulated at the overall corporate level. These planning premises begin with the outlook for the economy and the industry, translated into what appears plausible for the particular firm given its current market share. The planning premises are supplied to the respective business unit management who use them as a basis for their own individual forecasts. The individual segment forecasts are then aggregated to provide an outlook for the firm as a whole. Meetings and discussions between the corporate level and the individual segments take place. A communication process is developed and iterations of meetings continue until a consensus is reached. The desired goal is a business plan that is understood and reasonable from the standpoint of the various segments and results in an overall firm outlook that is satisfactory from the view of top management.

1.6.5 Corporate strategy and strategy levels

Strategy is formulated and practised at different levels of management in the firm. Over the years a multitude of different definitions of corporate strategy have been developed. One of the most extensive definitions came from Andrews, one of the so-called 'first wave' of strategists in the design school (Andrews, 1987:13):

Corporate strategy is the pattern of decisions in a company that determines and reveals its objectives, purposes, or goals, produces the principal policies and plans for achieving those goals and defines the range of business the company is to pursue, the kind of economic and human organisation it is or intends to be, and the nature of the economic and non-economic contribution it intends to make to its shareholders, employees, customers, and communities.

This definition of strategy as a pattern of decisions is in line with Mintzberg's concept of 'strategy as a pattern of actions' (Mintzberg, 1994:23) that implies that strategy emerges from consistency in behaviour. The strategic decisions contributing to this pattern are effective over long periods of time and affect the organisation in many different ways. They also focus and commit a significant portion of its resources to the expected outcomes.

The above definition of corporate strategy refers to the strategy that guides the overall activities of the corporation and does not specifically define strategy as practised at the corporate or top level in the firm. 'Corporate strategy' in this thesis refers to the latter concept and is given more explicit definition in the following paragraph.

Corporate strategy. Corporate strategy is the strategy formulated by general management at the corporate or top level and is their overall managerial plan for running and directing the business organisation as a whole; as such it cuts across all of the firm's activities – its different businesses, the divisions, product lines, and the technologies utilised (Thompson and Strickland, 1996:37). Corporate strategy has three main dimensions. Firstly, corporate strategy manages the scope and mix of the firm's various activities in order to improve corporate performance. This managing of the corporate business portfolio require decisions and actions regarding both when and how the firm should get into new businesses and what role external combination through acquisition or joint venture will play; which existing businesses the firm should get out of; and what corporate management should do to improve the performance of the overall corporate portfolio.

In a second dimension corporate strategy coordinates the different businesses in the overall portfolio and manages them for maximum synergy. Effective coordination of the interrelated activities in a diversified firm enhances the competitive strength of its business units. This management of synergy in a multi-business firm with various operating companies is critical for optimising the performance of the businesses in the combined structure.

In a third dimension the corporate strategy establishes investment priorities and allocates corporate resources across the firm's different activities. With limited resources it is essential to channel investment capital to those strategic business units with the highest expected profitability, and to deploy the available internal resources according to the success requirements of each business unit.

Business unit strategy. Business unit strategy is the divisional management's plan for directing and running a particular business unit. Business strategy deals explicitly with how the firm intends to compete in that specific line of business, coordinating the key functional areas in the business unit to develop a sustainable competitive advantage, developing responses to changing environmental conditions and controlling the pattern of resource allocation within the business unit. The central thrust of business strategy is therefore how to build and strengthen the firm's long-term competitive position in the marketplace (Thompson and Strickland, 1996:41).

In a single business firm corporate strategy and business strategy becomes the same thing, except when the firm begins to plan for diversification. A single business firm has only one business focus and there are therefore no decisions on the scope of the firm's business involvement. The distinction between corporate strategy and business strategy is therefore mainly relevant for firms that have diversified into more than one industry.

Functional area strategies. Functional area strategies are the plans for managing the principal activities within a business. The functional strategies for marketing, promotion and distribution; production or manufacturing; financial functions; human resources and labour relations; research and development/technology each explicitly indicate the contribution of such activity to the overall corporate and business unit strategy.

Operational strategies. Operational strategies refer to the strategic approaches and initiatives for managing key operating units (plants, sales units, distribution outlets) and for handling daily operating tasks with strategic significance such as advertising campaigns, materials purchasing, maintenance, and distribution. Operational strategies, while of lesser scope than the higher levels of strategy making, add relevant detail and completeness to the overall strategy.

A strategy is well formulated if it complements and executes corporate strategy, is well aligned with its co-strategies on business unit level, and if it is consistent and interlocks smoothly with its fellow strategies on functional and operational level. The power of strategy in a multi-layer organisation depends on the synergy and the extent to which the strategies of various organisation levels augment each other. Management at the different levels in the firm should therefore ensure that strategies are consistent and that corporate strategic priorities are fed into lower levels of planning.

1.7 GENERIC CORPORATE STRATEGIES MOTIVATING THE STRUCTURING OF BUSINESS COMBINATIONS

The generic corporate strategies described in this section are not intended to be described in detail, but are related specifically to the structuring of business combinations and are therefore portrayed in this context. It is relevant to note that these various corporate strategies are not mutually exclusive. An acquiring firm may have elements of more than one strategy, for example a firm may have a longer-term diversification strategy executing it through internationalisation, but it may also be partially vertically integrated. A restructurer could be involved in different diversified industries. In most cases, however, a firm would have more characteristics of a particular corporate strategy rather than another, and therefore may be described as predominantly a related diversifier or restructurer as the case may be.

1.7.1 Globalisation or internationalisation strategies

Firms following an internationalisation or globalisation strategy largely prefer to use the external combination route to enter and establish themselves in new foreign markets. A firm with multinational aspirations is usually first a straightforward exporter. Next the firm will move to shift marketing and production overseas. In the succeeding phase of the strategy the firm starts acquiring foreign firms in countries to which it is distributing and implementing decentralised control. Some large acquisitive firms are specifically searching for small local firms abroad with an excellent established product, which they then acquire and afterwards financial and marketing muscle is utilised to boost the product into national markets. Other large firms with established product lines and supporting delivery systems in their home base buy smaller firms in other countries with large markets as platforms and distribute their products through the acquired firm's operations. External combination through acquisitions, mergers, joint ventures and alliances may provide an expedient route to achieve globalisation objectives.

1.7.2 Growth strategies

Growth strategies are extremely popular because most business executives tend to equate growth with success. It is therefore common practice to set growth targets in certain measurable indicators like assets, turnover, market share or earnings. Higher sales associated with growth enable the firm to take advantage of the experience curve effect to reduce unit costs and thereby increase profitability.

A firm can either grow internally or externally. Internal organic growth is accomplished by increasing market share and internal product development. External growth may be accomplished through combination with other firms in the form of mergers, acquisitions, alliances and joint ventures.

This is a quicker way to effect growth, but may involve higher risk due to the possibility of a problematic fit in the combination.

There are a number of different directions a growth strategy can take the firm. Ansoff's (1987:109) growth vector matrix remains a useful framework to indicate the different growth options and thus different growth strategies. Market penetration denotes a growth direction through the increase of market share for the present product-markets. Firms expand geographically by acquiring other firms in the same product-markets, but in new geographical areas. Market development denotes the entry of new markets with present products. Firms combine with other firms to gain quick and easy access to new markets. Product development creates new products to replace and complement existing ones. A quicker route than internal product venturing is to acquire external firms with already developed new products. These directions of growth all expand the core business of the firm. The planning of growth in these directions could therefore be called core growth strategies. The other alternative growth direction is diversification, where the firm enters new markets with new products.

In recent years there has been a trend of lacklustre revenue growth. Many firms with apparently strong records of growth have achieved them through unsustainable incremental moves such as through international expansion, acquisitions or aggressive price increases, rather than through steady growth from the core business. Research by Mercer Management Consultancy of major US firms in numerous industries (Slywotzky and Wise, 2002: 74) accounted for such tactical moves and discovered that the core businesses of these firms were expanding at a relatively slow pace, and some were actually shrinking.

A five-year study of corporate growth involving 1850 firms by Bain & Company (Zook and Allen, 2003:67) tracked specific growth moves and linked them back to individual firm performance. One major finding was that most sustained, profitable growth comes when a firm pushes out the boundaries of its core business into an adjacent space. They identified six types of adjacent moves that successful firms used to outperform their competitors:

- Growing new products and services;
- Using new distribution channels;
- Entering new geographical areas;
- Addressing new customer segments by modifying a proven product or technology;
- Moving into 'white space' with a new business built around a strong capability;
- Expanding along the value chain.

Some of these firms have used business combinations to effect a faster adjacent move. Vodafone combined with the US firm, Airtouch Communications and acquired the German firm, Mannesheim, in its geographical expansion. De Beers extended its diamond business from wholesaling into retailing through a joint venture.

1.7.3 Diversification strategies

Diversification is viewed as encompassing within a single company two or more activities each of which constitutes the sole activity of a more specialised firm. A classification framework provided by Wrigley (Rumelt, 1974:11) is useful from a management point of view to distinguish between diversification routes. This framework is based on his concept of 'core skills' which he described as the skills required by the firm to compete in a particular product-market era. Those firms that adopted a strategy of diversification in which new product-areas were related to the 'core skill' of the firm were termed 'related', while those that entered new product areas, which bore no relation to 'core skills', were termed 'unrelated'. Those firms that adopted a strategy of limited diversification, in that the distinguishing feature of these firms was that the new product area did not contribute more than 30% of sales, were termed 'dominant product' firms.

Wrigley's classification framework consists of the following categories: Single product – firms which grow in the area of one main product line so that at least 95% of sales lie within this single product area. Dominant product – firms which grow primarily by the expansion of one main product line, but which have added secondary product lines making up 30%, or less, of the total sales volume. These secondary activities may be related or unrelated to the primary product area. Related product – firms that grow by entry into related markets, by the use of related technology, by related activities or some combination of these, such that no one product line accounts for 70% of total corporate sales. Unrelated product – firms that grow by expansion, into new markets and new technologies, unrelated to the original product-market scope, in such a way that no one product line accounts for 50% of the total corporate sales.

Related diversification has also been termed concentric diversification. Salter and Weinhold (1979) have emphasised that related diversification strategies are strategies that exploit synergies in respect of marketing, production and similar science-based research. Concentric therefore denotes the relatedness of new products or services through either technology or marketing to existing products and markets. Unrelated diversification has also been described as conglomerate diversification. Conglomerate diversification was usually motivated as an investment into an attractive high growth industry. The highest potential for synergy was in the financial area. Conglomerate diversification has therefore often been linked to portfolio management and the search for businesses that may remedy

weaknesses in the current corporate portfolio. A firm with reserves of cash to invest, because it has a number of cash cows, may seek to buy businesses with high growth potential in new industries.

Rumelt (1974:149) found in his research that the highest levels of economic performance occurred among firms using strategies of 'controlled diversity' – diversification that preserves and builds upon some central skill or strength. The lowest levels of performance, in contrast, were found amongst vertically integrated firms and those that operated in several completely unrelated areas.

Contributions from the finance discipline have asserted that corporate diversification is a leading example of the agency relationship between shareholders and managers, which argues that managers make decisions that increase their utility while potentially decreasing the value of the firm. Agency explanations for why managers diversify firms have expounded that managers diversify their firms to reduce the idiosyncratic risk that they face, given that they have large undiversified equity positions in their own firms. The other agency explanation is that managers diversify to capture private benefits through managerial incentives. Recent research (Aggarwal and Samwick, 2003:111) found that diversification is positively related to managerial incentives. Consistent with previous studies they found that firm performance is increasing with more incentives and decreasing with more diversification. The link between firm performance and managerial incentives was weaker for firms that experienced changes in diversification, than it was for firms that do not. Their research suggests that managers diversify their firms in response to changes in private benefits rather than to reduce their exposure to risk.

1.7.4 Vertical integration strategies

Vertical integration is a strategy that expands or contracts the business definition primarily in terms of functions performed in the vertical continuum. Backward integration refers to the acquisition of supplier firms in order to utilise the value added and to ensure the supply of materials from this segment of industry. Forward integration involves the purchase of wholesaling and retailing companies again to utilise the value added and to control the distribution channels of that industry segment (Jauch and Glueck, 1988:236).

Supplier firms can range from production and processing of raw materials to the manufacturing of needed components. Distributing firms provide the shipping, storage, delivery, installation and repair of goods, and the generation of demand. The basic operations of an industry can be expressed as a vertical continuum ranging from raw material exploitation to finished product sales. As a firm takes some input and transforms it into output it adds value in the form of utility to the buyer of its output. In each phase the total material costs plus the value added is the material cost input to the next phase.

The value added varies at different stages in the chain of transformation. The success of a vertical integration strategy therefore depends on the degree of value added and the relatedness of technology and management systems to the current main line of business. Advantages of vertical integration may be better control of suppliers and distribution and possible cost savings. Disadvantages may come in the form of increasing dependence on one industry and the risk of possibly monopolising and limiting free competition in industry. As part of vertical integration a firm may also engage in business with other firms. Oil firms have a high degree of vertical integration owning oil wells and also controlling the distribution to consumers through either owning or franchising retail outlets.

1.7.5 Restructuring strategies

The acquiring firm that bases its strategy on restructuring becomes actively involved in restructuring new businesses after acquisition. The acquirer will typically identify underdeveloped, sick or threatened firms or industries on the threshold of significant change. After acquisition the acquirer or parent company intervenes, often changing the business unit management team, shifting strategy or infusing the acquired firm with new technology. It then makes follow-up acquisitions to build a critical mass, and sells off unneeded or unconnected parts, thereby reducing the effective acquisition cost. The result is a strengthened company or a transformed industry. Later the parent firm sells the units when restructuring is complete, the results are clear and market conditions are favourable. Provided that the target industries are structurally attractive the restructuring model can create enormous shareholder value (Porter, 1987:52).

A restructuring strategy requires a corporate management team with the insight to spot undervalued companies or positions in industries ripe for transformation. The trick is then to actually turn the new business units around even though they may be in new and unfamiliar businesses. The best restructurers realise that they are not just acquiring companies, but that they are restructuring an industry. They plan to integrate the acquisitions in order to create a whole new strategic position.

1.7.6 Portfolio management

Portfolio management of a group of businesses is based on the concept of managing an investment portfolio. It is a strategy for optimising the overall corporate objective, be it growth or return on investment, under constraints such as available funds or the number of competent managers. Individual businesses are graphically represented on a four- or nine-cell matrix, located according to a) the attractiveness (equated with growth and total size) of the respective markets in which they are competing (vertical axis) and b) the estimated strength of each business versus its competitors in that market (horizontal axis). Specific strategic implications are associated with particular positions on the

matrix, subject to the parent firm's assumed overriding objective of achieving an overall portfolio that will appropriately balance risk and return.

In a portfolio management strategy the acquiring corporation seeks to create shareholder value in a number of ways (Porter, 1987:51). It can use its expertise and analytical resources to identify attractive acquisition candidates. The parent firm may provide low cost capital that reflects its corporate wide fundraising ability. It may introduce professional management skills and discipline to the acquired business units. It also provides high-quality review and coaching, unencumbered by conventional wisdom or emotional attachments to the business.

An acquiring firm engaging a portfolio management strategy utilises combination through acquisition or merger to implement the strategy. A firm with a number of 'cash cows' may have surplus cash to invest without attractive investment opportunities. The answer to their dilemma is to acquire a 'star' with high growth potential and in need of a cash infusion. Similarly, a firm with a number of attractive investment opportunities, but without cash resources, could merge with a cash rich company to employ the excess capital productively elsewhere in the combined structure.

Porter (1987:52) has argued that portfolio management is not a valid corporate strategy in advanced economies where capital markets are well developed and where professional management is no longer the privilege of large corporations. In developing countries where there are few large companies, capital markets are undeveloped and professional management scarce, he thought that portfolio management might still work as a valid model.

1.8 EXTERNAL BUSINESS COMBINATION VERSUS INTERNAL ORGANIC GROWTH

External combination through vehicles such as mergers and acquisitions may be a very expedient means of expanding the business organisation quickly. In one move key business functions such as a new product line may be added, access to a new market obtained, a marketing organisation or distribution network acquired and a product development team could be taken over. Thereby the slow and painful process of new product development and distribution is bypassed. Furthermore, a complete management hierarchy is in place to run the operation. Many acquiring firms choose to leave the acquired firms as standalone subsidiaries with only partial integration of a few selected support functions. Some reasons for going the external combination route versus internal organic growth are:

- To acquire a position in key international markets and achieve economies of scale and scope for global production and distribution;

- To save time in developing a new product line, a specific technological based competence or a new research and development team;
- To acquire specific technological expertise such as patents, which is often proprietary to a specific line of business;
- To protect the source of supply of raw materials or to assure outlets of finished products in a vertical integration strategy;
- To acquire beachheads or platforms to move into emerging high-growth markets globally;
- To acquire a firm with synergistic financial benefits such as under-utilised tax losses, excess capital or abundant productive investment opportunities;
- To acquire an undervalued corporate portfolio where more aggressive portfolio management can be applied to restructure resource allocation and upgrade financial results;
- To develop new technology in a cost-effective way to increase the competitiveness of the current product mix;
- To enhance the distribution capability of the firm through increased access to new global markets.

An in depth study of external business combination activity during 1997 to 1999 in the United States by Bower (2001:94) had revealed that the thousands of M&A transactions represent very different strategic activities. His research indicated that acquisitions occur for five reasons:

- To deal with overcapacity through consolidation in mature industries;
- To roll-up competitors in geographically fragmented industries;
- To extend into new products or markets;
- As a substitute for research and development;
- To exploit eroding industry boundaries by inventing an industry.

The above identified strategic reasons for effecting an acquisition each present different challenges. Although acquisitions may be justified with one of the strategic reasons identified above, the quality of thinking, preparation and post-acquisition management is often inferior and lead to poor results.

1.9 SPECIAL ROLES OF BUSINESS COMBINATIONS IN THE IMPLEMENTATION OF CORPORATE STRATEGY

Business combinations play a special role when their utilisation provides an expedient and more effective way of realising the objectives of corporate strategy. The same strategic objectives could be pursued via an internal organic growth route, but not with the speed and results possible to be achieved through successful combination with other firms.

The acquisition of a firm with unique knowledge and capabilities can make a significant contribution to the corporate renewal of the acquirer. Such an acquisition can bring into the acquirer capabilities it finds hard to develop. It can also provide the opportunity to leverage existing capabilities into more significant competitive positions. Acquisitions may provide firms with new insights into their own strategic direction and may provide the acquirer with new productive business opportunities that can influence the future direction of the firm. Some acquisitions lead to major strategic and organisational adaptation in the acquiring firm. For example, the internationalisation of an acquiring firm may require an adaptation in the strategic mission of the firm and may necessitate a new global control and management structure.

There are additional benefits to the successful acquirer that gain the 'halo effect' as described by Grubb and Lamb (2000:24). Well known skilful acquirers can become the 'merger partner of choice' and are then often approached by potential targets as white knights in hostile takeover situations. These acquiring firms are approached with many more attractive opportunities than the average firm. They are also able to retain far more top managers and attract the highest skilled employees.

Firms in highly developed technological industries make extensive use of strategic joint ventures that offer them a cost-effective way of acquiring new technologies and competencies. Japanese industrial firms with a strategic intent to build a global leadership position in the convergence of computing and communications entered into a myriad of joint ventures with other firms and managed to build core competencies rapidly and at low cost (Prahalad and Hamel, 1990:80). Access to technology has been an important motivation for Japanese foreign direct investment and research and development (R&D) abroad. They have adopted a strategy of external and collaborative R&D growth through business combinations that enabled a faster build-up of overseas R&D capabilities than possible through internal growth and learning in a network of greenfield R&D sites (Belderbos, 2003:254).

South African acquiring firms are utilising joint ventures to enter new markets and strengthen distribution networks internationally. The financial services group, Old Mutual, structured an equity joint venture with a local firm in India to enter this vast market with its established product range. The South African diamond-mining firm, De Beers, recently structured an equity joint venture with a French luxury goods firm to obtain wider international retail capability. These combinations through joint ventures and alliances are cheaper, faster, more flexible and far easier to enter into or exit from than corporate mergers and acquisitions. Since no acquisition control premium needs to be paid, these alternatives are financially less risky. Strategic alliances are increasingly used in many industries such as e-commerce, communications, transportation, financial services, media and information technology (Grubb and Lamb, 2000:65). The proliferation of alliances is driven by their speed of completion, more

immediate cost savings, instant geographic expansion to new regions and fewer approvals by governments or shareholders.

1.10 CONCLUSION

This first chapter has outlined the various forms of business combination that could possibly be utilised as combination vehicles by a firm intent on growing its business through external combination. The contribution of the process perspective has emphasised that the quality of the decision-making process itself, given all its various constituent activities and role-players from diverse fields, has a substantial impact on the eventual decision and the subsequent results of the combination. Each acquiring firm has an approach to this decision-making process that is unique to its management style, corporate strategy, organisational structure and culture.

In this chapter the different approaches to strategy formulation over the years, key activities common to a strategic planning process as well as several central concepts of strategy were highlighted. This included the specific role and function of corporate strategy as well as generic corporate strategies. These strategy approaches and concepts serve as a context for the review of business combination activity in South Africa within a macroeconomic context as well as the descriptive research that outlines specifically how acquiring firms in South Africa manage their business combination decision-making processes.

Furthermore, the basic principles and concepts of strategy highlighted in this chapter, together with insights gained from observing the best practices of successful acquiring firms, have been applied in chapter five to develop a prescriptive strategic framework for the planning of business combinations.

CHAPTER 2

RESEARCH FOCUS AND METHODOLOGY

2.1 OBJECTIVES OF THIS CHAPTER

This chapter outlines the research approach and methodology adopted in assessing the business combination phenomenon to achieve the defined research objectives. The first objective of this chapter is to provide a broad introduction to the research phenomenon. The second objective is to define the research problem and provide an outline of the essential aspects of this problem. The third objective is to define the specific research objectives of the study. Fourthly, a delimitation of the research scope is provided. The fifth objective is to describe selected relevant aspects of the nature of the research phenomenon pertinent to the selected research methodology. Following this, the essentials of the grounded theory approach underlying the gathering of qualitative data through interviewing in respect of researching the business combination decision-making process, is provided. The seventh objective is to describe the empirical research methodology utilised to assess the business combination decision-making process and combination strategy formulation at the corporate level in acquiring firms.

2.2 INTRODUCTION TO THE RESEARCH PHENOMENON

The structuring of business combinations with other firms is a major growth route open to the firm seeking an increase in assets, sales, market share, an expansion in operations or the acquisition and development of new capabilities to enable higher levels of efficiency and competitiveness. Combination through mergers, acquisitions, joint ventures, strategic alliances and other forms of combination provides the means to achieve the set strategic and financial objectives of the combination-intent firm. Due to the significant effect these forms of business combination have on overall business performance, the selection of the specific combination vehicles to be utilised in its combination strategy, requires thorough analysis and planning.

The decision-making process facilitating the planning, analysis, search, selection and integration of target combination firms is the primary subject focus of this research. This decision-making refers not only to one decision to select and integrate a target firm, but encompass in scope a series of decisions made during a usually lengthy and activity-full process. This decision-making process is usually initiated by the motivation to structure an external combination through a corporate strategy initiative and ends with the evaluation of the success in respect of the integration or linking of the combining firms. In many combination-active firms it is usually not just one acquisition and integration, but may be a continuous activity of searching, screening, negotiating and integrating firms in an aggressive growth through

acquisition strategy to build a large diversified combination structure spanning several industries or countries.

2.3 DEFINITION OF THE RESEARCH PROBLEM

The structuring of business combinations through mergers and acquisitions has a poor performance record. Research in both the United Kingdom and United States has found that most mergers and acquisitions do not meet expectations. Most studies evaluating the performance of combinations through M&A have focused on short-term performance in share price reaction, which includes performance within a period of one to two years. Performance over the medium term would include performance over two to five years, while long-term performance for the purpose of this thesis is regarded as performance for a period longer than five years. The systematic assessment of the long-term performance of acquisitions is very difficult since it is not always possible to separate out the effect of combinations from other factors that affect performance in the long run. The performance of a firm in the long run may be affected by firm-specific factors such as strategy, product-market competitiveness and management variables, as well as a variety of external factors such as market conditions, industry performance and economic conditions that may possibly determine the firm's long-term performance.

Several studies that have examined the short-term effect on share prices have found that shares of target firms gained value, but most studies showed an underperformance. Michael Porter (1987:45) showed that sales or disinvestments were the fate of 74% of the acquisitions in unrelated new fields ventured by his sample of large American firms from 1950 to 1986. A study by Sirower of 100 large transactions from 1994 to 1997 found that two thirds of the transactions met with negative market reactions and for the most part remained under-performers a year later (Grubb and Lamb, 2000:155). Other international research (Galpin and Herndon, 2000:2) has also indicated disappointing results: just 23% of all acquisitions earn their cost of capital; when an M&A deal is announced, a company's stock price rises only 30% of the time; synergies projected for M&A deals are not achieved in 70% of cases; and in acquired companies, 47% of executives leave within the first three years. Research by KPMG International in 1999 that studied 700 of the most expensive transactions from 1996 to 1998 found that 83% of transactions failed to boost shareholder wealth, while 53% reduced shareholder wealth (Grubb and Lamb, 2000:155). Research by Andersen Consulting that evaluated all large mergers completed between 1994 and 1997 found that 44% fell short of financial and strategic expectations (Grubb and Lamb, 2000:155).

Recent research using a meta-analytical procedure (King, Dalton, Daily and Covin, 2003:187) found that on average and across the most commonly studied variables (conglomerate acquisitions, related acquisitions, method of payment, and prior acquisition experience) that acquiring firms' performance

does not positively change as a function of their acquisition activity and is negatively affected to a modest extent. A study of 2130 US mergers announced between 1994 and 2000 (Mitchell, Pulvino and Stafford, 2004:61) focusing on price pressure around mergers, found that on average the abnormal stock price reaction to a merger announcement was -1.20% for the full sample of acquirers over the period. When stock was used as the merger consideration, the abnormal stock price reaction was -2.65%. These researchers found that about half of the negative stock price reaction to fixed-exchange-ratio stock mergers was due to downward pressure caused by merger arbitrage short selling of acquirers' stock around merger announcement dates.

Empirical research evidence generally suggests that average returns to successful bidders are null, while the synergistic benefits of acquisitions usually accrue to the shareholders of targets. Although most studies show that, on average, acquirer shareholders about break even, very few emphasize that this mean hides a large variance in acquirer gains. Anecdotal evidence suggests that some mergers lead to major losses to acquirer shareholders, while others can generate large returns to the shareholders of successful acquirers. Capron and Pistre (2002:781) combined an event study with a survey of post-acquisition resource transfer on a sample of 101 horizontal acquisitions and found that acquirers do not earn abnormal returns when they only receive resources from the target. They found that acquirers can expect to earn abnormal returns when they transfer their own resources to the target.

In the South African context research by Affleck-Graves (1988:132) clearly indicated that conglomerate combinations have significantly under-performed when compared with non-conglomerate firms on both a market return basis as well as on the basis of two accounting measures of return, namely return on assets and return on equity. Research by Ernst and Young Corporate Finance (Thayser, 2001:68) measuring short term effects on the acquiring company's share price by comparing the price one week before the cautionary announcement to the price two weeks after the transaction announcement, found that of a total of 560 transactions 251 showed a decrease, 238 showed an increase, while 71 transactions were not material. Less than half showed an increase, indicating a lack of the desired share performance by the acquiring firms.

The performance record does not look much better for combination through joint ventures and alliances. McKinsey & Company had assessed the performance of 49 joint ventures and alliances in 1991 and found that only 51% were successful – that is each partner had achieved returns greater than the cost of capital. In 2001 they assessed the outcomes of more than 2000 announcements of alliances and the success rates still hovered at just 53% (Bamford, Ernst and Fubini, 2004:91).

The failure of business combinations has produced an enormous amount of literature, but relatively little before the eighties has approached the problem from a corporate strategy perspective. Research

by Brews (1987:10) during the 1980s on corporate growth through acquisition in South Africa indicated that 40% of the sample companies active in merger and acquisition transactions had not formally adopted a growth by acquisition strategy and 30% indicated that they had not developed an acquisition profile. This may be so interpreted that South African corporate management were at the time either: a) not completely convinced of the need for strategic planning and analysis of corporate combinations, or b) the knowledge and skills to strategically analyse and plan the structuring of business combinations were not readily available. It may also be an indication that acquisitions are sometimes conducted in response to specific acquisition opportunities presented to the acquiring firm, and not the result of a planned combination strategy and specific acquisition criteria.

This thesis argues that strategic planning and an appropriately organised combination decision-making process enables the combination-intent firm to develop combination criteria consistent with its planned overall corporate strategy and in line with corporate objectives. The acquiring firm can therefore target firms with a high degree of strategic and organisational fit and successfully integrate willing firms in line with its strategic direction and business focus, and subsequently manage the identified synergies in the resulting combination to achieve the desired strategic and financial performance.

Research problem outline

General theme: The structuring of business combinations through vehicles such as mergers, acquisitions, amalgamations, joint ventures and strategic alliances.

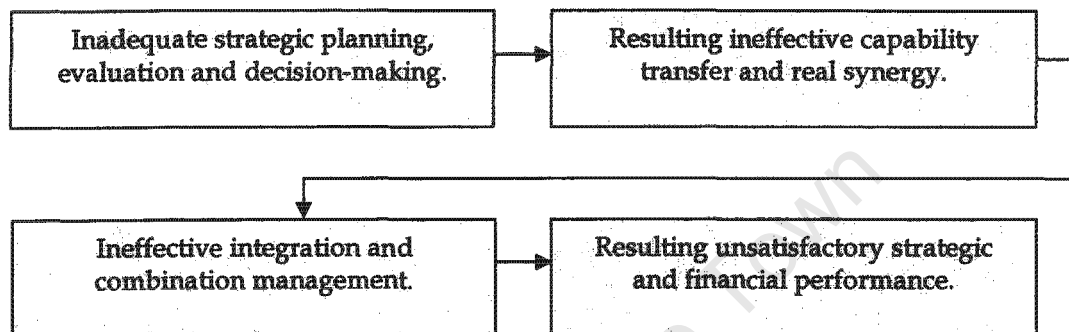
Problem: The poor performance of business combinations that fail to meet strategic and financial expectations.

Possible causes:

- Inadequate strategic planning in respect of business combination decision-making in the acquiring firm.
- Inadequate analysis of strategic and organisational fit between the combining firms.
- Over-estimation of synergies and overpaying by the acquiring firm.
- Ineffective management of the business combination decision-making process by the acquiring firm's management.
- Insufficient capability transfer and synergy achieved as a result of poor strategic and organisational fit between combining firms.
- Ineffective management of the integration process and the resulting combination in general by the acquiring firm.

A review of the literature on M&A via a content analysis showed that the payment of too high a price in acquisitions and the lack of planning to integrate combining organisations are perceived to be the leading causes of the failure of business combinations (Kode, Ford and Sutherland, 2003:29). From a planning perspective the following model of the research problem may be constructed indicating how inadequate strategic planning may impact on the results of a business combination:

Figure 2.1: Model of the research problem from a planning perspective



This model shows the cause and effect impact that inadequate strategic planning and decision-making as one of the possible causes of unsatisfactory performance of combinations, may have on the results of a business combination. Ineffective planning could result in a low level of capability transfer and synergy achieved through an integration that was not thoroughly planned and managed. This is in line with previous research by Haspeslagh and Jemison (1991), who have asserted that the quality of the combination decision-making process itself has a substantial effect on the eventual decision and the subsequent results of the combination. The quality of the strategic planning and the degree to which the process is structurally designed to facilitate efficacious decision-making in terms of identifying the right target, effective capability transfer and integration, may determine the extent to which this process facilitates an effective business combination that will deliver the desired performance.

2.4 THE RESEARCH OBJECTIVES

The main intent of this research is to assess the business combination decision-making process as practised in South African firms and from both this empirical and strategy theory basis develop a strategic process framework apropos the planning of business combinations. An additional focus is to provide a broad review of business combination activity within a macroeconomic context in South Africa in order to identify the major drivers of combination activity and highlight the specific combination vehicles that were utilised by acquiring firms. This review is provided immediately after the introductory chapter and the description of the research methodology, since it logically flows from the introduction of the various forms of business combinations and their role in strategy. The assessment of

the decision-making in practice precedes the prescriptive framework in the last chapter, since it builds on the observed best practice in industry by acquiring firms. The research objectives are:

1. To provide an overview of business combinations, the various combination forms and their use in corporate strategy as well as a brief synopsis of key strategy approaches and concepts (Chapter 1).
2. To provide a ten-year (1991 – 2001) review of business combination activity in South Africa within a macroeconomic context and indicate relevant economic trends and factors affecting combination activity as well as the specific combination vehicles utilised during this period (Chapter 3).
3. To assess the state-of-the-art in the business combination decision-making process in large South African acquiring firms in terms of empirical decision-making models, compare it with an earlier normative model and apply the paradigm model of grounded theory (Chapter 4).
4. To develop a conceptual strategic framework for the planning of business combinations in terms of the combination decision-making process (Chapter 5).

2.5 DELIMITATION OF THE RESEARCH SCOPE

This research is specifically concerned with the business combination phenomenon and providing a strategic planning approach apropos the structuring of business combinations and more specifically at the corporate level in the acquiring firm. The scope of the business combination decision-making process ranges from the motivation to decide on a combination strategy up to the post-combination evaluation of the integration of the acquired firm with the corporate strategy and operations of the acquirer. Given this focus, the financial, legal and regulatory considerations in structuring a business combination are excluded. It is not the purpose of the study to focus on financial analysis and valuation as well as regulatory and legal considerations, but to provide an appropriate strategic framework for the process of planning business combinations.

Given the focus on the decision-making process facilitating the structuring of business combinations, it is relevant to highlight certain relevant aspects of the business combination decision-making phenomenon, that have implications for the research methodology to be used in assessing this decision-making process. These characteristics are described in the next section followed by a description of the grounded theory method as the most suitable research methodology to assess the state-of-the-art in combination decision-making.

2.6 THE NATURE OF THE RESEARCH PHENOMENON INFLUENCING THE SELECTION OF THE SPECIFIC RESEARCH METHODOLOGY

2.6.1 Qualitative nature of the business combination decision-making process

The first aspect considered significant for the selected research methodology is that business combination decision-making is facilitated by a complex process with certain structural characteristics and dynamic interactions. This process has an overall purpose and should therefore be appropriately structured to efficaciously facilitate the achievement of its defined purpose. This process consists of a set of specific decision-making activities that may be analysed in terms of its qualitative characteristics and attributes, which may further be described according to a range in the dimensions of these factors. This decision-making process contains not just one decision, but a set of decisions made during a lengthy and activity-full process. The purpose of the combination decision-making process is to make a set of constituting combination decisions that would effectively accomplish business combination with the desired strategic and financial results. The structural interdependence of this dynamic decision-making process means that certain decisions are conditional for subsequent decisions and that certain required actions should occur before the following actions may be performed. For example, a profile of the ideal combination target needs to be formulated before an efficacious search for candidates can commence.

The second aspect of significance, that was considered relevant for the design of the appropriate research strategy, is that the combination decision-making process with its constituent set of activities can effectively be described in predominantly qualitative terms and attributes. The quantification of certain key dimensions such as the defined criteria in respect of size, financial profitability and the financial evaluation of a combination candidate, plays an important role, but is not as pivotal as the qualitative decisions, judgements and descriptions. The formulation of a specific corporate strategy (for example, the development of a global market position or the development and acquisition of a specific technological competency) and the definition of an ideal combination profile (for example, the need to enhance the product mix or very competent existing management in the target firm), are primarily decisions in terms of qualitative factors that determine the quantification of key properties and dimensions. These qualitative factors and quantitative dimensions go hand in hand, for example, when planning a global diversification strategy, the ideal would be to also quantify the desired income profile from the relevant global areas.

The third aspect of significance, that has influenced the selection of the specific research methodology, is the consideration that combination decision-making operates in a very complex context with many interdependent relationships internal to the decision-making process itself, as well as interactive relationships to other internal factors and conditions within the combination-intent firm. For example, the combination decision to expand through acquisition would depend on the firm's selected growth direction, the nature of its current businesses and the very specific capabilities that the firm possesses

that could possibly be employed productively in a proposed combination. Furthermore, combination decision-making is co-dependent on a variety of very dynamic external macroenvironmental conditions and factors. For example, the decision to follow a specific strategy to expand into a specific global area, would depend on global economic and specific country economic growth rates as well as particular industry attractiveness.

The dynamic interactive nature and complex context of the combination decision-making process therefore requires a research method facilitating a systematic qualitative analysis of the categories of decision-making activities, various organisational factors and resources, their attributes and dimensions, as well as interdependent relationships with organisational resources and other relevant factors. Furthermore, such a qualitative analysis should consider the intervening conditions that may affect the unfolding of the decision-making process and the specific action/interactional strategies that executive managers employ to control the process in order to achieve the set objectives of a particular combination strategy. In addition, the consequences and various outcomes of specific interactional strategies and the combination strategy itself as a whole, should be anticipated and understood within a dynamic environmental context.

2.6.2 Characteristics of the combination decision-making process

The combination decision-making process is characterised by a high level of interaction. At the interactional level various management and specialist personnel are performing activities together both in a group and as individuals in relation to another with regard to combination planning and integration. There are thought, talk and action processes involved in performing these activities. Interaction occurs through processes such as group formulation of a combination strategy and profile, discussing and debating the strategic merits of a combination target as well as the due diligence results, the negotiation of price and management reporting structures, the structural integration, and finally, group evaluation of integration success and combination performance.

The decision-making process consists furthermore of many actions. Certain definite action processes may be identified such as searches to find likely combination targets, the investigation and valuation of target firms, the due diligence inquiry, the negotiation of price and management structures and the integration of physical operations. The management of these processes often occurs in an informal way. The executive with combination responsibility has to steer and manage the overall process with all the various role-players, who are participating, although in many cases specific managers and specialists may not be reporting to him or her in the formal organisation structure. Integration managers are sometimes appointed from other divisions in the acquiring firm and have to establish new working relationships with the integration role-players on both sides in the combination.

There are many relationships and mutual interactions with aspects external to the firm itself such as economic conditions and stock market performance as well as regulatory players and measures that influence the timing and structural form of a combination. There are also relationships with factors external to the combination decision-making process itself such as the financial resources of the firm, which influence the decision in respect of the size of the combination target. The integration of the combining firms and installing new management reporting lines affect the reporting structure of the combined firms such as in a possible new merged structure. The combination decision-making process therefore requires a systems approach through which the interrelationships with external and other internal factors need to be assessed and considered with circumspection.

Another characteristic of the particular research phenomenon researched here is that human behaviour plays an important role. Managers and specialists betraying common characteristics of human behaviour are taking and implementing the combination decisions. Humans usually act to protect their own interests and would attach a higher priority to the objectives of their own firm and own function in playing their role in the process. People have a limited capacity to absorb and process information and have developed their own specialised field of knowledge and skills. Each person participating in the process has limited insight in the expert field and function of the other role-players. People are generally inclined to be apprehensive and resistant to drastic new change and are comfortable to staying within their own established style of behaviour and culture. Acquiring managers therefore need to be sensitive to these aspects of human behaviour to ensure that all role-players are managed so that all participants and functions can optimally contribute to achieve the purpose of the combination process.

The decision-making process occurs within the organisation structural dimensions of the firm and usually different functions of the firm, for example, general management, financial management, legal, and auditing services as well as functional management areas such as marketing, production and operational managers are involved in the process. Management and specialists from different hierarchical levels in the organisation structure, for example, top-level general management, divisional management and lower operational unit level, all participate. The combination planning and decision-making process thus transcends other organisational reporting relationships and processes.

2.6.3 Qualitative research methods and the selection of grounded theory as the appropriate research strategy

A number of qualitative research methods have been designed to research qualitative research phenomena as encountered here in the combination decision-making process. Five such common

qualitative research designs have been identified by Leedy and Ormrod (2001:318):

- *Case study.* In a case study a particular individual, program, or event is studied in depth for a defined period of time. The purpose here is to understand one person or situation in great depth.
- *Ethnography.* In an ethnography the researcher looks at an entire group in depth – more specifically, a group that shares a common culture. The researcher studies the group in its natural setting for a lengthy period of time. The purpose here is to understand how behaviours reflect the culture of a group.
- *Phenomenological study.* This study attempts to understand people's perceptions, perspectives and understandings of a particular situation. The purpose here is to understand an experience from the participant's point of view.
- *Grounded theory study.* A grounded theory study is the research method that is least likely to begin from a particular theoretical framework. The researcher begins with the data and uses a prescribed set of procedures for analysing the data and constructs a theoretical model from them. The purpose here is to derive a theory from data collected in a natural setting.
- *Content study.* A content analysis is a detailed and systematic examination of the contents of a particular body of material for the purpose of identifying patterns, themes or biases. Content analysis is typically performed on forms of human communication such as books and newspapers. The purpose here is to identify the specific characteristics of a body of material.

Given the nature of the combination decision-making process as clearly being a qualitative phenomenon in business and the specific focus in this research on the business combination decision-making itself, which occurs in a large number of acquiring firms with various role-players involved, it is logical that the ethnographic, phenomenological and content study research methods would not be the appropriate research method. It is also not the purpose of this research to study just the specific approach of only a few firms to combination decision-making as in a case study approach, but rather to study the approach to business combination decision-making in general by South African acquiring firms.

The grounded theory study method is a qualitative research method with appropriately designed techniques to analyse a complex qualitative phenomenon with many role-players and many interactive relationships in a dynamic context. The researcher is therefore able to categorise the various decision-making activities and can construct empirical models as they emerge from the data collected through interviewing key executives managing the combination decision-making process.

The grounded theory study approach, after its design in social studies, had been taken up and extensively used in studies of management and organisation that were published in prominent journals. It has been one of, if not the most, prevalent methods used in qualitative studies published in this discipline (Locke, 2001:93). Grounded theory is particularly useful for examining processes such as decision-making, socialization and change. It was successfully used in Eisenhardt's study of how senior management makes fast strategic decisions as well as by Burgelman in his model of how internal corporate venturing occurs through defining new business opportunities, integrating the process into corporate strategy and structuring an internal selection environment (Locke, 2001:108-109).

Given that the purpose of this research is also to develop prescriptive theory for the planning of business combinations, a grounded theory study approach is very suitable since its purpose is to derive a theory from data collected in a natural setting. The grounded theory study method has therefore been selected as the most appropriate research method to analyse the combination decision-making process and to provide the empirical base to develop prescriptive theory.

2.7 THE GROUNDED THEORY STUDY METHOD OF QUALITATIVE RESEARCH

Glaser and Strauss (1967) described their discovery of theory from qualitative data, which is systematically acquired and analysed, as grounded theory. Grounded theory enables the researcher to describe a research phenomenon through the systematic analysis of the empirical phenomenon, systematically obtaining the data and building a theory grounded in the empirical data. "Generating a theory from data means that most hypothesis and concepts not only come from the data, but are systematically worked out in relation to the data during the course of the research. Generating a theory involves a process of research." (Glaser and Strauss, 1967:6).

These proponents of grounded theory believed that their approach is more successful than theories logically deduced from prior assumptions. They asserted that it is likely to be a better theory to the degree that it is inductively developed from empirical research. Other canons for assessing a theory such as logical consistency, clarity, parsimony, density, scope, integration, as well as its fit and workability are significantly dependent on how the theory was generated. These principles are enhanced by the grounded theory research approach.

Since the purpose of this thesis is not only the description and explanation of the combination decision-making process as the research phenomenon, but also the design of prescriptive theory for the planning and management of business combinations, the prescriptive validity of the grounded theory approach adds value in making a contribution that will be useful to management in practical business situations.

2.7.1 Grounded theory principles and techniques

Grounded theory is inductively derived from the study of the phenomenon it represents. That is, it is discovered, developed and provisionally verified through systematic data collection and analysis of the particular data pertaining to that phenomenon. Therefore, data collection, analysis and theory stand in reciprocal relationship with each other. The research findings constitute a theoretical formulation of the reality under investigation, rather than consisting of a set of numbers, or a group of loosely related themes (Strauss and Corbin, 1990:23).

Grounded theory is a scientific method. Its procedures are designed so that, if they are carefully carried out, the method meets the criteria of scientific research. The theoretical contribution is significant and there is theory-observation compatibility, generalisability, reproducibility, precision, rigor and verification (Strauss and Corbin, 1990:31). It should also be recognised that creativity is a vital component of the grounded theory method. Its procedures force the researcher to break through assumptions and to create new order out of old conceptions. Creativity manifests itself in the ability to aptly name new categories and to make free associations that are necessary for generating stimulating questions. The researcher should always be validating any categories and statements of relationships arrived at creatively through the total research process.

Theoretical sensitivity (Strauss and Corbin, 1990:42) refers to an awareness of the subtleties of meaning of data. Researchers come to the research situation with varying degrees of sensitivity depending upon previous reading and experience with or relevant to an area. It can also be developed during the research process. Theoretical sensitivity refers to the attribute of having insight, the ability to give meaning to data, the capacity to understand and the capability to separate the pertinent from that which is not. This is done in conceptual rather than concrete terms. Theoretical sampling is the process of data collection for generating theory whereby the researcher jointly collects, codes and analyses the data and decides what data to collect next and where to find it, in order to develop this theory as it emerges. The process of data collection is controlled by the emerging theory. Beyond the initial collection of data, further collection cannot be planned in advance of the emerging theory. The basic questions in theoretical sampling are to what groups or subgroups does one turn to next in data collection and for what theoretical purpose. Multiple comparisons are possible and so groups are chosen according to theoretical criteria. The basic criterion governing the selection of comparison groups for discerning theory is their theoretical relevance for furthering the development of emerging categories. The researcher chooses any groups that will help generate as many properties of the categories as possible, and that will help relate categories to each other and to their properties. In the case of this focus the researcher after investigating acquiring firms carrying out a series of smaller acquisitions, turns to large

mergers of equals to assess, for example, how integration as a category is different when two firms of equal size combine.

2.7.1.1 Coding

The central process by which theories in the grounded theory approach are built from data is called coding. Coding represents the operations by which data are broken down, conceptualised, and put back together in new ways. It builds rather than only tests theory and gives the research process the rigor necessary to make the theory 'good' science. It provides the grounding, builds the density, and develops the sensitivity and integration needed to generate rich, tightly woven, explanatory theory that closely approximates the reality it represents. Grounded theory development are effectively accomplished through the utilisation of three coding techniques, namely open coding, axial coding and selective coding.

2.7.1.1.1 Open coding

Open coding is the part of analysis that pertains specifically to the naming and categorising of phenomenon through close examination of data. During open coding the data are broken down into discrete parts, closely examined, compared for similarities and differences and questions asked about the phenomena as reflected in the data. The first step in this analysis is conceptualising of the data. Conceptual labels are placed on discrete happenings, events and other instances of phenomena. The process of grouping together what seem to pertain to the same phenomena is called categorising. This classification of concepts is discovered when concepts are compared one against another and if they appear to pertain to a similar phenomenon they are grouped together under a higher order, more abstract concept called a 'category'. Categories are developed in terms of their 'properties', which can then be dimensionalised. Properties are the characteristics or attributes of a category and its dimensions represent locations of a property along a continuum. Thus a property such as colour can vary in intensity from high to low. Each occurrence of a category can have a separate dimensional profile.

The categories that were discovered and confirmed through open coding in the combination decision-making process of acquiring firms included: 'corporate strategy', 'combination/acquisition criteria', 'search, screening and selection of candidates', 'approach, due diligence and negotiations' as well as 'integration'. Properties of the category 'combination criteria' were factors such as 'management competence', 'strong market position' and the 'profitability of the candidate'. Properties such as 'strong market position' and 'the profitability of the candidate' have dimensions which could be located on a continuum ranging from high to low with quantification in terms of a desired percentage depending on the industry and the preference of the acquirer in terms of the particular property.

2.7.1.1.2 Axial coding

Axial coding is the procedure whereby data are put together in new ways after open coding by making connections between categories. The focus is on specifying a category in terms of the conditions that give rise to it; the context in which it is embedded; the action/interactional strategies by which it is handled, managed, carried out; and the consequences of those strategies. These specifying features of a category are referred to as sub-categories. Sub-categories are thus linked to a category by a set of relationships denoting causal conditions, phenomenon, context, intervening conditions, action/interactional strategies and consequences (Strauss and Corbin, 1990:97).

The phenomenon is the central idea, event or happening about which a set of actions/interactions is directed at managing or handling, or to which the set is related. In this research the central idea or event is the business combination decision initiated by a strategy to combine or acquire another firm and thus effecting a merger, acquisition or joint venture with an eventual linking or integration of the combining firms. It is motivated by the corporate strategy or intent of the acquiring firm causing the initiation of the combination process and through a series of action/interactional strategies managing the various combination activities that lead to significant consequential changes in the organisations involved.

Grounded theory is an action/interactional-oriented method of theory building. In the phenomenon one is studying, there are individuals, groups or collectives involved in action/interaction, which is directed at managing, handling, carrying out, and responding to a phenomenon as it exists in context or under a specific set of perceived conditions. Action/interaction has certain properties. It is processual, evolving in nature. It can thus be studied in terms of sequences, or in terms of movement, or change over time. Action/interaction is also purposeful, goal oriented, and undertaken for some reason in order to respond to or manage a phenomenon. Action/interaction therefore occurs through strategies and tactics designed to achieve the desired purpose.

Combination activity has a high impact on the organisations and employees involved through the actions/interactions between the organisations and the new work situations created by the resulting combination. The eventual situations are significantly determined by the effectiveness of the strategies and tactics followed by the combining firms to get the best transaction possibly done for their respective stakeholders.

2.7.1.1.3 Selective coding

Selective coding is the process of selecting the core category, systematically relating it to other categories, validating those relationships and filling in categories that need further refinement and development. The core category is the central phenomenon around which all the other categories are integrated. The

relating of categories to the core category is carried out by means of the elements of the paradigm model – namely the relevant conditions, context, strategies, and consequences. The identification of their relationship to the core category orders them into subsidiary categories in paradigmatic relationship.

In chapter four containing the empirical models the paradigm model is applied and illustrated through the example of the internationalisation of an acquiring firm and outlining in this situation what the relevant causal conditions, context, action/interactional strategies and consequences are in a grounded theory analysis. The logical flow of a specific corporate strategy with the implications for subsidiary categories provides a good illustration of the dynamics of the paradigm model.

2.7.2 Constant comparative method

The constant comparative approach combines, by an analytic procedure of comparison, explicit coding with theory development. The purpose of the constant comparative method is to generate theory more systematically by joint coding and analysis. According to this approach the researcher should start by coding each incident in his data into as many categories of analysis as possible. The comparison group in which the incident occurs is noted. The basic procedure in the constant comparative method is, while coding an incident for a category, to compare it with the previous incidents in the same and different groups coded in the same category. The constant comparison of the incidents soon starts to generate theoretical properties of the category. The analyst then starts thinking in terms of the full range of types or continua of the category, its dimensions, the conditions under which it is pronounced or minimised, its major consequences, its relations to other categories and its other properties.

As coding continues the constant comparative units change from comparison of incident with incident to comparison of incident with properties of the category that resulted from initial comparisons of incidents. Constant comparison causes the accumulated knowledge pertaining to a property of the category to readily start to become integrated; that is related in many different ways, resulting in a unified whole. After the analyst has coded incidents for the same category a number of times, it becomes clear whether or not the next applicable incident points to a new aspect. If no new aspects can be identified the incident is not coded since it only adds bulk to the coded data and nothing to the theory. Theoretical saturation is therefore achieved.

The use of the constant comparative method makes probable the achievement of a complex theory that corresponds closely to the data since the constant comparisons force the researcher to consider much diversity in the data – each incident is compared with other incidents, or with properties of a category, and in terms of as many similarities and differences as possible. The researcher is therefore forced to develop ideas on a level of generality higher in conceptual abstraction than the qualitative material being

analysed. The method thus facilitates the identification of underlying uniformities and diversities and using more abstract concepts to account for differences in the data.

2.8 EMPIRICAL RESEARCH TO ASSESS THE BUSINESS COMBINATION DECISION-MAKING PROCESS IN ACQUIRING FIRMS

Grounded theory development requires first hand observation of the research phenomenon and its data. The highly qualitative data of the business combination decision-making process necessitated an approach where the researcher could closely interact with the key participants managing the combination decision-making process in the acquiring firm. The best method to obtain in-depth insight and analysis of the nature of the business combination decision-making process and the environment as practised in South African firms, was identified to be through interviewing of key executives and their support staff in combination active firms. To ensure that each interview covered the entire spectrum of the business combination decision-making process and allowed for probing in respect of a specific approach or technique, a structured interview guide was compiled with relevant questions pertaining to the various elements in the combination decision-making process. This questionnaire facilitated the gathering of qualitative data through the interviews.

2.8.1 Key variables influencing the nature of the business combination decision-making process

Exploratory interviewing revealed a number of key aspects regarding the combination decision-making process that have sensitised the researcher to key variables influencing the nature of the decision-making approach. The researcher recognised that a diversity of approaches to business combination decision-making was likely to be found in different firms. These diverse approaches are attributable to certain relevant organisational and combination characteristics.

The size of the acquiring firm is likely to affect the degree to which the business combination decision process is formalised. The larger firm has usually more expert resources at its disposal and will utilise a more structured approach in organising these resources to plan, analyse and implement a combination decision. The large firm usually has a more formal organisation structure with more sophisticated management processes and procedures and therefore needs to adopt a more structured approach to effectively plan and implement the combination decision in this structured environment. The large firm is usually better staffed in terms of acquisition and financial staff and should therefore be in a better position to manage its combination decision-making activities.

The frequency of the combination decisions by an acquiring firm may also determine the degree of structure in the firm's process. Management learns and acquires cumulative experience in planning, justifying, analysing and implementing combination decisions and would reuse successful practices.

The frequent use of the same techniques would tend to lead to their formalisation. In very active acquiring firms there are investment guidelines or an acquisition framework prescribing the procedures for acquisition decision-making. More frequent use of specialised resources would also justify the permanent employment of these skilled staff. Firms making combinations on a frequent basis are more likely to employ persons with full-time merger and acquisition responsibility in their corporate finance departments. This was evident in one of the very active acquiring firms, which had an executive with the sole responsibility of managing the integration of acquired firms and to make sure that capability transfer and cultural integration occur smoothly.

The diversity and scope of the firm's business would affect the combination decision-making approach. An acquiring firm with global operations and looking to expand into new global areas or specific world markets would have a more complicated decision-making process than a firm, which is just operating in one country. The multinational acquirer would also need to consider country attractiveness and risk in its combination decision-making and search for combination opportunities. A single business firm with a narrow market focus would have a more limited and less complicated framework of combination alternatives than that of a diversified firm. This firm is likely to follow a horizontal growth or vertical integration strategy and combination candidates would be subjected to a focused and rigorous screening and evaluation of whether the candidate would fit the firm's current product-market scope, production and distribution operations. In the diversified firm the evaluation is wider in terms of economical conditions, industry attractiveness and organisation structural issues. Integration approaches and procedures will vary for a multinational versus a one-country firm and a single business versus a diversified acquirer. The single business firm grows by merging with similar businesses and tends to integrate operations fully if the required level of control could be obtained, while a diversified multinational firm may combine with unrelated businesses and establish separate autonomous divisions or subsidiaries with only partial integration of selected support services and operations.

The status of the acquiring firm in its parent structure would also determine its procedures. A freestanding autonomous firm is likely to employ less formalised methods than a subsidiary in a large diversified combination structure. Unlike subsidiary management, who are required to meet certain evaluation procedures and approval mechanisms at corporate level, the autonomous firm do not have such formal required procedures and can use more informal evaluation and approval procedures. The corporate office of a holding company in a large diversified firm would have structured methods and procedures guiding the decision-making and approval of mergers and acquisitions in subsidiary business units. The employment of an acquisition committee at corporate level is an example of this formalised approval and evaluation of combinations

2.8.2 Sampling of acquiring firms for structured interviewing in terms of the business combination decision-making process

2.8.2.1 Purposeful theoretical sampling

The descriptive research was primarily aimed at assessing the state-of-the-art of the decision-making process as practised by large corporate acquiring firms in South Africa that are frequently making business combinations through the various combination vehicles. These large corporate firms are responsible for the majority of the business combinations effected in South Africa and could be conveniently accessed for interviewing. These acquiring firms were identified from the published Ernst and Young annual reviews of merger and acquisition activity as the sampling frame. Whilst the list provided a population of the acquiring firms active in effecting mergers, acquisition or joint ventures in a given year, it did not provide further data in terms of the size of the firm, the frequency of accomplishing combinations or the diversity and status of these firms.

In line with a grounded theory study approach, purposeful theoretical sampling was utilised to collect data of a relevant range of phenomena and contexts of acquiring firms' combination decision-making, that enabled the researcher to assess the state-of-the-art of the decision-making process and enabled cross-contextual comparisons. The sample was therefore designed to encapsulate a relevant range in relation to the wider universe, but not necessarily to represent it directly. This range was identified as large acquiring firms making relatively frequent business combinations (more than two in a three-year period). The rationale for this was that large acquiring firms in this range are responsible for effecting most of the business combination activity in South Africa. It was also anticipated that a more structured and sophisticated approach from a strategic planning perspective was likely to be found in these firms due to their resource base and their relative frequency in making combinations. In line with the theoretical sampling approach of grounded theory, certain firms in this range were selected to study on the basis of their relevance to the specific research objective of the descriptive research, the research questions, the theoretical position and analytical framework of the researcher with a view towards the development of prescriptive theory. "Theoretical sampling is concerned with constructing a sample (sometimes called a study group), which is meaningful theoretically and empirically, because it builds in certain characteristics or criteria which help to develop and test your theory or your argument" (Mason, 2002:124).

The researcher was in this purposeful sampling process sensitive to the relevant variables identified in the previous section namely the size of the acquiring firm, the frequency of making combinations, the diversity of the acquiring firm's business and its status, and therefore ensured that the sample included firms that represent all the above-mentioned characteristics. The first three of these factors were used as primary sampling categories, while the last one was not considered to be as important given the research objective for the descriptive research and used as a secondary sampling category. These sampling

categories represent the strata of this stratified sample used for the interviewing process. See Appendix B for the details of the sample.

In theoretical sampling, whether or not the sample is large enough to be statistically representative of a total population, is not a major concern as in quantitative research. Qualitative samples are usually small for practical reasons such as costs in terms of time to generate and analyse qualitative data and money, which was a factor in this research. The key question in qualitative research is rather whether the sample provides access to enough data, and with the right focus to enable the researcher to address the research objectives and questions. In theoretical sampling the issue is whether theoretical saturation has been achieved. This means that the researcher samples until theory-saturation has been achieved, that is until the researcher knows that he has a picture of what is going on and can generate an appropriate explanation for it. In this research the stratified sample of thirty (30) firms had provided the researcher with adequate data to assess the state-of-the art of the combination decision-making process as practised by South African acquiring firms, and to generate appropriate empirical models explaining the process as well as a description of the decision-making activities through the saturation of the various identified categories.

2.8.2.2 Qualitative data collection through interviews

Given that the grounded theory research method requires first hand observation and interpretation of the data, face to face interviewing of key executives with combination responsibility in the acquiring firms was chosen as the best method to obtain as direct a response as possible. To increase the chance of reaching these senior executives, the initial request was sent to the chief executive officer (CEO). The vice-presidents or directors of finance and directors of corporate development were expected to be more likely to agree to a request delegated to them by the CEO than to one received directly. The gathering of data through the interviews was supplemented by data recorded in annual reports, articles in magazines and newspapers as well as case studies presented at the annual mergers and acquisitions conference organised by the Institute for International Research.

The focus in terms of the combination decision-making process encompassed in scope the motivation or intent to structure business combinations with other firms in the corporate strategy of the firm, the formulation of a specific combination strategy through a selected combination vehicle, the decision on the desired level of control as well as the appropriate structural fit with the corporate body. It furthermore included as key activities the definition of an ideal combination profile, the search, screening and selection of combination or acquisition targets, the subsequent negotiations with the target firm and then the integration of the combination or acquired firm followed by a post-acquisition review by the acquiring firm.

The dimensions of size, frequency, diversity and status of the acquirer were used in a comparative mode to identify different emphases by these acquiring firms. The interviewing sample included acquiring firms that made combinations, which were unsuccessful. These unsuccessful combinations were characterised by the long time it took for successful integration as well as the fact that these acquiring firms themselves were later merged or integrated into more successful acquirers.

In the initial stages of the research during 1995 a structured interview guide was used to obtain qualitative data and construct empirical decision-making models. The results were compared with earlier prescriptive literature outlining a so-called normative model. During the final stage of the research during 2002 an updated version of the structured interviewing guide was used to assess changes in the nature of the process in terms of its categories, subcategories, properties and its dimensions. The major changes in the questions posed were in terms of corporate vision, mission, combination strategy and vehicles as well as the environment, which has changed considerably over the period. See appendix A for the updated interview questionnaire.

2.9 CONCLUSION

The business combination decision-making process is facilitated by a lengthy and complex process that consists of a set of decision-making categories and specific activities that may be analysed in terms of its qualitative characteristics and attributes. The decision-making process can best be described in predominant qualitative terms and attributes. The quantification of certain key dimensions plays an important role, but is not as pivotal as the qualitative decisions and judgements. Another aspect of significance, that has influenced the selection of the specific research methodology, is the consideration that combination decision-making operates in a very complex context with interdependent relationships internal to the process itself as well as relationships to internal factors and conditions within the combination-intent firm. The decision-making process is furthermore also dependent on a variety of dynamic external macroenvironmental conditions and factors.

Given this highly qualitative nature and context of the combination decision-making process as the research phenomenon, after considering the available qualitative research methods, the grounded theory research method was deemed to be the most appropriate research method to assess the state-of-the-art of the combination decision-making process in practice. Grounded theory provides an appropriate theoretical framework for qualitative research with specifically designed techniques to analyse qualitative research phenomena in a complex context. In line with a grounded theory study approach, purposeful theoretical sampling was utilised to collect data of a relevant range of phenomena and contexts of acquiring firms' decision-making processes, which enabled the researcher to assess the state-of-the-art of the combination decision-making approach. This range was identified as large acquiring firms making relatively frequent combination decisions, since these large acquiring

firms are responsible for effecting most of the combination activity in South Africa and are likely to employ a more structured and sophisticated approach to their decision-making from a strategic planning perspective.

The open and axial coding of the data gained from the interviewing process allowed the researcher to objectively categorise data to develop specific empirical models of the combination decision-making process as practised in acquiring firms. Selective coding through the paradigm model has facilitated a dynamic analysis of the causal conditions of the combination decision, the local and global context of South African combination decision-making, the specific action/interactional strategies utilised by acquiring firms to manage their processes as well as the consequences of a specific strategy through combinations.

A theoretical system is useful if it can both explain and predict. The grounded theory method tests the substantive meaning developed between concepts, categories, properties and interrelationships by comparing it to the empirical evidence. The grounded theory research method is thus a very appropriate qualitative research method for the objective of developing practical prescriptive theory for combination decision-making, since the theory is rooted in the assessed empirical situation, where acquiring management has already tested and verified their management methods. The prediction validity of the grounded theory research method used here, justifies its relevance in developing strategic decision-making and management theory that is particularly useful for the strategic planning and management of business combinations.

CHAPTER 3

REVIEW OF BUSINESS COMBINATION ACTIVITY IN SOUTH AFRICA WITHIN A MACROECONOMIC CONTEXT

3.1 OBJECTIVES OF THIS CHAPTER

The purpose of this chapter is to provide a broad overview of business combination activity in South Africa within a macroeconomic context. The first objective in order to sketch this context is to highlight characteristics of the South African economy that are relevant to the nature and level of business combination activity during the period, 1991 – 2001. The second objective is to identify selected key macroeconomic factors that significantly affect business combination activity and analyse the nature of these relationships, for example, how combination activity is affected by movement upwards or downwards in respect of these variables. The third objective is to provide an overview of business combination activity through mergers, acquisitions and joint ventures in South Africa during the period, 1991 – 2001, and to indicate the key drivers that have motivated the level of combination activity as well as the various combination vehicles utilised during this period. Significant shifts that have occurred in terms of the vehicles used to effect business combination are indicated as part of this review. Since internationalisation by South African acquiring firms has been such a major driving force of activity during the second half of the 1990s, a fourth objective is to highlight the major motivations in this offshore thrust. The fifth objective is to briefly describe the trend in world-wide combination activity as is specifically evident in cross-border consolidation by same industry players.

3.2 RELEVANT CHARACTERISTICS OF THE SOUTH AFRICAN ECONOMY

3.2.1 Exceptional mineral wealth with large mining firms

South Africa's primary natural asset is its exceptional mineral wealth resulting in the country being the world's largest producer of gold, platinum, chrome, ore, and some other scarce minerals. The country has a very strong mining sector with large firms in this sector, which have played an important role in the development of the South African economy. Many South African combination transactions have therefore occurred in the mining sector as a result of a focus on core mining activities or as a consequence of consolidation in the industry through the merging of mining firms. Natural resources based firms were amongst the first South African businesses to expand offshore and acquire mining operations in other areas of the world such as other African countries, Australia and the Americas. The mining giants such as Billiton and Anglo American were also the first firms to list offshore to attain improved access to international capital. This sector also produced the largest merger transaction in South African history with the BHP Billiton merger on 29 June 2001 of R223,2bn.

3.2.2 Open economy with strong trade links

South Africa has an open economy characterised by strong links with other economies. The strongest trade links are with the major industrial countries such as the United States (US), Germany, the United Kingdom (UK) and Japan, which have generally been South Africa's most important trading partners. This interdependence implies that South Africa's economic fortunes are closely linked to economic conditions in these countries. The proportion of Gross Domestic Product (GDP) that is exported was as high as 25,8% in 1998 relative to 11% for the US and the UK. Imports as a percentage of Gross Domestic Expenditure (GDE) was 24,8% in 1998 compared to 9,3 and 12,8% for Japan and the US respectively. (Mohr and Fourie, 2000:134). Since 1990 the South African economy has become substantially more open towards the rest of the world. It has extended its involvement in regional and international financial co-ordination, for example, as member of the newly established G20 group of nations and by promoting trade and investment in the Southern African Development Community (SADC) region. Exports and imports have grown substantially and trade relations have diversified leading to rapid growth of exports to sub-Saharan Africa and a significant expansion into Asian and American markets. There was an increase in the share of exports to the rest of Africa, which exceeded 15% of total identified exports. Exports to Asia also exceeded the 15% mark (Mohr, 2002:220). Tariff protection as reflected in the simple average import tariff, dropped from 30% in 1990 to just above 14% by 1998. Recent free trade arrangements with the European Union (EU) and the SADC are expected to enhance the further opening-up of the South African economy through improved market access for South African exporters.

It was therefore logical that international extension of South African businesses through business combinations such as mergers and acquisitions occurred apropos the economies of these major trading partners in the developed countries. For example, the progression of South Africa's giant firms in financial services was to extend its operations offshore first to the UK and afterwards to the US.

3.2.3 Structure of Gross Domestic Product (GDP)

In line with the usual structural shifts during economic development, the South African economy has changed over the past decade in terms of the relevant contribution by the constituent sectors, most notably in respect of a decline in the primary sector (agriculture, forestry, fishing, mining and quarrying) and an increase in the size of the tertiary sector (wholesale, retail, motor trade, catering and accommodation, transport and communication, finance, real estate, business services, as well as community, social and general government services). The primary sector's share decreased from 11.9% in 1994 to 9.5% in 1999 whilst the tertiary sector's contribution grew from 60.4% to 65.8% over the same period. The transport and communications sector grew rapidly as did communications infrastructure and information technology in general. Inflows of foreign capital, investment into South Africa by foreign financial institutions, and the entry of foreign banks into South Africa has helped to expand the

country's financial and business services considerably. Declines that have occurred in the share of GDP accounted for by construction and mining may be attributed to declines in the residential housing market and lower levels of fixed capital formation in the public sector, as well as a decrease in gold production. The highest business combination activity in value through mergers, acquisitions and joint ventures for 2000 and 2001 occurred in the primary sector and the tertiary sector produced the next highest level of activity.

3.2.4 Economic performance

The South African economy did not grow very rapidly during the period, 1991 – 2001, as indicated by table 3.1 below. On the contrary, growth was actually negative during the first three years of the period when the economy was in a downward phase from March 1989 to May 1993. An upward phase from June 1993 to November 1996 achieved positive real growth in 1993 and an increase to above 3% in 1994 and 1995 to a high of 4.3% in 1996. Afterwards a downswing in the economic cycle followed from December 1996 to August 1999 followed by the current upswing with a high of 3.4% in real growth achieved in 2000. Despite the contraction in major world economies in 2001 the South African economy achieved 2.2% growth in real GDP in 2001 (South African Reserve Bank Quarterly Bulletin, June 2002).

Table 3.1 Economic growth in South Africa, 1991 – 2001.

Year	Annual percentage change in real GDP	Annual percentage change in Gross National Income (GNI)	Annual percentage change in real GDP per capita
1991	-1.0	-0.4	-3.1
1992	-2.1	-2.4	-4.2
1993	1.2	1.1	-0.9
1994	3.2	4.1	1.1
1995	3.1	2.7	1.0
1996	4.3	4.4	2.1
1997	2.6	2.3	0.5
1998	0.8	0.5	-1.3
1999	2.1	1.3	-0.0
2000	3.4	3.0	1.3
2001	2.2	1.9	0.2

Source: South African Reserve Bank Quarterly Bulletin, June 2002.

The average economic growth South Africa achieved over the period 1991 to 1998 of 1.0% was, however, low compared with 2.5% for the US, 1.9% for the UK, 2.2% for Japan, East Asian countries such as Korea (5.8%) and Thailand (5.2%), and South American countries such as Argentina (4.9%) given that

the growth in the highly developed industrialised countries in recent years occurred off very high levels (Mohr and Fourie, 2000:120).

3.2.5 Balance of payments constraint

One of the most important features of the South African economy between 1985 and 1993 was a significant and sustained net outflow of capital due to the domestic political situation and sanctions (Mohr and Fourie, 2000:137). This situation developed in 1985 when the country could not meet its foreign debt repayments and during the following years the debt commitments, the weak economic performance, domestic political unrest and uncertainty caused a massive net outflow of capital while foreign financial sanctions prevented significant inflows of capital.

Table 3.2 South Africa's balance of payments, 1991 – 2001.

Year	Current account balance R millions	Financial account balance R millions	Change in net reserves R millions
1991	6 241	-2 543	4 137
1992	5 552	-1 491	564
1993	4 867	-5 669	-8 913
1994	336	4 359	2 887
1995	-7 989	19 781	8 586
1996	-8 128	13 394	-5 103
1997	-10 426	27 049	10 861
1998	-12 867	17 300	-4 109
1999	-3 926	32 515	25 865
2000	-3 653	2 220	5 114
2001	-1 687	-11 010	5 182

Source: South African Reserve Bank Quarterly Bulletins, December 1999 and June 2002.

Table 3.2 above shows that the outflow of capital in the years 1991 to 1993 ran to an accumulated amount of R9,7bn. After 1994 with the general elections and the establishment of a democratic government, South Africa regained access to international capital markets, a small current account surplus was recorded and there was again a net inflow of foreign capital. The financial account surplus in the subsequent years can be ascribed to the abolition of financial sanctions and South Africa's re-entry into the international capital market. After 1994 the financial account surpluses were generally large enough to finance current account deficits, largely because of significant portfolio investment especially during the years, 1997 – 1999, as well as direct foreign investment. The inflows were erratic and most consisted of speculative portfolio investment in South African bonds and equities, rather than the more

sought-after direct investment that was needed (Mohr, 2002: 226). The financial account surpluses enabled a more flexible monetary policy resulting in a progressive relaxation of exchange controls and enabled the large corporates to move to offshore listings in Europe and North America.

Exchange controls were further relaxed in 2001. The limit per new foreign investment (outside the SADC region) increased to R500m in February 2001. The limit per new foreign investment in the SADC countries is R750m. The ability of South African corporates to utilise their local balance sheet as security against two-year, or longer, term loans for non-residents has also facilitated foreign investments (Thayser, 2002:13).

3.2.6 Foreign direct investment and portfolio investment

Net foreign direct investment (FDI) into South Africa, distinguished from a portfolio investment as a stake of 10% or more and required to remain invested for at least a year, was negative for most of the period, 1991 – 2000, but in 2001 a huge R85,9bn was recorded as indicated in Table 3.3 below.

Table 3.3 Foreign net direct investment and net portfolio investment, 1991 – 2001.

Year	Net direct investment R millions	Net portfolio investment R millions
1991	111	666
1992	-5 514	4 950
1993	-941	2 417
1994	-3 040	10 008
1995	-4 557	9 020
1996	-970	9 567
1997	6 756	30 580
1998	-6 737	20 375
1999	-475	52 346
2000	4 280	-13 835
2001	85 921	-76 626

Source: South African Reserve Bank Quarterly Bulletins, December 1999 and June 2002.

2001 was a good year for foreign direct investment and a poor one for foreign portfolio investment. The anomaly was mainly due to the R153,7bn restructuring of Anglo American plc and De Beers in June 2001. The inflow of FDI occurred when De Beers Consolidated distributed its large holding in Anglo American to its shareholders. This resulted in a decline in foreign direct investment assets held by resident investors, in effect an inflow of FDI. De Beers acquired 100% of De Beers Consolidated (excluding Anglo shares), that resulted in an increase in FDI in SA. The portfolio outflows came when minority shareholders in De Beers sold their shares to Anglo American plc, since a significant number of

the sellers were non-resident and it constituted portfolio outflows. South African shareholders were compensated for De Beers shares with shares in Anglo American plc, which increased the foreign portfolio assets held by residents, technically an outflow of foreign currency. Reserve Bank figures showed a net FDI at R85,9bn in 2001, which was sharply up from the R4,3bn the previous year. But R76,6bn of net portfolio investment flowed out of the country in 2001, far more than the net R13,8bn that left in 2000.

A survey by the management consultancy firm, AT Kearney, found that South Africa suffered from a number of difficulties in attracting foreign direct investment (FDI). It is located geographically very far from Europe, Japan, and North America; its market is relatively small; and Africa was perceived as a high-risk destination for investment. AT Kearney asserted that the best chance the country has of attracting investment would be to identify and concentrate on the development of particular high-growth economic sectors such as the communications sector (2000/01 Survey, SAIRR: 448).

3.2.7 Reasonably well developed capital market

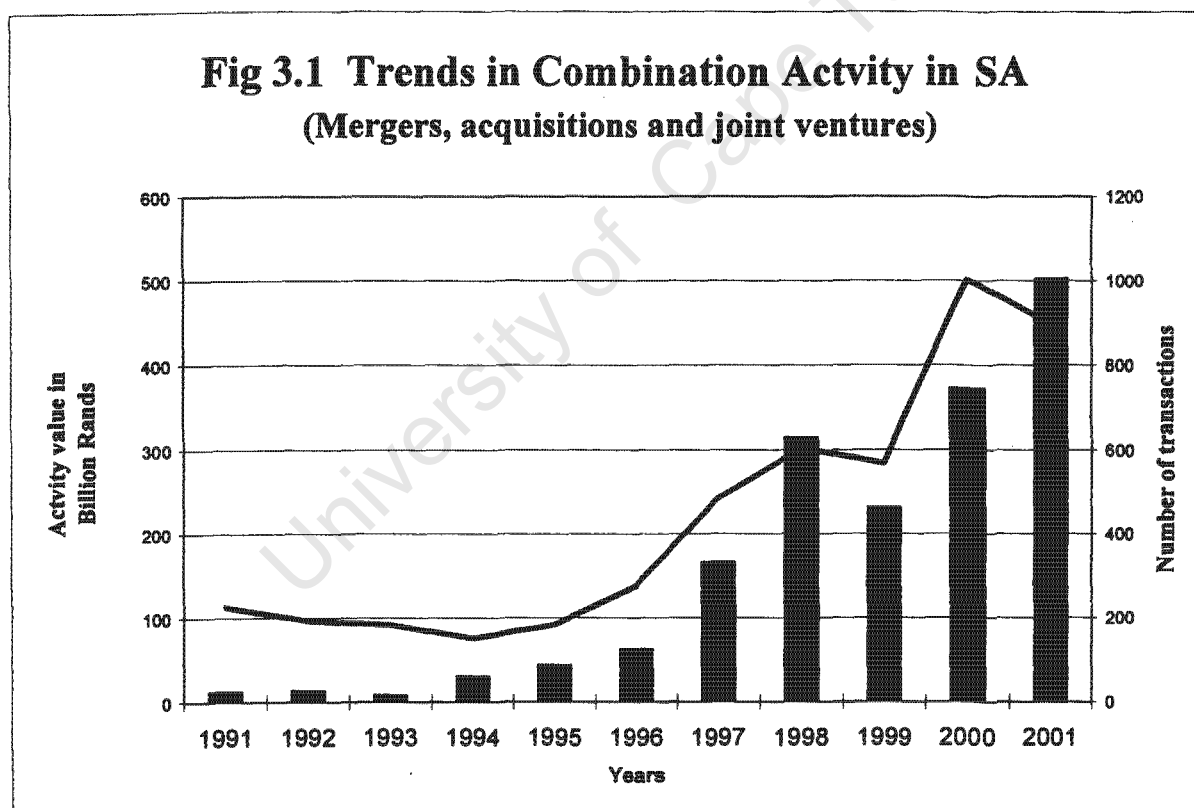
After 1994 South Africa regained access to the international capital market and foreign capital started to flow into the country again. The country has received 'investment grade' status in 2000 by rating agencies such as Moodys Investors Service and recently by Fitch Investors Service. Today the South African capital market is reasonably well developed and attracts international portfolio capital in the emerging market category. The progressive relaxation of exchange controls made possible by the strength of capital inflows has enabled South African corporations to restructure into focused international groupings with improved access to international capital through listings mainly on the London, New York and Sydney bourses. Locally the strong long-term assurance industry with its large administered retirement funds has attracted substantial amounts of capital that is available as institutional investment through the Johannesburg Stock Exchange (JSE).

3.2.8 Market size and geographic position versus world markets

The size of the consumer market and the geographic position of South Africa versus world markets have been a consideration for some global players. The automotive manufacturing industry serves as a good example. The manufacturing operations of major motorcar manufacturers and the supporting component supply chain were based in the Port Elizabeth and East London areas initially as assemblers for the South African market and other African countries. Recently these production bases have been used to export large numbers of vehicles to European, American, other African and Asian markets. The Asian market is expected to produce 70% of the global automotive market growth until 2005. The transnational automaker, DaimlerChrysler, with local manufacturing facilities, has publicly announced its intent to become the world's largest car manufacturer by 2003 and recognised that achieving this

intent hinges upon rapid expansion into Asia. Certain basic input costs such as raw materials, electricity and labour are lower in South Africa for large-scale manufacturers. Another consideration was that a base in South Africa might be used as a platform for further expansion into other African countries. The headquarters of Coca Cola for Africa was located in Port Elizabeth after an equity joint venture with a local firm and the confectionery and beverages firm, Cadbury Schweppes, bought out minorities to gain 100% control of the South African chocolate subsidiary firm. The size of the South African M&A market has attracted several large international financial players, such as UBS Warburg and Merrill Lynch, which have started up operations in Johannesburg. UBS Warburg was the advising firm on the BHP Billiton and De Beers transactions.

3.3 TOTAL BUSINESS COMBINATION ACTIVITY IN SOUTH AFRICA THROUGH MERGERS, ACQUISITIONS AND JOINT VENTURES DURING THE PERIOD, 1991 - 2001



Corporate combination activity through mergers, acquisitions and joint ventures in South Africa has increased very significantly since 1991 from the R12,4bn mark to the level of R502,4bn in 2001. Most of the substantial M&A activity in value terms occurred through transactions in the mega deal category (value in excess of R5bn) in the years, 1997 to 2001.

Benchmarked against GDP total transaction value increased from 3.75% in 1991 to above the 5% level in 1994 and then further increased to reach the level of 51.5% level in 2001. (Cf. appendix B). Figure 3.1 above illustrates the increase in both the total value of combination transactions as well as the total number of transactions achieved in the second half of the period from 1997 to 2001. The graph illustrates the surge in total combination activity values during the second half of the period from 1997 to 2001. The total number of transactions increased to ten times the level during the first half of the period to reach a peak of 1002 transactions in 2000.

The major drivers of corporate combination transactions over recent years causing an increase in activity were several major cross-border and specifically outward internationalisation transactions in the later part of the 1990s; inward investment by international firms; a black economic empowerment (BEE) trend; the merging of related businesses as well as the unbundling of large conglomerates to unlock underlying shareholder value in the first half of the period.

In the next section a few identified economic factors that are directly affecting the level of combination activity are taken and the correlation with total combination activity statistically examined. These factors are economic growth as indicated by total gross domestic product value, the performance of the stock exchange using the JSE All Share Index and total market capitalisation as key indicators, and interest rates as an indicator of the cost of capital for acquiring firms.

3.4 KEY ECONOMIC FACTORS AFFECTING BUSINESS COMBINATION ACTIVITY

3.4.1 Economic growth

An upswing or downswing in the business cycle with its corresponding effects on the turnover and earnings of firms in the economy would have a relationship with business combination activity. During an economic upswing higher earnings are generated, share prices are therefore generally improving, and business confidence levels are higher associated with the perceived economic stability and positive outlook. Successful firms are in these conditions able to build up cash reserves and improve gearing ratios. Higher share ratings for the acquiring firms facilitate the use of equity to finance M&A transactions. Notably the significant increase in 1994 in M&A values occurred during a year when a relatively high real growth in GDP was achieved. The relatively high real growth of 4.3% in 1996 led to the highest annual increase in M&A activity (167%) the following year – close to tripling the value of activity versus the previous year. On the other hand, when there is a contraction in the business cycle, combination through mergers and acquisitions are seen as too high a risk in a volatile market. In an economic downswing a lag effect occurred on combination activity. The severe contraction in 1992 led to a decrease in M&A activity the following year. The lag effect was also evident in 1999 with a 26.4%

decline after the trough in the business cycle of 1998 when growth of only 0.8% in real terms was recorded.

Table 3.4 Total M&A values and economic growth, 1991 – 2001.

Year	Total M&A value R millions	% change versus previous year (py)	GDP R millions at current prices	Nominal growth: % change versus previous year	Real growth: % change versus previous year at constant 1995 prices
1991	12 450		331 980		
1992	13 387	7.5%	372 227	12.1	-2.1
1993	8 110	-39.4%	426 133	14.5	1.2
1994	30 530	276.5%	482 120	13.1	3.2
1995	43 459	42.4%	548 100	13.7	3.1
1996	62 254	43.3%	617 954	12.7	4.3
1997	166 206	167.0%	685 730	10.9	2.6
1998	314 725	89.4%	739 504	7.8	0.8
1999	231 599	-26.4%	802 840	8.6	2.1
2000	372 261	60.7%	887 795	10.6	3.4
2001	502 379	34.9%	975 196	9.8	2.2

Source: 1) Ernst & Young, Mergers and Acquisitions: Annual reviews of activity, 1991 – 2001.
2) South African Reserve Bank Quarterly Bulletins, December 1999 and June 2002.

A correlation analysis with GDP values as the explanatory variable and M&A values in a subsequent year as the outcome variable indicated high Pearson's and Spearman's correlation coefficients of 0.951 and 0.976 respectively. This statistically confirms a strong positive linear relationship between economic growth as indicated by total GDP at current prices and total M&A activity values and is consistent with the above observations about a cause and effect relationship between economic growth and total business combination activity. See Appendix D for the details of the correlation analysis.

3.4.2 Stock exchange performance

In the following analysis three key indicators of stock market performance, namely the JSE all share index, the total market capitalisation and the price-earnings multiple of the local bourse were taken and compared with total M&A activity. Acquirers tend to be more confident and acquisitive when their current share valuation is relatively high, the economic outlook bullish for further appreciation and mergers can be effected at favourable stock exchange ratios; or acquisitions may be negotiated at reasonable price levels in cash. The third merger wave in the US demonstrated this sentiment when increased M&A activity was fuelled by high stock prices during the bull market (Gaughan, 2002: 35).

Acquiring firms used aggressive acquisitive strategies to boost earnings per share achieving an increase in the share price and then utilised the high valued paper to make more acquisitions.

Table 3.5 Total M&A values and JSE performance, 1991 – 2001.

Year	Total M&A value R millions	% Change versus previous year	JSE All Share Index	% Change versus previous year	Total JSE market capitalisation R millions	JSE P/E ratio
1991	12 450		3 440		340 078	11.4
1992	13 387	7.5%	3 259	-5.3%	336 642	13.5
1993	8 110	-39.4%	4 893	50.1%	506 240	20.0
1994	30 530	276.5%	5 867	19.9%	635 770	19.0
1995	43 459	42.4%	6 228	6.2%	893 092	16.0
1996	62 254	43.3%	6 658	6.9%	989 267	18.0
1997	166 206	167.0%	6 202	-6.8%	1 005 030	13.5
1998	314 725	89.4%	5 430	-12.4%	903 546	13.0
1999	231 599	-26.4%	8 543	57.3%	1 522 163	14.0
2000	372 261	60.7%	8 326	-2.5%	1 474 839	18.0
2001	502 379	34.9%	10 442	25.4%	1 676 296	13.3

Source: 1) Ernst & Young Mergers and Acquisitions: Annual reviews of activity, 1991 – 2002.
2) Indices Department of the Johannesburg Stock Exchange.

There was a lag effect evident in analysing the numbers. The 50% change in the JSE All Share Index in 1993 was followed by the large increase of 276% in M&A activity value in 1994. The decline of -12.4% in 1998 was followed by the -26.4% decrease in combination activity in 1999. The increase of 57.3% in the share index in 1999 was followed by the 60.7% increase in M&A activity the next year. Correlation analysis confirmed that there is a strong positive leading relationship between the JSE All Share Index (JSE ASI) and total M&A values. The Pearson's and Spearman's correlation coefficients between the outcome variable M&A values lagged 1 year and the JSE ASI as the explanatory variable were calculated at 0.823 and 0.855. See Appendix E for the details of this correlation analysis. There was also a strong positive relationship with total JSE market capitalisation in the previous year, for which Pearson's and Spearman's correlation coefficients of 0.916 and 0.976 were calculated. See Appendix F for the details of this correlation analysis. The quantitative analysis therefore is consistent with the claim that acquirers were more active in making combinations when there was stronger share performance and a bullish outlook for the bourse.

The price-earnings ratio is the ratio of the market price of a firm divided by the earnings available to common shareholders on a per share basis. The higher the price-earnings ratio, the more investors are

willing to pay for a firm's stock given their expectation about the firm's future earnings. A high price-earnings ratio for the market indicates widespread investor optimism. A similar one-year lag effect relationship as evident above with the JSE all share index was apparent between the JSE price-earnings ratio and combination activity as indicated by total M&A values. The price-earnings multiple went to a record 20 before the strong increase in M&A activity for 1994. It declined to 13 at end 1998 before the contraction in M&A activity the following year in 1999. It ended at 18 in 2000 before the record R502bn M&A activity recorded in 2001. The JSE price-earnings ratio may therefore be seen as a leading indicator of combination activity through mergers, acquisitions and joint ventures.

3.7.1 The cost of capital – interest rates

The access to capital is a major factor for the acquiring firm in its consideration of growth and expansion through acquisitions. The availability of funds and even more relevant, the cost of capital that is financed through loans, would determine the size and the number of acquisitions the acquiring firm could consider in its expansion programme through combinations. Acquiring firms used cash to pay for acquisitions in 51% of the total M&A value in transactions in 2000. In 2001 15% of transactions were financed with cash and another 32% was financed through cash/shares combination.

Table 3.6 Total M&A values and interest rates, 1991 – 2001.

Year	Total M&A value R millions	% Change versus previous year	Predominant prime overdraft rate of clearing banks at end of year	Change in basis points
1991	12 450		20.25	
1992	13 387	7.5%	18.25	- 200
1993	8 110	-39.4%	15.25	- 300
1994	30 530	276.5%	16.25	- 100
1995	43 459	42.4%	18.50	+225
1996	62 254	43.3%	20.25	+175
1997	166 206	167.0%	19.25	- 100
1998	314 725	89.4%	23.00	+375
1999	231 599	-26.4%	15.50	- 750
2000	372 261	60.7%	14.50	- 100
2001	502 379	34.9%	13.00	- 150

Source: Ernst & Young Mergers and Acquisitions: Annual reviews of activity, 1991 – 2002.

South African Reserve Bank Quarterly Bulletins, December 1996, December 1999 and June 2002.

The cost of capital for acquiring firms through borrowing funds is generally also related to the general financial market conditions and the liquidity of merchant banks. In conditions where there is a high

demand for money, merchant banks would tighten up on their lending criteria on more risky transactions. In this analysis the predominant prime overdraft rate of clearing banks at the end of the respective year is used as an indicator of the cost of capital for acquiring firms in the prevailing money market conditions. The cost of capital for divisions of large firms may be lower given their access to corporate capital. Large diversified firms with stable earnings are generally also able to negotiate lower rates with banks or are able to raise capital through stock and bond issues at more favourable rates.

Table 3.6 above indicates an inverse relationship between interest rates and M&A activity in the South African market. When interest rates, as defined by the predominant prime overdraft rate of clearing banks, were reduced in 1992, 1993 and 1994, especially with the 300 basis points in 1993, there was a significant increase in business combination activity the next year. Similarly, the high increases in M&A activity values in 2000 and 2001 were preceded with a reduction of 750 basis points in interest rates in 1999. On the other hand when interest rates increased by 3.75% in 1998 to end at the very high level of 23% by the end of that year, there was a contraction in combination activity the next year in 1999. There is therefore an inverse relationship between the cost of capital using interest rate as an indicator and total business combination activity through mergers, acquisitions and joint ventures.

3.5 REVIEW OF BUSINESS COMBINATION ACTIVITY THROUGH MERGERS, ACQUISITIONS AND JOINT VENTURES IN SOUTH AFRICA DURING THE PERIOD, 1991-2001

The transactions indicated in this review of combination activity include transactions, which have been publicly announced during the period described as recorded by the annual Ernst and Young reviews of M&A activity. The sources of information used by the Ernst & Young surveys include formal press announcements to shareholders, public relations releases published in the financial press and directors' reports accompanying published financial statements.

The purpose of this review of business combination activity is to provide an overview of the most significant activity through the largest transactions as well as the major trends and drivers of activity in general, and not to comprehensively discuss all activity. Only the major and largest transactions are indicated to serve as examples of the trends in combination activity. The specific combination vehicles utilised to effect these combination transactions are highlighted in italic font.

1991

One of the major combination trends that were causing R12,4m M&A activity in 1991 was the reshuffling and refocusing of some of the major groups in response to difficult economic conditions experienced in

the country this year. One such large transaction was in the financial services industry with the R1,7bn *merging* of UBS Holdings, Allied Group, Volkskas Group and Sage Life, forming the ABSA group (Amalgamated Banks of South Africa), which occurred in the first half of the year. Another transaction was the R1,2bn *reshuffling* by the industrial holding vehicle of the insurance giant Sanlam, namely Sankorp, of its industrial interests between Malbak and Murray & Roberts. This was done to focus the construction firm Murray and Roberts on gross domestic fixed investment-related activities and to let Malbak concentrate on consumer-orientated businesses. Another transaction facilitating a refocusing was the R1,1bn *sale* by Barlow Rand of Middelburg Steel & Alloys to a consortium controlling the Columbus steel project. This *refocusing* trend represented a reversal of the diversification philosophy that major groups had followed previously.

Increased political acceptability of South Africa abroad was reflected in an upsurge of interest in overseas investment on the part of South African acquiring firms. The *acquisition* by Liberty Life of a *controlling interest* in Transatlantic Holdings for R719m followed by Transatlantic's *acquisition of a controlling and ultimately 100% interest* in the UK firm, Sun Life for R880m, was one such outward investment. Outward investment caused significant acquisition activity, but a corresponding increase in publicly announced inward investment transactions did not occur, due to the domestic political situation.

The *buying out of minority shareholders' interests* and the subsequent delisting of twenty four (24) firms represented just over 10% of all combination transactions. Several of these transactions involved the simplification of pyramid structures that supported the notion that the then relative illiquidity of the market combined with its two-tiered nature (the difference between perceived quality shares and other shares) made listings relatively unattractive this year.

1992

In 1992 the total M&A transaction values increased to R13,4m contributed by the three deals in the mega deal category. These three transactions dwarfed other transactions during the year and accounted for nearly one-third of the total value this year. These transactions included Royal Corporation's *acquisition* of Del Monte International for R2,1bn, ABSA's *acquisition* of Bankorp for R1,2bn and Sappi's *acquisition* of Hannoversche Papierfabriken for R1bn.

Offshore investment activity was another major trend this year contributing R4,7bn, more than double the 1991 figure of R2,3bn. The significant transactions included an *acquisition* in Europe by Mondi, which acquired an Austrian pulp and paper firm for R560m. The local banks, First National, and Investec *acquired* overseas subsidiaries in transactions totalling R815m and W&A Investment Corporation *acquired*

an offshore scaffolding firm for R118m.

The offshore investment activity lasted until the South African Reserve Bank restricted the use of the financial Rand for this purpose. These restrictions were imposed towards the end of the year and required that finance for overseas investment be raised abroad unless substantial short-term benefits to South Africa could be demonstrated. In terms of the new regulations, repayment of loan finance had to come from income generated by the foreign entity. These restrictions dampened the accelerating interest in cross-border investment and led to the termination of a number of transactions being negotiated, but for which currency approval had not yet been obtained.

1993

The total value of transactions decreased by 39,4% in value to R8,1bn in 1993 versus the previous year and the total number of transactions decreased from 193 to 184 this year. The decrease in South African activity was not in line with international trends, where there was a marked resurgence in activity both in value and volume of combination transactions.

In 1993 there was a notable absence of transactions in the mega category (higher than R1bn). The largest transaction was an *acquisition* by Gencor of the interests in Richard's Bay Minerals held by Indsel, the Industrial Development Corporation, and Old Mutual. This was far lower than the biggest deal in 1992, which was Royal's *acquisition* of Del Monte International worth R2,1bn. Gencor later used this acquired interest to help fund its \$1,5bn *bid* for the offshore, Billiton, for which Reserve Bank approval was already obtained, provided that Gencor raise the purchase consideration offshore.

Outward investment in 1993 accounted for 13% of total activity and R1bn in value and was significant in the light of the tightened central bank restrictions. There was also a significant increase in inward investment in 1993, which recorded an increase of 268% to over R400m. This represented only 5% of the total but was a positive trend for the local economy.

The marked feature of the M&A activity during 1993 was the process of corporate *unbundling*. This phenomenon was designed to unlock the underlying value of a conglomerate to its shareholders. This is similar to what is called 'equity carve-outs' in the US. The major South African corporations that went through the unbundling process included Gencor and Barlows. These transactions were excluded from the M&A recorded transactions as there was no real transfer of ownership and the large value of the transactions would have had a distorting effect on the statistics.

There was a growing incidence of firms to form *joint ventures* and combine skills and assets. *Joint*

ventures effected included Sasol/AECT's merging of their petrochemical and plastics interests, the Femcotec/Unihold combination of their automotive manufacturing activities, the processed food and distribution *joint venture* formed by ICS and Foodcorp, and the ICS/Nestlé ice-cream *joint venture*. There was also a marked increase in the number of foreign firms investing into South Africa through *joint ventures* as occurred in the Amic/Daewoo and Pillsbury/Foodcorp combination transactions.

1994

1994 with the democratic general elections was a watershed year with South Africa regaining acceptability in international circles. The focus on international deals both inward and outward was therefore bound to increase and there was a surge in cross-border investment with two transactions over R1bn concluded by South African acquiring firms purchasing offshore assets.

The total value of transactions announced in 1994 increased fourfold to R30,5bn and a new record since Ernst & Young began the survey of M&A activity. The increase was primarily contributed by four mega transactions with a combined value of over R20bn. The return of these mega deals demonstrated the ability of South African corporations to fund offshore acquisitions despite the continuing stringent exchange control regulations.

In the largest of these transactions Trans Natal Coal *gained control* of Rand Coal for R5,9bn. The combined operation, renamed Ingwe Coal, became the third largest producer of coal in the world and the world's largest exporter of steam coal. In another billion rand transaction two of JCI's gold mines were *merged* in a transaction worth R4,8bn. In the biggest offshore transaction of the year the paper and pulp firm, Sappi, *acquired a controlling interest* in SD Warren, the market leader in coated wood-free papers in the US. The transaction amounted to \$1,6bn with Sappi *acquiring a controlling interest* of not less than 70%. Sappi provided only \$250m in cash to the deal with the rest of the funds provided by lenders against the security offered by the target firm. Sappi did not use South African currency, but was able to borrow \$200m against assets already held outside the country. In the second largest offshore transaction Gencor *acquired the Billiton assets* from Royal Dutch Shell's metal division for a purchase consideration of \$1,1bn.

Political power arrived for the previously disadvantaged communities in 1994 and black economic empowerment (BEE) started to contribute to combination activity. The process began in 1993 when Gencor disposed of its 10% shareholding in Metropolitan Life to the firm now known as New Africa Investments (NAIL). NAIL *acquired* in 1994 a *further 20% interest* in Metropolitan Life and also *gained an effective 52,5% interest* in The Sowetan newspaper and an effective 7,1% in the cellular network operator MTN for R84,5m. Another major emerging black businessmen grouping was Real Africa Investments

which during the year *acquired* 51% in African Life from Southern Life for R163m and then followed up with an *investment* of R132m in the Oceana Fishing group in partnership with Tiger Oats. Thebe Investment Corporation was a third grouping, which *acquired a controlling interest* in insurance brokers Hubert Hosken & Co for R9m, followed by an *acquisition of a controlling interest* in Citizen Bank and formed a R20,4m insurance *joint venture* with Fedsure. A feature of these BEE transactions was the imaginative way in which finance was raised. In many cases the sellers participated by providing funding, but in addition all avenues for harnessing existing black sources of capital was pursued such as from stokvels, worker unions and mineworkers provident funds.

Outward investment amounted to R10,6bn in 1994, compared to just over R1bn in 1993, which was largely contributed by the Sappi/SD Warren and Gencor/Billiton *acquisitions*. The continuing restrictive exchange control regulations necessitated that South African corporations wishing to expand offshore had to source funding for foreign acquisition offshore. As Sappi did, Gencor had persuaded offshore lenders to provide loan capital against the security of the offshore assets being purchased without recourse to Gencor itself. Gencor provided only \$335 m in cash raised from the sale of certain of its existing offshore assets. Other notable outward investment transactions were all into the UK and included Pepkor's *acquisition of management control* of retailer B&J Holdings, Nampak's *acquisition* of Blomocan, and Murray and Roberts' *acquisition* of Alloy Wheels International.

Large international firms recommitted themselves to investment into the country and corporations such as Coca Cola, Kentucky Fried Chicken and Pepsi Cola re-established themselves with the promise of further investment. By the end of 1994 the total value of inward investment announced by foreign buyers was double that of 1993 at R821m. Transactions disclosed included Federal-Mogul's *acquisition of* 100% of the shares in the motor spares retailer Varex, and IBM re-entered the local market by *acquiring* 24% of the information technology firm, ISG, which was formed when IBM disinvested from the country in the eighties.

Unbundling continued to be a focus for the major groups supported by the result of Gencor shares, which used to trade at a 15-20% discount to underlying share value and this year after the *unbundling* move was trading at a premium. *Unbundling* transactions announced during the year included JCI's *unbundling* of Argus Holdings, Gencor's *unbundling* of Keeley Granite Holdings, Barlow Rand's *unbundling* of Romatex, and the *unbundling* of Elcentre Corporation.

Several *strategic alliances* were made between local and international stock broking firms in response to proposed changes in JSE rules. SG Warburg, the UK merchant bank, set up a *research sharing arrangement* with Ivor Jones; Roy & Co, James Capel undertook to *acquire a 30% stake* in Simpson Mckie and Davis Borkum Hare & Co with Smith New Court agreed to *create a jointly owned stock broking firm* in New York.

1995

The business community was encouraged after 1994 with the democratic elections and given continuing positive economic conditions another strong increase in combination activity was achieved. Transactions valued at R43,5bn were recorded, up 42% on 1994. The drivers of this activity were several cross-border transactions confirming the intent of big business to compete in the international arena; a record R3,9bn in inward investment; continued black economic empowerment; and a healthy growth in the number and value of ordinary transactions.

The largest single transaction of the year was the *merger* of the tobacco interests of the SA-based Remgro and Swiss-based Richemont in a deal valued at R8,7bn from a South African perspective. The merger gave Remgro a third stake in Rothmans International, the then fourth largest tobacco firm in the world. Another international deal was the US\$400m (R1,46bn) *joint venture* between Coca Cola and the Port Elizabeth-based SA Bottling Company.

Outward investments were mostly financed through offshore borrowings and the sale of offshore investments. The largest outward investment deal was Sentrachem's R865m *acquisition* of the US Hampshire Corp. The South African fuel company, Sasol, took a majority stake in the Schuman/Sasol *joint venture*. Investec announced the R243m *acquisition* of the UK firm, Clive Discount House, financed from offshore resources.

The R3,9bn of inward foreign investment was much higher than the R821m in 1994 with information technology firms investing and large foreign financial services firms buying into local stock broking firms. SBC International, the then world largest cellular phone company, *bought a 15,5% stake* in MTN for R300m. Commercial Union plc *acquired 15%* of Commercial Union SA, the US computer company, Unisys, *bought back* Unidata from Datakor for R130m, and Mitsui and Nissan Diesel *acquired 13%* of Automakers for R112,5 m in the first Japanese investment since sanctions were lifted.

BEE produced 23 transactions valued at R12,3bn. This included the *unbundling* of Johannesburg Consolidated Investments (JCI) by Anglo American to black shareholders. Amongst the smaller transactions were the *acquisition of a 15% stake* in the dairy products Clover Holdings by Dynamo Investments; Thebe Investments *acquired a 5% stake* in electronics firm Altron, and New Africa Investments Limited (Nail) with its partner Metropolitan Life rescued the troubled African Bank for R55m.

The SA transactions were done against the background of record international M&A activity. US transactions valued at \$700bn were done which represented a tripling of the activity versus 1992. This was driven by lower interest rates, high liquidity amongst investment banks and soaring share prices.

1996

BEE as well as increasing *unbundling* continued to be driving forces in 1996 in line with a continued economic upswing. The former accounted for 11% and the latter for 18% of the total activity. An acceleration of *mergers and acquisitions* occurred as the country responded to the challenge of reshaping its economy in response to international pressures as well as internal social and politically changes. The total value recorded was R62,2bn, a 43% increase over 1995. This particular year there was a significant increase in the number of mega transactions worth more than one billion Rands, which represented 64,5% of the total activity. Three giant BEE transactions appeared in the mega deal list: African Mining group's *acquisition* of 34,9% of JCI for R2,9bn, the R1,6bn *restructuring* of New Africa Investments Limited (Nail), and the *acquisition* by the National Empowerment Consortium (NEC) of 35% of industrial conglomerate, Johnnic, for R2,6bn. NEC comprised close to 40 business, trade union, and community groups, with grass roots representation of more than one million, and established a new model for BEE with its broadening of the black ownership base.

The largest *unbundling* of the year was that of Genbel and involved the distribution of its underlying share holdings in Dimension Data, Genbel Securities (Gensec), Engen, Gencor, Grintek, Investec, Sappi and others to Genbel shareholders in a transaction of R5,2bn. The acceleration of large *unbundling* transactions reflected a renewed search for business focus as a means of optimising shareholder value and an increasingly competitive business environment. This focus was in stark contrast to the 1960s and 1970s when firms pursued conglomerate diversification as a hedge against business risk.

About 40% of the transactions in 1996 were the *merger or acquisition of related businesses*. These included the *merger* of Boland Bank with the banking and financial interests of NBS Holdings as well as the *merger* of Adcock Ingram and The Premier Pharmaceutical Company in response to changes taking place in the medical industry.

1997

Unbundling gained further impetus in 1997 (transaction value was 2.7 times more than 1996) through the *unbundling* of household names such as Malbak, Servgro, Hunt Leuchars & Hepburn and M-Net. Another major driver was the increasing emphasis on 'focus' in the consolidation to core businesses and *merging* with similar or related businesses to gain economies of size and increased strength towards international relevance. South Africa's largest combination (R17,2bn) to this date, resulted when Anglo American's gold interests were *merged* in the holding vehicle, Anglogold. The R11,9 bn *merger* of the gold interests of Gencor and Gold Fields reflected the seriousness of this trend.

BEE continued to be a major driver as well as further inward investment. The largest inward investment was the *acquisition* by SBC International Inc and Telekom Malaysia of a 30% stake in the partially privatised Telkom in a transaction valued at R5,5bn. The largest commercial investment was the R2,3 bn *purchase* of Sentrachem by The Dow Chemical Company from the USA. South African firms continued to invest internationally in 1997 with the largest investment by Sappi in an R6,1bn *buyout* of the Dutch paper and pulp firm KNP Leykam. Outward investment by information technology firms included Persetel Holdings, which *acquired* 70% of Telemation Netzwerk AG in Germany and Didata invested R1, 1bn to *acquire* Datacraft Australia.

1998

In 1998 total combination activity of R166,2bn was recorded, which represented an 89% jump over the 1997 value in line with a global trend to seek size to be more competitive in world markets. A record \$2,4 trillion in transactions was effected in the US, which represented an increase of 50% versus the previous year. The two largest combination transactions this year were also the largest in South Africa's history to date: the R71,3bn *merger* of Anglo American Corporation (AAC) and Minorco to form Anglo American plc prior to its listing on the London Stock Exchange, and then a R59bn *merger* of the financial interests of AAC and Rand Merchant Bank Holdings to form the financial services group, FirstRand, with its operating companies: Southern Life, First National Bank and Momentum Life.

The AAC and Minorco *merger* was one typical move of the mining industry to veer away from the concept of individually listed mines and to create mining firms with critical mass. It reflected an endeavour to streamline corporate structures through the *acquisition of minority interests* and subsequently delist a number of mining and industrial entities. In this process mining giant groups such as AAC and Billiton disinvested from non-mining activities and sought listings internationally to gain access to cheaper capital. Restructuring in the financial sector was driven by an attempt to achieve economies of scale in an industry that is required to invest heavily in technology and an objective to take advantage of perceived synergies in bancassurance through the cross selling of products.

1999

The seven-year series of increasing transaction values was finally paused in 1999 when R231,6bn was recorded, which was 26,4% down on the previous year. The South African M&A market ran counter to the trend in the rest of the world where the explosion of M&A activity continued unabated by the unbroken upwards movement of the world stock markets during the year, particularly the technology stocks listed on NASDAQ.

A major driver of combination transactions for this year in South Africa was group *restructuring and unbundling* as a result of a focus on core business and the streamlining of corporate structures through the elimination of unnecessary cross-holdings and reducing the number of shareholder entry points into the groups. The complex cross holdings and common directorships were gradually being dismantled. Corporate unbundling promoted a strict industry focus, greater focus, operational control of assets, and clear management responsibility. Prominent unbundlings in 1999 included the R4,3bn *unbundling* by Liberty Life of its investments in Bevcon, SA Breweries, Edgars, Metro, Adcock Ingram and The Premier Group. Other major *unbundlings* included the *unbundling and winding up* of Bevcon as well as the investment holding company, CG Smith, which *unbundled* its stakes in Tiger Oats, Illovo Sugar and Nampak.

Mergers of related businesses continued to be a driving force by acquiring firms aiming to achieve critical mass through market share and growing the focused business along industry lines. Rembrandt Group and Richemont AG announced a *merger* between Rothmans International and British American Tobacco (BAT). Remgro *exchanged* its one-third interest in Rothmans International for BAT shares worth R15,6bn. Standard Bank Investment Corporation *bought the 50%* of Liblife Controlling Corporation it did not already own for R5,6bn. Sasol Chemicals Industries *purchased* AECI's 40% interest in Polifin and after *acquiring the minority interests*, delisted Polifin.

Black economic empowerment transactions in line with the general refocusing trend shifted from a conglomerate approach in the early 1990s towards the *building of focused business groups* in selected industries. Johnnic completed its transformation to a focused telecommunications, media and entertainment group by *increasing its interest* in Omni Media Corporation and M-Cell and *disposing of non-core assets* such as stakes in SA Breweries, Edgars and Adcock Ingram. New Africa Investments Limited (NAIL) *sold* its technology investments in line with its intention to transform itself into an operational company focused on financial services.

Cross-border investment was a growing activity with outward investments totalling R28,1bn in 1999 compared to the R18,5bn in 1998. This reflected increasing globalisation of the South African economy through strong domestic firms diversifying their operations offshore through *acquisitions*, but on the other hand, *inward investment* at R13,4bn was slow due to the higher risk profile of South Africa as an emerging market. The largest inward investment was the R3,5bn *acquisition* by Verisign of Thawte, a global provider of digital certificate products and services that create security and authenticity in electronic commerce.

2000

Combination activity in 2000 grew by a healthy 61% to R372,2bn. The major driver accounting for just over half the growth in transaction value was further offshore expansion by South African firms recently listed on the London Stock Exchange (LSE), while the transaction to facilitate the offshore listing of Dimension Data in London accounted for most of the other half. Underpinning the recovery in total value was the significantly higher number of transactions within the mega deal (now categorised as value in excess of R5bn) category. There were seventeen transactions in this category and two deals with a value exceeding R15,6bn, namely the Dimension Data *unbundling* and the Rembrandt Group *restructuring*.

Whilst R78,8bn or 21% of the total activity came from transactions concluded offshore by acquiring firms with primary listings elsewhere the purely local market was more subdued. Large-scale *unbundling* by conglomerates were drawing to a close and the new wave of unbundling by tightly controlled firms such as Pepkor and the Rembrandt group were fuelled by the JSE's new prohibition on certain control structures. The apparent outward investment by major South African corporate firms with a primary listing on foreign bourses grew almost fourfold. This was, however, not true outward investment since the capital was not flowing from South Africa, but from the domicilium of the listed companies, typically London.

Movement in terms of BEE shifted away from *minority stakes* in large listed companies in favour of *management control of smaller unlisted companies* and *equity joint ventures*. This shift resulted from the unpopularity and later prohibition by the JSE of the traditional means of attaining control through *pyramid structures* and 'N' shares. Special purpose vehicles (SPVs) and deals financed through high leverage became unaffordable in the context of low JSE share prices. After a slow start to company share buybacks following the amendment of the Companies Act in 1999, *buyback of own equity* became a strong trend in M&A activity during 2000 aiming at improving earnings per share and strengthening the share price.

Mergers and acquisitions of related businesses through *share swaps* and *acquisition* emerged as the major driver accounting for 491 transactions valued at R180,4bn in 2000. The most prominent of these transactions were the *swap* by Transnet of its 23% stake in MTN for a *stake* in M-Cell, effectively giving M-Cell 100% *ownership* of the mobile telephone company MTN in a transaction worth R12,1bn. Nedcor *exchanged its 20.1% holding* in Dimension Data International for shares in Dimension Data plc. The

R9,1bn *share swap* raised Nedcor's *direct stake* in Dimension Data to 8.2%. Two groups – Anglo American plc and the Rembrandt Group – continued to rationalise their investment portfolios by *swapping* non-core investments for core investments. Anglo American plc disposed of one of its non-mining assets, a 15% *stake* in financial services group, FirstRand, to the Rembrandt group in exchange for two mining assets, 7% of Billiton and 11% of Gold Fields.

Unbundling and *group restructuring* remained a major driver of combination activity and accounted for 58 transactions valued at R143bn in 2000. This was significantly higher than the 60 transactions valued at R80bn in 1999. The largest transaction of the year was the transfer by Dimension Data of all its subsidiaries, assets and liabilities to Dimension Data plc, a company listed on the London Stock Exchange. The transaction was followed by an *unbundling* of ordinary shares in Dimension Data plc to shareholders by way of a distribution in specie. The Rembrandt Group *restructured by splitting* into two more focused listed companies. The split had the group retaining its established investments in tobacco, banking and mining and renaming the company, Remgro, whilst the technology orientated assets were separately floated under a new listed company, Venfin. Remgro simultaneously collapsed its four-tier control structure and replaced it with the issue of unlisted high-voting 'B' shares to the controlling shareholder, Rembrandt Trust.

2001

The underlying trend in 2001 was a contraction in M&A transactions in South Africa. Companies make deals typically in an environment of stability and 2001 was a volatile year even before the September 11 terrorist attack in New York. The record, however, shows that 2001 was a record year in terms of the value of transactions announced, R502,4bn, which was 35% higher than the 2000. This paradox was attributed to two transactions, which accounted for 75% of the total M&A value during the year. Without these two transactions the value of total deals would have fallen to a third of the total recorded in 2000. The first of these two transactions was the R232,2bn *merger* of the South African mining giant, Billiton, with the Australian listed mining group, BHP, to create the world's largest diversified mining firm and a *dual listed company* – both in London and Sydney – as an alternative to a *full merger* with both companies continuing as separate legal entities, but operating as a single economic entity. This was the largest *merger* both in South African and Australian corporate history and created the world's largest diversified mining firm. Billiton was the first of the large South African mining groups to attain a primary listing in London in 1997 and was the first to be subsumed into a larger international group. The second one was the South African diamond firm, De Beers, which was delisted following its *acquisition*

by a consortium comprising Anglo American plc, the Oppenheimer family and De Beers Botswana, after being listed on the JSE for more than a hundred years.

The underlying trend of reduced M&A activity was already in a downward trend at the beginning of the year as the US economy in particular went into a contraction phase. This was bound to affect South Africa sooner or later. Then came September 11, the global equities crash and the collapse of the Rand. These extremely negative events accelerated the dampening of domestic M&A activity as many deals in the pipeline were postponed until less volatile times. Cross-border activity, which has over the past few years become a large component of global activity, also was negatively affected by the above factors.

The major M&A activity during 2001 was in the resources sector, which currently makes up just over half of the market capitalisation of the JSE, compared to 17% by the financial services sector. Two years ago these two sectors each accounted for 33% of the market's total value. The major transactions were the \$28bn *merger* of Billiton plc with the Australian firm, BHP, and the \$18,7bn *restructuring* of De Beers Consolidated's shareholding leading to its delisting. The biggest black empowerment transactions were also in the resources sector given the size of this sector and the empowerment aspects of the new Minerals Development Act.

Many of the largest transactions announced during 2001 involved South Africa's six major offshore listed firms: Old Mutual plc, Anglo American plc, BHP Billiton plc, SA Breweries plc, Liberty plc and Dimension Data plc. Given that the foreign markets on which these firms are listed have an average valuation considerably higher than the JSE, these offshore listed firms represent over half the valuation of the JSE and are consequently likely to continue to dominate M&A activity into the future.

The fourfold increase in outward investment during 2000 was sustained during 2001. This quantum growth in apparent outward investment was as a consequence of the number of major South African firms having their primary listing on foreign bourses. In contrast, the underlying trend in inward investment to the country continued to slide from a position, where a few years ago the levels of outward and inward investment were in broad equilibrium. From 1994 to 1998 the rate of growth of inward investment matched that of outward investment, but has since decreased each year. Outward investment should continue to be a strong trend in South African M&A. Competition legislation effectively bars many large firms in mature markets from growing domestically, thereby forcing them to look abroad for expansion. Since the failed Nedcor/Stambic bid, for example, most banks have concentrated their attention on foreign acquisitions. The domestic market is not large in global terms, and is not growing fast enough to satisfy the growth aspirations of many corporates.

The BBE movement remained one of the most important sectors for M&A activity, but has since 1998 awaited a new direction that was expected from the government and Black Business Council. The nature of black empowerment has irrevocably changed from *minority stakes* in large listed firms in favour of management control of smaller unlisted companies, as well as *joint ventures* and *strategic alliances* in which values have often not been announced.

There has been a steady reduction in the value and importance of unbundling within M&A over the past three years. In 1999 it accounted for nine of the year's largest transactions, but its contribution in 2000 shrunk to four of the year's 17 mega transactions. During 2001 there was only one mega transaction, which primarily involved an unbundling.

Share buy-backs as a fairly recent trend, continued to be a popular means of corporate restructuring among listed and unlisted firms alike, but their value declined in relation to 2000 and the average transaction value was low compared to other types of transactions. Share buy-backs were permitted for the first time in 2000 following the amendment to the Companies Act in 1999. They were seen as a means to improve earnings per share and thereby strengthening a share's valuation as well as enhancing the balance sheet.

Since Nedcor's hostile bid for Stanbic in 2000, which did not win regulatory approval, contested or hostile bids have become an increasing feature of South African M&A transactions. AngloGold was involved in two, but it ultimately withdrew from its bidding war with Harmony Gold for Freegold, in order to focus on its bidding contest with the American based Newmont Mining, for Normandy Mining based in Australia. After twice increasing its bid, it again withdrew as its assessment was that the price was getting too high.

The regulatory environment continued to realign with world standards. The JSE's new listing rules contributed to achieving the desired effect of raising the quality of local listings, as well as improving the operations of the local market. More than a hundred small capitalisation firms have delisted or have been bought out since 1998. The recently introduced competition regulations continued to make their presence felt, and fewer transactions than were expected were turned down by the competition authorities. Tough economic conditions world-wide and locally led to a business environment that was testing local management.

Table 3.7. The twenty largest South African business combination transactions, 1991 – 2001.

	Description of the combination transaction, the combination vehicle, and the new entity formed.	Value R billions	Year
1	<i>Merger of Billiton plc with Australian mining house, BHP Ltd, to create dual-listed company, BHP Billiton.</i>	223,2	2001
2	<i>Buy-out of De Beers' minorities by Anglo American plc, CHL and Debswana and the subsequent delisting of De Beers.</i>	153,7	2001
3	<i>Merger of Anglo American Corporation and Minorco to form Anglo American plc prior to Anglo American plc's listing on the London Stock Exchange.</i>	71,3	1998
4	<i>Merger of financial interests of Anglo American Corporation and Rand Merchant Bank to form FirstRand.</i>	59,0	1998
5	<i>Sale of Dimension Data's assets to Dimension Data plc and unbundling of consideration shares.</i>	57,5	2000
6	<i>Sale of SA Breweries' assets to SA Breweries plc and unbundling of consideration shares.</i>	34,3	1999
7	<i>Rembrandt group restructuring – split to two focused groupings, Remgro and Venfin.</i>	33,5	2000
8	<i>Gencor's sale of its non-precious metals to Billiton prior to Billiton plc listing on the London Stock Exchange.</i>	23,5	1997
9	<i>Merger of BoE Corporation and Orion Selections.</i>	18,7	1998
10	<i>Merger of Anglo American's gold interests under new vehicle, Anglogold.</i>	17,2	1997
11	<i>Disposal by Rembrandt Group of its 33% shareholding in Rothmans International to British American Tobacco in exchange for BAT shares.</i>	15,6	1999
12	<i>BoE unbundling and group restructuring.</i>	13,7	2000
13	<i>Unbundling of M-cell shares by Johnnic Communications.</i>	13,3	2001
14	<i>Unbundling of JCI Investments and eventual sale of JCI to Investec.</i>	13,3	1998
15	<i>Unbundling of SA Breweries stake by Bevcon.</i>	13,2	1999
16	<i>Anglo American plc's acquisition of Rio Algom.</i>	12,5	2000
17	<i>Anglo American plc's acquisition of Tarmac plc.</i>	12,3	2000
18	<i>MCell acquisition of stake in MTN from Transnet.</i>	12,1	2000
19	<i>CG Smith unbundling and winding up.</i>	12,0	1999
20	<i>Merger of gold interests of Gencor and Gold Fields of SA into new Gold Fields.</i>	11,9	1997

Source: Ernst & Young Mergers & Acquisitions, Annual review of activity, 2002: 3.

3.6 INTERNATIONALISATION THRUST BY SOUTH AFRICAN ACQUIRING FIRMS TO EXTEND OPERATIONS OFFSHORE

The thrust by South Africa's giant acquiring businesses to extend their footprint internationally and expand operations offshore has been underpinned by *an internationalisation mindset* in synch with increasing globalisation and an increase in cross-border activity world-wide as well as certain macro environmental factors, mainly domestic political and economical considerations, that accelerated the offshore listing of these firms. The offshore listings by South African firms were aiming to achieve improved access to international capital markets to fund globalisation programmes as well as having an objective of improving their stock market ratings by extending the international investor base.

The current list of offshore listings by South African originating firms includes:

- 1) The dual listed mining group, BHP Billiton plc, which resulted from a merger between the London-listed South African mining group, Billiton plc (Billiton listed in August 1997 on the LSE) and the Sydney-listed Australian mining house, BHP (BHP Billiton is dual listed on the London and Sydney stock exchanges);
- 2) The merged brewery group, SABMiller plc, resulting from an acquisition of the US firm, Miller, by the South African brewer, SA Breweries (SAB listed on the LSE in March 1999);
- 3) The South African mining group, Anglo American plc (listed on the LSE in May 1999);
- 4) The multinational financial services group, Old Mutual plc, which grew from the local assurance group (listed on the LSE in July 1999);
- 5) The information technology group, Didata plc (listed on the LSE in July 2000);
- 6) The luxury goods firm, Richemont (Luxembourg, Switzerland);
- 7) The financial services group, Liberty plc;
- 8) The gold mining firm, Goldfields (listed on the New York Stock Exchange in May 2002);
- 9) The banking group, Investec plc (listed on the LSE in July 2002);
- 10) The gold mining firm, Harmony Gold, (listed on the NYSE in November 2002).

The dual listed companies (DLC) structure by BHP Billiton and Investec feature unified boards of directors and management, separate legal entities and listings, but bound together by contractual agreements and mechanisms. Shareholders have common economic and voting interests and are entitled to equivalent dividends, joint electorate and class right voting. In the case of Investec all foreign businesses are held by Investec plc with a primary listing on the LSE and a secondary listing on the JSE. Investec Group Ltd with a primary listing on the JSE holds all its subsidiaries in Southern Africa and Mauritius (Investec annual report, 2002: 26).

The major motivations in the business rationale that were causing the internationalisation of these large acquiring corporates from South Africa were predominantly along the following dimensions:

- To attain *profitable investments in the same line of business* that would enable a productive employment of capital. The South African mining giants, Anglo American and Billiton, acquired various mining operations in other African countries, Australia and the Americas to acquire mineral rights and land, to employ excess capital profitably and to apply core business competencies for the benefit of shareholders. Anglo American's gold vehicle, Anglogold, is currently the world's largest gold mining firm and has a world-wide portfolio of mining investments. Billiton's merger with the Australian, BHP, created a new spider web of cross-country holdings that integrated the South African economy with the rest of the world. According to its 2001 annual report, 80% of BHP Billiton's assets were outside South Africa (SA Giants 2001, Financial Mail, 2001:2).

- To obtain *broader international industry expertise, a physical presence through staff, infrastructure, and distribution networks*, as well as *captured market share in international markets*. This was particularly relevant for the internationalisation by South African financial services firms. Old Mutual, the market leader in the local life insurance industry, was one of the first South African financial giants to acquire a UK based firm, Providence Capital, in 1986 to obtain a presence in European markets and develop expertise in the international investment sphere (Personal interview, G. Griffin, 1992). Expansion of the Old Mutual International arm with operations in the UK, Guernsey, Hong Kong and Boston in the US followed. Later the Boston-based United Asset Management was acquired for \$2,9bn, which increased funds under management from £45bn to £169bn in 2000. A further acquisition in the UK of the Gerard Group for £529 m strengthened Old Mutual's share of the UK private client asset management and stock broking business. A further international diversification of its life assurance business was the joint venture with an Indian financial services group, Kotak Mahindra, to set up a life assurance firm in India.

- To obtain *improved access to international capital for further offshore product-market extension* and improve the competitive positioning of both its South African and foreign/offshore operations. The information technology firm, DiData, listed in July 2001 on the London Stock Exchange and used the capital raised there to finance further expansion into North American, Europe and Australian markets. It acquired foreign firms such as Chernikeeff Networks in the UK and ComTech Communications in Australia and had announced a R8bn acquisition programme for 2001. It has, however, recently suffered severely from the disenchantment with technology stocks and the world-wide volatile markets since 11 September 2001 as well as a problematic situation in that acquired firms were not able to deliver the projected earnings.

- Investec, a modest leasing and instalment finance business established during 1974 in Johannesburg, made its first successful international foray in 1992 when it acquired Allied Trust Bank in London and obtained a banking licence. This was followed by an acquisition of the New York based Ernst & Co in 1998 and an acquisition of a controlling interest in Israel General Bank. It also subsequently established operations in Botswana and Namibia as well as Australia. In 1999 it acquired Gandon Capital Markets in Ireland and listed in July 2002 on the LSE, which enabled it to *reduce its cost of capital significantly, improved its access to international capital markets* and broadened its international investor base.

- The local brewer, SA Breweries, moved into other African countries, Europe, China and the central Americas in the 1990s, when the local beer consumer market did not offer any significant growth opportunities after strong growth was achieved in the 1980s. The firm moved its primary listing to London in early 1999 after it had disposed of most of its previous diverse investments in South Africa to focus on brewing. When SAB moved to London about 85-90% of its profits came from South Africa, but the offshore profits increased to around 53% in 2002. Through its expansion into selected other world markets it became the world's fourth largest brewer. In mid 2002 SA Breweries plc acquired the US brewer, Miller, (twice the size of the SA brewer's business) for \$5,6bn and the new merged entity, SABMiller, became the world's second largest brewer. The *acquisition achieved critical mass* through the acquired operations world-wide and the captured existing market share.

Some commentators on mergers and acquisition activity have argued that offshore combination through mergers and acquisitions by these large corporates have diverted much-needed capital away from the South African economy. Most of the capital has, however, been raised offshore, largely in London. In aggregate, however, about a quarter of the market capitalisation of the JSE has moved offshore and with it possibly a greater proportion of South Africa's M&A activity. In most of these cases these acquiring firms have been internationalising their business before they listed offshore. The upside of increased internationalisation is that tying in foreign shareholders through primary offshore listings has increased the profile of South African firms and the country on global radar screens. This may make it easier for local combination-intent businesses to find international partners for combination and also attract higher levels of inward investment by multinational firms. The outward internationalisation thrust by South African large corporates have been in line with a world-wide consolidation in a wave of large scale mergers to achieve critical mass and competitiveness on a global front.

3.7 WORLD-WIDE CONSOLIDATION THROUGH MEGA-MERGERS TO ACHIEVE CRITICAL MASS AND COMPETITIVENESS

3.7.1 Fifth merger wave in the United States

The US M&A authority, Patrick Gaughan (2002: 51), has called the series of increased M&A activity in the US during the period, 1992 – 2001, the fifth merger wave. The fourth wave of US mergers occurred during 1984 –1989, characterised by the use of aggressive takeover tactics, leveraged buyouts and junk bonds financing (Gaughan, 1994:3). The fifth wave featured many large mega-mergers. There were fewer hostile deals and more strategic mergers occurred. These transactions were financed through increased use of equity, which resulted in less heavily leveraged combinations. The M&A market became characterised by consolidating deals, which were called 'roll-ups'. Fragmented industries were consolidated through larger scale acquirers that were called 'consolidators'. The financial market was initially enthralled by these deals, but changed its view when these transactions failed to deliver on promised gains such as lower costs and greater synergies. The deals of the fifth wave were part of a world-wide phenomenon, with a large number of mergers taking place in Europe and Asia.

3.7.2 World-wide increased combination activity in the 1990s

The 1990s had seen a world-wide increase in mergers and acquisition activity reaching new dimensions in swiftness and size. Total activity world-wide increased to \$2,4tn in 1998, \$3,3tn in 1999 and reached the highest level to date of 3,5 trillion dollars in 2000. The combined Gross Corporate Product (GCP) of new global merged entities such as DaimlerChrysler, Exxon Mobil, and Citigroup is rapidly approaching the GDP of countries such as Canada, one of the G-7 countries. The size of these new huge firms had raised the concerns of chief executives of other firms who feared that their firms might end up as regional second-tier players if they did not expand globally. In South Africa size as a factor in becoming globally competitive had been quoted as a reason for local banking consolidation as was argued in the Nedcor hostile takeover attempt of Stanbic.

The largest transatlantic merger in history, valued at an estimated \$40bn, occurred in November 1998 when Germany's, Daimler-Benz, and the third largest US car manufacturer, Chrysler Corporation, combined to achieve a new global giant in the automotive manufacturing industry. Cost savings was a major consideration in this merger as the combined firm subsequently announced 33 000 retrenchments in early 2001. Two global oil producers, Exxon and Mobil, announced their merger in the same month of 1998 and indicated the rationale as the need to focus on expanded growth opportunities as well as a proposed \$2,8bn in cost savings based on the elimination of duplication and excess capacity, the realignment of operations and a reduction in the workforce. This merger in the oil industry was argued to bring two types of benefits: near-term operating synergies and better returns due to the ability to fund a greater number of long-term growth projects.

The US based financial services firm, Travelers Group, was involved in mergers and acquisitions valued at \$80bn within a 12-month period during 1997 and 1998, which included \$9bn for Salomon Inc, \$1bn for a stake in Japan's Nikko Securities, and more than \$70bn with Citibank. The \$72,6bn merger resulting in Citigroup represented a consolidation in the financial services industry that was driven by a strategic vision of offering its customers global one-stop-shopping in financial services (Habeck, Kroger and Tram, 2000: 33).

Table 3.8 Ten largest world-wide business combinations through mergers and acquisitions at October 2002.

Acquirer	Target	Transaction value \$ billions	Announced year	Effective year
Vodafone Airtouch plc	Mannesman AG	202,8	November 1999	June 2000
America Online Inc.	Time Warner	164,7	January 2000	January 2001
Pfizer Inc.	Warner- Lambert Co.	89,2	November 1999	June 2000
Exxon Corp.	Mobil Corp.	78,9	December 1998	November 1999
Glaxo Wellcome plc	SmithKline Beecham plc	76,0	January 2000	December 2000
Travelers Group Inc.	Citicorp	72,6	April 1998	October 1998
SBC Communications Inc.	Ameritech Corp.	62,6	May 1998	October 1999
Shareholders	Nortel Networks Corp.	61,7	January 2000	May 2000
NationsBank Corp	BankAmerica Corp.	61,6	April 1998	September 1998
Vodafone Group plc	Airtouch Communications	60,3	January 1999	June 1999

Source: Gaughan, 2002: 4.

World-wide M&A volume jumped 36 percent to \$3,3 trillion in 1999, racing forward at \$1,6bn per business hour. US merger volume rose to a record \$1,75 trillion while Europe more than doubled to \$1,23 trillion, capped by the British firm, Vodafone Airtouch's \$202,8bn hostile takeover of the German firm, Mannesman – the largest business combination in history to date. US volume totalled \$6,5 trillion in the 1990s – more than half of this volume occurred in 1998 and 1999 alone. In January 2000, America Online announced the largest acquisition in US history, initially valued at \$183bn, of media and cable giant, Time Warner. Europe's Glaxo Wellcome and SmithKline Beecham Pfizer won a takeover battle against American Home Products, and acquired Warner-Lambert for \$89,2bn and in the process created a pharmaceutical giant at over \$230bn (Grubb and Lamb, 2000: 9).

Fig 3.2. M&A Transactions World-wide

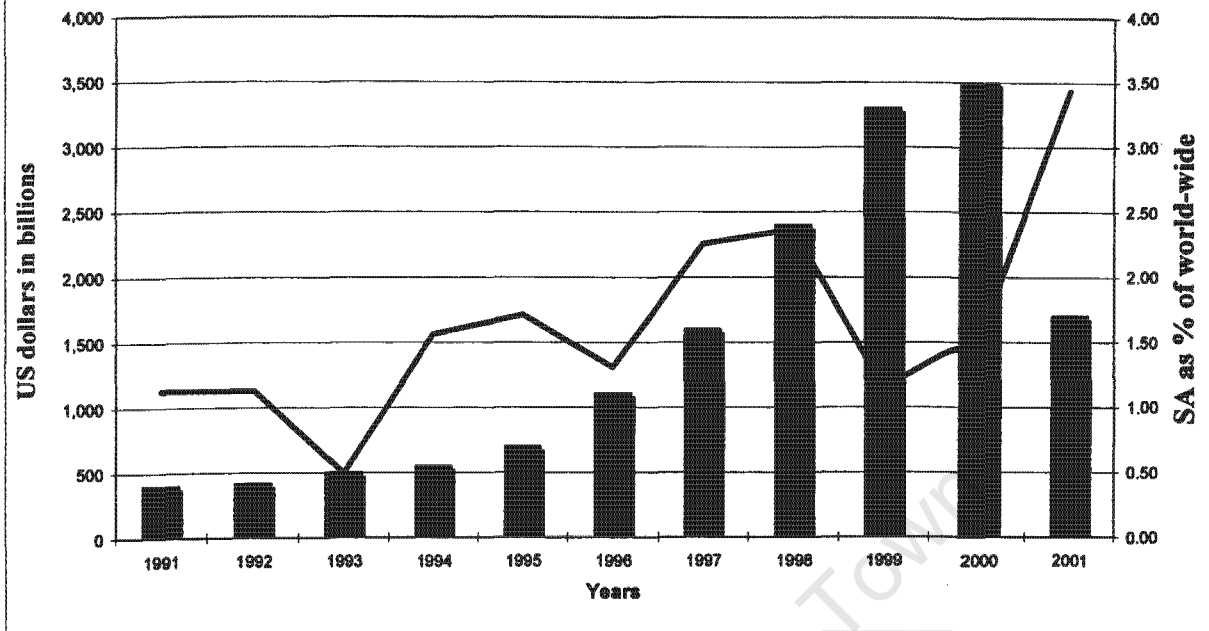


Figure 3.2 above depicts the phenomenal growth in total M&A transactions during the second half of the period to reach a peak of \$3,5 trillion in 2000. The slowdown in the pace of M&A activity world-wide, which became evident in the later part of 2000, continued and the value of world-wide M&A activity declined drastically by 48% to \$1,7 trillion from 2000's \$3,5 trillion. The absence of the mega transactions was particularly prominent. Whereas there were in 1999 seven mergers at more than \$50bn apiece, there were only two in 2000 and both were in the first month of the year. There were a number of failed merger attempts as firms generally moved into a protective mode.

The reasons for the slowdown in combination activity were similar to those causing a decline in South Africa – share prices fell a long way off their highs and therefore reduced the attractiveness of corporate equity as the means to pay for acquisitions. At the same time, for those acquirers that wanted to pay in cash, junk bonds all but dried up as a source of finance for acquisitive firms. Banks also tightened up on their lending criteria on riskier deals. The volatility of stock markets had an effect on the level of deal making in that acquiring corporate managers became more cautious, not wanting to commit to a transaction on one day only to find that the price had changed significantly the next day. The slump in the US economy had altered boardroom attitudes and M&A activity started to slow down in Europe even before America, particularly in the case of European acquisitions of US firms.

3.7.3 The transnational corporation as result of large-scale cross-border combination

Massive mergers and large-scale acquisitions have resulted in a new breed of firm that appeared on the corporate landscape since the 1980s, the transnationals, which exceed national boundaries and transcend

definitions of national identity. These corporations regard the entire globe as a single theatre of operations and locate factories, office staff and research where it makes the most sense for the global market that they serve. The transnational enterprise has been described as the fifth stage in what Dekker (Ruigrok and Van Tulder, 1995:138) called the transnationalisation of business:

The transnational enterprise is a network of organisations in which synergy plays an important role. Production in many cases is 'no longer local for local', but is situated in 'world production centres'. The firm produces only in a few places for the entire world or at least for a region. Concentration of products in some world production centres will take place in particular in those production processes in which scale advantages play an important role, transportation costs are low and which serve a large and homogenous market – for example by standardisation.

The business that transnationals do outside their countries of origin ideally generates sales and profits that are proportional to the world-wide distribution of their markets. In many cases that means 30% in Europe, 30% in North America, 20% in Japan, and 20% in other countries. Transnational corporations view the world as one vast seamless market in which all major decisions are focused to gain a global competitive advantage (Wendt, 1993:40).

In the current market every industrial firm is already competing against global products in most market segments. In many industries only these transnational firms with huge economies of scale and clout in the global market are able to lower costs and improve the quality of their products through breakthrough innovations in products and processes that are necessary to remain competitive. Transnationals such as Smithkline Beecham Pfizer and DaimlerChrysler have achieved this status through a cross-border merger of equals, which is the quickest combination vehicle to offer this massive type of consolidation.

The emergence of global products and services in the sense that they are widely available in many countries meeting the needs of local markets around the world and becoming instantly recognisable by people of many nationalities, have resulted in increasing sophistication by consumers who are seeking the best quality that they can buy. In many cases this consumer demand for global best quality can only be provided by huge transnationals with critical mass and cost advantages based on their global production and market offering. Such global products are manufactured in many countries and brought to market through a vast transnational network of plants, people and capital.

The leapfrogging advances made in information and communication technology as exemplified by the computer industry, biotechnology and the Internet have for long been a driving force underlying the consolidation and convergence of industries (Grubb and Lamb, 2000:164). Discoveries in one industry

often lead to cascading re-applications in other industries. While swifter communication created new links between businesses, these links often lead to combination opportunities. Many firms seek to merge, acquire or create formal alliances with others to obtain access to the best technologies to ensure that their technical expertise keeps them on the cutting edge in the continually reinvented competitive landscape.

Goods, people and capital are increasingly moving across national borders. Capital moves instantaneously from country to country at the touch of a button and international investors can acquire stocks in markets around the world trading in a global securities market that never closes. The movements in exchange rates, interest rates and stock prices in various countries have become interconnected to such an extent that international capital markets can be described as truly global. In the global capital market multinational corporations and financial institutions have considerable advantages over local ones. They have better access to capital, a broader base to finance research and development, and have a broader distribution of risks (Soros, 2000:299). The offshore listing drive by South African corporates was motivated by the need to have improved access to this mobile global capital.

Expert commentators on M&A activity (Grubb and Lamb, 2000: 137) asserted in 2000 that world-wide consolidation was rapidly gathering steam and could be expected to continue at an increasing rate. They argued then that global combination is in its infancy and foresaw a world-wide roll-up with speed and intensity not unlike many national roll-ups of highly fragmented local industries as in the US. They based their prediction on the logic that the world's thousands of businesses are still extremely fragmented; the further impetus of critical forces such as increasingly advanced commerce and communications technology; as well as the simultaneous demolition of many long-standing social and political walls of national protectionism, as evident in the establishment of the European Union (EU). Considered that these driving forces should gain further momentum and impact, they predicted a further acceleration of the trend to consolidate to fewer large-scale global players. This prediction should hold true when world-wide economic growth picks up again.

3.7 CONCLUSION

Combination activity in South Africa during the period, 1991-2001, was fundamentally affected by key characteristics of the South African economy such as its exceptional mineral wealth, the structure of Gross Domestic Product, economic growth performance, foreign direct investment and its market size and position versus world markets. The largest mergers during the period were effected in the primary sector in industries such as gold, diamonds, platinum, and coal mining.

The offshore expansion through combination by South African acquirers occurred into the major developed economies of the world in Western Europe, Northern America and Australia. This expansion

gained momentum after 1994 with South Africa's re-entry in the international capital market and the subsequent relaxation of exchange controls when some corporates made selective acquisitions offshore. This internationalisation accelerated later in synch with an increase in cross-border M&A activity world-wide. Further impetus was provided through offshore listings in financial centres such as London and New York when these corporates attained improved access to international capital and diversification of their investor base. Increased globalisation of these now multinational firms resulted in the shift of the headquarters and seat of the chief executives of some of these firms to particular world centres.

The major drivers of combination activity in the first half of the period, 1991-2001, constituted a reshuffling and refocusing trend that represented a reversal of the diversification philosophy followed previously. In line with this trend large corporations embarked on the unbundling of non-core investments to unlock underlying value to their shareholders. Mergers and acquisitions of related businesses represented another major drive in attaining critical mass and take advantage of economies of scale and larger market share. Black economic empowerment initiatives were responsible for a significant contribution to total combination activity since 1993. Towards the end of the period black economic empowerment activity shifted from minority stakes in large listed firms to management control of smaller unlisted firms and equity joint ventures in the building of focused groups in selected industries. Inward investment after 1994 picked up to be a significant driver of combination activity, but did not achieve the same level as outward investment transactions.

In the outward internationalisation by South African acquiring firms the acquisition of relatively large firms as platform acquisitions were amongst the first combination vehicles to be used. These combinations were largely the acquisition of stock, either 100% or a controlling stake, and establishing the acquired firms as subsidiaries. Later these acquired operations were managed by divisional geographic management structures or regional hubs in the specific global area, for example, North America, Europe, Asia or Australia. Some acquiring firms embarked on aggressive world-wide acquisition programmes to globalise operations and were noted as amongst the most active acquirers world-wide. Joint venture, as a combination vehicle for expansion was extensively utilised in capital intensive industries such as natural resource mining, in fuel and chemicals as well as the beverages industry. Joint ventures were used for both upstream as well as downstream expansion. A large merger of equals as a combination vehicle was effected in the mining sector with the South African and Australian business combination, BHP Billiton, which represented the largest transaction to date in these two countries.

The high levels of consolidation that have occurred due to cost savings as well as revenue enhancement considerations in many industries through cross-border mergers and acquisitions in synch with positive global economic conditions in the 1990s up to 2001, has since slowed down.

Given the key driving forces that will continue to impact as well as the extent of fragmentation in some industries, it is likely that large acquirers will increasingly use the most suitable combination vehicles for their particular cross-border expansion as well as internal consolidation to achieve increased competitiveness.

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CHAPTER 4

PRESENTATION OF THE EMPIRICAL RESEARCH FINDINGS IN TERMS OF THE BUSINESS COMBINATION DECISION-MAKING PROCESS IN SOUTH AFRICA

4.1 OBJECTIVES OF THIS CHAPTER

The results of the structured interviewing process in accordance with the grounded theory method focusing on the business combination decision-making process as practised in South African acquiring firms are presented in this chapter. The results are presented in terms of a summary of the sample of acquiring firms that were interviewed and empirical process models summarising the practice in acquiring firms based on information gained from the interviews. A comparison with an earlier summarised normative model as outlined in prescriptive literature is done and followed by a synopsis containing more detail of the empirical process activities in the combination decision-making of acquiring firms.

The first objective of this chapter is to highlight the relevant characteristics of the acquiring firms in the interviewing sample. Through the interviewing it became evident that the combination decision-making process was fundamentally different depending on whether a combination was a planned or an opportunistic situation. The second objective of the chapter is therefore to outline the planned and opportunistic empirical process models presenting these different decision-making practices. This is effected by summarising the empirical process models in the categories, subcategories and properties that emerged through the application of the grounded theory research method. The third chapter objective is to take a typical internationalisation through acquisition strategy and analyse the dynamic interrelationships in terms of the paradigm model of grounded theory. The fourth chapter objective is to compare the empirical process to an earlier normative model of combination decision-making as advanced in the prescriptive literature and highlight the essential variances with the practice in acquiring firms. The fifth objective of the chapter is to provide a synopsis describing how acquiring firms manage the various constituent elements in the combination decision-making process in their organisations. Finally, conclusions are presented to indicate to what extent the empirical processes in terms of business combination decision-making reflect prescriptive or emergent strategy modes.

4.2 THE SAMPLE OF ACQUIRING FIRMS THAT WERE INTERVIEWED

A few relevant characteristics of the acquiring firms that were interviewed, are indicated in this section to provide a background for the interpretation of the empirical process models and process activities, which

are summarised in this chapter. The grounded theory research method and the complexity of the combination decision-making phenomenon required first hand observation of the phenomenon in practice. It was therefore decided to interview face to face chief executive officers, vice-presidents or directors of corporate finance, and vice-presidents or directors of corporate development and their supporting staff. This was a more difficult research method than written feedback through mailing questionnaires, but very necessary to obtain as direct a response as possible from the key decision-makers involved in the structuring of combinations.

The focus of the research in this regard was to establish the state-of-the-art in the combination decision-making process in South African acquiring firms and to describe the key constituent activities of the process as managed by the acquiring firms given the rationale of the process perspective to combination decision-making as was highlighted in the first chapter. The description of sample characteristics presented here is therefore not aimed at comprehensively describing business combination characteristics, but merely to indicate the scope of the sample and certain relevant characteristics as a context for the description of the empirical decision-making processes.

The sample for interviewing that focused on qualitative aspects of the decision-making process was taken from large combination active firms in South Africa as captured by the Ernst and Young annual reviews of merger and acquisition activity. The sample contained thirty (30) acquiring firms from a variety of industries ranging from the banking, construction, electronics, information technology, insurance, mining, retail and support services industries. It included acquiring firms that effected mergers and acquisitions in South Africa as well as a few of the major multinationals, which originated from South Africa and currently also have listings on other of the world's major bourses. These acquiring firms have aggressively expanded offshore in recent years in synch with a global increase in cross-border combination activity. The frequency of combinations was a primary sampling consideration and the sample therefore included acquiring firms that conducted only a few combinations, firms with average combination activity as well as very active acquisitive firms that undertook more than ten combinations in a three-year period.

Size of total assets:	%
• < R1 000m	21 %
• R1 000m - R5 000m	17 %
• R5 000m - R10 000m	13 %
• R10 000m - R50 000m	21 %
• R50 000m - R100 000m	7 %
• > R100 000m	21 %

The sample indicates a fair distribution across the various large size categories used.

Combination type:	<u>%</u>
• Acquisition of stock:	65%
• 100% whole firm	36 %
• 50-100% controlling stake	16 %
• < 50 % minority interest	13 %
• Acquisition of assets	7 %
• Joint venture	14 %
• Merger of equals	3 %
• Strategic alliance	1 %
• Acquisition of block of business	10 %

The majority of combinations performed by acquiring firms were the acquisition of stock (65% of the combinations) in the sample. Among the acquisition of stock the majority of acquisitions were 100% of stock and establishing the acquired firms as wholly owned subsidiaries.

Frequency of combinations (past three years):	<u>%</u>
• 1	10%
• 2 – 3	53%
• 4 – 5	27%
• 6 – 9	3%
• 10 +	7%

The majority of the acquiring firms in the sample have done 2-5 combinations in the past three years, with most doing 2-3 combinations. Some very active world-wide acquirers performed more than ten combinations in a three-year period.

Organisation structural integration:	<u>%</u>
• New subsidiary with partial integration	73 %
• New division of acquiring firm	7 %
• Complete integration	20 %

Most of the acquisitions were established as subsidiaries of the acquiring firm with partial integration of selected functions. When the business acquired was unrelated to current business, the firm was established as a new division in the acquired firm's structure. In the case of smaller acquisitions the operations of the acquired firms were fully integrated in the structure of the acquirer. Complete

integration in terms of name, top management structure and divisional structures was effected in the case of a merger of equals.

The interviewing sample included a merger of equals through a share exchange in the mining industry (the largest undertaken from South Africa in the period 1991 – 2001) and a large amalgamation in the banking industry. It also included some of the largest local acquisitions undertaken during the period as well as many joint ventures such as frequently effected in the mining and construction industries. Less frequent in occurrence were strategic alliances, but they were also found among the combination activity of the sample of acquiring firms that were interviewed.

4.3 EMPIRICAL PROCESS MODELS OF THE BUSINESS COMBINATION DECISION-MAKING PROCESS IN SOUTH AFRICAN ACQUIRING FIRMS

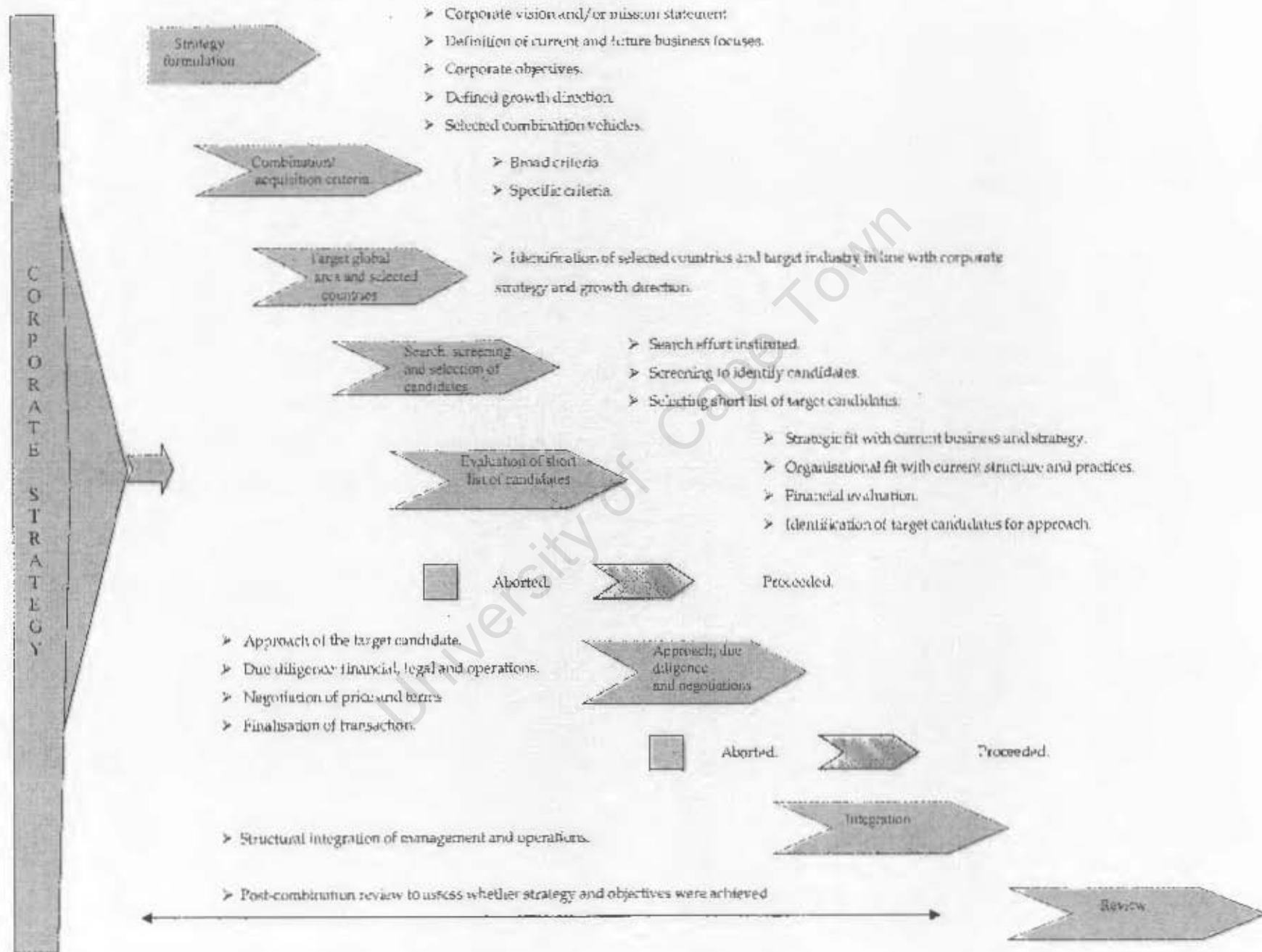
The interviews with key executives with combination responsibility in acquiring firms revealed that the business combination decision-making process was fundamentally determined by the way in which the combination originated. Two broad situations in general were encountered in practice that presented the two ends of the combination process continuum. At one end of the continuum the business combination was a truly planned combination by the acquiring firm and at the other end of the continuum it represented an opportunistic situation, where an opportunity was presented to the acquiring firm. These two different situations in the structuring of business combinations are described in the following section outlining the planned and opportunistic combination decision-making models in detail.

4.3.1 The planned empirical combination decision-making model

The planned business combination was characterised by the systematic development and implementation of a well-defined corporate and combination strategy. The corporate strategy was aimed at expanding the business in selected business sectors, a specific global area and through a specific form of combination such as through acquisition of relatively large or possibly smaller firms, joint ventures, strategic alliances or even a possible merger of equals. There was a corporate vision or mission statement defining the desired future business position and business scope as well as the specific corporate objectives and the formulated corporate strategy to achieve the desired future were explicitly defined. The corporate strategy through combination led directly to the formulation of a set of combination or acquisition criteria that were applied in a search and screening effort. See Fig.4.1 for an outline of the planned combination decision-making model.

The essential characteristic of the planned business combination decision-making model lies in its origin and motivation in the corporate strategy of the acquiring firm. Firms exhibiting characteristics of this planned combination decision-making process had in most cases formally adopted a growth through combination strategy. During annual strategic planning sessions such as group planning

Fig 4.1: Planned combination decision-making model



conferences as well as day-to-day strategy discussions the future business sectors and the countries or markets the firm should be in, were debated and the preferred businesses and world markets to be engaged, were identified. The scope of future business and the specific country expansion targeted were formally adopted by corporate management and also approved by the board of directors in most cases. Corporate objectives were formulated with regard to future growth in strategic and financial parameters. Financial targets were set, for example, in terms of the return on equity or the desired growth in profits to be achieved.

As part of this strategic process the management of the acquiring firms also made a decision on what type of combination would be pursued. For example, an acquiring firm with a growth strategy to expand into a selected global area, envisaged the acquisition of relatively large firms as platforms for expanding into the targeted world market. It could have been the development of a specific technological capability or specific skills for which a joint venture with another firm would be sought. The suitable combination structural options to implement the formulated corporate strategy were therefore identified by corporate management. Acquiring firms have referred to their strategic process as formulated at two levels – a corporate strategy and then a merger and acquisition strategy that was outlining the specific combinations sought to implement the corporate strategy.

Acquiring firms following the planned combination process have as a next step developed a set of criteria on the basis of the formulated corporate strategy and objectives. These criteria were in most cases of a broad nature defining aspects such as the business sector, the market share of the candidate, the managerial competence sought, the desired profitability of the candidate, and the potential to grow the business as part of the acquirer. One or more specific criteria were defined as an aid in the screening of candidates. These specific criteria related to the required return on funds employed, the desired return on investment and specific revenue or operational synergies sought.

In the middle nineties when diversification was still being pursued, there were some cases with a distinct step where the new target industry was identified. This occurred in the cases of related and unrelated diversified growth directions, where management considered a number of alternative industries and evaluated these in terms of the long-term attractiveness and their management capability versus the specific industry. This step was also sometimes formulated in conjunction with the decision on corporate growth direction; for example, a related diversification move was envisaged by a new entry in the information technology industry.

The planned combination process was characterised by a formal search effort instituted in the acquiring firm looking for preferred acquisitions. This was usually performed by divisional executive officers such as the divisional chief executive as well as financial, planning and corporate development executives.

They made it known in the identified country and/or industry that the acquiring firm was considering combinations or acquisitions in their geographic area or specific industry. In this process the large acquirers usually employed corporate finance departments, who assisted with the search and screening process. Others had corporate development executives and staff performing this task. Merchant bankers would have been approached to provide suitable candidates according to the specified criteria. In some cases it was common knowledge in the business community that an acquiring firm was pursuing an aggressive growth through acquisition strategy and merchant bankers would have approached such acquirers with potential candidates and ideas. Screening of the candidates that were identified through the various methods was performed through a broad screening process on the basis of the formulated corporate strategy and combination criteria. A short list of target candidates suitable for detailed evaluation would typically have been compiled.

The detailed evaluation of short listed candidates focused on the strategic fit of the candidate with the corporate strategy and the structure of the acquirer as a primary consideration. The issue investigated was whether the candidate would effectively achieve the implementation of the corporate strategy, for example, in terms of capturing or increasing market share in a targeted business sector. Other issues evaluated was whether it facilitated the enhancement of the product mix as in expanding a product line as well as the extent of value creation in the fit with the rest of the group's business activities, for example, in market, manufacturing or logistical synergies. Financial evaluation of target firms by the financial staff of the acquirer was usually extensive. On the basis of the detailed evaluation a target candidate or candidates were identified for approach. In some acquiring firms a large number of potential acquisition candidates were evaluated in this way – one acquirer indicated that it considered nineteen candidates and then effected one acquisition of these candidates.

The approach of the selected target candidate followed and if the vendors positively responded to the approach and the proposed combination, the due diligence study was agreed to and started. The due diligence study focused on a verification of the financials of the target, technical and commercial aspects of the operation as well as legal factors. In manufacturing situations environmental concerns were additional foci in the due diligence. If the acquirer was satisfied with the results of the due diligence inquiry and a final valuation was made of the target, negotiations proceeded until an agreement was reached on price and terms and the transaction then finalised subject to final regulatory and shareholder approval. Simultaneously with negotiations and flowing from the due diligence a plan for the structural integration was drafted and after the transaction had been finalised, the selected integration of management and operations was effected. The integration plan would have specifically defined how the merger of the combined firms was to be undertaken as well as how the desired transfer of capabilities and the identified synergies would be achieved.

4.3.2 The opportunistic empirical combination decision-making process model

The opportunistic combination process was fundamentally characterised by the fact that the combination decision-making process was initiated by an opportunity that was presented to the acquiring firm. This opportunity resulted from either a direct approach by the vendors to the board of the acquirer through the chief executive, or a merchant banker or other intermediary approached the acquiring firm's management on behalf of the vendors. Opportunities were also identified lower down in the acquiring firm's organisation such as at a divisional level or in a subsidiary, where an operational manager learned that a firm is for sale through social contact with business associates in the industry. Opportunities such as these may have resulted from a group divesting a particular non-core business, a business that was in trouble or the owners wanted to sell for personal reasons. In South Africa many such opportunities were created by black economic empowerment initiatives. See Fig. 4.2 for an outline of the opportunistic situation decision-making model.

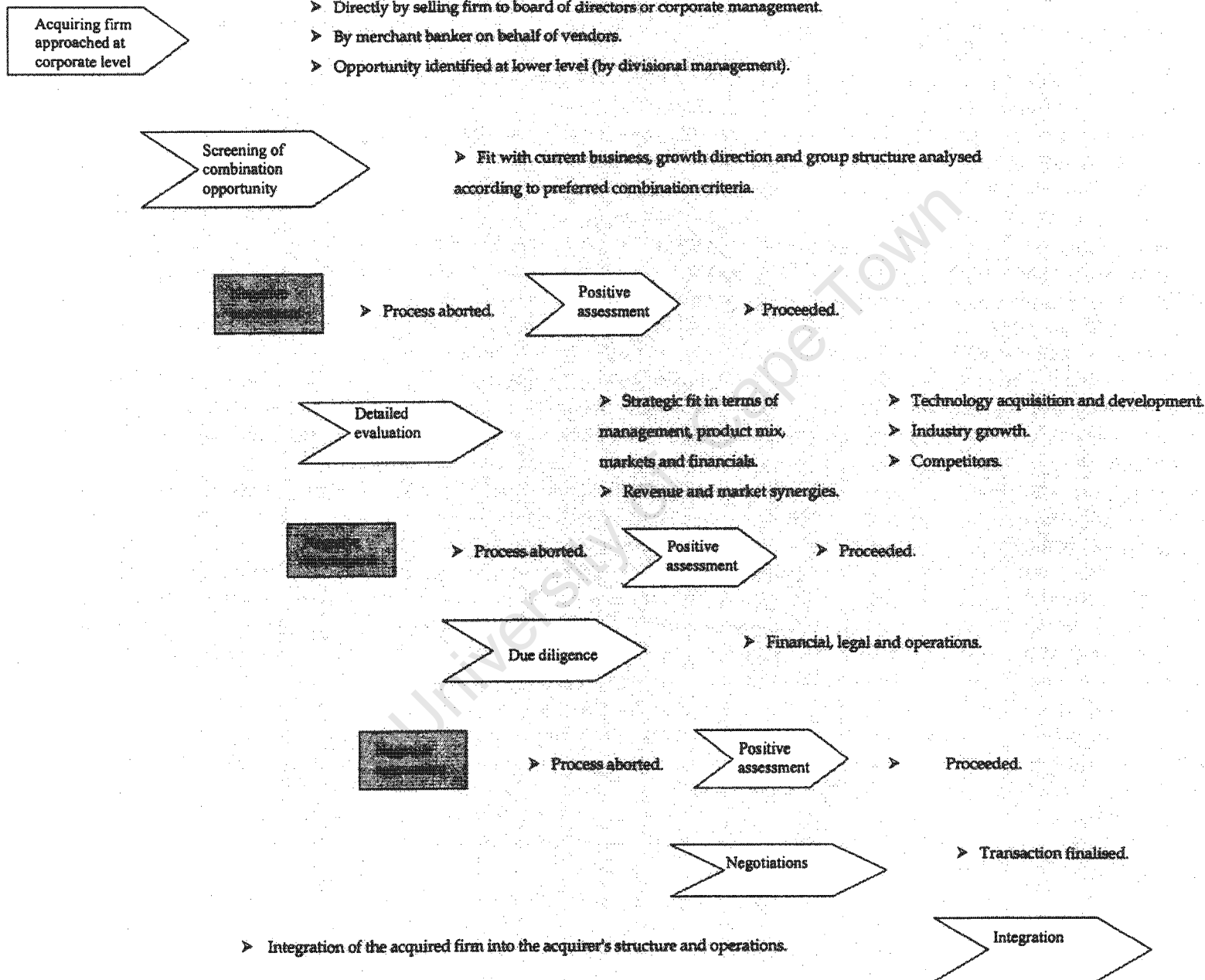
The acquiring firm would have responded to the presentation of the opportunity by a preliminary screening of the combination or acquisition opportunity. The primary considerations used in this screening would firstly have been an assessment of the strategic fit with the acquirer's current business activities, its intended growth direction and the group structure, and whether it would strengthen the position of a divisional business in a particular business sector or region. Secondly, an evaluation of the acquisition opportunity in terms of the acquirer's established combination criteria was undertaken. These criteria reflected the acquirer's combination strategy and preferred acquisitions and thus served as a further test of whether the opportunity presented a desirable combination vehicle.

There was no consistency as to the body or person facilitating the screening in the acquirer. In some cases an executive committee of corporate management completed the screening while in other cases the chief executive officer or a divisional chief executive would have performed the screening and made a decision whether to proceed with a detailed evaluation. If the combination opportunity did not prove to be attractive on the basis of the above-mentioned criteria the decision would have been taken not to proceed and the process aborted.

A positive decision to proceed would have resulted in a detailed evaluation. A response to the relevant party that the acquiring firm was interested, was communicated and the vendors made available access to and information about the opportunity. The detailed evaluation typically focused on the following aspects:

- Financial aspects such as the size and quality of assets, the level of gearing, profitability and future cash generating capability;
- The managerial competence and their willingness to continue;
- The quality of the product mix and the synergy potential with the acquirer's;

Fig 4.2: Opportunistic situation decision-making model



- Revenue and market synergies;
- Manufacturing capacity and potential cost saving synergies.

The results of the detailed evaluation would again have required an assessment of the attractiveness of the opportunity as a combination vehicle. A positive outcome would have advanced the process to negotiations while a negative assessment would have terminated the process. If the acquirer were still interested in the target, the due diligence study focusing on a verification of the financials, technical and other commercial aspects of the operation would have been undertaken. If the acquirer was satisfied with the due diligence assessment, it proceeded with negotiations to agree on price and terms of the transaction. Thereafter the acquisition would have been presented for final regulatory and shareholder approval.

Negotiations were conducted by a team from the acquiring firm with the vendors of the about to be acquired firm. Successful negotiations resulted in the legal consummation of the transaction and the integration of the acquired firm with the acquirer's management structure and operations thereafter.

4.4 INTERNATIONALISATION STRATEGY OF ACQUIRING FIRMS ANALYSED IN TERMS OF THE PARADIGM MODEL OF GROUNDED THEORY

In the above planned and opportunistic decision-making models the principles and method of grounded theory have been applied to outline the two respective models in terms of their relevant categories and properties. Here the paradigm model of grounded theory is applied to explain the dynamic interactions of the research phenomenon in terms of the causal conditions that give rise to it, the context in which it is operating, the action/interactional strategies by which it is handled and managed, as well as the consequences of an internationalisation strategy.

4.4.1 Causal conditions: Strategies of the acquiring firm

Internationalisation through acquisitions in selected markets world-wide has been a popular generic strategy of South African acquiring firms. The acquiring firm would typically have formulated a vision to attain a global leadership position in its selected niche markets and set an objective to acquire a targeted market share in a few key world markets. Some acquiring firms made inroads into these targeted markets through first making platform acquisitions and then leveraged these as a base by adding capacity and building critical capabilities. The offshore listings to obtain access to international capital and to diversify the investor base were key in the implementation of this strategic thrust. The improved access to international capital, which would fund further expansion into world markets was a major factor that made it imperative to obtain offshore listings and greater exposure in world financial markets. South African acquiring firms knew that to achieve globalisation objectives they needed to be able to integrate acquisitions quickly in a very competitive environment that required increased speed and flexibility in relation to the market as one of the rules of the game.

4.4.2 Context: Local and global environment

One key consideration motivating the internationalisation of South African firms was the fact that market saturation was achieved in the local market. This consideration was especially relevant in the case of the insurance industry and also the beverage industry. These firms have succeeded in building a strong base in the local industries in terms of market share and critical capabilities and could leverage these in the larger international markets. The larger and sophisticated world markets were attractive given the increased market exposure and economies of scale of a larger operation with global brands. These acquiring firms were generally well aware that they would be entering a new business environment with different rules of the game. Value creation would be based on their ability to exploit linkages in the new network of businesses and the speed of reconfiguration after acquisitions were effected or joint ventures established. The capability to utilise information and communication technology in their business to manage a multinational operation would be critical for success.

4.4.3 Action/interactional strategies: Combination process management by the acquiring firm

The South African acquiring firms faced a new challenge in terms of their capability to manage the combination decision-making process – they were entering a new acquisition market and had to establish a foothold and new networks. They also had the country dimension as a new category in the acquisition decision-making process and had to assess country attractiveness and risk before selecting target countries for entry. They had to establish contacts and networks in the financial markets as well as in banking and legal sectors to assist them in their search, screening, selection and evaluation of acquisition candidates. In addition, they had to learn the nature, demands and success factors of the local market in their industry to accurately evaluate the market position of target candidates. Approaching and negotiating deals required sensitivity for cultural dimensions and faster decision-making in competitive bidding situations. The integration of acquired firms were often more complex, because of cultural issues both in terms of national cultural differences as well as different corporate styles and management.

4.4.4 Consequences: New capabilities needed by the acquiring firm

South African acquirers soon realised that a whole range of new management competencies and organisational capabilities were needed to manage a multinational firm with global operations. One requirement for success was to develop or acquire top executive talent with experience in international markets and with the ability to manage globally 24 hours a day. One executive in South Africa confessed that he had underestimated this requirement since he had to go in to the office at four o'clock in the morning to work with his Australian counterparts. The ability to develop competitive advantage and sustain performance in multiple diverse markets around the world required improved strategic

planning and management capabilities. Parent firms had to develop new organisational structures to manage reporting relationships with staff around the world. Joint accountability and performance management systems were central in the new structure spanning different regions of the world and diverse markets where it was difficult for top managers to keep up with the dynamics of local markets requiring increasing gains in efficiency through innovation.

4.5 A NORMATIVE MODEL OF THE COMBINATION DECISION-MAKING PROCESS (CIRCA 1975)

In this normative model of the combination decision-making process, the approach was to prescribe the desirable procedure, but not describe the acquisition decision-making process used in practice. Gordon, Miller and Mintzberg (1975) conducted an extensive ten-year review of the acquisition literature and developed a model to capture the essential process of this prescriptive literature. The model was designed to reflect the main thrusts of the normative literature and not the best or most detailed. The model was thus a synthesis of the views in the literature. The literature on acquisitions (the term used, but encompassing mergers) was found to be extensive and rather global in scope. The far-reaching consequences of the acquisition decision were indicated as a rationale for the broad orientation. No major discrepancies or 'schools' could be found in the normative acquisition literature. Variations in the emphasis of certain steps were noted, for instance, the importance of a post-acquisition plan that was stressed in some books and articles while others cursorily passed over this step.

The normative model is presented here to indicate the differences with the actual practice in South African firms around 1995-2002 and to highlight the progress made in terms of strategy concepts and practice relevant to business combinations. The normative model demonstrates that already in 1975 a considerable high level of sophistication in terms of the acquisition decision-making process in prescriptive literature was achieved. The comparison of the state-of-the-art process in 2002 to this 1975 model illustrates the progression and advances made in corporate strategy and combination strategy since the 1970s.

4.5.1 The normative process model

The consideration and definition of the objectives of the acquiring firm is described in the normative literature as an essential step since acquisitions should help the firm attain those objectives. The clarification of objectives can stem from top management discussions and should guide the acquisition decision. The utility of acquisition as a basic tool in helping to achieve objectives should be established. Acquisitions might be a useful tactic if it is the goal of a firm to grow in a certain area, but if profitability is a corporate objective, other strategies might be more appropriate. A policy decision on acquisitions is needed. In the light of the firm's goals and its cursory research into the general advantages and

limitations of acquisitions in terms of its financial situation, it should decide whether to further entertain acquisition as a potential tactic.

Broad objectives that pertain directly to the acquisition should be defined that may list the basic desired characteristics of acquisition candidates. These characteristics may be constructed on the basis of the firm's marketing, financial and production resources and aspirations.

An examination of the firm's strengths should be undertaken. Acquisitions should complement the firm's strengths. Strengths might be assessed by identifying the products that are successful, the financial reserves of the firm, the unique skills available to the firm that give it a particular competitive advantage or profitable market segments that could be exploited via acquisitions. Simultaneously the firm's weaknesses and limitations should be examined.

In the next step more specific criteria should be established, which acquisition candidates must meet in the light of objectives, strengths and weaknesses. Top management should assign responsibility for analysing and screening acquisition possibilities. It would be sensible to include individuals from a multitude of disciplines and specific representation of a discipline that is the focus of expansion. The acquiring firm is to determine if attractive acquisition candidates exist in the light of established criteria. The acquisition group in consultation with investment dealers, and informal meetings with competitors should perform this task. The acquirer should determine if the firm has sufficient resources to acquire the desirable candidate and furthermore, a financial analysis must be undertaken to establish the effects of the acquisition on the present and projected asset, equity and debt positions.

It should be established how urgently the firm must acquire the candidate. Management need to consider to what extent the firm requires a new product line, markets, management group, technical resources or whether it can afford to wait awhile. The general availability of alternative acquisition candidates could also influence the advantage of selecting for immediate acquisition. The attractiveness of acquisition candidates, sufficiency of resources and urgency are considerations influencing the timing of the acquisition.

If it is decided to proceed with acquisition, several potential candidates should be located and screened. A rough evaluation should be performed of whether it is worthwhile to follow up on these candidates by comparing their basic features with the established criteria. Selected candidate(s) are to be analysed in detail on their management resources and skills. It is relevant that management's capacity to be in tune with current trends in the industry needs to be established as well as their competence in adapting their organisation to its environment. Any special skills or technical knowledge, which the candidate might have, and that could prove useful to the acquiring firm, are to be considered.

The compatibility of the candidate's orientations with the acquirer should be analysed by, for example, examining synergy in distribution channels and product promotional efforts or by regarding the benefits of increased economic scale, which might stem from a merger of production facilities. Marketing and production specialists in both the acquiring firm and candidate can provide insight on the compatibility. The candidate's growth potential may be assessed by examining the sales, profit and market growth rates of the firm and its industry as well as evaluating financial and market forecasts by impartial parties. The financial position of the candidate should be evaluated through inspecting parameters such as the debt to equity ratio, past and projected earnings and the state of capital equipment. This should include the examination of financial statements and records as well as technical operations through plant tours.

The next decision is which firms should be approached and the determination of a fair price to pay. It is then to be established whether the candidate is willing to accept the bid price or a price close to that offered. The financing arrangements should be decided upon by obtaining expert counsel in determining the cheapest or most efficient method of financing. Negotiation with the target candidate is then initiated. The attitude of the candidate's management towards acquisition may be assessed through interviewing to determine whether executives seem motivated to become part of a larger corporate endeavour. It also needs to be assessed whether their reluctance could pose serious problems to the successful integration of the firms. The climates within the acquirer's own firm to the specific acquisition proposal also needs to be examined, for example, what are shareholders and employees thinking and to what degree do their feelings represent an obstacle to a successful integration of the firms?

The decision whether to make the acquisition is then to be confirmed. A post-acquisition appraisal is subsequently performed to obtain an insider's view of the state of the new acquisition. This is considered essential for establishing the constraints and opportunities, which must be considered in order to devise a plan for integrating the firms.

The last step indicated in the normative model is the design of an integration plan. Key questions which should be addressed are whether the acquired firm's top management should be replaced; whether inefficient facilities should be closed down; whether similar production processes should be combined under one roof; and whether it is desirable to re-orientate distribution channels.

4.5.2 Comparison of the empirical process in South Africa (circa 1995 - 2002) to the normative model (circa 1975)

The empirical process followed in South African acquiring firms during the period interviewing was undertaken (1995 - 2002), indicated that corporate combinations were motivated and initiated by a broader concept of corporate strategy than only the formulation of corporate objectives. Corporate strategy involved management deliberation of the firm's current business scope and the future business

sectors as well as the global geographical areas in which the combination-intent firm should be investing. The growth direction of the combination-intent firm was debated and defined in terms of the desired competencies and capabilities associated with critical product, market, and technology dimensions of the firm. Corporate thrusts such as internationalisation and the pursuit of industry segment dominance through achieving largest market share were described or labelled as a corporate strategy rather than a corporate objective. The corporate strategy generally also outlined the combination vehicles to be utilised, for example, the acquisition of stock with majority control, acquisition of a minority interest, a strategic alliance, or a joint venture. In the empirical process as practised by acquiring firms corporate objectives were largely financially orientated, while the above-mentioned dimensions were portrayed as corporate strategy.

The normative model prescribed an examination of the acquirer's strengths and weaknesses. This is described as a formal step to be undertaken and strengths and weaknesses defined in relation to the acquisition strategy. In the empirical process models the formulation of strengths and weaknesses featured as an informal process, which is a management awareness of these strengths and weaknesses rather than a formal analysis. In the empirical process a formal examination of strengths and weaknesses with the intention of formulating combination strategy did in most cases not occur as a special exercise for this purpose. The evaluation of strengths and weaknesses was undertaken as part of the self-analysis for annual strategic planning exercises.

The consideration of broad objectives relating to the combination – that is the identification of the basic desired characteristics of acquisition candidates, did not feature as a separate distinct step in the empirical process models. The desired characteristics of the candidates were defined and named as acquisition criteria and generally in broad terms. It also did not precede an assessment of strengths and weaknesses as prescribed in the normative model.

In the empirical process there did not seem to be any formal emphasis on the specific timing of the acquisition. The issues of whether attractive acquisition candidates are available at the current time, whether the firm is in a position to acquire, and whether new competencies or market outlets are required immediately, did not feature as a formal step in the process at some stage in practice. In the empirical process models the timing of the combination unfolded as an integral part of combination strategy development. The above-mentioned issues were evidently considered at some stage in the minds of corporate management, but were only formally articulated if they constituted a halt to the combination process. The question of timing was pertinent throughout the process and informally assessed at every stage.

The definition of criteria and the search and screening of acquisition candidates according to the defined criteria are common to both the normative and empirical models. The empirical process featured the determination of broad and detailed criteria by acquiring firms as an important step in the process. The narrative to the normative model also mentioned that both levels of criteria setting should be involved. Both the normative and empirical models emphasised the link with corporate objectives, strengths and weaknesses, while the empirical models also indicate the significance of other corporate strategy dimensions such as the business scope, the planned growth direction and the specific combination vehicle that influenced the definition of criteria.

The aspects to be considered in the detailed evaluation outlined in the normative model were all found to be applied in the empirical process. Factors such as management competence, the compatibility with acquirer's efforts and objectives, the growth potential of the target and its industry and the examination of the financial position of the target candidate were evaluated to make a decision whether a target firm should be approached in the planned approach, or to proceed into negotiations in the opportunistic model.

The normative model indicated three specific steps after negotiation before a final decision was to be made whether to acquire. The first one was a checking question to assess whether the terms were reasonable specifically in the light of estimated future cash flows. This step was an integral part of the detailed evaluation of the target candidate where a target price range was determined with a maximum limit above which the acquisition would not be attractive. The assessment of the candidate's management towards the acquisition and the reaction of own employees and shareholders to the possible acquisition were not acknowledged as separate distinct steps in the empirical process models. These activities were found to occur in the empirical process, but were considered to be a dynamic part of the process and could not be pinpointed in a specific position in the sequence of activities.

4.6 PROCESS ACTIVITIES IN EMPIRICAL COMBINATION DECISION-MAKING (CIRCA 1995 - 2002)

4.6.1 Corporate vision, mission, objectives and strategy

The first focus of the interviews was to ascertain whether there is a relationship between a corporate vision and mission statement and a specific strategy of combinations. A vision statement is a definition of the ideal future state for the organisation in terms of the desired future market position. The essential function of the corporate mission statement has been described in the strategic management literature as being the definition of the firm's business in respect of desired product, market, and technology dimensions. It was found that most of the acquiring firms had either a defined vision or mission statement outlined in their annual reports. In some cases the mission statement fulfilled the role of a vision statement in that it articulated the desired future position. It was predominantly in respect of this

definition of an ideal future state for the enterprise that the vision or mission statement had significance for a strategy of combinations. It served as a directional and steering framework for the corporate growth direction and the consideration of new combinations. One example of such a mission statement driving a series of world-wide acquisitions was one of a local banking group: "We aspire to be one of the world's great specialist banking groups, driven by our commitment to our core philosophies and values" (Investec annual report, 2002:1). Another example was the one of a leading local fuel and chemicals firm with its vision statement: "To be a respected global enterprise, harnessing our talents in applying unique, innovative and competitive technologies to excel in selected markets in the energy and chemical sectors in Southern Africa and world-wide." (Sasol annual report, 2002:1). In this case the vision statement indicated a preference to expand into selected markets world-wide and these preferred directions were filters for the screening of countries into which expansion would be considered.

It was found that some firms do formally enunciate in their mission statements that it is the intent of the firm to grow through acquisitions, or even in the case of one acquiring firm stating that it is the business of the firm to acquire major business ventures. In such cases the mission statement served as a direct motivation for the growth through combination strategy. In most of the combination active firms the intent to grow through acquisitions was clearly defined in the corporate strategy of the acquiring firm through the annual strategy sessions or group planning conferences and documented in the corporate or business plans. In its annual written communication to shareholders in the annual reports the strategy to grow through acquisitions was formally defined as a growth route other than through organic growth. The way that acquisitions were employed in the firm's business model or value creation model was also outlined. For example, one gold mining firm's strategy was based on acquiring low-margin operations with turnaround potential that become available in a market undergoing change and consolidation. After acquisition the operations were restructured through addressing overhead costs, working costs and organisation structures so that higher cash operating profits were achieved and the acquisitions then delivered consistent returns operating at higher and sustainable margins. This acquiring firm has made twenty-three local and global acquisitions in the past six years (Harmony annual report, 2002:7). This value creation model is used when evaluating future acquisition opportunities in the gold-producing countries of the world.

A South African based information technology firm focusing on the network market embarked on a global acquisition programme a few years ago to extend its operations into key North American, European and Australian markets. Its strategy was to build and acquire the necessary technical capability to provide both for the integration and connectivity requirements of global corporations and to develop appropriate global service offerings to increase its competitive position. It made ten acquisitions in the US during the past three years, including a leading e-business consulting firm, and also made market entry acquisitions in Europe and Australia. Acquisitions were the most effective and speedy

route to implement this strategy. The firm is also utilising alliances with other technology partners to provide part or all of the solution and develop long-term partnerships with its clients by implementing and managing the solution on their behalf (Dimension Data annual report, 2001: 9).

The question whether the firm had formal corporate objectives was put to assess whether the firm had objectives that were written down and whether the firm had taken formal action to approve or adopt the objectives. It appeared that there was not any consistency in formalising corporate objectives. The most common form of objective formulation was in financial terms, for example, to increase returns to shareholders in terms of share price growth and dividend yield, to achieve an improved market rating, or growth in earnings per share. One acquirer had a corporate objective to achieve the doubling of its profits – half of it from acquisitions and the other half from existing businesses. The strategic dimensions of corporate objectives were defined in terms of industry leadership, expansion in selected markets, customer service, and size of assets in relation to largest competitor.

The chief executive was principally responsible for the development of corporate objectives. In most cases the objectives were developed in co-operation with his top management team. The participation of the rest of his top management team seemed to be a function of corporate management style. In cases of an open participative management style objectives were jointly developed as a group. Where the chief executive officer's style was autocratic, there was less involvement of other top managers and the chief executive was solely responsible for developing and setting corporate objectives. These objectives were documented in annual business plans and strategic plans presented to the board of directors.

4.6.2 Combination or acquisition framework

It was found that in the very large acquiring firms that frequently effect business combinations that there were formal acquisition frameworks documented at a corporate level to guide the acquisition decision-making process. In one corporation it was called 'investment guidelines' and in another an 'acquisition framework'. These documents provided guidelines for the acquisition decision-making in the acquiring firm and for divisions such as setting threshold levels for executives in terms of the size of the acquisition that they may approve. It also outlined the essential activities to be performed in diagrammatic format indicating key decision points with the factors that needed to be considered as well as the sequence of the required activities.

4.6.3 Analysis of corporate strengths and weaknesses

The majority of firms responded that they do a corporate analysis of strengths and weaknesses as part of their annual strategic planning exercises. This was done as a fundamental input to strategy formulation. In a few cases special exercises were undertaken to identify strengths and weaknesses towards the

objective of formulating a combination strategy. Management indicated that they are generally well aware of their strengths and weaknesses and did not typically facilitate special analysis to ascertain what they were. In the usual exercises as part of strategic planning the identification of strengths and weaknesses was not an independent activity, but was linked to the development of strategies. The annual strategy development processes were facilitated in some cases by external consultants.

4.6.4 Combination options and level of control

The identification of the specific combination options to be utilised in respect of a growth strategy appeared to be an essential step in the planning of a combination strategy. Most firms confirmed that they did consider alternative combination options. The most general options that were considered were the acquisitions of relatively smaller firms or joint ventures in a 50/50 - share ownership. As indicated in the sample characteristics there were also a few large mergers as well as a merger of equals effected with an offshore partner.

Management of acquiring firms generally preferred a majority level of control. Some firms only undertook acquisitions where they could eventually acquire 100% ownership of share capital. Majority control was preferred since it facilitates the full implementation of strategy and expedites strategic and operational decision-making as the acquirer sees fit. Acquiring firms would like to have full control to manage the cash of the acquired firms and dividend pay-out and therefore some acquirers favoured the approach of not having any minority shareholders and bought these out to have 100% control. Operational control and a high level of integration needed to achieve the identified synergies were also mentioned as reasons for preferring a high level of control. Acquiring management acknowledged that it was not always possible to obtain the desired level of control.

Other acquiring firms responded that 100% control was not an issue, but that the building of shareholder value was important. One acquirer expanded into Europe through joint ventures with joint control in partnership with existing firms. In another firm's global expansion into Asia it had to find strong local partners and formed joint ventures in partnership with local governments. It needed local collaboration for development of local markets and to gain effective lobbying for regulatory approval. In the case of this firm there were many subsidiaries that were not wholly owned and although effective control was vested solely with the acquirer through management contracts, in certain cases the other significant shareholders had veto powers.

The issue of structural integration with the acquiring firm received a high level of attention in the decision-making process. The form that this integration would take, for example establishing the acquired firm as a new division with only partial integration, a new standalone subsidiary, or full absorption, was a consideration addressed early in the negotiations. It was preferred to give the vendors an indication of

how the firm will be integrated in the structure of the acquirer early on in the negotiations. Product, market, and manufacturing synergies were most often mentioned as reasons for the decision on the level of integration.

4.6.5 Combination profile or acquisition criteria

All firms responded positively to the question whether criteria were determined in the definition of a so-called combination or acquisition profile to screen possible combination candidates. None of the interviewees however referred on their own initiative, to their set of criteria as a combination or an acquisition profile. The extent of formally adopting and approving these criteria varied. A minority of firms did not have their criteria formally documented and an executive committee or the board of directors did not approve the criteria. The majority of firms had, however, formally documented and communicated their criteria. The criteria were generally used as internal management criteria. One interviewee responded that the criteria were used as a motivation rationale when the acquisition was presented to the board for approval.

Most South African acquiring firms used a general set of broad criteria rather than specific defined criteria to evaluate acquisitions. The general criteria that were mentioned included:

- Whether the candidate was in the right business sector and presented a strategic fit with the acquiring firm's products, markets and technology;
- The extent of value creation provided by the candidate;
- The extent of product mix enhancement that the candidate offered;
- A strong market position by the candidate, for example, number one or two in market share;
- The profitability of the candidate – it should have a strong cash generating capability;
- A competent management team in the acquisition candidate;
- A low level of financial gearing in the acquisition candidate.

Some of the acquiring firms did use specific criteria for a detailed evaluation of acquisition candidates, which included the following:

- Financial measures such as the return on capital employed (ROCE) or a hurdle rate for the return on investment (ROI);
- The size of the business in terms of assets or assets under management;
- The size of its market share or production capacity;
- Specific synergies sought such as revenue enhancement synergies and cost savings synergies, for example, whether it presented the potential for lower production or manufacturing costs, or logistical costs or purchasing economies of scale.

It was found that in certain industries such as gold mining, some acquisition-intent firms have set very specific criteria. Examples of such criteria included a required production capacity of a certain number of ounces of gold, that mines should have at least a ten year life, and that the operations should meet a required cost structure such as not exceeding on average half of the current price of gold.

It is significant that broad general criteria were predominantly used by the acquirers. This indicated the need to have criteria that would facilitate the quick identification of opportunities, but not provide a too narrow delimitation and thereby eliminating most opportunities. The focus through primarily broad criteria rather than specific criteria also signalled a willingness to look at all suitable opportunities in the market. This reflected to an extent the relatively limited market scope in South Africa, which lacks an abundance of acquisition opportunities open at a given time as in other larger markets. This was obviously not relevant for the large corporates that had moved internationally and had many markets and candidates to consider.

The broad criteria were realistic in the sense that acquirers acknowledged that in practice the perfect combination candidate did not exist. The more specific criteria were utilised to eliminate some candidates that were initially identified as possible acquisition candidates.

4.6.6 The combination team

All the firms predominantly used a task group approach to screen and evaluate combination candidates, approach them, negotiate and finalise the transaction. This team in most cases consisted of the chief executive officer, the chief financial executive (vice-president, financial director or general manager), the planning and development executive (if this position existed in the acquirer) and the executive manager in control of the relevant division where the acquisition was to be integrated. This was the situation where the acquirer had a corporate and divisional structure. In a single business firm without a multi-divisional structure there would not have been a divisional executive manager involved, but other functional officers such as the operations or manufacturing director or company secretary. These executives in the large acquiring firms were assisted by a corporate finance department headed up by a director of corporate finance. Other internal human resources that were utilised were legal advisors and auditing firms. Their involvement was on an ad hoc basis where their contribution was required, for example, in performing the due diligence.

External resources that were contracted to assist and advise were predominantly merchant bankers and accountancy firms, where a suitable internal auditing resource was not available. Merchant bankers were utilised as sources of possible acquisition candidates and assistance in structuring the financial package. During interviewing in 1995 none of the acquiring firms had a full-time acquisition department performing acquisition functions. In one case the firm had an executive director with responsibility solely

for mergers and acquisitions and carried this designation. He had no acquisition staff, but used other internal support staff such as financial, legal and auditing staff. This situation where no full time acquisition specialists were employed reflected the market situation in South Africa at the time. The frequency of acquisitions completed and the size of the market in terms of the number of acquisition candidates available did not then require a full time search, screening and evaluation capacity. This is in contrast with the 2002 situation, where large combination active firms processing frequent acquisitions had specialised staff in corporate finance, who assisted in the search and screening activities, and performed financial evaluation and due diligence tasks.

4.6.7 Search and screening of combination candidates

Acquiring firms that have adopted a growth by combination strategy would have instituted an organised search and screening effort. A combination or acquisition team specifically briefed to search out and screen combination candidates would have been put together. The team would be typically chaired by the financial or development executive and include managers lower down in the organisations from the relevant division involved. The search effort itself appeared to be more of an informal search through connections with merchant bankers, lawyers, stockbrokers and prominent industry people, rather than a formal search in the sense of identifying all candidates in the industry associated with the acquirer's focused growth direction and screening them according to defined combination criteria. Acquiring firms rather relied on their connections in the financial sector and the specific industry they were interested in and made sure that they communicated to these relevant parties that they were looking for appropriate combinations.

Screening and in-depth analysis were conducted by the members of the combination team. They enlisted the services of suitable subordinate management and functional specialists such as financial, marketing, manufacturing and human resources. It was found that the screening and analysis focused predominantly on own determined areas of focus, but some firms did use generic checklists as presented in academic and business books. Responding to the question of which aspects the acquiring firm considered important to investigate and evaluate in depth, the general areas of management, finance, market, product fit and manufacturing synergy were mentioned. The examination of organisational and cultural fit was seldom alluded to in 1995. One executive responded that they do not pay a lot of attention to culture, because they believe that it can be managed. It was found in 2002 that acquiring firms do pay significant attention to the issue of cultural fit and some firms went to great lengths to ensure a smooth cultural integration.

In evaluating market, product, manufacturing and economy of size synergies, it was indicated that no formal techniques were utilised to undertake such an assessment. This question was asked to establish whether there were any formal techniques used in practice since few academic techniques have been

presented in readily available texts. Contributions in academic theses have been made, but these were not readily accessible to South African practising management at the time. Interviewees have stressed that they do have knowledgeable management that have been in their particular business for a long time and are capable of making an accurate assessment of potential synergy.

The in-depth analysis of the target firm was facilitated by a variety of methods: using industry information and statistics, financial, product and market information made available by the target firm, visits to the target firm's operations and manufacturing facilities as well as question-and-answer sessions with the target firm's management. The detailed evaluation of the target firm was carried out in most cases through a comprehensive due diligence study. This focused on gathering information to:

- Value the target;
- Deal with the risks of buying;
- Do tax and financial planning to achieve the optimal deal structure;
- Develop a successful integration hypothesis and plan.

There were in general three independent areas of focus during the due diligence inquiry:

- Legal due diligence, which focused on contractual agreements and key issues to be addressed such as: ownership, contracts, financial position, property, environmental, employment and pensions, intellectual property rights, information technology and taxation;
- Financial due diligence, which focused on the validation of historical information and key issues such as: accounting policies, accounting systems and management information, trading results, cash flow statements, assets and liabilities, taxation, insurance and pensions;
- Commercial due diligence, which focused on strategic and operational aspects such as: competitive position, quality of key relationships, operational techniques, culture, management competence, and organisational structure.

The due diligence ensured that the assumptions made during preliminary targeting and valuation efforts were validated and updated, and thus provided the acquirer with a more informed basis for negotiations and integration and even cancelling the transaction if no strategic fit was found. In the case of hostile take-over situations it was not possible to have access to the target in order to carry out such a detailed due diligence.

The chairperson of the combination task team containing the results of the detailed evaluation and due diligence generally put a report together. This would usually have been presented to the executive

committee, which would have taken the decision to continue or to abort a specific acquisition target if it proved to be insufficiently attractive to meet corporate combination criteria.

4.6.8 Negotiations with the target firm

The chief executive, the financial executive, the corporate development executive, and the divisional chief executive (in the case of a multi-divisional structure) were generally in the team that conducted negotiations with the target firm. In the case of large multinationals that carried out many acquisitions world-wide, the chief executive officers were not involved in negotiations and divisional executives of regional hubs did the approach and negotiations with the target firm. In these very active acquiring firms the locus for driving acquisitions has shifted from the CEO level to divisional executives as these firms have increasingly been using acquisitions as an important means to implement corporate and divisional strategies. These acquiring firms have set up their own internal corporate finance units that were responsible for acquisition valuation, due diligence and managing post-acquisition integration. This shift has followed the trend in US acquiring firms where it was already in the 1990s not uncommon for many corporations to have a M&A budget whereby managers were encouraged to seek out and acquire strategically attractive firms and then be evaluated on the performance of acquisitions (Inkpen, Sundaram and Rockwood, 2002:240).

At an early stage in the negotiations the acquiring firm would have given the target firm an indication of what they were willing to pay – some acquiring firms would have indicated a range, for example, a minimum and maximum limit and on this basis negotiations would have gone ahead. Before due diligence a confidentiality agreement would have been signed by the parties. The next documents typically drawn up would have been a memorandum of understanding and then finally the merger or acquisition agreement when both parties were willing to finalise the price and terms of the transaction.

4.6.9 Financing of the combination

The financial executive was responsible for structuring the financing package advised by the participating merchant bank. From the responses obtained it was difficult to generalise the preferences of acquirers in the method of financing combinations. Most acquirers sought the best financing technique that was appropriate in the particular case and in the economic environment at the time the combination was being made. Cash and bank loans were used to avoid any dilution of equity. One acquirer only used cash for its acquisitions since the corporation had large cash reserves available and the divisions had access to cash with a lower cost of capital. The financing method to a large extent depended on the pricing of acquirer's shares at the time of the transaction – if highly priced the acquirer would have been more inclined to use equity. Where the stock market was placing a high premium on the acquirer's share so that the combination could be transacted without materially diluting the acquirer's earnings per share, most firms

would have considered using shares. On the other hand, acquirers with low share ratings preferred to use cash.

When paying through equity the share exchange ratio was determined and negotiated. The exchange ratio is the number of the acquirer's shares that were offered for each share of the target. The number of shares depended on the valuation of the target by the acquirer. Both the acquirer and the target conducted a valuation of the target and from this process the acquirer determined the maximum price it was willing to pay while the target determined the minimum it was willing to accept. Within this range the actual agreement price depended on each party's other investment opportunities and relative bargaining abilities. The acquirer determined the per share price it was offering to pay based on its valuation of the target. The exchange ratio was then determined by dividing the per share offer price by the market price of the acquirer's share.

4.6.10 Integration of the combination

The time and effort spent on planning the integration depended to a large extent on whether the target firm was to be operated as a standalone subsidiary with retention of its management structures, or whether it was to be fully absorbed within an existing division or subsidiary of the acquirer. In the first case little integration planning was necessary, while in the latter case where the acquired firm was to be integrated into an existing division or subsidiary, extensive assimilation planning had to be done. The choice of integration method depended on whether any product, market, or manufacturing interdependency existed and whether improved synergy could be better achieved through full or partial integration of activities. Naturally in the case of a merger with full or partial integration of the business units and management structures, integration planning and management was of critical importance and substantially more effort and co-ordination was put in to both before and after the effective merger date. Acquirers in general recognised that effective integration was critical for the success of the combination and that rapid integration within a hundred days was important to achieve the desired synergies.

There was a general preference by the acquiring firms to try and retain the services of good management in the acquired firms. This was especially important when the acquisition was made in a new field or sector, where the acquiring firm needed the specific management expertise. The approach to retain management corresponded with the type of combination performed, since most acquisitions were the acquisition of stock and establishing the acquired firm as separate subsidiaries – competent management had to be kept in place.

The management members responsible for the integration were also involved in the negotiations. The divisional managing director where the acquisition was integrated, would have been part of the negotiations. He also had overall responsibility for the co-ordination of the integrating phase. The

acquirers have generally put together task groups to achieve the integration that involved management of the acquirer and specialist expertise such as finance, information technology and human resources staff as well as the acquired firm's management in key functions.

4.7 CONCLUSION

The planned and opportunistic combination decision-making processes found in practice correspond with a classification by Reed and Lajoux (1999: 35) of acquiring firms as either *opportunity makers* or *opportunity takers*. An opportunity maker will typically – in a planned mode – develop acquisition criteria on the basis of its identified expansion of core business and search for acquisition candidates with particular operational characteristics in one or two specific industries. This practitioner seeks to cherry-pick the suitable industry player that best complements or supplements current operations and long-range plans of the acquirer. The transactions of the opportunity taker are finance-driven rather than operations-driven. The opportunity taker – through a network of brokers, investment bankers and finders, try to pinpoint firms that will be bargains such as the result of corporate spin-off sales where good firms are sold off due to cash-flow problems. The opportunity taking approach is thus random, unstructured and unplanned.

The planned combination decision-making model is clearly in line with the *prescriptive strategy mode* in that the corporate strategy was planned in a rational and co-ordinated fashion on the basis of current resources as well as environmental and industry opportunities followed by the definition of combination criteria on the basis of the corporate growth direction and objectives.

The opportunistic decision-making model represents an *emergent strategy mode* in that the combination opportunities taken influence corporate growth in terms of the business focus and products. The combination opportunities utilised in this mode determined the firm's business focus and its market positioning in terms of the product line.

The insights gained from the empirical research in terms of the combination strategy of acquiring firms as well as the way that they organise their constituent process activities, have provided a sound base to develop prescriptive theory formulating a strategic planning approach to business combination, which is presented in the next chapter.

CHAPTER 5

A STRATEGIC APPROACH APROPOS THE BUSINESS COMBINATION DECISION-MAKING PROCESS

5.1 OBJECTIVES OF THIS CHAPTER

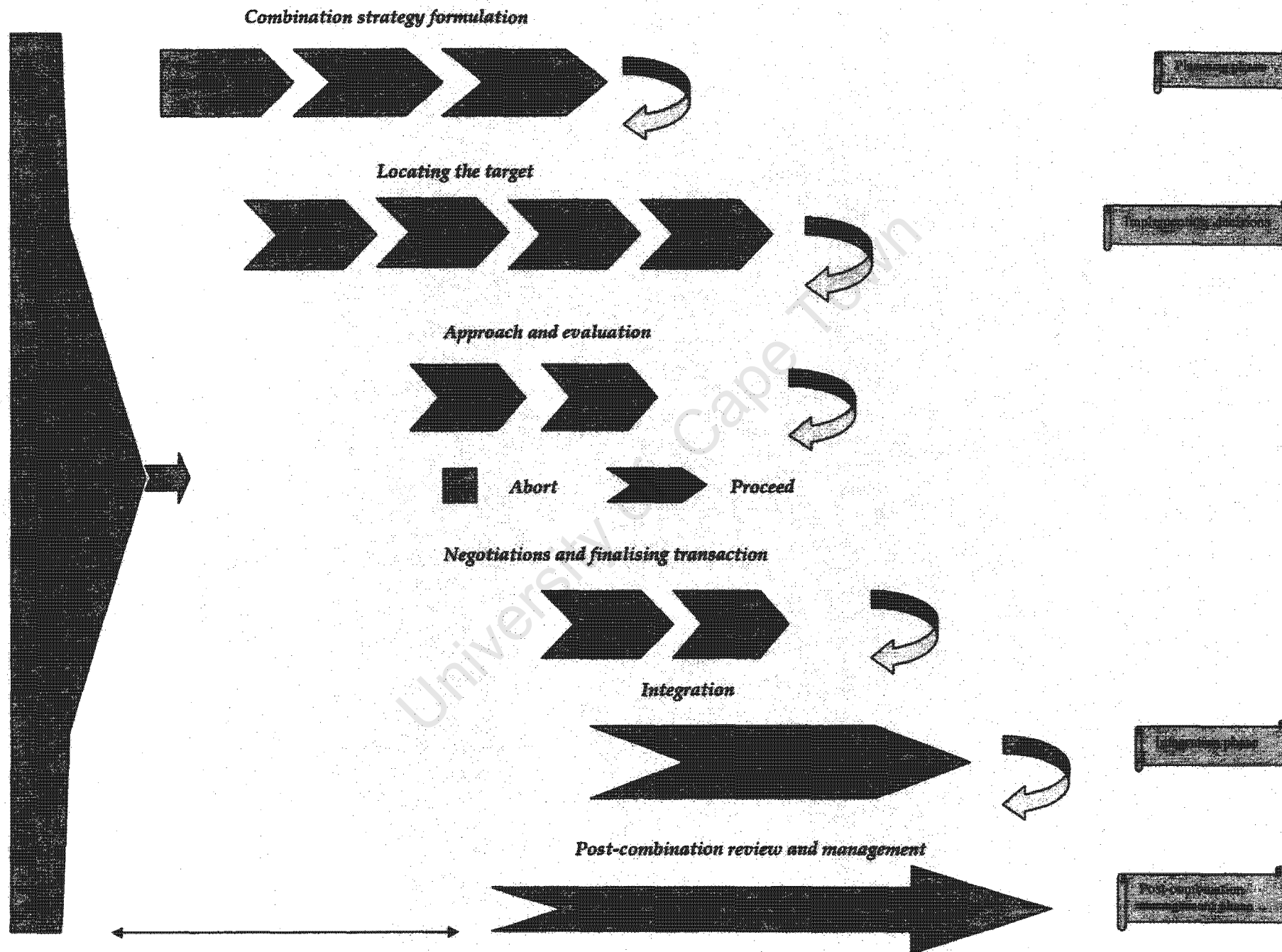
In the introductory chapter it was emphasised that the combination decision-making process itself is an important determinant of combination efficacy and efficiency in terms of delivering the desired strategic and financial results. The appropriate organisation of the activities and the participants in the combination decision-making process within a dynamic environment, in such a way that the process and the decisions it facilitates are effective towards achieving the corporate vision and objectives, is therefore an important responsibility of corporate management. The purpose of this chapter is to provide an appropriate strategic framework for the planning, organisation and management of the corporate combination decision-making activities.

The first objective is to indicate the crucial importance of corporate strategy defining vision, objectives, and growth direction as well as the effective formulation of a combination strategy selecting the suitable combination vehicle and the appropriate level of control. The combination strategy should furthermore highlight the definition of an ideal combination profile outlining, in turn, characteristics of the ideal candidate. The second objective is to describe the essential activities in locating the target firm such as the identification of target industry sectors, the search, screening and evaluation of alternative combination candidates, and the selection of the appropriate combination target fitting combination strategy. The third objective is to describe the approach and detailed evaluation of candidates followed by negotiations with the target firm, and after the transaction is successfully concluded, the integration process with the structure and operations of the acquirer. The fourth objective is to underline the importance of following through with post-integration management of the target combination firm as part of the new parent structure in line with the corporate objectives and strategy of the acquiring firm. A final objective is to emphasise the interdependent nature of the constituent activities requiring that dynamic interrelationships always be considered during the decision-making process.

5.2 PROCESS OVERVIEW AND STRATEGIC FRAMEWORK FOR BUSINESS COMBINATION DECISION-MAKING

The business combination decision-making process may be divided into a number of selected distinct phases that combination-intent corporate management has to carefully manage in the structuring of successful combinations to achieve the desired strategic and financial results. Fig. 5.1 depicts an overview

Fig. 5.1 STRATEGIC FRAMEWORK FOR BUSINESS COMBINATION DECISION-MAKING - PROCESS FLOW



of the strategic framework for the combination decision-making process. The first phase is one of *planning* where the corporate strategy is formulated to steer and drive the business combination process. This involves the setting of strategic direction through the articulation of a corporate vision and mission statement as well as the definition of corporate objectives and the desired growth direction. This planning should be based on a thorough internal analysis as well as external environmental scanning and industry analysis. Essential in combination strategy formulation is the consideration of alternative combination vehicles and the selection of the most suitable vehicle through which the combination strategy may best be implemented to achieve defined strategic objectives. This combination strategy should also identify the appropriate level of control and the approach to the structural integration with the corporate structure. The combination strategy should, in addition, also define the characteristics sought in the ideal candidate and therefore document an ideal combination profile specifying the key criteria.

The *implementation phase* of the formulated strategy is then enacted through search and screening activities to locate alternative candidates and after thorough evaluation of these candidates in terms of the defined criteria, to select the ideal combination target. The selected target firm is approached and if it is willing to combine, the price and terms are negotiated, and the transaction finalised. Following this, the acquiring management can merge the acquired firm into its parent structure in the *integration phase* and work towards achieving identified synergies. After successful integration, the parent firm should continue in the *post-combination phase* to manage the acquired firm as part of its group structure to achieve corporate objectives in line with the strategic direction set in its corporate strategy.

5.3 FORMULATION OF CORPORATE AND COMBINATION STRATEGY

5.3.1 Formulation of corporate strategy

Setting strategic direction and determining corporate objectives to guide the long-term growth of the firm is a crucial prerequisite for the structuring of successful business combinations. The corporate strategy of the combination-intent firm should be the steering framework guiding the whole combination decision-making process. If a corporate vision and growth strategy is not formulated to guide the growth direction, the suitable combination vehicles to be utilised and the definition of an ideal combination target profile, the combination decision-making process will lack a holistic view, logical coherence and a definitive guide to ensure the desired organisation of staff and required allocation of resources. Corporate strategy should therefore serve as a guide for the formulation of the various decisions in respect of the constituent elements in the combination strategy such as the appropriate combination vehicle, the degree of relatedness and the profile of the ideal combination candidate.

This view is in line with leading strategy exponents such as (Lynch, 2000:11,12) who have emphasised that vision is key in the formulation of a corporate strategy and should therefore be considered first in a strategy with combination intent. A *clear and compelling vision* is the key departure point for the

formulation of corporate strategy and should be articulated with a view to stretch and move the organisation forward beyond the current situation towards the desired future. This should require innovative and feasible strategies to make the desired future a reality. The development and establishment of a superior competitive position in the new global order phase may be a vision requiring the crafting of innovative and realistic strategies to achieve such a desired future state that is beyond the current resources of the firm. Secondly, the *strategy should be sustainable* facilitating the development and sustenance of a lasting competitive position and capability. For instance, there would be little point in a specific country based firm with global aspirations entering into a new global alliance with a firm in another major economy if the combination only lasted for a year. Such a combination will require large capital investment and the benefits are likely to be only realised in the longer term. Thirdly, the strategy should be *distinctive from that of competitors*, possibly involving innovation. A sustainable strategy is more likely if the strategy is distinctive from those of actual or potential competitors. Fourthly, the corporate strategy should offer *competitive advantage* at the business unit level that is not only distinctive, but also a real advantage in terms of cost or quality that would allow the business to grow. Combination strategy should therefore clearly indicate how competitive advantage for specific businesses would be enhanced in terms of product, market and/or technology dimensions. Fifthly, there is the necessity to *exploit linkages externally* between the organisation and its environment. These links may be with suppliers, customers, competitors, regulatory bodies and the government. Large-scale combination through mergers and acquisitions usually depends on the approval of regulatory bodies. Sixthly, the corporate strategy should *leverage vertical linkages* in a combination structure, for example through the distribution of manufactured products of one firm through the distribution network of another firm in a group.

5.3.1.1 The vision of the desired future

The key departure point for formulating corporate strategy is the articulation of a vision of the desired future that should define where leadership of the firm intent on expansion through combinations would ultimately like to see its firm positioned in the long-term. This may be the vision of a firm with industry leadership and market dominance in a single defined industry, or possibly the vision of a large diversified group spanning several business activities in a number of industries, or that of a diversified multinational group with global operations and market dominance in selected industries. The more concrete this picture of the desired future is painted in the fundamentals of the firm's makeup, the more compelling it will be and the easier it will be to develop feasible strategies that could effectively be implemented. The firm intent on growth through external business combination may, for example:

- Define the composition of its revenue streams from the various targeted global areas as well as the size of these revenues;
- Identify the particular business sectors or markets in which it would engage;

- Define the ideal business mix of the firm in terms of the constituent contribution to revenues or profits. It may in addition specify the nature and scope of its product or services line, the location of manufacturing operations to enable global cost advantages, as well as the nature and scale of the distribution and marketing networks the firm should ideally have in place to achieve the desired revenues.

The vision articulated by corporate ownership and management will therefore be a key determinant of the definition of businesses they would like to be in, as well as the targeted markets in terms of country and industry dimensions. The vision of the desired future should therefore be considered before formulating the contents of the mission statement and corporate strategy.

5.3.1.2 Mission and definition of the business

The corporate mission statement is essentially a definition of the business(es), in which the firm is engaging and would seek involvement. This definition of the nature and scope of the firm's business activities will, as argued above, be principally determined by the vision that the board of directors, corporate general management and other stakeholders have created of the firm's desired future position. An acquisitive firm intent on high growth through external combination, but in a current limited growth industry sector, should articulate in which directions it will move in terms of the definition of its business. This mission formulated by management may indicate whether a firm would grow primarily through acquisition of smaller firms, through strategic alliances, or whether a merger or amalgamation with an equal partner with subsequent diffusion of ownership and dilution of corporate culture and values may be considered.

Defining the business that the combination-intent firm will pursue, necessitates a succinct description of its products, functions and markets, which may be undertaken in accordance with a conceptual framework of Abell (1980:17). *Products (or services)* are the outputs of value created by the business system offered to the identified *customer groups* through solving *customer functions* as identified in their needs, wants or problems. Customer functions may be described in terms of the *processes and/or technologies* utilised to create and add value to satisfy these customer functions. Markets refer to the types of customers or geographic regions the combination-intent firm is targeting and where the products and/or services are sold. A good mission statement in terms of defining the business of the firm, should be as precise as possible and indicate these major components of strategy: products, markets, functions and technologies in which the combination-intent firm will respectively engage and utilise to achieve the articulated vision.

Many firms pursuing diversification have found in the past that through acquiring a series of businesses unrelated to their mission or business definition, they have become conglomerates, with little to tie them

together other than financial objectives. Such firms typically find a need to return to or focus on core businesses, because they cannot effectively manage the unrelated diversity of their businesses. This underlines the rationale that a clear business definition in the mission statement should preferably serve as a determinant of the growth direction and act as a guide to the type of combination vehicle and ideal combination target sought. It requires strategic thinking and a clear definition since it serves as a guideline for the various participants in a combination programme.

5.3.1.3 Corporate objectives through backwards planning

There is usually a hierarchy of objectives at the various organisational structural levels in the business organisation such as at corporate, line of business (or divisional), functional and operational level (Thompson and Strickland, 1996:35). Corporate objectives deal with desired overall corporate performance and in theory convert the corporate mission statement into designated performance outcomes at the top level in a combination structure. These objectives direct organisational energy and resources to what needs to be accomplished to achieve the vision.

Corporate objectives may be defined for each key result area that is deemed to be important for successful accomplishment of the vision and mission of the firm. Two types of key result areas relevant at corporate level are financial and strategic performance. Acceptable financial performance is a basic requirement for continued existence, while achieving satisfactory strategic performance is crucial to sustaining and improving the firm's long-term market position. Financial objectives may refer for example, to a target rate of return on equity, return on funds employed, or a set rate of growth in earnings or earnings per share. Strategic objectives may refer to factors such as the degree of globalisation or internationalisation, industry leadership, diversification of risk, size of market share, size in assets relative to competitors, a broader or higher quality product line, specific general or technological capabilities underlying the development of specific products and expanded growth opportunities.

A combination-intent firm's strategic objectives are of paramount importance in structuring business combinations, because they articulate its strategic intent to diversify its revenues or to stake out a particular business position. The strategic intent of a parent firm in a multinational may, for example, be to exercise industry leadership in selected global markets. The strategic intent of a small firm may be to dominate a specific market segment in a particular country. Such a desired leadership position or market dominance may in some instances only be achieved by developing the needed capabilities through combination with other firms, that would complement the development or acquisition of the required capabilities to achieve the desired future position. The time horizon underlying the concept of strategic intent is usually long-term. Research by Hamel and Prahalad (1989:36) on Japanese firms has indicated that those who rose to prominence in their markets almost invariably began with strategic intents that were out of proportion to their immediate capabilities and market positions. These firms have set

ambitious long-term strategic objectives and then pursued them relentlessly, even obsessively, over a long-term period. Strategic intent thus signals a deep commitment to winning – achieving transnational or multinational status and operations, unseating the industry leader, remaining the industry leader, or gaining a significantly stronger business position. Some of the major Japanese exponents of strategic intent have achieved their intended positions with the required capabilities developed through the structuring of many collaborative combinations in the form of strategic alliances and joint ventures.

An ambitious firm with the strategic intent of becoming a large multinational group spanning several industries, ideally needs to quantify its future in terms of both long-term and short-term objectives. Long-term objectives in this way are generally seen as setting targets five or more years ahead, and raise the debate of what actions need to be taken next in order to achieve the targeted long-range performance later. Long-term objectives may be linked to the desired strategic capabilities the firm would require in order to attain a desired future business position as visualised and defined in the vision statement. These capabilities may be the mastery of specific technologies underpinning the development and production of competitive products or the specific combination of physical and human resources underpinning manufacturing or distribution capabilities.

The development of long-term objectives may best be undertaken according to the *backwards-planning* process advocated by British strategists, Hay and Williamson (1991:38). The vision of the desired future position (at the time the word 'mission' was popular as the term to denote this and was used by these authors) may be used as the starting point and then milestones derived from working back towards the present. This enables the efficacious planning of the capabilities and activities needed in $x-1$ and $x-2$ years where x is the year the vision will be achieved. In such a proactive futuring process the relevant identified milestones will be the specific targets contained in the strategic objectives. For example, a firm intent on becoming a multinational group may identify a milestone indicating this desired future state as achieving 50% of revenues outside its home country base with the targeted revenues per foreign country, or possibly the number of new divisions, or the market share in specific targeted global areas such as North America, Europe, Asia or Australia. An aspiring transnational may identify its revenues as 30% from Europe, 30% from North America and 40% from other world markets.

Successive application of a backwards-planning procedure allows the identification of the actions that need to be taken next to build the future needed capabilities. Short-term objectives may then spell out the immediate and near-term results to be achieved in building the required capabilities. Short-term targets indicate the speed at which management wishes the firm to progress as well as the level of performance being aimed at over the next two or three planning periods.

Corporate objectives should ultimately serve as a direct determining guide for the definition of specific combination criteria in the ideal combination profile. A particular corporate objective to enter a new country or business sector and achieve a targeted market share would indicate the targeted business sector and required market share sought in the ideal acquisition candidate. Specific manufacturing, distribution or technological capabilities that will be required to achieve this position will indicate the specific production, marketing or technological expertise sought in an ideal combination or acquisition target. A strategic objective to build industry dominance would focus growth direction in that specific targeted industry and define the appropriate nature of the business, combination-intent management should search for in specific terms. A financial objective, for example, a 40% return on funds employed, would restrict the search for candidates enabling this return. Corporate management intent on pursuing a combination strategy to achieve corporate objectives therefore needs to link relevant corporate objectives to the combination strategy and define the nature of the combination targets that they intend to pursue.

5.3.1.4 Growth directions open to the acquiring firm

5.3.1.4.1 Organic growth

The decision in respect of the primary growth mode of a firm may vary on a continuum from pure *internal organic growth* (on the left) or *external growth through combination* with other firms (on the right of the growth mode vector). Internal organic growth may be accomplished by developing the strategic portfolio of the firm in terms of product or market extension as conceptualised by Ansoff (1987, 109). His growth matrix has delineated four major growth opportunities: *market penetration* denotes a growth direction through the increase of market share in the present product markets; in *market development* new missions or needs are sought for the firm's products; while *product development* creates new products to replace current ones or extend the firm's product range. Growth through *diversification* is distinctive in the fact that both products and missions (or market needs) are new to the firm. In the first three alternatives the common thread is clearly indicated as being either marketing skills or product technology or both. In a diversification strategy the common thread is less apparent and is weaker.

Two major diversification strategy categories have been indicated. In *related diversification* acquiring firms would grow by entry into product-markets, which exploit synergies in respect of marketing, production and similar science-based research. Related diversification has also been termed *concentric diversification*. *Unrelated diversification* denotes a growth into new markets and new technologies unrelated to the original product-market scope. Unrelated diversification has also been described as *conglomerate diversification*. Theoretically the above growth vectors may all be pursued by internal organic growth. In practice, however, related and unrelated diversification is predominantly achieved through combination with other firms.

5.3.1.4.2 External growth directions

External growth through combination with other firms may be described in terms of the following growth categories: *horizontal growth* is accomplished through combining with firms having the same product-market scope than the acquiring firm. These are usually competitors operating in the same product-markets. *Vertical growth* expands or contracts the business definition primarily in terms of functions performed in the value chain. *Backward integration* refers to the acquisition of supplier firms in order to utilise the value added and to ensure the supply of materials from this segment of industry. *Forward integration* involves the purchase of wholesaling and retailing companies again to utilise the value added and to control the distribution channels of that industry segment (Jauch and Glueck, 1988:236). *Related diversification* involves diversifying into businesses whose value chains have appealing strategic fit relationships to the acquiring firm in terms of product, market or technology dimensions. A strategy of *unrelated diversification* involves diversifying into whatever industries and businesses hold promise for attractive financial gain. The strategic fit is a secondary consideration (Thompson and Strickland, 1996:199).

5.3.1.4.3 International expansion

The international expansion route when moving out of the home country opens up a wide range of international options in terms of the countries and markets for the firm intent on internationalising its business. Generally overseas expansion occurs by the expanding firm exporting to foreign markets as a first step. Thereafter an overseas office is established followed by overseas manufacturing that increases exposure to international risks such as unfavourable currency movements. The next step is usually major multinational activity with multinational operations in different countries. Global operations may be introduced in a mode where there is high degree of international commitment and the ability to source production and raw materials from the most favourable location anywhere in the world (Lynch, 2000:585).

The combination-intent firm planning to extend operations internationally has an added complexity in its decision-making process as it needs to evaluate country attractiveness and risk factors as influenced by country specific political and economical conditions. It also needs to analyse the specific industry and markets targeted in the countries versus its own capabilities. In formulating entry strategies into foreign countries, the choice of combination rather than greenfield investment is a central decision that will depend on political, economic, industry and market considerations as well as the capability profile of the investing firm versus the targeted business sector.

Research by Anand and Delios (2002:129) has found that upstream and downstream capabilities were significant determinants of the choice to enter a foreign market by acquisition or greenfield investments. Investors expanding internationally tended to acquire domestic firms when the sector in which the foreign

firm was investing, was technically superior to the same sector in the home country of the investing firm. They found that the relative technological advantage (the difference in R&D intensities) was a significant determinant of entry mode choice. This entry mode behaviour conforms with a technology-sourcing motive for foreign investment and to acquisitions. Technological assets tend to be tacit and firm-specific and therefore interfirm transfer is subject to inefficiency. The most efficient route for this is an internalized exchange, for example through interfirm transfer between a parent and subsidiary. The choice between exploitation of existing capabilities and exploration of new technologies corresponds to the choice between using greenfield and acquisitions as entry mode, and is strongly influenced by the relative technological position of the home and host country environments with the relatively superior technological position of the host country encouraging acquisitions. Downstream capabilities are not fungible to the same degree as technological capabilities. Brands and sales forces tend to be more location-bound than upstream capabilities. The lack of cross-border fungibility of marketing capabilities means that a firm undertaking a foreign expansion, must secure these capabilities when investing, or attempt to develop new capabilities after making the investment. Research investigating the sources and gains in cross-border acquisitions (Seth, Song and Pettit, 2002:921) found that there were multiple sources of value creation in synergistic cross-border acquisitions, namely the reverse internalization of valuable intangible assets (such as technological capabilities), asset sharing and financial diversification. Gains had accrued to bidder firm shareholders only for reverse internalization.

Research by Harzing (2002:222) had shed more light on the management of acquisitions versus greenfields with regard to the headquarters – subsidiary relationship. Her analysis found that compared to greenfields investments, acquisitions were allowed to operate more independently with lower levels of control exercised towards them. This was also reflected in the lower level of expatriate presence in acquisitions in general. Consistent with this picture, acquisitions were displaying a higher level of local responsiveness in the form of local production, R&D, and the modification of products and marketing for local markets. In the light of the above considerations a combination-intent firm planning to enter a foreign market through acquisition should consider the cross-border fungibility of the capabilities it has, or wishes to attain, as well as the level of control it needs to exercise.

5.3.1.4.4 Growth through external combination

External expansion in one of the above categories of growth directions may be accomplished through a wide range of combination vehicles such as a *merger* through absorption, the *acquisition of stock* and establishing the acquired firm as a subsidiary, the *acquisition of assets* or a *block of business*, a *partnership*, a *joint venture*, a form of contractual *strategic alliance* as well as *licensing and franchising*. Although external combination through such particular vehicles may be an expedient growth mode, it involves high risk since the successful combination of two or more firms, each with its own distinctive strategy, unique resource configuration, organisational design and culture may become problematic.

Growth through predominantly leaning towards either internal organic growth or towards the structuring of external combinations, does not constitute mutually exclusive routes. A firm may pursue both growth routes with appropriate vigour and the commensurate allocation of resources, provided that the management capacity and capability of managing both routes are in place. The formulated strategic growth direction should ideally be based on a sound and intensive analysis of the firm's current strategy, resources and distinctive competencies. The basis for growth through external combination should always include environmental scanning and an evaluation of industry attractiveness and risk before defining the ideal combination profile.

5.3.1.5 Corporate internal analysis

The internal analysis of the current strategy, resources and capabilities of the combination-intent firm is a vital activity to ensure a sound base to the decision on the corporate growth direction and the appropriate combination vehicle to be pursued. Corporate management needs to have a complete understanding of the firm's current strengths and weaknesses and its capability to successfully implement growth through external combination. Management should therefore determine what its distinctive competencies are so that they can make decisions about how to utilise these capabilities in a combination strategy. It should also establish whether there are weaknesses that will limit strategic options and may need elimination in order to implement the selected combination strategy.

The internal analysis is best conducted in a systematic fashion considering all the relevant factors significant for the consideration of a combination strategy. The following are the most relevant factors that need to be examined in respect of current strengths that may be possibly leveraged in a combination strategy.

Current objectives and strategy. The first consideration should be an evaluation of the firm's current corporate objectives and strategy. The current growth direction and the success of the current strategy in achieving the set strategic and financial objectives should be evaluated. This will give an indication of what current strategies should be continued, what current strategic thrusts could be complemented with combination strategy moves and whether the design of significant new strategies is necessary.

Financial resources and performance. The current financial position and resources of the firm play a crucial role in determining what it can or cannot do in the future. Typical analysis that needs to be carried out in assessing the financial position and performance may include the following:

- The desirability of trends in financial parameters such as return on funds employed, return on equity, earnings per share, profitability margins and debt ratios.

- The firm's sources and uses of funds as well as cost of capital and how they compare to those of its major competitors.
- The income distribution of the firm from geographical sectors and business segments.
- Percentage distribution of profits derived from various business units (or divisions) and products.
- The strengths and weaknesses in the financial position of the business.

The evaluation of financial resources and capabilities may, for example, confirm that there is excess cash or leverage potential that could be utilised in a successful external combination compared to what may possibly be achieved through internal capital investment in organic growth. Specific trends in revenue streams from current business activity may also indicate the need to diversify towards decreasing the exposure to specific country or industry risk, or move into industries with lower levels of competitive activity and higher associated profitability.

Distribution and marketing. The distribution and marketing capability of the firm is frequently its most important resource. Typical analysis that needs to be conducted in assessing the firm's distribution and marketing capability may include the following:

- The distribution channels that are currently being used and comparison of them with the distribution channels utilised by competitors.
- The impact of new technologies and their utilisation in distribution channels.
- The extent to which the total distribution and marketing task (through research, advertising and promotion, distribution or sales) is performed by the firm.
- The strengths and weaknesses in the firm's distribution and marketing capability.

Evaluation of the distribution and marketing organisation of the acquiring firm should include both physical distribution as well as human related competencies. A primary consideration is the depth and breadth of market coverage provided by the distribution and marketing organisation representing its ability to reach existing customers and potential new customers. This may refer to geographical areas covered as well as the total segments of the market served. The distribution practices and marketing organisations of competitors should be examined and compared with those of the acquiring firm. A distribution and marketing organisation may not be similar to a competitor's, but analysing such differences may help to focus attention on particular strengths or efficiencies.

Distribution and marketing strengths are generally high in order of importance in most appraisals of the acquiring firm's capability to undertake a program of expansion or diversification through external combinations. A well-trained efficient marketing organisation that effectively covers the market under the

direction and control of experienced marketing executives could provide the basis for business combination programmes. In appraising distribution and marketing capabilities it is therefore important from a combination-intent perspective to examine the latent potential for channelling additional products into the same markets or applying the marketing strategies and techniques of the firm to enter new markets.

Product offering. The product offering and capability of the combination-intent firm in the market place also needs careful assessment. Pertinent aspects of analysis will include:

- The share of the market the firm's products in the business units currently occupy and the extent to which this share is increasing or decreasing.
- The extent to which the share is concentrated in a small number of customers, or diversified.
- The trends in the profitability of the various products.
- The stage of the product life cycle of the firm's products.
- The trends in demand and whether they represent increased or decreased opportunity for the combination-intent firm.
- The strengths and weaknesses in the acquiring firm's product offering.

It is particularly relevant to assess the breadth of the product lines in comparison with the competition. Features available in competitive products and not found in the acquiring firm's products as well as specific products not offered by the firm should be identified. Product life and the remaining life in existing products and the extent to which they are becoming obsolete should be assessed. This should be related to engineering and product development resources in the programmes currently underway. Weaknesses in the product line may take the form of too narrow a line, lack of optional features, quality inconsistent with the firm's objectives, over-design and obsolescence as well as poor design in respect of manufacturing economy. These all affect the firm's competitive position and may require an extensive rebuilding effort before new external combination can be considered. The firm's primary resources should be strengthened first.

Manufacturing capability and capacity. The adequacy and efficiency of the manufacturing facilities, equipment, expertise, processes and organisation to achieve the corporate objectives, for example in market share, need to be assessed. Human expertise should be seen as an integral part of manufacturing resources. Vendors, sub-contractors and raw material or component manufacturers in the supply chain may be considered as manufacturing resources and as opportunities for vertical backwards acquisition. In considering future combination through acquisition, some judgement should be made as to whether suppliers are capable of meeting increased volume requirements and price demands.

Research and product development. A strong capability for research and development of new innovative products, new processes or major improvements to existing products and processes may be a distinctive competency. Technological expertise, technical skills and facilities for product development should be examined in terms of their ability to meet the needs of the existing business as well as their potential for being a base for expansion of the firm's activities. If such a capability does not exist and its lack begins to be reflected in a loss of market share, it may be too late to correct this condition solely through internal efforts and acquisition of external expertise may be the best solution. Sometimes a patent position developed by a small firm is sorely needed by a larger firm and acquisition may be far less expensive and much quicker than trying to find a way to circumvent the patent.

Management competency. Managerial competence is a crucial strength required for corporate success through external combination. The capabilities at all levels of management in the acquiring firm should therefore be assessed and consideration should be given to experience in the relevant targeted industry, qualifications, training, past performance and apparent potential for further development. In assessing management it is important to understand underlying motivations. Individual interests, which can be a valuable asset, may be overlooked. An acquiring firm is more likely to be successful in an area where management interest is high, even though the firm's capabilities are only average, than in an area where management interest is low. A strong marketing and sales management, field organisation and distribution system may be a prime resource of the firm and could be useful for firms using acquisition as a method of attaining new products, and distributing those through an established distribution channel. Management versatility and depth, particularly at general management level, are especially critical in a major new combination programme. Some firms undertake merger and acquisition programmes as a means of utilising surplus management resources, while others deliberately build up a larger and more capable management team than is necessary to carry on the existing business in anticipation of an external combination programme.

Organisational structure. The organisational structure of the combination-intent firm can either help or hinder a firm in achieving further expansion through combination. Some pertinent analysis would include:

- The type of organisation structure that is currently employed, for example in terms of sectoral, divisional, matrix or functional hierarchical reporting structure, and an evaluation of the degree to which it is appropriate to the firm's corporate objectives, strategy and market posture.
- The relationship between the parent and its divisions or subsidiaries, for example hands on management or an arms length approach – the degree of autonomy by subsidiary units.

- The responsibility and accountability relationships established as well as the nature of the reporting lines from business unit executives to the parent firm's executive.
- The degree of centralisation versus decentralisation of support services in the current combination structure as well as the contracts and fees asked for these special support services.
- The style of management used (autocratic or participative).
- The strengths and weaknesses of the present organisational structure.

The analysis of the type of organisation structure employed as well as its characteristics would indicate whether the structure employed is suitable for the further structuring of combinations. The evaluation would also need to take into account what integration approach will be followed, for example a complete absorption of a target firm within current operations, the preservation of a target combination firm as a new autonomous subsidiary, or the establishment of the acquired firm as a new division to incorporate a new business sector.

5.3.1.6 Strengths in crafting combination strategy

The consideration of all the above factors in the internal analysis should be consolidated in a list of dominant strengths and weaknesses – strength is an activity the firm is performing particularly well or a distinctive characteristic that provides a strategically useful capability versus its competitors. A strength may be the mastery of a specific technology, a particular organisational resource or competitive asset, or an activity the firm is performing so well that it puts the firm in a position of market advantage, for example, the branding of its products. A weakness is an organisational resource or activity that the firm lacks or performs poorly in comparison to competitors, or a condition that puts it at a market disadvantage.

Once the firm's internal strengths and weaknesses in relation to its combination-intent have been identified, the two lists should be carefully evaluated. Some strengths are more important than others, because they count for more in determining performance, in competing successfully, and in forming a powerful combination strategy. Likewise, some weaknesses can prove fatal, while others do not matter in a combination route or can be easily remedied.

From a combination strategy-making perspective, the firm's strengths are significant because they could be the cornerstones of the combination strategy. Combination strategy should be grounded on the firm's outstanding strengths and market capabilities. If a firm does not have the competencies and resources to craft an effective combination strategy and is intent on pursuing further growth through combinations, management should move quickly to develop the required capabilities.

The development of particular core competencies at the corporate level in the acquiring-intent firm may be a valuable base in developing a successful combination strategy. Core competencies are built by

consolidating the firm's technological, production and marketing expertise into collective capabilities that enhance its competitiveness. The relevance of a core competence to combination strategy-making lies with the added capability it gives the firm in seeking possible combination opportunities in related markets and its potential for being a cornerstone of the combination strategy. It is easier to build competitive advantage in a newly acquired firm when the parent firm has a core competence in an area pertinent to the market success of the acquired firm.

5.3.1.7 Environmental scanning and opportunity analysis

The purpose of environmental scanning in this context is to identify those opportunities and positive factors that could be beneficial to combination plans as well as the forces in the external environment that may negatively affect the combination activity of the acquiring firm. It should not be aimed at developing an exhaustive list of every possible factor that could influence the business, but rather focus on identifying the key variables that will make an impact and offer actionable responses in the combination strategy. The external environment may be divided into the macro and micro-environment. The external macro-environment may be divided into seven broad categories: the political, economic, socio-cultural, technological (PEST), demographic, regulatory/legal, and physical environments. It remains useful to use these windows in surveying the total macro-environment in order to focus on pertinent forces and relevant opportunities.

An assessment of the political environment through examining the political orientations of the key political parties and their policies towards the structuring of business combinations is essential. They have an influence on the combination activities of firms through regulatory laws and practices, such as national competition policy governing corporate combinations through mergers and acquisitions.

Scanning the economic environment is probably the most relevant. The general state of the economy (for example depression, recession, recovery, or prosperity) and the point in the economic growth cycle is an important timing factor in the combination decision. The level of interest paid by firms, the inflation rate, the unemployment rate as well as the level of consumer income and expenditure are key economic variables determining market attractiveness and growth. Stock market performance will also guide the timing of an acquisition as well as the financing structure used in the transaction.

The demographic environment is characterised by population, age and gender variables. Population growth, age structure and level of urbanisation are macro-factors determining the size and growth in the markets of industries and demographic analysis is therefore an essential environmental scanning activity. Socio-cultural forces include factors that relate to the beliefs, values, attitudes and other cultural characteristics of the acquiring and target firm's customers. Dynamic social forces can influence the demand for a firm's products or services and can alter its attractiveness as a combination target. The

determination of the exact impact of social forces on a firm's performance is difficult at best. Nevertheless, assessing the changing values, attitudes and demographic characteristics of a firm's customers is an essential element in assessing the possible performance of the business. This becomes particularly relevant when moving into a new country with a different set of consumer preferences.

Consideration of developments in the regulatory or legal environment with effects on the procedures and techniques in compiling a business combination is a very necessary environmental task. A specific large industry merger may require approval of the relevant regulatory bodies such as the Competition Board or the Ministry of Finance. The opportunities and threats of new regulatory policy and legal developments on combination methods and transactions should therefore be carefully assessed before embarking on a specific combination route.

Technological forces may influence business firms in several ways. Technology is the systematic application of scientific or other organised knowledge towards practical economic purposes and includes new ideas, inventions, techniques and processes in the value chain. Technological innovation may significantly alter the demand for a specific firm's or industry's products or services; a technological edge by a firm's competitors may make its products or services obsolete or over-priced. Utilisation of new technologies by the firm's research and development process could produce new products and processes and create new markets or enhance the efficiency of distribution channels. The need to acquire new technology or specific technological expertise motivates many combination moves, particularly joint ventures set up in respect of research and development.

The physical environment refers to physical dimensions such as raw material supply and physical operating conditions such as agricultural conditions. This environment has a definite impact on operating performance and should be examined for both acquiring and target firms. Even though no clear implications may be seen, the question of possible adverse supply conditions and its impact on the chosen growth direction should be considered.

Microenvironment scanning may focus on areas such as the particular industry involved, suppliers, competitors and the specific target markets of the combination candidate. All these relevant environments should be subjected to a rigorous scanning, identification and analysis of key environmental factors in order to identify new relevant opportunities and pertinent influences on the firm's chosen growth direction and proposed combination moves. The focus of the analysis should lean towards researching long-term trends and developments since combination strategy involves long-term investment and commitment. The possible assessment of new targeted markets and their long-term attractiveness and growth can only be accurately evaluated on the basis of systematic and thorough environmental scanning and analysis.

5.3.2 Formulation of combination strategy

The combination strategy of a combination-intent firm may be defined in terms of the specific *objectives*, the specific *capabilities sought*, the *appropriate combination vehicles* to be used, the *ideal combination profile* defining criteria such as the size of a target acquisition, the *level of control* the firm would like to exercise, and the *approach to integration* of the target firms with the corporate structure. Successful combination strategy hinges on corporate management taking a definite view on how they would like to implement corporate strategy through combination with external firms in respect of these primary considerations.

5.3.2.1 Consideration of the range of alternative combination vehicles

The consideration of alternative growth directions open to the firm should be accompanied by an evaluation of the various combination vehicles through which the particular growth strategy can best be implemented. External growth may, for example, be effected through the following combination vehicles: the absorption of a smaller firm through *merger*, the stock *acquisition* of another firm and its establishment as a *subsidiary* or as a new *division*, the *acquisition* of all or part of the *assets* of another firm, joining forces with another firm or firms in a *partnership*, effecting a *strategic alliance* or *joint venture with another firm*, *buying a block of existing business* from another firm or through *amalgamating* or *consolidating* with an equal marriage partner (merger of equals). It is clear that there is therefore a considerable range of options open to the combination-intent firm in terms of the possible combination vehicles that may be used to implement its particular strategy. Each of these combination vehicles will have its own relevant advantages and disadvantages depending on the objectives and requirements of the combination strategy as well as the specific resources and capabilities of the combination-intent firm.

5.3.2.2 Combination vehicles utilised in generic corporate strategies

The effectiveness and suitability of a particular combination vehicle for the implementation of a particular strategy, will depend on the objectives and nature of that strategy per se. An internationalisation strategy may be effected through the *acquisition* of smaller firms in the target country, *merging* with another firm of equal size, through *equity* or *project joint ventures* or through *strategic alliances* with foreign firms. The *acquisition* of overseas firms at either 100% or a majority stake of the shareholding has been the predominant combination vehicle utilised by South African firms expanding into foreign countries.

A horizontal growth strategy is usually accomplished through *merger by absorption* or the *acquisition of stock and establishing the acquired firm as a subsidiary*. Backward and forward vertical integration could be effected through all the identified combination vehicles as well as *licensing* and *franchising* in a forward integration direction. Related or unrelated diversification could be accomplished through using combination vehicles such as *merger through absorption*, an *amalgamation* or *consolidation with an equal*

partner, acquisition of stock and new subsidiary, through a joint venture, the forming of a consortium, or through the purchase of a block of business or assets.

A firm intent on restructuring could accomplish the strategy by either absorbing other firms by *merger*, which is usually also a diversification move and through *acquiring 100% of the stock* in another firm and later selling parts of the acquired firm. A portfolio management strategy would normally be effected through *stock acquisition* and establishing the acquired firm as a *subsidiary* or through *merging* an acquired business into a current division. An active portfolio management strategy would then be implemented by infusing the acquired firm with capital, technology or transferring management and technical expertise. A passive portfolio management strategy would be to regard the *acquisition of stock* as only a financial investment, merely earning dividends and capital gains through share price appreciation.

The consideration of a particular corporate strategy growth direction and the evaluation of the appropriate combination vehicle would usually be linked to each other and should therefore be considered together. The acquiring firm may for example, focus on an internationalisation strategy through the acquisition of a majority shareholding position in a foreign firm, or through a joint venture with an overseas firm. The market entry strategy into a new country should therefore simultaneously define the most suitable combination vehicle to effectively achieve the strategic objectives of such a move. The South African diamond firm, De Beers, which effected a 50/50 equity joint venture with the French firm, LVMH Moët Hennesy-Louis Vuitton to move into the luxury diamond retail market in the United States, exemplifies a forward integration market entry strategy through a selected combination vehicle (Shone, 2003: 3). A combination-intent firm may, for example, decide on a related diversification strategy by merging through absorption, or a forward integration strategy through the acquisition of assets, or an unrelated diversification strategy through acquisition of stock and subsidiary, a joint venture or a form of strategic alliance. This is, however, not a rigid description in the sense that combination-intent firms utilise only one vehicle to implement a particular strategy. A firm may decide on a vertical integration strategy, and choose to explore and look for target candidates to combine through more than one type of combination vehicle, for example, through the acquisition of stock and subsidiaries as well as through the formation of joint ventures and franchising. In all the above situations there is typically a deliberate decision to pursue the selected corporate strategy through a particular combination vehicle, which will link the combination-intent firm to other external firms and that may result in the structuring of further combinations by the acquiring firm.

5.3.2.3 Evaluation and selection of the suitable combination vehicles

The evaluation and selection of the most suitable combination vehicles through which the corporate strategy could most effectively be implemented, should be a carefully considered decision on the basis of

the specific corporate strategy and its objectives as well as the unique resources and distinctive capabilities of the firm.

Combination opportunities should be matched with the developed competencies and unique resources of the firm and the strategic fit of this match should be considered. The firm's own unique capabilities and resources may be better suited for a specific form of combination, for example, a financial services firm with an established brand name and expertise in banking may prefer to acquire smaller firms to capture the market share and clients in the targeted market. A firm with exceptional portfolio management capabilities may be better geared towards an unrelated diversification strategy and acquiring stock and subsidiaries in a financial investment approach, while a firm with only average skills in this respect should rather refrain from conglomerate diversification. An acquiring firm with a well-developed acquisition integrating capability may be better suited to continue growth through the absorption of smaller firms into its existing structure and operations. The American firm, Cisco Systems, which has acquired 25 smaller firms since it was founded in 1984 and reached \$100 billion in market capitalisation faster than any other company in history serves as an excellent example of such a combination capability (Habeck, Kröger and Träm, 2000:31).

5.3.2.4 Advantages and risks of specific combination vehicles

Although the suitable combination vehicle will largely depend on the specific combination strategy and resources of the combination-intent firm, the following advantages and risks of the alternative combination vehicles may be identified in general terms. The following factors were partially sourced from Lynch (2000: 584). Other factors had emerged from the interviewing in combination active acquiring firms.

Acquisition through absorption

- Speedy acquisition of capabilities such as larger market share and specific technological expertise;
- Suitable for acquiring relatively smaller firms in the same line of business;
- Risk of acquiring unneeded assets that need to be sold later;
- Risk of problems in human relations after acquisition.

Acquisition of stock and establishing the acquired firms as a subsidiary

- Suitable for large-scale acquisition and cross-border expansion where competent management and key staff could be retained;
- Buying instant market size and share;
- Fast extension to a new geographical area;
- Retention of firm exclusivity in technical expertise;

- May not be possible to acquire 100% of stock and have to deal with minority shareholders;
- May involve paying acquisition premium and therefore expensive;
- May be difficult to dispose of unwanted parts of the acquired firm.

Acquisition of assets

- Limited capital investment, while full operational control;
- May be tax advantageous;
- Risk of problems in technical integration.

Merger of equals

- Suitable for large-scale cross-border combination to attain critical mass in assets;
- Quick acquisition of new capabilities and market position;
- Cost savings from economies of scale and scope;
- Irrevocability of combination – new legal entity;
- Risk of problematic human relations after merger;
- Risk of losing management control through subsequent power clashes;
- Risk of losing short-term operational focus;
- Risk of poor cultural fit and a clash of cultures, where a foreign partner is involved.

Joint venture

- Suitable when a more flexible arrangement is desired with limited liability, but joint control;
- Expertise sharing and gains in research and development joint ventures;
- Avoids the cost of paying acquisition premiums;
- Fewer approval by regulatory bodies and shareholders;
- Ring fencing of risk and liabilities in created entity;
- Have to share profits with partner;
- Risk of losing control to some extent;
- Risk of management problems when parent firms intervene.

Strategic alliance

- Can develop close relationship with partner without the irrevocability of merger and acquisition;
- Use joint expertise, resources and commitment;
- Allows partners to learn about each other;
- Locks out other competition;
- Involves a relatively slow approach;
- Risk of partners not fully committed to make alliance a success.

Mckinsey and Company on the basis of recent research on joint ventures and alliances (Bamford, Ernst and Fubini, 2004:94) pointed out the following situations when joint ventures and alliances may present a better alternative than mergers and acquisitions. The further removed a new business opportunity is from a combination-intent firm's core competencies and existing businesses, the more likely it is that the firm will consider an alliance instead of an acquisition. Alliances tend to have higher success rates than M&As when the objective is to enter a new region, product area, customer segment or to develop new capabilities. Alliances have lower success rates when control is important, for example when the goal is consolidation of operations or improved performance.

Expanding firms assume that the fastest way to gain new products or capabilities is to buy or merge with another firm. Mergers and acquisitions often require that the buyer pays a premium of 20% to 50% over the stock price of the targeted firm, which most acquirers never recover. By contrast, a joint venture typically involves no premium.

An unwilling M&A target or partner can also be a barrier. If two firms are comparable in size, and one party is unwilling to participate in a merger, a joint venture may be an attractive alternative for capturing specific capabilities from another firm. The integration of an acquired firm takes substantial time and resources. It can tie managers up for years while core business goes unattended. A joint venture or contractual alliance may be a safer alternative.

Equity joint ventures may be most suitable when value will be gained by integrating assets or capabilities, or when the size of the prize warrants the effort of setting up a separate firm with its own culture and profit and loss. Contractual alliances can be a good alternative when the relevant assets or capabilities cannot be carved out of the parent firms and when value creation is driven by improved coordination and learning, not resource integration.

5.3.2.5 Level of Control

Together with the evaluation of the suitable combination vehicle, the issue of the desired level of control and the appropriate structural fit with the corporate firm, should also be considered. A combination is more likely to be successful when the level of control and the structural fit with the acquiring parent firm are in line with the requirements for the effective implementation of the particular corporate strategy. An incorrect level of control and structural integration may result in severe problems later in the combination and could result in the eventual withdrawal by the acquiring firm.

The following are alternative levels of control that an acquirer needs to consider in evaluating whether it will facilitate the effective implementation of the defined corporate and combination strategy (Weinberg and Blank, 1989: 1015, 1016).

Complete ownership of the share capital in a company. In this situation the 100 percent shareholder has the same level of control over the other company that the shareholder would have with the outright purchase of a truck or machine. When there is, however, no one single owner of all the share capital of a company and wide diffusion of share ownership, control does not necessarily requires 100 percent ownership of its shares.

Majority or 'voting' control. This is control exercised by persons holding shares conferring the majority of the voting power normally exercisable at a general shareholder meeting of the company. As a result of various legal devices, such as non-voting, restricted or weighted voting equity shares, 'gearing' of the capital structure or pyramiding of companies, the persons in a position to exercise the majority voting power may hold a minority or even a very small portion of the equity. In cases where shares are widely held by the general public or institutional investors, a single block of shares together may be enough to influence management's decisions or even to bring about the appointment of new management. Control over the majority of votes may enable the acquirer to exercise effective control with a share ownership falling short of the 50 percent level.

Minority shareholding or 'effective' control. The cost of an acquisition is considerably reduced for an acquiring company if it is prepared to exercise control of a target with the presence of minority shareholders. In this situation control is exercised through holding a block of shares, which, having regard to the dispersion of the remaining shares among a large number of shareholders, enables control effectively to be maintained by a combination of the voting power conferred by the block of shares held and the position of strength conferred by control over the proxy-gathering machinery.

Special resolutions. So long as there is a minority shareholding outstanding there is always the risk that there may be problems in the passing of special resolutions. Areas of a company's operation that are particularly sensitive are:

- Transactions for the sale and purchase of goods between the target company and the majority shareholder;
- The raising of new capital with the attendant dilution effect on existing shareholders;
- Extra-ordinary transactions such as the disposal of assets, changes in the company's articles of association and merger agreements.

An equity control of 75 percent or more allows the acquiring firm to pass special resolutions committing the target company to whatever is so approved.

Simple majority control. Another crucial point of control is where the acquirer commands a simple majority of the target's shares. The acquirer reaches this position when it owns one share more than precisely half the issued voting shares of the target firm. This is usually referred to as the 51 percent majority position. With a 51 percent majority shareholding an acquirer may appoint or dismiss the target firm's board of directors and may thus determine the target firm's strategic and operating policies.

Management control. Management control is mere control over the proxy-gathering machinery, which due to the inertia of shareholders, enables the existing management to maintain control, especially where shareholding is very widely dispersed. While management control may confer sufficient hold over a company in normal circumstances, it may lose its holding power in the face of a take-over bid where the terms are pitched high enough.

The level of control that an acquiring company will need depends on what it intends to do with the target once the transaction has been finalised. A firm should set itself a minimum level of control, which it must be able to obtain for its combination plans to go ahead. This is the hurdle or threshold for equity control – any holding of shares below that level will be insufficient to provide the acquirer adequate control. The corporate strategy and objectives of the acquiring firm should determine this level of control.

5.3.2.6 Structural Integration

Linked with the decision on the level of control is the selection of an appropriate structural fit with the corporate body. The nature and objectives of the corporate and specific combination strategy will determine this fit. The following are the principal structural options that an acquiring firm may use in integrating a combination target:

- *Stand-alone subsidiary.* If an acquiring firm wishes to cause the least disruption to the target firm and its management, it will choose to allow the target firm to remain a stand-alone subsidiary. This means operational independence of the target firm's management, although the target firm's board will be subject to the acquiring firm's policies and ultimate decision-making power. This is an appropriate form for control levels of 51-90 percent where there are outside minority shareholders.
- *Operating division.* An acquiring firm may choose to treat the target as an operating division above the 75 percent shareholding level, or the point that allows for special resolutions to be passed. This will include the target firm's management within the operating framework of the acquirer as parent firm. The target firm may be required to work to a common set of objectives together with its fellow-division(s), or to a budget imposed by the acquirer. It may also be

required to enter into trade agreements with its fellow-divisions which would not apply were it a freestanding subsidiary.

- *Full integration.* If the target is 100 percent owned by the acquirer, it may be organised precisely as the acquiring firm wishes. Subject to the existing contractual obligations of the target firm, assets may be disposed of or switched to other group firms, its management can be transferred within the acquirer's group structure and business and trademarks can be allocated as the acquirer sees fit. Full integration of the target firm means that it ceases to exist as a separate legal entity and its operations are fully integrated with the acquiring firm. The target firm's staff and management are absorbed into the acquirer's organisation.

The acquirer should carry out a thorough analysis of the relative benefits of a specific level of control and structural fit well before announcing a bid or opening negotiations. Once formulated these plans will have to be argued and justified in front of regulatory bodies, the target firm's shareholders and its management.

5.3.3 DEFINING THE IDEAL COMBINATION TARGET PROFILE

5.3.3.1 Relatedness of the proposed combination

After agreement has been reached on the determined corporate strategy through a selected combination vehicle, the next step is to develop a profile of the ideal combination target. Firstly, before considering the detailed criteria of the ideal combination target that will fit the acquiring firm's strategy, management should consider the degree of relatedness to its current business of the ideal combination. Relatedness refers to the extent to which two firms complement each other in respect of products, markets, distribution networks, production methods and techniques, and similar science-based research.

It is apparent that this decision in terms of the relatedness of the combination would be dependent on the acquiring firm's growth direction and competence profile. A particular weakness in for example, the product line or distribution network would need to be complemented by another firm's strength in this area. This makes it essential that a comprehensive resource analysis has been performed and that a complete competence profile has been determined. The evaluation of the strategic fit with the target firm should be considered on this basis. The basis of competency in terms of management expertise and capacity to handle diversity may be another deciding indicator. The depth and scope of technology in the acquiring firm is another factor that would also indicate its capability to diversify into new product markets. Another important factor in considering relatedness and possible diversification is the firm's capability in transferring skills to a target firm. Synergy achieved in a combination is a function of the capability to transfer skills to the acquire firm and if management is able to achieve revenue enhancement, even in unrelated combinations, a wider scope of relatedness can be considered.

5.3.3.2 Rationale for defining an ideal combination profile

The definition of an ideal combination profile, which realistically articulates the ideal implementation of the corporate strategy, objectives and growth aspirations of the acquiring firm, is vital to the success of any combination programme. Without a desired profile with a list of criteria, the combination-intent firm will tend to be guided by impulse and emotion in reacting to opportunities, with the almost inevitable result that considerable time, effort and money will be expended on abortive investigations of candidates, which could easily have been identified as inappropriate after only cursory screening on the basis of defined combination criteria. A comprehensive list of criteria outlining an ideal combination profile, enables the acquiring firm with a defined strategic growth direction to select rather than merely react to opportunities. The following considerations support the rationale why an acquiring-intent firm may benefit from the definition of an ideal combination profile.

The process of defining the desired characteristics of an ideal combination candidate by itself, serves to focus management thinking on a realistic course of action. The top corporate managers in a combination-intent firm may have divergent views about the specific course that the firm should pursue in a programme of growth or expansion. Each key executive usually tends to reflect the professional bias of his special field or business area of management responsibility in expressing his sincere views on future growth plans in general and with regard to combination profile criteria specifically. Divisional general managers and general managers of marketing, manufacturing as well as research and development, may each have primary interest in expanding their own base of operations and may be more attracted to candidate firms providing this preferred expansion. Resolution and compromise of these typical differences in top management thinking should be effected in working out selection criteria so that the final ideal combination profile is in line with corporate strategy and reflects a realistic appraisal of the combination-intent firm's needs and opportunities.

A written outlined profile specifying a list of criteria sought in the ideal combination candidate, approved by top management, provides the firm's staff involved in the combination programme with definitive guidelines. Serious goal-directed effort may commence when management-approved criteria are placed in the hands of the staff concerned with the combination programme. Good definitive criteria to work with enable the combination staff to target firms that generally fit the requirement for closer evaluation. They avoid wasting evaluation time and effort on firms too small or too large or otherwise unworthy of consideration.

Detailed criteria enable thorough and speedy selection of attractive possibilities from large numbers of potential firms thereby making it feasible to cover broad areas of interest in an efficient manner. Moreover, through the application of criteria that are sufficiently definitive to select candidates for further evaluation it is possible to rank these candidates by order of choice in order to determine which ones

warrant priority consideration and possible approach. Furthermore, a detailed ideal combination profile enables the combination-intent firm to draft a memorandum that broadly outlines the firm's selection criteria in enlisting the help of outside sources for leads. Many combination-intent firms seek assistance from sources outside the firm to augment internal activity in developing leads to potential candidates. It is extremely useful to give such sources a standardised memorandum briefly outlining selection criteria. Such a list is useful to stimulate the thinking of outside participants about potential candidates and avoid time-wasting discussions about possibilities of no possible interest.

5.3.3.3 Basis of criteria development

The criteria of the ideal combination profile should be in line with the firm's defined strategic objectives, the growth direction chosen and reflect a realistic appraisal of the firm's internal capabilities as well as the opportunities presented in the external environment. It is integral to the success of the combination strategy that the strategic thread is woven from the strategic direction set at corporate level to the formulation of the ideal combination profile. Furthermore, the temptation to set rigid criteria that do not permit flexible application should be avoided. Care should be taken in setting limits/standards of acceptability so that the screening criteria do not operate as arbitrary 'knock out' factors without allowance for the application of judgement. The best approach is to have the criteria reflect minimum limits/standards of acceptability. It is also important to recognise that all criteria do not have equal weight. The appropriate weighting or prioritising of criteria needs careful consideration, since there are no rules or guidelines and each combination-intent firm has a unique set of conditions under which it formulates its combination strategy.

5.3.3.4 The criteria to be considered

The factors to be included in a list of criteria will vary from one firm to another. Some acquiring firms prefer to work with a brief one-page list while others compile criteria lists in elaborate detail. In cases where the list may become extensive, it is due to special requirements of the acquiring firm and it is often reflective of the complexity of the industry into which it is seeking to expand.

Definition of business sector. The first consideration is a further refinement of the degree of relatedness decision in that the specific business sector, in which the acquiring firm seeks to extend its sphere of operations, needs to be defined. The decisions in respect of the growth direction and the degree of relatedness will naturally serve as guidelines.

The definition of the target business area should be in terms of the products or services produced, the markets to which they are delivered and the technology utilised in producing these products to the served markets. This definition may be in broad terms and possibly refers to specific industry segments. The

definition of the business area where a combination is sought, would be determined by the attractiveness of the business sectors considered. Growth potential and competitive conditions are some of the variables influencing the attractiveness of business sectors.

Size. The size of the firm that will be considered may be stated in terms of market capitalisation, assets, revenues, sales turnover or cost to acquire. This is usually a fairly fixed criterion and should be stated in terms of minimum and maximum limits. The minimum assets or sales turnover is set to exclude from consideration firms that the combination-intent firm viewed as too small to be worth the trouble of combining with, given that the time, effort and cost involved in the acquisition of a small firm is usually just as great as in the acquisition of a relatively large firm.

The revenue or sales size limits that are set, may vary depending on the relatedness between the acquiring firm and the combination target considered. The sales volume is usually increased for targets in business areas further removed from that of the acquiring firm. The reasoning behind this is that small firms in a business area far removed from that of the acquiring firm may tend to present more operating problems than larger, more stable firms.

Profitability. This factor may be stated in terms of minimum acceptability and in slightly different terms depending upon how the combination will be effected. If cash purchase in an acquisition is contemplated, the criterion may be stated in terms of the return on investment expected.

Return on funds employed in the target firm is often used as a criterion by the acquirer to assess whether the target would produce the acceptable minimum return required by the acquirer. If the merger or acquisition is to be effected by an exchange of shares, then the criterion could be stated in terms of earnings per share after consolidation. Many acquirers state that they will not dilute earnings per share to make an acquisition.

Management. The quality and depth of management needed in the target firm is an important factor in the target combination profile. This would refer essentially to top management, but lower levels could be included if specific functional managerial competence is sought. The management expertise needed would be determined by the specific combination strategy pursued. If the acquiring firm considers it to have strong management competence in its business area and embarks on a related combination, it would not be sorely in need of competent management in the target firm. The acquiring firm formulating a combination strategy in an unrelated business area, where it has no management experience, would prefer good, competent and reliable management in the target firm. The specific management competence sought, should thus be clearly highlighted in the target combination profile. It is obvious that the further afield the acquiring firm goes from its own in search of new opportunities, the more important

it is to be assured that the management and technical organisation is not only highly competent, but that it will continue to function well as a division or subsidiary of the acquiring firm. Acquirers may go to great lengths to attempt to lock in the management of the acquired firm.

Combination strategy requirements. A further set of criteria measures the compatibility of the target combination firm with the combination-intent firm's activities and the extent to which the target firm provides a vehicle for achieving the objectives and growth aspiration of the acquiring firm. Some of these criteria may be used for preliminary screening, while others will be utilised during detailed investigation and analysis of specific target firms. Such criteria may specify requirements in respect of market growth prospects, the nature and extent of the target prospect's resources, technical competencies, its reputation, personality factors, and the specific nature and quality of products. Care should be taken to give the proper weight to specific requirements and to avoid setting down standards, which are superfluous and bear little or no relationship to the combination-intent firm's fundamental requirements.

5.3.3.5 Use of criteria

Although historical performance is significant in evaluating a proposed target firm, the combination-intent firm should primarily be concerned with the future outlook. Criteria do not constitute a simple formula, which can mechanically evaluate the historical facts of the potential combination and produce an automatic acceptance or rejection, but provide the basis for careful analysis and additional forecasting. The acquiring firm should keep in mind the extent to which it may benefit from a change in the character of the acquired firm as well as the likelihood of the combination of the two firms having a synergistic effect. The application of criteria should not be allowed to deteriorate into a mechanical procedure.

The validity of the criteria specified in the ideal combination profile should be checked from time to time, particularly whether it still reflects the objectives and growth aspirations defined in the corporate and specific combination strategy. If combination activity stretches over a long period of time and target firms, which have been identified previously, should again be reviewed, the acceptance or rejection recommendations resulting from previous examination by top management should be re-examined closely. If the criteria do provide a match in the current situation, management may concur to continue with detailed investigation.

5.4 LOCATING THE COMBINATION TARGET

5.4.1 Identification of industry sectors

The description of an ideal combination profile with its definition of criteria, is typically followed by an identification of the specific industry sectors where the target firm is likely to be found. The respective corporate growth direction and the accompanying decision on the degree of relatedness in terms of

products, markets and technology, will determine the preferred industry sector. The Standard Industrial Classification (SIC) may be a useful framework of reference in framing the total available sectors and defining the industries. The classification used in the listing of firms on the stock exchange may be another useful framework used to target specific industry sectors.

The ideal combination profile with its specified criteria may then be utilised as filters to select those industry sectors, which are most appropriate to the firm's combination strategy. If the definition of business type in the criteria does not restrict the firm to consider options in specified industry sectors, a wider scope of possible industry sectors where the ideal target is likely to be found, could be considered. In this case the consideration of the attractiveness of various industry segments becomes an issue and therefore alternative industry segments need to be analysed and evaluated. Identified potential industry sectors may be analysed and characterised by evaluating the following aspects:

- The relative growth rate of the industry sector versus other sectors;
- The critical success factors, or basis of competitive advantage;
- The industry driving forces shaping the future of the industry sector;
- The degree of competitive rivalry in the industry sector; that is the intensity of product, pricing, distribution and communication strategies, determining the relative distribution of market share;
- The bargaining power of suppliers and buyers in the industry sector;
- The threat of other firms entering the industry sector with substitute products or services;
- The potential threat of new entrants into the industry sector;
- The impediments to entry, that is the economies of scale, specific assets required, cost and learning curve effects, reputations of incumbents, asymmetries created by licenses and patents, brand identity barriers and high exit costs of the industry sector;
- The richness of technological opportunity in the industry sector, that is the measure of the innovation base within an area;
- The strategic groups – that is the cluster of firms within an industry sector that have specific assets in common and follow similar strategies in terms of key decision variables.

The acquiring firm should analyse the quite different abilities that enable strategic groups operating within the same industry sector to take advantage of their environmental and operating conditions to secure a profitable position. It is therefore essential to correctly define the identified industry sectors from a strategic perspective. This definition must allow for sustainable competitive advantage to be clearly assessed and should describe the essence of the particular capabilities needed to develop and sustain a competitive position.

Once the attractiveness of alternative industry sectors has been assessed in terms of the degree to which they present a desirable avenue for strategic growth, a priority list of the industry sectors most attractive to the chosen combination strategy, the suitable combination vehicle and the ideal profile of the target may be determined.

5.4.2 SEARCH AND SCREENING

5.4.2.1 Search for the ideal combination target

Having established an ideal combination profile and identified the target industry sectors, the firm is in a position to search for target firms meeting the criteria of the ideal combination candidate. By this time, many candidates who are available may have come to the acquiring firm's attention, but it is unlikely that any will be found desirable in terms of the ideal profile. It is almost axiomatic that firms that are available and actively marketed, are rarely desirable and many have problems that few would be acquirers would want to take on and solve. Therefore, an active search program must be instituted in order to compile a comprehensive list of ideal combination candidates that will best implement the combination strategy.

The objective of the search is to find a suitable firm willing to entertain a proposal that it combines with the acquiring firm. Two types of information are thus needed: what firms fit the ideal target profile and what firms are willing to deal. The first type of information is obscured by the unwillingness of many firms to disclose operating figures in the detail needed, and the second type of information is generally not announced, since management recognises that an announcement that it is for sale, weakens its bargaining position and undermines the morale of employees.

Given this problem, it is obvious that the acquiring firm can proceed in one of either two ways. It can begin by searching for an ideal match of characteristics with its target profile, and then determine whether the owners are willing to negotiate. Alternatively, it can search for firms willing to negotiate, and then screen the available firms for the degree to which they meet the criteria. The latter method has some merit in that it narrows the search at once to firms known to be available. However, since this approach is likely to produce a list of firms with widely varying characteristics of size and product mix, it is usually employed by an acquiring firm with surplus funds that is seeking investment opportunities, which will provide a suitable return irrespective of the nature and role of the acquired firm.

The advised procedure for an acquirer who has definite growth objectives, and has formulated a specific combination strategy with a defined set of ideal criteria, is to compile a list which identifies the universe of firms meeting primary combination criteria. It then needs to obtain enough information about these firms to narrow the search to the most attractive ones, and then to determine the willingness of these attractive firms to negotiate.

Often an acquirer will exclude some firms from consideration on the mere assumption that they would not be willing to consider a combination. This could be a mistaken assumption. Times and circumstances change and firms who were approached the previous year, for instance, may currently be willing to explore possibilities anew for any of the following reasons: a corporate holding company's decision to divest one of its subsidiaries due to a shift in growth focus; a principal stockholder may have died and it may be desirable to diversify his estate; or the need for a stronger manufacturing, technological or distribution capability or capacity, which could be supplied by an acquirer, but is now recognised where it was not earlier. The point is that if a candidate firm is desired in terms of the combination strategy and ideal target profile of the combination-intent firm, an approach should be made.

5.4.2.2 Screening and evaluation of candidate firms

For the purpose of narrowing down the field to the priority targets, a limited number of candidate firms should be selected for intensive screening and evaluation. With a shorter list an intensive information-gathering endeavour based on the information needs specified in the criteria of the ideal combination profile, may be instituted. The assistance of outside consultants or other specialists, who may be able to make discreet enquiries, may be very useful in accumulating less readily available information on the target firms.

When all the available information had been compiled, it is advisable to check it against the full set of criteria of the ideal profile in order to make an evaluation of each candidate under consideration in determining the relative extent to which each one meets the requirements. This task is a difficult one of equating a number of factors of unequal weight. Some firms try to solve this problem by assigning number values to the criteria elements, which in turn are factored by number values given to each candidate firm on the basis of how closely it meets each criterion to eventually arrive at a numerical sum or score for each candidate under consideration. This approach is partially valid to the extent that it attempts to apply mathematical logic as a substitute for a subjective analysis, but it fails to replace human judgement as the ultimate factor in decision-making. It is therefore useful only for validating judgement or pointing out the need for a review of judgement, where the choice of mathematical rank is widely disparate from the rank determined by judgement.

5.4.2.3 Selection of the combination target

The result of the screening and evaluation process is a priority list of the potential combination targets. These alternative candidates should be narrowed down to two or three and finally the best candidate through close scrutiny of which candidate provides the required capabilities and characteristics sought, and the best strategic fit with the acquiring firm's strategy and resource configuration in terms of its financials, products and markets.

The combination task group will typically then put its proposed candidates to the chief executive or board of directors, who would make a final decision to confirm a specific candidate as the selected combination target representing the best combination opportunity and vehicle.

5.5 APPROACH AND EVALUATION OF THE TARGET FIRM

5.5.1 Approach of the target firm

The next action is to assess the availability and willingness of these potential targets to enter into a proposed combination. This assessment could be achieved by a direct approach to the board of directors or the corporate management of the target firm, or through a third party such as a merchant bank or consultant. The approach should be motivated by a sound rationale and outlining of the specific benefits to be achieved through the proposed combination.

The problem of approaching a target firm is a delicate one. If it is not handled properly the entire relationship between interested acquirer and target candidate may be terminated at the first approach. The most effective approach will be founded upon careful consideration of all the relevant background information that the acquirer is able to gather about the target firm. Relevant background needed for this approach may include an analysis of the following dimensions:

- *Share ownership*: the distribution of share ownership, the direct and indirect shareholding of the members of the board of directors, blocks of shares held by large institutions in their portfolios.
- *Interlocking directorships*: the directors and their other business connections, any directors or officers of other firms, banks or institutions, acquaintance or relationship of the acquirer's executive officers or directors with the directors of the target firm and how close is the acquaintance.
- *Banking connections*: the candidate's bankers and other sources for short and long term capital.
- *Management*: the executive management at corporate level as well as business unit executives.
- *Operations*: a good knowledge of the candidate firm's operations is required for the initial discussions. This may include product line information, production methods and technology, distribution networks, pricing practices and other policies.

All the above background information collected in the foregoing research should then be correlated with the financial data prepared in the course of the preliminary evaluation. The objectives of this step are:

- To identify the most suitable persons in the target firm to approach;
- To consolidate sound strategic and business reasons for proposing the combination;

- To define the critical areas to be initially discussed with the candidate firm and how to deal with them;
- To anticipate what will motivate the vendors or sellers;
- To anticipate possible questions which may be raised and the answers to be given.

If the approach of the target firm results in a willingness of the target to consider the proposed combination and enter into negotiations, an undertaking of intent is signed and the target firm would make available information and data, which is needed to conduct a detailed evaluation through due diligence.

5.5.2 Due diligence

The due diligence evaluation has traditionally focused on verifying the financial, taxation and legal aspects of the target firm. This has been expanded in recent years to include technical capabilities, operations and human resources – specifically management of the target firm. Due diligence should be far more business and market-oriented to assess what the target firm can bring to the acquiring firm (Habeck, Kröger and Träm, 2000:35). The focus should therefore be on evaluating the full range of growth synergies, and not only efficiency synergies that may be achieved through cost savings. Growth synergies may be achieved in the combination through combined market power in accessing new markets and customer groups, developing new products in the combination, and geographic expansion through the distribution network of the acquired firm.

While an assessment of the profitability of the target firm is a critical part of the financial due diligence, it is also essential that the acquiring management understand the true economic profitability of the target's customers. Selden and Colvin (2003:76) have pointed out that many businesses have large numbers of unprofitable customers, which they call 'duds' and 'disasters', that after accounting for the cost of capital of the invested capital for such customer segments, deliver negative economic profit and shareholder value creation. Their study has indicated that just 25% of customers, the 'darlings', generate most of the economic profit and the share-owner value creation. They argue that that just by shutting down some of the target firm's worst customers and redeploying assets to other customer segments, the acquirer may change the transaction from a big loser to a big winner. The financial due diligence of the target firm should therefore include an analysis of customer financial profitability to identify value destroying customers so that acquiring management could either sell them off or turn them into value creators.

Since large acquisition premiums are being paid for target firms in excess of their stand-alone values, it stands to reason that there must be some relationship between the size of the premium and the value of the anticipated synergies from the combined firms. It is therefore important that as part of the financial due diligence, there should be a mechanism for the evaluation of these synergies relative to the acquisition

premium. The uncertain future payoffs from identified synergies should therefore be estimated. A common approach to achieving performance improvement in a combination is through the identification of the value drivers of the identified synergies and extrapolating the increased cash flows into a discounted cash flow model. Direct valuations of the various aspects of the synergies could then be made and compared with the proposed purchase price. The estimated present value of synergies should be considered and compared with the premium. If the synergies equal the premium paid, the seller captures all the value. A break-even analysis may then be used to determine whether the acquirer will capture any value. The break-even analysis could serve as a checkpoint for the acquirer to re-assess the continued pursuit of the target. If the acquisition still prove to be able to generate shareholder value, acquiring management could continue to pursue the acquisition through bidding or negotiations.

5.6 NEGOTIATIONS AND FINALISING THE TRANSACTION

5.6.1 Negotiations framework

Most firms following the external combination route through acquisition have a policy of avoiding a competitive bidding situation that could impact negatively on the eventual price being paid. For example, in a recent acquisition by the South African acquiring firm, Dimension Data, of a North American firm, Nextcom, the acquiring firm started with a high bid to avoid other bidders also coming in and pushing the price of the acquisition too high. It is therefore important at the outset to ascertain whether the target candidate is engaged in another merger or acquisition discussion. In the unlisted sector secrecy is important to the acquirer, because unwanted rumours may bring in a competitive bidder for the candidate firm.

Before starting with negotiations it is important to develop a clear map of the players, who are likely to influence the formal and informal decision processes. This should include extra players in the governance processes beyond those representing the two firms. Along with assessing the persons, who will be sitting across the table, is figuring out the intricacies of the larger organisation behind him or her. Then a strategy should be designed so that the right people with the right arguments are reached in such a way that allows for maximum impact on the negotiations process to yield a sustainable transaction (Sebenius, 2003: 78). Early determination of the basic needs and desires of the acquirer and the seller is therefore very important to constructive discussion early on in negotiations. When the basic requirements have been clarified, the foundation is provided for tailoring the merger or acquisition agreement. Initial discussions should therefore focus on the basic needs and benefits of the two parties and highlight the economic benefits to be gained by combining the two firms. The underlying thesis is to explore the validity of the original concepts motivating the combination in respect of their advantages with an emphasis on doing what will be of greatest benefit to the shareholders.

The chief executive of the acquirer initially has to convince the executives of the candidate firm of the soundness of the combination and endeavour to avoid discussion of specific terms. His response to early questions on terms should be that if the combination is economically sound there should be no serious difficulty in arriving at terms equitable to both shareholder groups. By developing the business and operating aspects of the combination as fully as possible, the seller should become intrigued with the future potential and thus be more receptive to the terms when proposed and more understanding as to why they are fair and equitable. These discussions could also reveal facets of the candidate firm's business not previously discernible, which may cause the acquirer to modify the terms initially formulated or be prepared to improve the terms beyond the range initially set.

Negotiations on mergers and acquisitions seldom consist of executives seated on two sides of a table utilising all sorts of clever and devious strategies to induce their opponents. Interchange of information, ideas and positions occurs during many meetings, telephone calls or other modes of communication in settings ranging from small private meetings to brief conversations during entertainment activities, but rarely in formal meetings with negotiators trying to outsmart the opposite side. The acquirer should strive for a series of cordial information exchanges with both parties attempting to jointly develop a mutually beneficial agreement. Conflicts, strategies, defeats and victories do occur, but should be avoided as much as possible – the optimum negotiation would be one where the participants did not realise that defeat had occurred as they signed the agreements.

The acquirer must assimilate all the information accumulated about the target candidate's business, industry and owners, and develop his own positions on the issues anticipated. In depth preparation involves a continuous analysis of the situation, based on all information available and determination of every issue that might conceivably arise both with bargaining positions and objectives. An analysis of the positions, motivation and aspirations of the seller's decision-makers should be conducted continually throughout the combination process and every effort should be made to understand the acts and reasoning of the sellers. Each piece of information and communication helps establish a common framework for the parties, which becomes tacitly acceptable by a willingness to continue discussions after the information is communicated to the other. The more information presented and the more views communicated and accepted, the broader becomes the framework of agreement and the area for differences continues to narrow. Eventually the parties reach the point where both want to go ahead with the transaction and they reach agreement on price either verbally or in a memorandum of understanding.

5.6.2 Price and financial terms

As soon as an agreement in principle has been reached, it is best to immediately prepare a merger or acquisition agreement that outlines the major terms of the transaction. If it is to be a cash transaction, the price is stated and under what conditions the price may be adjusted. If it is to be an exchange of stock, it

will recite the capitalisation of each firm in terms of outstanding shares and the number of presently authorised shares or shares of a new issue, which are to be exchanged to effect the merger or acquisition. The agreement may state that the combination and the detailed agreement shall be subject to approval by each board of directors and legal counsel of both firms. The proposed combination agreement will then subsequently need to be ratified by the boards of directors and a general shareholders meeting of the participating firms.

5.7 INTEGRATING THE COMBINATION TARGET IN LINE WITH CORPORATE STRATEGY

5.7.1 The integration challenge

The task of integrating the combining firms, each with its own unique strategy, specialised resource configuration, organisational structure and culture presents one of the critical challenges in the combination process. This is the critical phase that may present the highest risk in the process. Problems that may emerge in human relationships could derail the implementation of the combination strategy and its objectives. Effective integration, on the other hand, will pave the way to implement the planned resource deployment and realise the identified synergies towards achieving the corporate objectives of the parent firm.

The guidelines for the integration task lie in the corporate vision and strategy as well as the specific combination strategy that has motivated the combination. Any forces that could influence the combination negatively should be identified, as well as the new skills that will be required to effect a successful implementation of the corporate strategy through the combination. The operating plan to achieve the strategy should be detailed in respect of the transfer of capabilities and the realising of synergy potential. This should be done in accordance with the objectives and policy of the corporate strategy that has motivated the combination.

5.7.2 Integration options

The extent and scope of the integration process would clearly be determined by the nature of the structural fit with the acquiring firm. In the situation of the acquiring firm preserving the autonomy of the target firm and establishing it as a stand-alone subsidiary, there would be minimum disruption to the target firm with only *partial integration* in selected areas. Management reporting structures, accounting and financing policies and procedures are some areas that are affected and should immediately be clarified. An example of this is when an acquisition is viewed purely as an investment wherein autonomy of the acquired firm is retained, and the changes effected are primarily in accounting methods to bring financial reporting and control in line. An acquired firm integrated as an operating division would retain operating policies and procedures, but aspects such as financial and accounting practices, human resource

policy and compensation would be aligned with the acquiring firm or new parent. The acquiring firm may also be able to provide more cost-effective purchasing and logistical arrangements that could change supplier and marketing arrangements.

Grubb and Lamb (2000:90) have argued that a minimalist approach to integration with a 'hands off' structure can be highly effective, profitable and successful, even when a large number of combined firms are involved. Acquired firms can run as stand-alone businesses and then combine revenue and profits at the end of the accounting cycle. By design, minimal integration forces acquirers to focus just on those merger integration actions that will provide the very best contribution to the bottom line. Minimal integration can protect acquiring management from attempting actions that will only distract and confuse the new organisation.

In the case of *full integration*, there may be hardly any of the acquired firm's functions that are not affected. The two firms' systems, assets, policies, practices, and staff are melded together into one united organisation. It is self-evident that such a full-scale integration requires diligent planning and preparation and it is imperative that it be completed in the shortest time possible. Full integration can only be accomplished on a fast track schedule when it is carefully planned in advance of the merger announcement and integration start-up. The most important task, and also the most sensitive, is typically the design of a new optimal structure for the merged entity.

5.7.3 Executing the integration

The first action called for after successful consummation of the transaction, is a thorough review of all data accumulated to date and the gathering of additional information needed to complete the assessment of the structural integration. In this way the acquiring firm will develop a thorough understanding of the resources and operations of the acquired firm and establish a sound basis for planning the future of the consolidated entity. The first major issue to be resolved, following the combination, is the nature and extent of consolidation that is desirable in terms of partial or full integration. In some instances it may be best for the acquired firm to continue operating essentially as an autonomous subsidiary, with only minimum direction and control from the acquiring firm. In other instances it may be advantageous to absorb fully the acquired firm within a relatively short period of time. If the acquired firm were obtained primarily for its product line and certain key individuals, integrating the individual into the acquiring firm's organisation and liquidating its production facilities, may be most appropriate.

If the structural fit with the corporate body has not been explicitly designed, nor defined in the combination strategy that a specific structural integration is preferred, then the issue of the extent of integration should be faced during the due diligence and negotiation stages. The basic requirements governing decisions in this regard are to maintain the strengths of the individual parties to the

combination and to develop new capabilities from the combination through achieving strategic interdependencies and potential synergies.

It is extremely critical for the acquiring firm to protect the value of its acquired firm during the period of transition. The value of good-will and future earnings expectations should be preserved. It is especially important that the acquiring firm act promptly to maintain the morale of employees and to retain the services of key managers, whose resignations would significantly reduce the value of the acquired firm. Accordingly a general plan should be prepared as soon as possible, which indicates how and where the acquired firm and its staff fit into the corporate structure.

It is important that there should be consistency in the management involved – from the formulation of corporate strategy right through to integration. The same management team responsible for formulating the corporate objectives and specifying the combination strategy, should have a hand in guiding the integration of the acquired firm with the corporate strategy and operations of the acquiring firm. Essential is the design of a communication system to provide timely and accurate information in both organisations and will build trust and confidence towards moving the combining firms into a business-focused mindset at a faster pace. Communicating the rationale behind decisions, future goals and objectives, new roles and responsibilities and managerial expectations through constructive dialogue and feedback, are vital to build trust and ensure credible leadership in the combination. Employee participation and the utilisation of integration teams may give focus and guidance, allocate resources, coordinate, improve morale and enhance implementation effectiveness (Horwitz, Anderssen, Bezuidenhout, Cohen, Kirsten, Mosoeunyane, Smith, Thole and Van Heerden, 2002:7).

5.7.4 Integration areas to be covered

The organisation of the integration task should start by recognising which skills are required and then determining whether they are available in the acquiring organisation or should be obtained externally. Consulting firms provide experienced service in respect of specialised tasks such as optimal organisation structuring, executive appraisal and compensation policies. In organising the various integration tasks, it may be found that certain activities can most effectively be accomplished by setting up project teams consisting of acquiring and acquired firm staff as well as specialists from consulting firms. For example, a special team may be tasked to identify revenue or growth synergies.

In covering the scope of the integration task, the areas that may need attention are the following, with the order of importance being determined by the characteristics of the firm acquired as well as the extent of integration:

- *Top management and organisational structure.* An appraisal is made of the individuals constituting top management of the acquired firm and the current organisational structure that is in place. The purpose should be to ascertain weaknesses in the acquired organisation so that corrective measures may be taken. There is also the need to identify strengths at the management levels of the acquired firm to ensure retention of competent personnel and to utilise their capabilities most effectively. The optimal design of reporting lines to the parent structure will depend on the extent of the desired integration.
- *Accounting and financial control.* This determines what changes in accounting policies and procedures of the acquired firm are required to conform with the accounting practices to those of the acquirer. Financial policy and procedures are to be communicated and instituted.
- *Distribution networks and marketing organisation.* Depending on the synergy potential between the acquirer's marketing organisation and that of the acquired; the integration of distribution networks should be a priority.
- *Product line.* Customer evaluation of the firm's products is essential to the pre-combination evaluation and important to the acquirer when deciding what actions must be taken. Consideration of the obsolescence of product designs, the breadth of the product line to meet customer requirements, and the desirable features of competitor products are the basis for a programme to maintain and develop the competitive strength of the acquired product line.
- *Manufacturing facilities and operations.* The realising of potential synergy through the integration of manufacturing operations is a motivating factor in many combinations. For example, the other partner in the combination could use materials or components produced in the plant of the acquirer. Sometimes there is the opportunity to combine operations and eliminate a manufacturing facility. In other cases, some production can be shifted to the facility with more efficient machinery and equipment.
- *Research and development.* In high technology based businesses the areas of research and development can be fertile fields of opportunity to effect better economies or increase the output of new or improved products without a commensurate increase in expense.
- *Human resource policies.* Human resources policies and fringe benefits may present more problems than opportunities. Employee relations and the intangible asset of morale should therefore be handled with great diplomacy.
- *Compensation.* Compensation administration must be analysed on a comparative basis with that of the acquirer and a plan developed to harmonise both plans. Incentive bonuses, profit sharing plans, retirement and pension plans should be similarly harmonised.
- *Information technology.* The integration of two firms, each having its own specialised developed information technology, is an extremely complex task. The administrative and marketing systems utilised in each separate firm could present substantial cost savings if integrated. The elimination of expensive hardware facilities may present significant cost saving opportunities.

Acquiring firms usually utilise an integration committee that will design a blueprint for the integration phase in terms of the optimal structure. Integration task teams should include trusted managers from the acquirer and key employees from the affected areas. It is important to co-ordinate the work of these teams in cases where the one requires information that needs to feed in from another. The more employees that are involved through the integration teams, the faster the organisation will move during the integration stage into a business-focused mindset. The need to achieve a business focus sooner rather than later, is the ultimate reason why most acquiring firms give themselves a hundred days to integrate newly acquired firms.

5.8 POST-COMBINATION REVIEW

It is particularly relevant from a strategic perspective that the acquiring firm's management should perform a formal review of the integration and the combination per se, evaluating to what extent strategic objectives such as the acquisition and development of specific capabilities, have been achieved through the specific combination vehicle. Often in routine management quarterly review sessions the focus is only on short-term operational performance.

The formal post-combination review serves as strategic inputs to line managers who are responsible for managing the acquired firm as part of the group. It would also serve to enhance the collective learning in acquirers so that lessons learnt are shared and mistakes are not repeated.

5.9 POST-COMBINATION STRATEGIC MANAGEMENT

After the successful integration of the acquired firm in line with the corporate strategy and the specific combination approach of the acquiring firm, it will be business as usual for the acquired firm. Parent managers could now manage the newly acquired entity as an integral part of their group structure and utilise its capabilities and resources to achieve its vision and corporate objectives.

Continued efforts will need to be made to realise optimal stretch and synergy in the combination. Tolerating sub par performance from acquired operations, has been pointed out as a reason why some acquisitions fail to meet expectations. The challenge for parent managers is to optimally leverage resources and newly acquired capabilities to achieve a shared vision.

5.10 PROCESS INTERDEPENDENCE AND DYNAMICS

It should be emphasised that the approach outlined in this chapter does not necessarily argue for a sequential step-by-step procedure. To the contrary, the strategic framework proposed in this chapter

acknowledges that the various constituent elements of the decision-making process are interactive and interdependent and many should be considered together. Accurate information flows through sound communication is a prerequisite for effective functioning since the various decisions at different stages are linked and influence the other directly or indirectly.

The fit between corporate strategy and the combination profile as part of combination strategy is an example that illustrates the interdependence. The criteria for the ideal combination candidate are directly guided by the particular corporate strategy. The definition of the targeted business sector, the size of the combination that will be considered, as well as the profitability and management criteria would all be influenced by the nature of the strategic thrust at corporate level. The extent of integration, such as full integration or only partial integration that establishes the acquired firm as a separate subsidiary or incorporates it as part of a current division, are decisions that flow from the corporate objectives and strategy. The identification of particular industry sectors, which will be examined for combination targets, is directly linked to the choice of growth direction formulated in the corporate strategy. A horizontal and vertical growth direction would indicate growth sought in the current industry, while related diversification would entail a focus on a wider scope of industry sectors that may be related in either product, market or technology dimensions. An internationalisation strategy would typically identify the targeted countries as an integral decision of the strategy, after considering the attractiveness of alternative world markets. The many decisions of the combination decision-making process are therefore directly linked and formulated simultaneously in many situations.

The planning of the integration phase is not a separate process activity that is necessarily only activated after negotiations have been completed and the transaction finalised. Integration planning should start early on in the process. During the due diligence process a hypothesis for ideal integration should already be developed. The integration plan should be refined during negotiations so that the integration of the combining firms can be implemented rapidly and in the shortest period to achieve the identified synergies sought.

5.11 CONCLUSION

In this chapter a strategic framework for the planning of external business combination has been put forward. In this framework all the various constituent activities that corporate managers need to plan and execute in the structuring of external business combination, have been described in four distinct phases to explain the logical flow of combination decision-making activities in a planned mode. The combination decision-making process is ideally initiated in a *planning* phase with the formulation of corporate and combination strategy by the combination-intent firm.

This is followed by an *implementation phase* where strategic decisions are implemented through locating, approaching, evaluating, negotiating with the combination target and then finally completing the transaction. The eventual consummation of the planned combination is effected with the *integration* of the target in line with the strategy, structure and operations of the acquiring firm. The strategic framework advanced here has emphasised the importance of a thorough review process with the result feeding into a follow-through *post-combination phase*, where the combined firm is managed as part of the acquirer's group to achieve corporate objectives in line with the strategic direction set out in corporate strategy.

The setting of strategic direction through a clear corporate vision, mission, objectives and defined growth direction of the combination-intent firm was identified as a crucial prerequisite for the formulation of successful combination strategy. A well-defined and compelling vision articulating the desired future position could serve to stretch the organisation to achieve its defined strategic and financial objectives at the corporate level. Corporate strategy should therefore indicate the desired growth direction of the firm based on thorough resource analysis as well as external environmental scanning and specific industry opportunities.

This chapter has also highlighted that a firm intent on pursuing external growth may define its combination strategy in terms of a few primary decision-making considerations. In line with its corporate strategy the combination-intent firm should define the specific combination objectives, the specific capabilities sought, the suitable combination vehicles to be used, the ideal combination profile defining criteria such as the size and profitability of a target acquisition, the level of control the acquiring firm would like to exercise, and the optimal level of integration of the target firms with the corporate structure of the acquirer.

The strategic framework is insistent that from a strategic perspective, corporate management should carefully evaluate the whole range of various combination vehicles to select the most suitable one, through which the particular growth strategy could best be implemented. Each of these various combination vehicles has its own relevant advantages and disadvantages depending on the objectives and requirements of the particular strategy as well as the resources and capabilities of the combination-intent firm. Several of these key advantages and risks in general, have therefore been identified in this chapter.

The strategic framework advanced in this chapter may serve a guide to corporate managers as well as all the other various role-players in the process so that they could efficaciously plan and execute external combination to implement corporate and combination strategy of the firm intent on growing through external combination.

CHAPTER 6

SUMMARY AND CONCLUSION

6.1 UNDERSTANDING OF THE BUSINESS COMBINATION DECISION-MAKING PROCESS IN SOUTH AFRICAN ACQUIRING FIRMS FROM A STRATEGIC PERSPECTIVE

The descriptive research presented in this thesis has attempted to develop a understanding of the business combination phenomenon from a strategic perspective as practised by acquiring firms in the South African context. The claim made here, is that this is the first time that the business combination decision-making of South African acquiring firms in empirical situations has been the subject of such an intensive research focus, that analysed combination decision-making with a specific emphasis on the overall management of all the various constituent activities in the process leading to business combinations. In addition, the business combination process through mergers, acquisitions and joint ventures has been researched from a strategy perspective. This was essential for making a sound contribution to the content in the M&A strategy discipline, since the strategic intent of the acquiring firms is prompting the structuring of these business combinations and is central to the way that these firms manage growth through external combination. The descriptive research has outlined specifically how South African acquiring firms have internationalised their operations and, arguably, has advanced a general understanding of the strategies that were employed by successful acquirers in the globalisation of their operations.

6.2 REVIEW OF BUSINESS COMBINATION ACTIVITY IN AND FROM SOUTH AFRICA DURING THE PERIOD, 1991-2001

The strategy focus of the research is especially relevant since offshore expansion strategies through mergers, acquisitions and joint ventures were amongst the major drivers of business combination activity during the second half of the period, 1991-2001. Combination activity in South Africa during this ten-year period was fundamentally affected by a few key characteristics of the South African economy such as its exceptional mineral wealth, the structure of Gross Domestic Product, economic growth performance, foreign direct investment and its market size and position versus world markets.

A review of combination activity within the macroeconomic context spotlighted the fact that the largest business combinations through mergers during the period were effected in the primary sector in resource based industries. Given the openness of the South African economy and its strongest trade

links, the large-scale offshore expansion through combination in terms of an internationalisation thrust by South African acquirers occurred into the major developed economies of the world in Western Europe, North America and Australia. This expansion gained momentum after 1994 with South Africa's re-entry into the international capital market and the subsequent relaxation of exchange controls when South African corporations made more selective acquisitions offshore. Further impetus was provided through offshore listings in financial centres such as London and New York, when large corporates gained improved access to international capital markets. Internationalisation by these offshore listed firms as a driver of combination activity, accelerated during 1999-2001 in synch with an increase in cross-border mergers and acquisitions world-wide. Increased globalisation in the operations of these now multinational firms, resulted in the shift of the headquarters, as well as the seat of the chief executives of some of these firms, to the particular world centres. The management structures of these firms were also adapted to enable effective global management through divisional geographic structures or regional hubs.

The major drivers of combination activity in the first half of the period, 1991-2001, was a reshuffling and refocusing trend that represented a reversal of the diversification philosophy followed previously. In line with this trend, large corporations embarked on the unbundling of non-core investments to unlock underlying value to their shareholders. Mergers and acquisitions of related businesses represented another major driver to attain critical mass and take advantage of economies of scale and larger market share. Black economic empowerment initiatives were responsible for a significant contribution to local combination activity from 1993. Towards the end of the period empowerment activity shifted from minority stakes in large listed firms to management control of smaller unlisted firms and equity joint ventures. Inward investment after 1994 picked up to be a significant driver of combination activity, but did not achieve the same level as outward investment transactions.

In the outward internationalisation by South African acquiring firms, the acquisition of relatively large firms as platform acquisitions in the targeted countries, were amongst the first form of combination to be used. These combinations were effected largely through the acquisition of stock in either a hundred percent, or a controlling stake, leading to the establishment of the acquired firms as subsidiaries. A few South African acquiring firms embarked on aggressive world-wide acquisition programmes to globalise operations and were noted as amongst the most active acquirers world-wide. Joint ventures as a combination vehicle for both upstream as well as downstream expansion, were extensively utilised in capital intensive industries such as natural resource mining, fuel and chemicals as well as in the beverage industries. A large merger of equals, as the appropriate combination vehicle, was effected in the mining sector with the South African and Australian business combination, BHP Billiton, which represented the largest transaction to date in these two countries and created the largest diversified resources firm in the world.

6.3 EMPIRICAL FINDINGS IN TERMS OF THE BUSINESS COMBINATION DECISION-MAKING PROCESS IN ACQUIRING FIRMS

Interviewing in large South African acquiring firms revealed that business combination decision-making was fundamentally determined by the way in which the combination originated. From the interviewing data two broad empirical models emerged as the predominant situations occurring in practice.

The planned business combination was characterised by the systematic development and implementation of a well defined corporate strategy, that was aiming to expand the business in selected business sectors or targeted global areas and through a specific form of combination such as through the acquisition of relatively large firms or joint ventures. An alternative situation was an opportunistic combination, when an acquisition opportunity was presented to the acquirer as occurring when large groups divested non-core businesses, or businesses were foundering, or as a result of black economic empowerment initiatives. The planned and opportunistic situations were summarised in empirical process models, describing in detail how acquiring firms managed all the various constituent activities of their combination process in these two modes.

The objective of the descriptive qualitative research, according to the grounded theory study method, was to assess the state-of-the-art in the combination decision-making processes of acquiring firms. It was found in general that there was more rigour and precise management of process activities present in 2002 than in the early nineties. An example of this rigour was the activity of very large acquirers, who made frequent combinations, and possessed prescriptive documentation such as an acquisition framework or investment guidelines, which provided direction and guidelines for divisional managers and specialist staff in terms of the procedures to be followed. It was also found that the corporate strategy of growth through acquisitions was well defined in terms of targeted countries, the identified mode of entry, the selected combination vehicle and the value creation model to be utilised.

There was also increased emphasis on critical activities in the process such as the due diligence investigation and the integration of the acquired firm. The due diligence inquiries, that were used to validate the financial information, also focused on legal aspects and technical operations. There was a shift in the due diligence towards a more business or commercial focus in order to assess strategic and market aspects and consequently advise on the appropriate integration strategy. The integration phase in general was planned in advance by line managers and various organisational functions, such as information technology and human resources were involved in a task group approach to effect a smooth integration. Crucial to successful combination was the speed of the integration phase and the imperative to complete it in a hundred days, was often mentioned. In large-scale acquisitions or mergers it took up to eighteen months to accomplish the fully desired integration. It was found that acquiring firms generally moved

quickly to achieve identified synergies and easy pickings were in most cases cost savings. A recent focus in the acquisition process was risk management as a formal function to identify potential risks associated with the combination and to protect the downside. This is essential, since definite risks of losing focus, productivity and talented employees in an environment of uncertainty are inherent in merger situations.

The planned combination decision-making model found in acquiring firms, was clearly in line with the prescriptive strategy mode, to the extent that the corporate strategy was planned in a rational and co-ordinated fashion on the basis of current resources as well as environmental and industry opportunities. The strategy was implemented through the definition of broad combination criteria and key characteristics of the specific combination that were sought in line with the formulated corporate growth direction and objectives. The combination criteria were used in search, screening and evaluation activities to identify, approach, negotiate and integrate the target most suitable for the implementation of the particular corporate strategy.

The opportunistic decision-making model represented an emergent strategy mode, in that the combination opportunities taken, influenced corporate growth in terms of its business focus and products. The combination opportunities utilised in this mode determined the firm's future business focus and market positioning in terms of its product line.

6.4 PRESCRIPTIVE CONTRIBUTION IN TERMS OF A STRATEGIC PLANNING APPROACH APROPOS THE STRUCTURING OF BUSINESS COMBINATIONS

The prescriptive thrust of the study aimed to provide a sound strategic planning contribution to the business combination decision-making process, given the central role that corporate strategy and objectives play in motivating external business combination. This focus of the research culminated in a strategic framework that may serve as a guide to corporate managers and other role-players in their planning, organisation and management of corporate combination decision-making activities.

The business combination decision-making process in the strategic framework was divided into four distinct phases to explain the process flow of key activities. The combination decision-making process is initiated by the planning of corporate and combination strategy by the combination-intent firm, followed by an implementation phase where strategic decisions are implemented through locating, approaching, negotiating with the combination target and then finalising the transaction. The consummation of the combination is effected with the integration of the target in line with the strategy, structure and operations of the acquiring firm. Finally, in a follow-through post-combination phase, the combined firm is managed as part of the acquirer's group to achieve corporate objectives in line with the strategic direction set in the particular corporate strategy.

The setting of strategic direction through a clear corporate vision, mission, objectives and defined growth direction of the combination-intent firm is a crucial prerequisite for the structuring of successful combination strategy. A well-defined and compelling vision articulating the desired future position could serve to stretch the organisation to achieve its defined corporate objectives and as a motivation for a strategy of growth through combinations. Strategic and particularly financial objectives at the corporate level, should set measurable goals and ideally quantify the desired performance in terms of key indicators. A 'backwards' planning approach has been suggested to determine the ideal situation three to five years out in terms of selected key parameters, and then working backwards to set the required interim targets to achieve the ultimate desired performance.

Corporate growth through external combination represents the other side of the continuum versus pure organic growth and may be pursued in terms of horizontal, backwards or forward integration as well as related and unrelated diversification moves. The international expansion route has been a major strategy for South African combination active firms and represents another dimension of corporate growth. In whichever direction the combination-intent firm is growing, its selected growth mode should always be based on a thorough internal analysis to identify outstanding capabilities, as well as weaknesses relative to the chosen growth direction on which the combination strategy may be based. Several of the relevant areas in the firm that should be evaluated, have been highlighted. From a combination strategy-making perspective, the firm's strengths are significant because they could be the cornerstones of a combination strategy. Combination strategy should be grounded on the firm's outstanding strengths and market capabilities.

This thesis has highlighted the theory that the combination strategy of a firm intent on pursuing growth through external combination, may fundamentally be defined in terms of the following primary considerations. It should define the specific objectives of the combination strategy that should be in line with corporate objectives and providing an implementing route for those objectives. The combination strategy should ideally define the specific capabilities in line with corporate strategy that are sought through a combination. The combination strategy should furthermore definitely identify the suitable combination vehicles to be utilised and the rationale for preferring the specific vehicles. The combination strategy should in the ideal combination profile define criteria such as the size and profitability of a target acquisition, the level of control the acquiring firm would like to exercise, and the specific approach to the integration of target firms with the corporate structure of the acquirer.

The evaluation of alternative growth directions open to the firm should be accompanied by a similar evaluation of the various combination vehicles, through which the particular growth strategy could best be implemented. There is a considerable range of options open to the combination-intent firm in terms of the combination vehicles, that are available to implement its particular growth strategy. External

growth may, for example, be effected through the following combination vehicles: the absorption of a smaller firm through acquisition, the stock acquisition of another firm and its establishment as a subsidiary or as a new division, the acquisition of all or part of the assets of another firm, joining forces with another firm or firms in a partnership, effecting a contractual strategic alliance or joint venture, buying a block of existing business from another firm, or through amalgamating or consolidating with an equal marriage partner (merger of equals). Each of these combination vehicles has its own relevant advantages and disadvantages depending on the objectives and requirements of the strategy as well as the resources and capabilities of the combination-intent firm.

Specific advantages and risks attendant in the various combination vehicles, that are valid in general terms, have been identified in this research as gained from empirical observation. Acquisitions in general facilitate the relatively rapid attainment of the desired assets, the target market share and critical capabilities sought by the acquiring firms. There are, however, the risks of acquiring unneeded assets, paying a high acquisition premium for control, as well as the possibility that human relations may become problematic in cases of poor cultural fit. A merger of equals may be a suitable vehicle for large-scale cross-border combinations to attain critical mass in assets and to achieve cost savings through economies of scale and scope, but substantive integration may result in the loss of operational focus in the short-term. Furthermore, cultural fit may become a problematic issue in cross-border combination and there is the risk of losing management control through subsequent disagreement and power clashes on issues such as aggressive acquisitive growth versus more conservative expansion. Joint ventures may present a more flexible arrangement with joint capital investment and the ring fencing of liability and risk in the created entity. They may also facilitate the effective sharing of expertise and resources, while locking out other competition. An advantage is that fewer approvals by regulatory bodies are needed for joint ventures compared to mergers and acquisitions. Strategic alliances between firms may include any sphere of operations and allow partners to work together in mutual beneficial ways, while potentially locking out other competition.

Combination strategy formulation should include the specification of an ideal combination profile, outlining clearly what characteristics are sought in the target firm. Definitive criteria may then be utilised as filters to select those industry sectors, which are most appropriate to the firm's combination strategy. Having identified the target industry sectors, the firm is in a position to search for target firms meeting the criteria of the ideal combination candidate. The result of the search and screening processes is a priority list of potential combination targets. Alternative candidates should then be narrowed down to two or three and finally the best candidate chosen through close scrutiny of which candidate provides the required capabilities and characteristics sought, and present the best strategic fit with the acquiring firm's strategy and resource configuration in terms of its financials, products and markets. Once a

selected target has been identified and successfully approached, an in depth due diligence inquiry should be performed.

The due diligence investigation has traditionally focused on verifying the financial, taxation and legal aspects of the target firm. This has been expanded in recent years to include technical capabilities and human resources, and specifically the management of the target firm. Such due diligence should be far more business and market-oriented in order to assess what the target firm can bring to the acquiring firm. The focus should therefore be on evaluating specific growth synergies, and not only efficiency synergies that may be achieved through cost savings. Growth synergies may be attained in the combination through combined market power in accessing new markets and customer groups, leveraging capabilities for developing new products in the combination, and further geographic expansion through the distribution network of the acquired firm.

After a transaction has successfully been negotiated and the price and terms finalised, the critical integration phase may be executed. The extent and scope of the integration process would clearly be determined by the nature of the structural fit with the acquiring firm. In the situation of an acquiring firm preferring to preserve the autonomy of the target firm and establish it as a stand-alone subsidiary, there would be minimum disruption to the target firm with only partial integration in selected areas. A minimalist approach to integration with a 'hands off' structure can be highly effective, profitable and successful, even when a large number of combined firms are involved. Acquired firms can run as stand-alone businesses and then combine revenue and profits at the end of the accounting cycle. By design, minimal integration forces acquirers to focus just on those merger integration actions that will provide the very best contribution to the bottom line.

In the case of full integration, there may hardly be any of the acquired firm's functions that are not affected. The two firms' systems, assets, policies, practices, and staff are melded together into one united organisation. It is self-evident that such a full-scale integration requires diligent planning and preparation and it is imperative that it be completed in the shortest time possible. Full integration can only be accomplished on a fast track schedule, when it is carefully planned in advance of the merger announcement and integration start-up. The need to achieve a business-focused organisation, sooner rather than later, is the reason that most acquiring firms give themselves a hundred days to integrate newly acquired firms.

It is particularly relevant, from a strategic perspective, that the acquiring management should perform a formal review of the integration and the combination per se, evaluating to what extent strategic objectives such as the acquisition and development of specific capabilities have been achieved through the specific combination vehicle. The result of such a formal post-combination review could serve as

strategic inputs to line managers, who are responsible for managing the acquired firm as part of the group.

After the successful integration of the acquired firm in line with corporate strategy and the specific combination approach of the acquiring firm, it will be business as usual for the acquired firm. Parent corporate managers could now manage the newly acquired entity as an integral part of their group structure and utilise its capabilities and resources to achieve the parent's vision and objectives through newly acquired capabilities and optimally leveraged resources.

6.5 CONCLUDING OBSERVATIONS

The high level of combination that has occurred due to cost saving as well as revenue enhancement considerations in many industries through cross-border mergers and acquisitions, in synch with positive international economic conditions in the 1990s up to 2001, has since slowed down. However, the continued impact of key driving forces, such as the high level of globalisation of consumer markets and enhanced information and communication technology as well as opportunities in unsaturated markets, will make it increasingly relevant for corporate managers to seek increased size through combination to increase competitiveness on a global front. Given positive economic growth conditions, large growth-intent firms are expected to increasingly use external business combination as a major growth route, both for domestic consolidation as well as cross-border expansion.

The prescriptive contribution of this research has highlighted that firms, which plan to expand through external combination, should carefully consider the range of alternative combination vehicles and implement their combination strategy through the most suitable and fitting vehicles to achieve corporate and combination objectives. Success in business combination will continue to be dependent on the ability of corporate managers to effectively manage the range of combination decision-making activities and various role-players through efficient process management in the planning, implementing, integration and review phases, not only to effect the best transaction, but specifically to manage integration activities as the absolutely critical phase to create value in the combination.

To return to the claim advanced at the outset in this summary chapter, this thesis has analytically examined the business combination decision-making process of acquiring firms in South Africa through a systematic review of the business combination process, drawing on empirical material culled from in-depth interviews over an extended period. Such a claim to originality is further supported by the uniquely South African context of the research. In terms of existing literature on business decision-making process, in particular the 'business combination' variant, the present research has provided examination of a hitherto relatively under-utilised target area – viz. the nature of business combination decision-making activity in the contemporary South African context. The thesis has provided a

systematic summary of business combination activity and the specific combination vehicles utilised in this context in order to implement corporate strategies. Furthermore, a strategic planning approach to the planning and implementation of business combinations defined in a decision-making framework, has been put forward as a guide for corporate managers and other role-players involved in the planning and execution of external growth through business combination.

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**QUESTIONNAIRE STRUCTURING INTERVIEWS WITH THE OBJECTIVE OF
DETERMINING THE PROCESS SOUTH AFRICAN CORPORATE MANAGEMENT
EMPLOY IN MAKING BUSINESS COMBINATION DECISIONS DURING 2002**

1. Corporate Vision, Mission, Objectives and Strategies

- Is there a direct link between the corporate vision and a specific strategy of combinations through mergers, acquisitions, joint ventures or alliances?
- Does the company have a specific strategy at the corporate level guiding or motivating combinations, for example, internationalisation, acquiring specific capabilities, access to markets, products or distribution channels?
- What are the reasons for following this strategy by means of combinations?
- Has the company formally adopted a growth through combination strategy?
- Does the company have formalised corporate or strategic objectives?
- Is a formal analysis of corporate capabilities and weaknesses done before deciding on an acquisition strategy?
- Who performs the above analysis and how is it performed?
- What considerations are influencing when a specific combination will be made – the timing of an acquisition?

2. Combination options

- Did you consider the various combinations options and their effectiveness as a means of implementing your strategy?
- Do you prefer a specific level of control? Do you consider alternative levels of control? And at which stage of the process do you do that?
- What are the considerations on the basis of which you decide on the level of control?
- Do you consider different structural fits for the incorporation of the combination or acquired firm and at which stage do you do that?
- What are the considerations on the basis of which you decide on a specific structural fit?

3. Combination or acquisition profile

- Did the company determine criteria for the development of a so-called combination or acquisition profile?
- Which criteria did you specify in this profile?

- Which financial criteria do you use?
- Who approves these combination or acquisition criteria?
- What steps do you follow next after having decided on an acquisition profile to identify targets for acquisition?

4. Combination or acquisition team

- How is the company organised to evaluate acquisition targets, approach them, negotiate, and consummate them? (for example, an acquisition task group approach)
- Who is included in the acquisition team?
- Who reviews and monitors the activities of the team?
- Does the company actively search out candidates that meet the criteria of the acquisition profile and who undertakes these searches?
- Does the company use external sources to assist in the search programme?

5. Screening of combination/acquisition candidates

- What information and commitments does the company require from the acquisition candidate before proceeding to a detailed analysis and evaluation?
- How is the company organised to conduct an in-depth analysis or due diligence?
- Which aspects do the company consider important to investigate and evaluate in depth?
- Is the scope for synergy examined in detail? Which synergies are evaluated and do you utilise a specific technique?
- Who reviews the ongoing results and decides whether or not to continue?
- How are these results of the evaluation utilised to assist in negotiations?

6. Negotiations

- Who reviews the results of the evaluations and decides to go on to negotiations?
- How is the general framework of the terms and conditions under which the negotiations are to be undertaken, decided upon?
- Who actually conducts the negotiations?
- At which point in the acquisition process is an initial determination of a purchasing price made?
- Who approves the results of the negotiations and finalises the deal?

7. Financing the combination/acquisition

- Does the company have a preference in the method it uses to finance acquisitions and why?
- Who is involved in designing the financing package that will be used and who approves it?

- Do you set a maximum price, which if exceeded, will worsen the position of the acquiring firm?

8. Integration of the combination/acquisition

- At what point in the process are operating managers involved to plan the integration of the two firms?
- Does the company have a preference in respect of how the acquired company is integrated – full integration or independent autonomy for a subsidiary?
- What approach is followed in respect of management of the acquired firm? Do you institute new management, retain management structures, or appoint a co-ordinating manager?
- What approach or methods do you use to achieve the projected synergies?
- Is a specific strategy designed to transfer skills in the combination?
- Who is responsible for coordinating the integration?

9. Evaluation and post-combination management

- Does the company perform a post-combination/acquisition review to determine how closely the acquisition has performed to the objectives and overall assessment at the time of purchase?
- Which aspects are considered in the review - strategic, financial, and organisational?
- Who does this review and to whom is the evaluation results presented?
- How do you make combinations work in post-combination management to achieve combination objectives?

APPENDIX B

SAMPLE OF ACQUIRING FIRMS THAT WERE INTERVIEWED IN GROUNDED THEORY STUDY

Table B.1 Sample of South African acquiring firms interviewed.

	Name of firm	Industry	Total Assets		Frequency of combinations in 3 years	Diversity	Status
			R Mil	Financial year			
1.	ABSA	Financial - banking	247 300	03/2002	3	Multi-business	Holding company
2.	Altech	Electronics and electrical equipment	1 750	02/2002	2	Multi-business	Holding company
3.	Anglo American	Mining	172 605	12/2002*	4	Multi-business	Holding company
4.	Bidvest	Support services	15 131	06/2002	4	Multi-business	Holding company
5.	BHPBilliton	Mining	236 495	06/2002*	3	Multi-business	Holding company
6.	Denel	Defense	Not available		2	Multi-business	Holding company
7.	Dimension Data	Information technology	8 976	09/2002*	7	Multi-business	Holding company
8.	ELB Group	Engineering	408	06/2002	3	Multi-business	Holding company
9.	Gencor	Mining	4 687	06/2002	2	Multi-business	Holding company
10.	Goldfields	Gold Mining	20 371	06/2002	4	Single business	Holding company
11.	Group Five	Construction and building materials	2 273	06/2002	2	Single business	Holding company
12.	Harmony Gold	Gold Mining	14 076	06/2002	5	Single business	Holding company
13.	IBM SA	Information technology	201	12/1995	1	Single business	Subsidiary
14.	Impala Platinum	Mining - platinum	14 772	06/2002	3	Single business	Holding company
15.	Investec	Banking - speciality and other finance	303 841	03/2002	16	Multi-business	Holding company
16.	Kumba Resources	Mining - other mineral extractors	10 208	06/2002	3	Multi-business	Holding company
17.	Aveng/LTA	Construction and building materials	8 302	06/2002	1	Multi-business	Holding company
18.	Malbak	Support services	3 391	03/2001	2	Multi-business	Holding company
19.	Mondi International	Paper and packaging	24 811	12/2001*	5	Multi-business	Holding company
20.	Nampak	Support services	13 510	09/2002	4	Multi-business	Holding company
21.	Old Mutual	Financial - life assurance	704 361	12/2002*	3	Multi-business	Holding company
22.	Otis Elevator	Support services	29	11/1995	1	Single business	Subsidiary
23.	Pepkor	Retail	751	06/2002	2	Multi-business	Holding company
24.	Premier	Food producers and processors	1 394	04/1999	4	Multi-business	Holding company
25.	SABMiller	Beverages	52 061	03/2002*	19	Multi-business	Holding company

Table B.1 Sample of South African acquiring firms interviewed (continued).

	Name of firm	Industry	Total Assets Mil Financial year	Frequency of combinations in 3 years	Diversity	Status
26.	Sasol	Oil and gas	63 857 06/2002	5	Multi-business	Holding company
27.	Sentrachem	Chemicals	199 12/1995	3	Single business	Holding company
28.	Standard Bank	Financial - banking	389 698 12/2002	2	Single business	Holding company
29.	Tiger Brands	Food producers and processors	10 518 09/2002	3	Multi-business	Holding company
30.	Q Data	Information technology	502 09/1995	2	Single business	Holding company

(1)

(2)

(3)

(4)

(5)

Source:

- (1) Annual reports according to JSE classification.
- (2) Annual reports. * Companies with balance sheets in US Dollar or UK Pound, for which total assets figures were converted to Rands at same month exchange rates to reflect similar currency for comparison in size.
- (3) Annual reports.
- (4) Annual reports.
- (5) Annual reports.

APPENDIX C

SOUTH AFRICAN AND WORLD-WIDE BUSINESS COMBINATION TRANSACTIONS, 1991-2001

Table C.1 Trends in South African business combination activity through mergers, acquisitions and joint ventures, 1991 - 2001.

Year	Number of M&A and JV transactions	Total M&A value R millions	% Change versus previous year	GDP R millions	Total M&A value as % of GDP
1991	226	12 450		331 980	
1992	193	13 387	7.5%	372 227	3.60%
1993	184	8 110	-39.4%	426 133	1.90%
1994	152	30 530	276.5%	482 120	6.33%
1995	184	43 459	42.4%	548 100	7.93%
1996	276	62 254	43.3%	617 954	10.07%
1997	485	166 206	167.0%	685 730	24.24%
1998	605	314 725	89.4%	739 504	42.56%
1999	568	231 599	-26.4%	802 840	28.85%
2000	1002	372 261	60.7%	887 795	41.93%
2001	897	502 379	34.9%	975 196	51.52%

Table C.2 Total value of M&A activity, South Africa and world-wide, 1991-2001.

Year	Total M&A value R mil	% Change versus previous year	World-wide mergers US\$ bn	% Change versus previous year	SA M&A activity as % of world-wide activity
1991	12 450		400		1.13%
1992	13 387	7.5%	415	3.8%	1.13%
1993	8 110	-39.4%	500	20.5%	0.50%
1994	30 530	276.5%	550	10.0%	1.56%
1995	43 459	42.4%	700	27.3%	1.71%
1996	62 254	43.3%	1 108	58.3%	1.31%
1997	166 206	167%	1 600	44.4%	2.25%
1998	314 725	89.4%	2 400	50.0%	2.37%
1999	231 599	-26.4%	3 300	37.5%	1.15%
2000	372 261	60.7%	3 500	6.1%	1.53%
2001	502 379	34.9%	1 700	-48.6%	3.44%

Source: 1) Ernst & Young, Mergers and Acquisitions: Annual reviews of activity, 1991 - 2001.
2) South African Reserve Bank Quarterly Bulletins, December 1999 and June 2002.

**CORRELATION ANALYSIS BETWEEN GDP VALUES AND TOTAL M&A VALUES
THROUGH THE COMPUTATION OF PEARSON'S AND SPEARMAN'S CORRELATION
COEFFICIENTS**

Year	Total M&A value R millions y	GDP R millions at current prices X
1991	12 450	331 980
1992	13 387	372 227
1993	8 110	426 133
1994	30 530	482 120
1995	43 459	548 100
1996	62 254	617 954
1997	166 206	685 730
1998	314 725	739 504
1999	231 599	802 840
2000	372 261	887 795
2001	502 379	975 196

r = the Pearson's correlation coefficient.

r_s = the Spearman's correlation coefficient.

x = the explanatory variable – GDP values.

y = the outcome variable – Total M&A values.

n = 10 paired data points in sample.

Pearson's correlation coefficient (r) between GDP values and M&A values lagged 1 year was computed by MS Excel as 0.951.

Spearman's correlation coefficient (r_s) between GDP values and M&A values lagged 1 year was computed by MS Excel as 0.976.

Interpretation: The sample correlation coefficients (r at 0.951 and r_s at 0.976) are in the moderate to strong positive range, close to +1, hence the statistical association in a lag 1 leading relationship between x = GDP values indicating economic growth and y = M&A values indicating total business combination activity is strong and positive.

CORRELATION ANALYSIS BETWEEN JSE ALL SHARE INDEX AND TOTAL M&A VALUES THROUGH THE COMPUTATION OF PEARSON'S AND SPEARMAN'S CORRELATION COEFFICIENTS

Year	Total M&A value R millions Y	JSE All Share Index X
1991	12 450	3 440
1992	13 387	3 259
1993	8 110	4 893
1994	30 530	5 867
1995	43 459	6 228
1996	62 254	6 658
1997	166 206	6 202
1998	314 725	5 430
1999	231 599	8 543
2000	372 261	8 326
2001	502 379	10 442

r = the Pearson's correlation coefficient.

r_s = the Spearman's correlation coefficient.

x = the explanatory variable – JSE All Share Index.

y = the outcome variable – Total M&A values.

n = 10 paired data points in sample.

Pearson's correlation coefficient (r) between the JSE ASI and M&A values lagged 1 year was computed by MS Excel as 0.823.

Spearman's correlation coefficient (r_s) between the JSE ASI and M&A values lagged 1 year was computed by MS Excel as 0.855.

Interpretation: The sample correlation coefficients (r at 0.823 and r_s at 0.855) are in the moderate to strong positive range, moderately close to +1, hence the statistical association in a lag 1 leading relationship between x = JSE All Share Index indicating stock market performance and y = M&A values indicating total business combination activity is moderate and positive.

CORRELATION ANALYSIS BETWEEN JSE MARKET CAPITALISATION AND TOTAL M&A VALUES THROUGH THE COMPUTATION OF PEARSON'S AND SPEARMAN'S CORRELATION COEFFICIENTS

Year	Total M&A value R millions Y	Total JSE market capitalisation R millions X
1991	12 450	340 078
1992	13 387	336 642
1993	8 110	506 240
1994	30 530	635 770
1995	43 459	893 092
1996	62 254	989 267
1997	166 206	1 005 030
1998	314 725	903 546
1999	231 599	1 522 163
2000	372 261	1 474 839
2001	502 379	1 676 296

r = the Pearson's correlation coefficient.

r_s = the Spearman's correlation coefficient.

x = the explanatory variable – Total JSE market capitalisation.

y = the outcome variable – Total M&A values.

n = 10 paired data points in sample.

Pearson's correlation coefficient (r) between JSE market capitalisation and M&A values lagged 1 year was computed by MS Excel as 0.916.

Spearman's correlation coefficient (r_s) between JSE market capitalisation and M&A values lagged 1 year was computed by MS Excel as 0.976.

Interpretation: The sample correlation coefficients (r at 0.916 and r_s at 0.976) are in the moderate to strong positive range, close to +1, hence the statistical association in a lag 1 leading relationship between x = total JSE market capitalisation indicating stock market performance and y = total M&A values indicating business combination activity is strong and positive.