Acquiring World-Class Resources Without Selling the Ranch

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Acquiring critical resources has become an increasingly important aspect of strategy as the established leadership positions of the 1980s have come under siege from new competitors in rapidly changing markets and technologies. In the 1980s corporations tended to focus their business portfolios on a few core businesses that had:

- Well-established product lines, enjoying number-one or number-two market positions
- Sustainable, commanding competitive positions (e.g., patent protection)
- Strong management with the capacity to assume additional responsibilities

Typically, corporate strategies in the 1980s focused on creating high-value/low-cost positions in each global segment. Some companies achieved leadership positions by staying at the leading edge of technology (Intel and Sun Microsystems), others by meeting the evolving needs of key customer groups (NCR in retailing and banking information systems), and still others by exploiting world-class business operations in a changing mix of businesses (Emerson Electric, Masco).

To achieve these positions, companies need both superb leadership competencies – such as research, development, marketing, and sales – and outstanding supporting skills – such as marketing support, financial services, and customer services – across the entire business system.

The problem is that even very successful core businesses mature. To thrive and grow, companies must move into new technologies or new markets where their key value-adding activities may be less valuable or even irrelevant. For example, a company may have patent-protected technology that guarantees success at the component level, while the firm's growth may require advanced ability in systems integration. Further, many companies are finding that the natural paths of technology development lead to markets or value-adding activities that differ significantly from their traditional markets or customer bases. For example, a personal computer manufacturer interested in palmtop displays is likely to need competence in key factors for consumer electronics. Taken together, these trends point to a need for new resources – more specifically, improved leadership competencies and supporting skills.

Internal development of such resources – including people, technology, and information – can be time-consuming, expensive, and very risky. In many consumer markets, only one in 10 new brands succeeds; for individual product introductions, the success rate can be substantially lower. Even modifying internal resources to serve a new market segment is fraught with risk, because the key success factors in the new segment may differ significantly from those in existing segments, as exemplified by the personal computer industry's transition to consumer-electronics-intensive palmtop display from its traditional business and education channels.

Another way to obtain needed resources is through joint ventures. While these may appear ideal on paper, all too often one of the two partners benefits while the other forgoes a control premium payout for its stakeholders. In addition, the inability of the chosen management team to fully integrate resources from the two companies often causes costly inefficiencies. Currently, as many as half of all joint ventures fail to provide anticipated benefits. For example, during the 1980s the U.S. robotics industry was partially fueled by joint ventures and strategic alliances between Japanese companies, which provided products and low-cost production, and US. companies, which provided marketing, sales, and service. Many of these failed because, without effective integration across the entire business system, the products, sales, and service did not meet customers' rigorous performance and price standards.

Faced with this discouraging picture, corporations are now reexamining the merits of outright acquisition. Acquisition is fast, and the acquired resources have established market positions that can be studied and evaluated. Furthermore, the acquiring company can exercise full management control. But conventional acquisitions, especially in high technology industries, are often outrageously expensive, threatening the payoff to the stakeholders. To keep the payoff high, buyers need to find new and creative ways to acquire world-class resources – while defraying their high costs. The first step is to choose the acquisition carefully.

Choosing the Resource

In evaluating a resource for potential acquisition, the critical question to ask is whether the acquisition will permit the company to achieve the same high performance and cost standards in the new arena as in its current businesses. Typically, this means insisting on a high-value/low-cost position in each market segment served.

To meet these standards the company must set very aggressive performance, cost, and expansion benchmarks relative to customer expectations and leading international competition. Its strategic options are likely to be constrained by the continually rising costs of developing new leadership products and the impracticality of setting very high, value-based prices during product introduction (except in extraordinary circumstances). Companies entering new arenas generally use cost-based or penetration pricing unless they develop a truly

proprietary product. At the same time, they rely on rapid volume growth to amortize R&D, introductory marketing, and advanced manufacturing. This rapid expansion, in turn, requires aggressive exploitation of economies of scale and skill to reduce the high cost of commercialization.

While achieving rapid growth in the face of these cost and price constraints is difficult, it has been done. NCR achieved world leadership in ATM banking equipment by launching a quality campaign rooted in extremely high standards – delivering twice the reliability of its closest competitor – and producing ATMs that cost the user a minimum amount in terms of the total cost of owning the product. American Express revitalized its mature Travel Related Services (TRS) business with a similarly aggressive strategy. Between 1978 and 1987, TRS increased its net income by 500 percent by imposing higher standards and taking a focused approach to the marketplace, in the face of fierce competition from Visa and MasterCard.

Carrying out a strategy within these bounds demands world-class leadership competencies and supporting competencies, which may vary significantly from a company's current set. Identifying these competencies is relatively simple. What is more difficult is determining how to obtain them within the financial resources of the corporation, and then how to leverage them aggressively to offset the cost of their acquisition.

Acquiring Resources Creatively

As mentioned earlier, acquiring world-class resources typically involves paying a premium. In the U.S. market, these premiums can be as high as 50 percent of the traded stock's market value. Obviously, reducing or eliminating this premium has a tremendous impact on performance. The key to avoiding excessive premiums is to acquire only the competencies needed to achieve market leadership, while seeking supporting skills from the most cost-effective sources, regardless of ownership.

For example, U.S. defense electronics companies have many excellent skills in communications electronics, database management software, and real-time computer programming, yet they lack effective design skills and channels of distribution within the industrial market. There is, therefore, an opportunity for established industrial, business, and communications vendors to license these skills far more cheaply – without paying any premiums – than if they created new skill bases in their own companies. Similarly, a number of U.S. companies are sourcing products developed and manufactured in Japan.

In some industries, it is useful to review assumptions about which functions are leadership competencies and which are supporting functions. Increasingly, ethical pharmaceutical companies are taking the view that their detailing sales forces, which they traditionally considered a core competency, are actually a supporting function. As a result, they have entered into co-marketing arrangements, effectively acquiring (by sharing) seasoned detailing sales forces without paying any premium.

Supporting competencies need not be acquired. In many cases, leasing, licensing, or joint ventures can be more effective. Here, too, it pays to shop around. And whenever a firm relies on outside entities, it is necessary to establish rigorous management controls and sourcing standards.

Federation partnerships are another useful approach. Companies such as Apple Computer and Sun Microsystems have used federations extensively to commercialize new ventures with minimal capital outlay and no control premiums. These partnerships clearly distinguish between leadership competencies and supporting skills. Apple concentrated on providing the critical components of its Macintosh computer system – such as its operating system and user interfaces – where it could exert competitive leadership while retaining control of its proprietary technology. It sourced many supporting components from other vendors (e.g., Adobe and Sony), third-party software developers, and value-added resellers or distributors. The federation concept has enabled Apple to achieve very high sales per employee (over $500,000, almost five times higher than some of its leading competitors), and very low equity investment per dollar of revenue (less than half the rate of some of its leading competitors).

Sun Microsystems used creative reseller programs (which capitalize on the value-added resellers' skill base) to develop a new channel of distribution to serve the burgeoning business workstation market, rather than retraining its direct sales force and deploying it in this much more fragmented market.

Another approach is to get your customers to finance the acquisition for you. US. semiconductor companies, notably Texas Instruments, are using innovative arrangements to finance expensive wafer fabrication factories (which can cost more than $200 million).

In one approach, TI teamed up with key customers Hewlett-Packard and Canon to build a factory, guaranteeing each customer a certain percentage of the factory's output. TI paid only a fraction of the cost of the factory. Perhaps more important, it locked up long-term purchase contracts with customers and did not have to surrender the rights to any technology. Both the chemical industry and defense/aerospace industries also make use of customer- funded facilities.

Increasing Acquired Resources' Productivity

A second way to offset the cost of acquisition is by rapidly increasing the productivity of the acquired resources. This approach emphasizes acquiring only the essential resources and synergistically grafting the existing competencies onto the acquired resources.

Many high-technology companies choose to acquire product lines or brands rather than complete businesses. The line or brand generally comes with an existing business and regional infrastructure (e.g., assembly, testing, marketing, sales, technical service, and general management). The acquiring company adds only the product-specific activities (R&D, specialized manufacturing, brand management) that will leverage the existing business. The objective is to maximize incremental profitability to pay for substantial acquisition premiums and to raise the overall level of profitability. These „strength-to-strength" additions leverage both companies' reputations and brand names.

For example, some ethical pharmaceutical companies have been able to acquire very high-priced name brand drugs because they were able to sell these drugs through existing distribution networks without increasing their sales, marketing, or general overhead expenses. Similarly established PC and workstation manufacturers have expanded their catalogs of application programs by using third-party software developers, thus stimulating demand without significantly increasing marketing, selling, or administrative activities. Such „strength-to-strength" combinations have occurred in a wide range of high-technology industries, including pharmaceuticals, electronics, medical equipment, advanced performance materials, and specialty chemicals.

To achieve superior performance in their acquired resources – as well as in their core businesses – a number of companies have used the business process redesign approach. For many reasons, businesses often operate below peak efficiency. In some cases, the internal control system masks unsatisfactory results, or critical businesswide or companywide processes impede performance. Many older core businesses require more investments in the future to sustain their performance than depreciation levels indicate. In still other cases, the corporation does not periodically question the basic business assumptions; thus, performance standards become too low. And it is sometimes difficult to justify an investigation because of the core business's entrenched position in the corporate portfolio.

Arthur D. Little's High Performance Business model[1] suggests that for both core businesses and new acquisitions, improving key business processes can reduce and eventually eliminate many of the conflicts that impede business performance, and can provide a huge competitive advantage.

Business process redesign begins with development of a thorough understanding of how to satisfy the business´s stakeholders (customers, employees, and owners). Once you know what your stakeholders really want, you need to optimize the entire organization in order to satisfy them. Processes are the focal point of this effort because processes are the chains of connection that cut across the entire organization. The company needs to test the performance of each process regularly, using benchmarks that reflect the best performance not only in the industry, but in other industries as well, irrespective of location, ownership, or control.

For example, many high-technology companies have severe quality and reliability standards imposed on their functional resources and on their business processes. A hard look at the execution of these functions can reveal opportunities to meet or exceed the standards while increasing productivity. Many times, the savings lie in the overhead activities that support these processes. In one case, the manufacturing and MIS staffing required to maintain the performance standards was far smaller than what was needed to acquire and start up the production processes and create MIS programs. However, only when the company had subjected itself to careful scrutiny did it identify and capture the savings opportunity.

Many high-quality seed companies began operations in such high-technology incubators as Silicon Valley in California. While these areas offer highly creative technologists and entrepreneurially oriented general managers, their high cost of living increases the costs of routine business functions such as manufacturing, marketing support, financial services, and customer services. Alternatively, the acquiring company may incorporate these supporting functions into the acquiring company's ongoing administrative services at more cost-effective locations. Thanks to MIS and telecommunications, these functions can be decoupled and transplanted. Even modest reductions in administrative expenses can offset as much as 50 percent of the acquisition premium. However, achieving full savings requires a thorough process redesign from the perspective of customer requirements and economies of scale.

Finally in a broader context, many businesses with network economics – i.e., television, telephone service, consumer products, and over-the-counter pharmaceuticals – achieve very high rates of productivity once they attain a critical mass of subscribers or customers. Beyond the critical mass point, the cost of serving additional subscribers is very low, while incremental revenue is very high. The creation of Sprint by GTE and United Telecom was predicated on exploiting the economies inherent in long-distance telephone service. Similarly, Sprint's current 20 percent discount for calls to other Sprint customers exploits such network economics.

Creating Additional Value

The third way to defray the costs of resource acquisition is to achieve exceptionally high growth rates, leveraging the acquired resource's competencies to increase share, expand the product line, or serve additional applications. This approach is very important in high-technology companies with high contribution margins (70 to 80 percent) in areas such as software and ethical pharmaceuticals. Companies must develop ambitious and application-specific marketing plans to achieve the high growth required to justify expensive seed resources. Such programs require the integration of steps across the entire business system. Ideally, these programs are developed during negotiations and the due diligence process, so that implementation can start on day one to avoid bad practices and achieve savings rapidly.

A thorough understanding of the business economics and the impact of leading and supporting competencies on those economics provides a basis for maximizing growth. The business team must understand the fully loaded and incremental economics of the business and the sensitivity of the product's value to penetration levels and to accelerated growth rates. In turn, the team must aggressively pursue program-driven growth – that is, growth created by explicit programs and executed by the business team. Typically, end-use-driven growth is not enough to justify the acquisition cost of world-class resources. Program-driven growth, which is proactive, is also needed to exploit the full value potential of the acquired resources. For example, Masco has offset substantial premiums by accelerating the growth of regional home fixture companies through rapid introduction of their products into new distribution channels and geographic areas.

Exploiting brand equity is one useful way to capitalize on program-driven growth opportunities. This can be accomplished by (1) increasing the number of customers, (2) broadening the geographic offering, (3) broadening the product's or service's positioning for new applications with line extensions or indications, (4) expanding product categories through related products, and (5) capitalizing on the technology's ability to increase the number of product features or reduce costs. Although most heavily exploited in consumer goods, brand equity is also widely used in industrial, business, and professional products. If brand equity is fully exploited, it is possible to combine the best in product quality and brand recognition with superior cost, thereby creating a product line with significant competitive advantages. For example, Ocean Spray Beverages and Tropicana Orange Juice have accelerated growth and expanded share by fully exploiting their brand equity in new categories in the supermarket.

A second approach is to „ride the industry standard." Many materials and semiconductor companies, realizing that they don't have the financial resources to offset the high costs of developing and exploiting new chip technology such as RISC (Reduced Instruction Set Computing), have sought to make their technologies industry standards by broadly licensing them. The high growth and license fees associated with the emergence of technologies that become industry standards typically offsets the loss of some proprietary advantage.

Similarly certain U.S. pharmaceutical companies have justified the high cost of co-marketing arrangements because such arrangements have accelerated product introduction and improved profitability during a limited period of patent exclusivity. Such co-marketing and/or direct distribution arrangements are widely practiced in the United States, Europe, and the Far East. In other industries, value-added distributors and resellers provide similar services.

Summary

Innovative companies in a broad range of industries have minimized the risk inherent in acquiring leadership competencies and supporting skills by choosing acquisitions carefully, acquiring them creatively and then managing them to create additional value to defray the high cost of acquisitions. They are ensuring that both their existing core businesses and their new acquisitions are generating an optimum level of sustainable cash flow. And they are fully leveraging their new skills and competencies by:

• Accessing resources creatively through the use of federations or partnerships

• Increasing the productivity of the acquired resources by focusing on product line or brand acquisitions and consolidating high-cost support operations

• Achieving high growth rates to offset acquisition premiums by exploiting the benefits of brand equity

We believe that companies can solve the resource dilemma if they apply to resource acquisition the same inventiveness and creativity they have applied to strategy development and are applying to business process redesign. Moreover, companies that pay attention to acquiring resources in creative and cost-effective ways will still own the ranch.

[1] *For a fuller discussion of the High Performance Business, see* Prism, *first quarter 1992.*

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