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It is intended to be used as the basis for class discussion rather than to illustrate either effective or ineffective handling of a management situation.

The case was compiled from published sources.



Lenovo's Acquisition of IBM's PC Division:

A Short-cut to be a World Player or a Lemon that Leads Nowhere?

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INTRODUCTION

On April 20, 2004, a group of directors at Lenovo gathered in a windowless conference room on the 10th floor of a high-rise building in Beijing, at the Lenovo's headquarters. The meeting was of critical importance to the future of the company. The one and only item on the agenda was to evaluate the potential acquisition of IBM's personal computer (PC) division. Amongst many concerns debated, the central one remained whether Lenovo's executives were capable of running a complex global business. Such an acquisition would open the way for China's largest computer manufacturer to purchase Big Blue's PC division for US\$ 1.75 billion. In turn, IBM had agreed to take an 18.9% stake in the new Lenovo.

Based in Beijing, Lenovo began as a spin-off of the Chinese Academy of Sciences' ("the Academy") new technology unit in 1994. It started its life as a reseller/distributor for AST computers and later HP and IBM. The company began making its own brand PC in 1990. Six years later, it became the first Chinese brand to outsell any foreign brand (including non-PC products) in China. Lenovo's stellar growth was attributable to the Academy's strong technological support and close relationship with the Chinese government. Turnover figures for the company in 2003 and 2004 were HK\$¹ 20 billion and HK\$ 23 billion, respectively.

Compared to Lenovo, IBM had a much longer history. Founded in 1896, the company started as the Tabulating Machine Company and focused on the development and production of punched card data processing equipment. Having later merged with two other companies, it changed its name to International Business Machine, or IBM, in 1926. In the fifties, IBM emerged at the forefront of business computing, reaching the peak of its dominance in the industry in the 1980s. Sales of IBM's PC division were US\$ 9.6 billion in 2003. IBM had been a major supplier of PCs to retail consumers, corporate and the US government. However, the PC division was far less profitable than the high-value products and services that it also offers. The rationale behind the divestment of the PC division was that IBM could then focus on high growth opportunities.

¹ US\$1:HK\$7.75 (1998–2005)

THE WORLD PC MARKET

At the time of the meeting, Lenovo's share of world PC market was only 2.2% and the company ranked number nine, behind Dell, HP, IBM, Fujitsu/Siemens, Acer, Toshiba, NEC and Apple. By acquiring IBM's PC division, the Chinese company would become the third largest PC maker in the world overnight. Competitive pressure has been increasing for all the players in the market as prices of PC continue to fall over the years. This is not least the result of Dell's business model. While through this innovative model the company had re-invented the computer industry and driven prices down significantly, the very forces that it relied on for success have unintentionally cut costs for its rivals. As a result, PC makers around the world had benefitted from the commoditization of components and the rise of the Internet as a sales channel pioneered by Dell.

As an industry expert opined, "the supply chain becomes as standardized as the components – the money has been wring out". Furthermore, it is increasingly difficult to cut production costs, given that many computer makers have already moved their PC production to low cost countries such as China. As an illustration, the labor costs for Lenovo were a rock-bottom \$ 3 per desktop PC, which is among the lowest anywhere. Such low cost helped drive its operating expenses to less than 9% of revenues, which was half the average for the computer hardware businesses and about the same as Dell's.

LENOVO'S GLOBAL EXPANSION STRATEGY

Lenovo had a 27% market share in China. Having assumed market leadership in its country, Lenovo aspired to become a global player. It attempted to achieve this by diversifying into non-PC areas such as mobile handsets, the Internet, various IT services and even going beyond IT. However, as Liu Chuanzhi, founder of Lenovo, pointed out:

"Things did not go well with our plans. We were too anxious to achieve our goals, we did not think through our plan clearly, and we did not succeed."

Trying for the second time, the company decided to follow a strategy that focused on expanding within the PC industry. This could be achieved by 1) building its foreign subsidiaries or 2) acquiring an existing global player. Given that the latter strategy would, in theory, allow the company to gain market share rapidly, establish distribution channels and solve problems such as lack of market and sales experience in foreign markets, acquisition represented the best strategic option for Lenovo. This reasoning underpinned Lenovo's possible acquisition of IBM's PC division. Specifically, there were a number of potential benefits, including:

- An unique opportunity to fulfill its globalization strategy and to achieve its global leadership in PCs and related products;
- Instant presence and coverage outside China;
- The widely recognized brand of IBM and its "Think" marks including "ThinkPad", "ThinkCentre", "ThinkVision" and "ThinkVantage". These brands would bring rapid global awareness that could assist Lenovo to establish a single world-wide brand;
- Enhancement of Lenovo's product portfolio using IBM's technology, laptops and commercial product lines and capabilities;
- Cost savings through economies of scale in procurement and best practice sharing;

- Access to a highly skilled and experienced product development team, advanced facilities and a portfolio of technology intellectual property and know-how;
- An experienced management team for the development and execution of international strategy and the management of large scale global operations.

Executives at Lenovo were confident that they would be able to save more than US\$ 200 million a year in supply chain efficiencies. By combining with IBM's PC division, declared Yang Yuanqing, Lenovo's current chairman, Lenovo would be the PC company with the best balance between innovation and efficiency.

CHINESE FIRMS AND OUTBOUND M&A

By the very beginning of the 21st century, it becomes increasingly common for Chinese firms to acquire Western companies. While big Chinese names such as TCL, Huawei and CNOOC had made offers to buy Western companies, Lenovo's deal heralded the dawn of Chinese firms becoming global players. The purchase of IBM's PC division would be different from all previous transactions in one important way: it stirred up questions about US technological leadership.

There was general skepticism over Chinese companies' ability to make and manage mergers and acquisitions (M&A) overseas. China-based firms had a long way to go when it came to understanding foreign markets. For example, for many of these companies, pricing and marketing strategies were still at the nascent stage of development. Coming out of a protected environment, Chinese companies were exposed to unfamiliar business concepts such as customer services and customer relationships. In fact, Chinese acquirers typically did not have a clearly defined view of the role of M&A in their globalization strategy and had the tendency to respond opportunistically to deals as they became available. The companies also lacked experience in managing a portfolio of businesses across diverse markets as well as a deep understanding of customers, competitors, distribution structures and the regular environment in these markets. Compared to large global firms, Chinese companies tended to have less developed management information systems, governance structures, managerial skills and corporate processes. They were also less experienced at eliminating duplication and waste in newly combined operations, and at establishing best practices.

Many of these problems were reflected in TCL's – China's largest television maker – disastrous acquisition of Thomson Electronic, a French counterpart. The Chinese firms had made at least four strategic errors:

- The highly commoditized CRT-based televisions ought to have been manufactured in low cost countries instead of remaining in Europe;
- European consumers were gradually turning away from CRT-based televisions to flat-panels. Not only did TCL fail to conduct proper market research on trends in television technology, but it also did not fully understand Thomson's operation in Europe and the needs of consumers;
- Thomson did not have a strong brand name outside France. Additionally, distribution channels for flat-panel and CRT-based televisions were different;
- TCL was inexperienced in managing global operations and lacked qualified managers.

Another major obstacle to success was the vast differences between how Western and Chinese companies operate. Cultural differences could cause problems. In 2002, Lenovo recruited in the US a group of IT elite hires to fill middle management. However, in just under a year, most of these recruits left the company. The main reason given was that they had found it difficult to fit into its corporate culture. For example, they

could tolerate neither the regular daily collective morning exercises nor the ritual of singing the company's official tune before any major meeting.

Chinese companies acquiring in the West often faced further non-economic challenges such as political barriers. In 2005, CNOOC, a Chinese state-own oil company, failed to acquire Unocal, a US oil company, facing opposition from the US Congress who cited national security concerns.

THE IBM AND LENOVO BRAND

As part of the merger agreement, Lenovo could use the IBM brand on its products in the 18 months following the acquisition. After that, Lenovo had another 18 months to co-brand its products, allowing customers to be weaned away from the IBM logo. Beyond this point, the "Lenovo" brand alone would appear on its products. As a result of the transaction, the Chinese company would own the "Think" series brand.

In spite of the progressive rebranding, some customers appeared to have already started to defect. According to a report, General Electric in late 2004 dropped IBM as one of its two PC suppliers to go exclusively with Dell for desktop and notebook computers, attributing their decision to Dell's lower prices. The same report also pointed out that IBM PC sale had lost momentum and suffered from component failures, the consequence of which pushed warranty costs up.

Additionally, in a survey of 100 Chief Information Officers half of the respondents reported that they would consider switching away from IBM to new vendors. Some analysts also predicted that Dell and HP would be the true winners in this merger as customers would think twice about buying ThinkPads or ThinkCentres. However, not everyone agreed with this. Some observers contended that this merger would create a stronger competitor to Dell and HP.

TO ACQUIRE OR NOT TO ACQUIRE?

Lenovo was confident that the acquisition would propel it to the ranks of world players. As Liu Chuanzhi said:

"I am excited by this breakthrough in Lenovo's journey towards becoming an international company... From the beginning, however, our unwavering goal has been to create a truly international enterprise. From 2003 when we changed our international brand name to 2004...to today's [merger] with IBM, I have been delighted to watch Lenovo become a truly world-class company."

However, potential rivals had a different opinion. Michael Dell opined:

"We're not a big fan of idea of taking companies and smashing them together. When was the last time you saw a successful acquisition or merger in the computer industry? ... It hasn't happened in a long, long time ... I don't see this one as being all that different."

One thing was yet for sure: the board of directors had reached the deadline to make a decision and had promised IBM to return to them by the end of the day with a definitive answer. The decision to be made today would engage the company on a route for global success or massive failure.