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Brand Investment Traps

The proven antidote is an integrated approach to brand management and brand science

By Andrew Pierce and Adrian Slywotzky

Brands have become increasingly fragile and difficult to sustain. Failure to invest in the right mix of activities at the right time risks eroding the brand. On the other hand, those companies that anticipate and avoid the common investment traps can reap superior growth in brand value over a long period of time.

When Mercedes Benz USA announced its 2004 sales this past February, the volume was the highest in its 40-year history. Spurred by investment in the entry-level C-Class line (priced as low as $26,000), overall sales rose 5% percent for the year. Yet five of Mercedes' high-end luxury models actually posted sales declines of up to 25%. Mercedes has slipped in the U.S. luxury car market, falling to third place behind Lexus and BMW, and its management has been wrestling with the tradeoff between preserving equity in a luxury brand and raising volume at lower price points, which risks diluting the value of the brand.

History shows that even great brands, from A&P to Howard Johnson to Polaroid to Zenith, are vulnerable to sudden collapse or to slow and devastating erosion. While each troubled brand has its unique story, the common theme that unites them is "misinvestment"—the company's failure to invest wisely for long-term growth of brand equity.

Some organizations ignore the necessity of brand investment altogether, using the brand as a cash account from which value can be drawn to improve the next quarter's numbers. The lack of visible bad effects in the short term encourages more borrowing, so that after years of deferral the cost to rebuild the brand becomes enormous. Failure to invest leads to a point of no return, where the cost or time to revitalize or reposition the brand outweighs the expected additional revenue. Such neglect may destroy the brand and even the company, since for many firms brand equity—the price or volume premium enjoyed by the branded product or service over a non-branded equivalent—can translate into as much as one-third to one-half of the company's total market value.

Failure to invest is just one of the common traps that can kill brands. The wrong mix of investments, the wrong investment sequence, failure to adapt an investment strategy over time, and other traps can also push brands toward the point of no return (see Exhibit 1).

The proliferation of investment traps over the past decade has made brand management quite complex. Branding has moved beyond the traditional sphere of packaged goods to become vital in almost every business sector, as indicated by the explosion of ad spending

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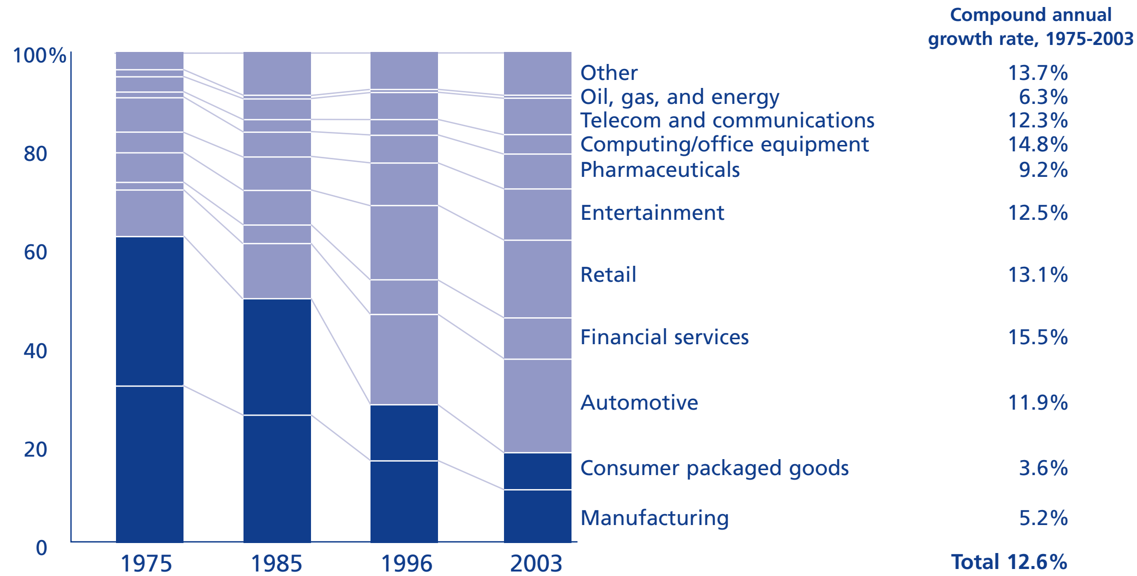
Exhibit 1 **Brand investment traps**

Trap	Description
1. Failure to invest over time	Assuming that the brand's value is largely self-sustaining, a mine to be exploited rather than an asset to be nurtured
2. Wrong investment mix	Overinvesting in advertising, promotion, sponsorships, or product marketing programs that do little to create brand value and distract from more urgent needs
3. Wrong sequence	Investing in marketing initiatives with a lower expected payoff in terms of increased customer revenue versus programs with a greater expected payoff
4. Myopic focus	Focusing only on a narrow set of brand dimensions or audiences, while ignoring other factors that are essential to building brand value
5. Wrong touchpoints	Investing to improve customer touchpoints of marginal relevance while neglecting others that are crucial to building brand equity
6. Wrong positioning	Emphasizing components of brand equity that do not drive customer behavior, while ignoring other components that do
7. Failure to adapt	Emphasizing brand dimensions that have become irrelevant to customers over time or have taken on negative connotations among customers
8. Spending too little on too many brands	Spreading investments across too many brands with minimal value, that operate in stagnant or shrinking markets, or that are rapidly becoming commoditized
9. Overstretching the master brand	Maintaining a single overarching brand to save money when several brands focused on different markets would attract more customers
10. Dilution	Licensing the brand to gain market share and access to new customer segments but diluting price premiums
11. Wrong metrics	Failing to measure the key indicators of brand health; choosing measures that have little or no real significance; or ignoring, denying, or rationalizing the warning signs that the metrics reveal
12. Trying to turn around a dead brand	Trying to revitalize a struggling brand in a situation where a new brand could achieve greater visibility and acceptance among customers in a shorter time and at lower cost
13. Failure to follow through	Overlooking the need to support a brand after a successful revitalization has occurred

by the telecommunications, pharmaceuticals, financial services, and other industries (see Exhibit 2). Other developments have further complicated brand management, including the multiplication of channels for advertising, marketing, and sales; the emergence of powerful new competitors thanks to globalization, venture capital, and technological advances in communication and logistics; and greater access to information among customers, suppliers, and competitors. As a result, brand premiums have become increasingly fragile and difficult to sustain.

Exhibit 2 **Branding for all**



Note: Media spend for telecom and financial services based on industry revenues multiplied by estimated industry ad spend-to-sales ratios.

Source: LNA, Schonfeld & Associates, Lippincott Mercer analysis

In this tumultuous environment, the classic model of brand management falls short. It assumes that brands matter primarily in packaged goods; yet, as we've seen, branding applies to most business sectors. In the classic model, brand management is a stand-alone function centered in the marketing department; as we'll explain, *integrated brand management* now must involve many other parts of the organization. Traditional brand management tends to focus on advertising and other traditional marketing or communications media, and it assumes that once funds have been allocated for next year's ad campaign, the brand investment strategy is complete. We'll show why this approach is short-sighted, because today's investments must be made in the context of a company's overall business design.

Finally, the discipline of brand management has been largely qualitative, the province of image-makers and pulse-takers. Creativity remains important, of course, but it should be supplemented with quantitative tools drawn from the emerging field of brand science, which allow companies to measure the strength of specific elements of their brand equity, brand value, and branded customer experience with greater precision than in the past.

This more effective integrated brand management approach combines sophisticated metrics with analytically based investment decisions and ties them directly to the company's busi-

ness design and economics. The approach also helps managers not just to anticipate and avoid the traps that can destroy their brands, but also to grow the brand's value over a sustained period.

The elements of brand equity

Integrated brand management starts by defining which elements of the brand create differentiation and influence customer behavior. This knowledge emerges from market research or in-market experimentation that shows how existing and prospective customers make choices in a competitive marketplace. This data can be augmented with brand image and customer experience data, which captures how customers perceive the brand at each touchpoint. Once collected, the list of 50 to 100 image and experience dimensions can be winnowed to a subset of six to ten of the brand's equity elements—attributes that shift the demand curve, all else being equal.

Certain equity elements apply to any brand, such as trust, reliability, and ease of doing business. Others apply to particular brands or types of brands. For example, innovation is an essential element of Sony's brand equity, but not of Coca-Cola's; family friendliness matters to Disney, but not to Harrah's; upscale image is crucial to Louis Vuitton, but not to the Gap. It's important to define the equity elements accurately and precisely as they apply to a given market. For example, in the automotive space, performance means something different to most European drivers (defined, agile, smooth) than it does to U.S. drivers (adroit handling and raw power).

Each equity element can have a positive or negative value, depending on whether it makes an individual customer more or less likely to buy. For Sony, innovation has a positive value to the extent that customers associate it with "the best and latest products"; it has a negative value if customers think of "products that are complex and hard to use." For Disney, family friendliness has the positive meaning of "fun for the whole family" and a negative meaning of "too bland for single, young adults." Getting the equity elements right is a critical prelude to the subsequent aspects of integrated brand management.

Having accurately defined the equity elements that matter most for the brand, it's also essential to monitor how their relevance changes over time and adapt the brand strategy as needed. The long-term decline of the venerable Oldsmobile and Plymouth brands occurred because General Motors and Chrysler did not adapt to the steady decay in the relevance of their brand attributes. Consumer perceptions of Oldsmobile and Plymouth didn't change drastically, but over time the number of car buyers who cared about their brand elements dropped consistently. GM's and Chrysler's marketing spend on those brands could have been put to more productive use for other brands in the portfolio.

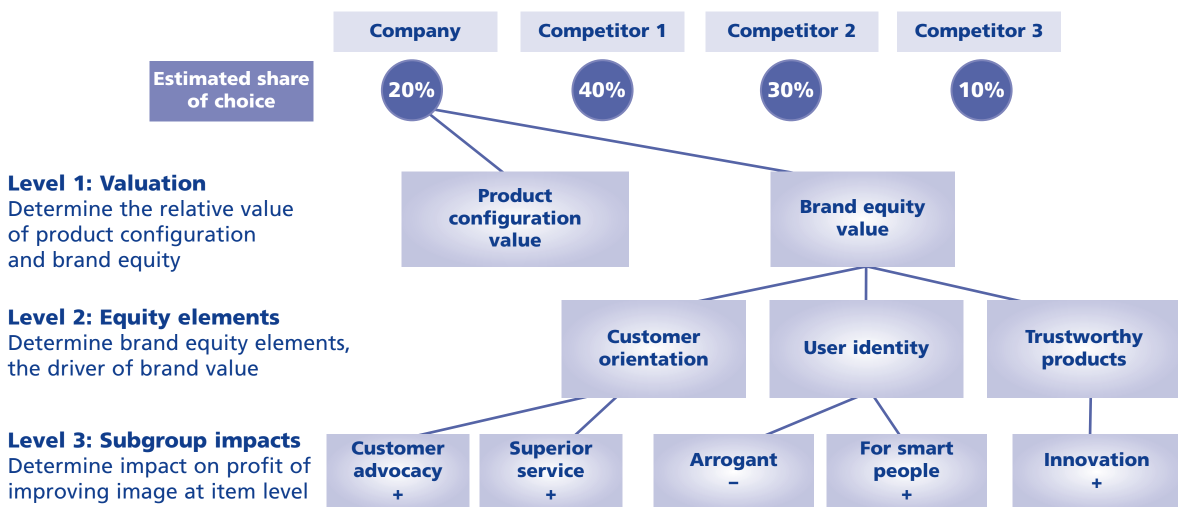
Customers' priorities vary, so one must distinguish the attitudes of different segments of existing or prospective customers toward the equity elements. Loyal and high-value customers who love a brand form a core group. Around that center, regular customers occupy the next ring; prospective customers the third ring; and those who have rejected the brand a fourth outer ring. Moving out along the successive rings, how quickly do positive perceptions about the brand fall off? At what point do negative perceptions dominate? Are there specific positive or negative attributes that pop up at a particular point?

Addressing such questions can help define the extent to which it is possible to expand the customer base and extend the brand without alienating the loyal core. To take an extreme case, when considering the polarizing Hummer brand of SUV, the outermost circle of rejectors contains people who dislike the Hummer for being huge, gas-guzzling, and militaristic. While it's unlikely that the Hummer brand could be reconfigured in a way to satisfy these people, GM was successful in building a brand that has broader appeal without running the risk of brand dilution.

Defining the brand's key equity elements and the value they have for specific customer groups (see Exhibit 3) thus reveals the many dimensions of the brand and informs decisions about extending it to new products, customers, or markets.

Exhibit 3 **How brand equity analysis works**

Determine which equity elements actually influence customer choice (illustrative)...



...then optimize investments in those equity elements

Customer segment size	Customer segment name	Equity elements	Five-year NPV (net assets)
2%	High value	Customer advocacy	
8%	Active investors	Superior service	
15%	Mass affluent	Innovation	
65%	Mass	For smart people	
10%	Retiree	Arrogant	

The right metrics to track brand health

With the profile of equity elements in hand, managers then need a system of metrics to track the brand's vital signs.

Just as established tools and guidelines track debt, working capital, and other components of a firm's financial health, there is a developing science of brand metrics that offers powerful diagnostic tools for measuring and monitoring changes in brand health. These tools go beyond the traditional measures of awareness, consideration, and preference to include data on brand premiums, brand as a percentage of shareholder value, brand extendability, and employee commitment scores. Well-designed metrics allow managers to measure the value of a brand, the return on marketing investments, and the elements of the customer experience that build or dilute equity in the brand. Thus, they can help managers take corrective measures or reallocate investments for the greatest positive impact on the customer experience.

For example, the Microsoft brand is widely respected in the software arena, including business-to-business markets. But certain metrics tracking perceived trust and perceived corporate intentions have revealed the danger lurking in one component of the brand's value. Executives from some other companies have publicly voiced their opinions characterizing Microsoft as a rapacious competitor and a dangerous ally. This reputation makes it harder for Microsoft to develop the partnerships it will need to succeed in new arenas such as entertainment. As one possible move, Microsoft might invest more in its relationship with an important constituency, and it could potentially benefit from improving its brand metrics system and developing a range of responses to the early warnings that the system raises.

Leading indicators of brand health, when correctly identified and assiduously monitored, can unearth very valuable information. For example, based on studying ten years' worth of customer data, one leading manufacturer of electronic components can define how customer loyalty, employee commitment, and brand equity are interrelated, and can link these relationships to operating and financial measures. As the company invested more to communicate its business strategy, it also saw a rise in employee commitment, customer perceptions of sales force knowledge, and brand consideration. Now the company knows that if employee commitment slips in the first quarter, customer satisfaction will slip in the second quarter and brand value will decrease in the fourth quarter.

Metrics point to the areas that need investment at any given moment. As the brand moves through its life cycle, as new competitors enter the market, and as customer priorities shift, the way a company invests in its brand will need to change. For instance, Hewlett-Packard is pushing deeper into digital entertainment as a brand known best for printers and PCs. The company could spend differently to reposition its brand in this new space or leverage investments in the Photosmart sub-brand to pave the way. At the same time, HP's investment in certain sponsorships may do little to help push the brand into this space, and may also increase the risk of overstretching the master brand.

A recovered brand poses its own special investment demands, since revitalizations are remarkably fragile. From 1998 to 2001, Volkswagen simultaneously redesigned several of its car models, redesigned its dealer network, and launched an aggressive marketing campaign, thereby revitalizing its brand and increasing annual sales by 150%. Since 2001, however,

VW has launched no new models and has reduced its marketing investment by 25%. As a result, sales have begun to slip back toward the levels of six years ago.

As these examples illustrate, the dynamic nature of brands, as well the fluid environment in which brands compete, means that brand investment calls for continual rebalancing.

As the business design goes, so goes the brand

Brand management doesn't stop with investment choices. A common mistake that many companies make is failing to consider brand strategy within the broader context of the business design. All the marketing and advertising in the world won't build or sustain a powerful brand if the business design around which the company is organized fails to deliver on the brand promise. Conversely, a company with a great business design is capable of developing a powerful brand through excellent customer experiences, even without significant spending on marketing and advertising—but that will happen only if the business design and the brand are aligned.

It follows that for every change in the business design, there should be a corresponding change in brand strategy (see Exhibit 4). If you change the target customer set, refine the value proposition, change pricing strategy, or make an acquisition that changes your scope of the business, you must make a corresponding adjustment to the brand strategy. Fail to make those adjustments and you will end up with a business design and a brand that no longer match.

Exhibit 4 **Keep them in synch**

If you change...	How should you adjust...
Business design components	**Brand strategy elements**
• Customer selection	• Target audience
• Value proposition	• Positioning
• Value capture/profit model	• Brand architecture and portfolio
• Scope of business	• Brand identity
• Strategic control	• Brand experience
• Organizational systems	• Brand metrics
	• Marketing mix

Consistency between brand and business design involves much more than marketing or advertising. It means adjusting investment in any area of the business that's dissonant with the brand promise. For example, when we studied ten years' worth of sales performance for all the brands competing in the mass-market, non-luxury U.S. automotive segment, we found that nearly 90% of the variation in sales among brands could be explained in terms of six key variables. Only two of these variables pertain to traditional marketing; the other four relate to product development and sales channel management. Yet all should be considered by automakers as they determine the optimal mix of brand investments, and all must be executed effectively in order to achieve sustained sales growth. The recent turnaround of Nissan in North America can be explained by Nissan's ability to use all six of the business and brand levers.

For many service companies, the most fruitful forms of brand investment may lie not in marketing but in areas such as R&D, customer service, or employee hiring and training. One bank that was struggling to revive the value of its flagging brand determined that the key problem was an inefficient complaint resolution process. A set of angry customers spread the word to others about their experiences. This crucial discovery surfaced only after the bank had identified its key customer points of contact and analyzed the relative impact of each touchpoint on customer perceptions of its brand. As a result, the bank could be confident that investing to fix the problem would yield a greater return than investing to expand the customer base through product introductions or advertising. Careful ROI analysis steers resources to those touchpoints that matter most.

Note, too, the importance of choosing the right sequence of brand investments. In the bank's case, if it had invested in marketing and advertising before improving its customer service system, the spending would have been counterproductive. Many of the potential new customers attracted by the marketing campaign would have been turned off by the bank's inability to serve them properly and would have abandoned the bank.

The tight link between brand and business design means that every strategic move must be considered in the light of its impact on the brand. A move that appears smart for the business in the short run might eventually hurt the brand. We see an increasing tension across industries between the need to redesign the business and the imperative to not change the brand.

The tradeoffs now being faced by the managers of American Express offer an illustration of this. In an effort to expand both the customer base and the merchant affiliations of its venerable charge card so as to compete more effectively against Visa and MasterCard, American Express has been making deals with mass-market retailers including Amazon, McDonald's, and Costco. These deals will open up large, low-cost customer acquisition channels, putting

Brand investment tradeoffs

Because brand investment choices are so complex, they often involve difficult and painful tradeoffs. Here are some classic dilemmas:

New versus old. Should a company extend an existing brand to include new product or service offerings, which risks diluting or confusing the brand image, or should it commit the resources required to build a new brand? Nissan and Toyota recognized the difficulty of extending their high-reliability, basic transportation brands into the luxury end of the market. They made the right decision and committed the necessary resources to build the Infiniti and Lexus brands instead, and Toyota recently added Scion to target young drivers.

Change versus continuity. As current customers age and new customer groups emerge, should a company emphasize change or continuity in its brand? IBM has adroitly managed the route of change over the past decade, transforming its brand image from "hardware maker with a tradition of conservative quality" to "information services provider with unmatched depth and breadth of expertise."

Promoting the brand versus escaping the box. An established company that has built a powerful brand may find itself boxed in by the brand. To expand its markets, should the company extend the brand or launch a new brand? On either course, how will it avoid alienating or confusing existing customers? Marriott realized that it could not reach the luxury market with the Marriott brand and decided instead to acquire Ritz Carlton.❖

pressure on the brand to resonate with several audiences. In addition, American Express is opening its network so that partner banks can issue American Express cards much as they currently issue Visa cards or MasterCards.

What impact will these moves have on the American Express brand, whose strength has long derived from its status as an exclusive, aspirational brand? When everyone can get an American Express card, issued by any bank rather than directly from American Express, and can use it to buy a cheeseburger rather than a Caribbean vacation, what will happen to the perceived value of the brand? The devil is in the details: Lacking careful measures, a strategic move that may be beneficial to the business in the short run can have a devastating long-term effect on the brand, one that may not become obvious for years.

A team sport

A brand is more than a promise. It's also a major financial commitment and, as we've seen, the mix of investments required to build and sustain a brand extend far beyond the traditional marketing sphere. If all the moving parts of the business don't synchronize to deliver the right experience to customers, then the long-term value of the brand surely will erode.

That is why brand management must be part of the senior executive agenda, starting with the CFO and CEO. And it is why the group designing an integrated brand investment plan should include people from human resources, production, finance, customer service, quality control, and other departments that contribute to delivering on the brand promise. The role of the brand manager expands as well, to be an educator and agenda-setter for an ongoing discussion about the brand.

Integrated brand management has become a team sport, not a one-department show. Even brand masters such as Richard Branson, who embodies his Virgin brand, cannot be truly effective unless all the moving parts of their business designs are fully aligned with the brand promise. Tomorrow's most successful companies will be those that integrate brand strategy throughout every department and level of the organization. ❖

Improving the Odds for M&A Success in China

China's unique environment poses risks for dealmakers

By Raymond Tsang and Frank Leung

Merger and acquisition activity in China has been heating up in recent years, particularly since China's accession to the World Trade Organization. Despite the appeal of M&A to both foreign and domestic firms as a way to improve competitiveness or to grow, these deals often fail to deliver on their promise. To raise the odds of success, companies can implement a framework that addresses China's unique business and regulatory environment.

At one time, foreign companies looked to China primarily as a source of low-cost labor. M&A in these cases were not the most effective means of investment, as foreign firms had difficulty maintaining the low cost structures of the companies they had acquired. As Chinese manufacturers have grown more sophisticated and product quality has improved, however, foreign companies have glimpsed an opportunity to create greater value through exports and have stepped up the pace of acquisitions. The auto parts sector, for example, has been a hotbed of M&A activity. An example is Robert Bosch GmbH, which has invested $600 million in China to date and expects to invest a further $600 million by 2007, a portion of which will be reserved for M&A opportunities.

China's rapid growth has also led to the emergence of a middle class with considerable purchasing power and enormous potential. Foreign companies are eager to tap into this market, and are investing in R&D centers to better understand local customer preferences and develop targeted products. These firms can also leverage the availability of inexpensive talent to develop products for overseas markets.

Domestic companies, on the other hand, are being driven by market forces to consider M&A. Particularly for firms in fragmented industries, increasing scale through M&A may be the only means of protecting their position in markets characterized by overcapacity and shrinking margins. Gome's recent acquisition of China Paradise (Yolo) in the electronics retail sector is just one of many deals where intensifying competition and industry consolidation are encouraging competing firms to merge or be acquired. High-technology, industrial goods, materials, and consumer staples were among the industries with the highest number of M&A transactions in 2005, according to Thomson ONE Banker and Mercer Management Consulting analysis.

The Near-Term Outlook

The results of this increasing interest in M&A on the part of foreign and domestic firms is that over the past five years, total M&A transactions in China have risen by an average 30% a year (Exhibit 1). In 2005, the total value of M&A amounted to $33 billion, versus $24 billion through July 2006. (For this article, we define M&A to include all investments that provide a controlling stake in an operating company in China, either by foreign or Chinese entities.)

Although M&A activity tends to be cyclical, it will likely continue to expand in China over the short- to medium-term based on several factors:

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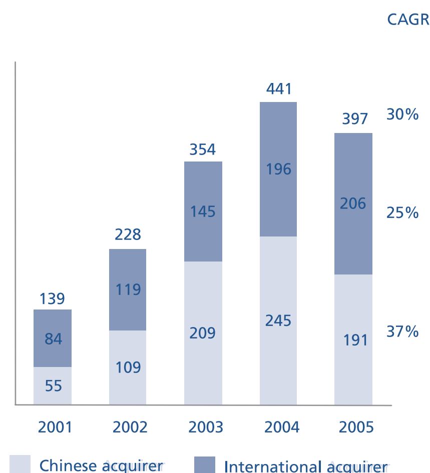
Exhibit 1 **M&A activity is surging**



Source: Thomson ONE Banker

- *WTO obligations*. China is committed to reducing import tariffs, allowing 100% foreign ownership in most manufacturing industries and permitting significant market access to foreign investors in previously restricted service sectors, such as retail and distribution.

- *Consolidation of fragmented industries*. The government is motivated to "clean up" highly fragmented industries and sees foreign investment as critical to adding operational experience and capital to the sector, which facilitates more rapid consolidation.

- *Influx of capital into the private equity sector.* The growing economy and market potential of China have attracted large capital commitments to China-oriented private equity funds.

- *Increasing importance of private companies*. The number and size of privately owned enterprises (POE) have grown significantly in recent years, presenting a new and attractive pool of potential targets for foreign investors. The M&A process involving a POE is more straightforward than for a state-owned enterprise (SOE), requiring fewer government approvals.

While it seems likely that the *pace* of M&A activity in China will not slow soon, the outlook for the *value* that these transactions should generate is less clear. Evidence from a wide range of industries suggests that reaping the benefits of M&A is proving to be more challenging than expected.

It could be argued that it is still too early to gauge whether past transactions have been successful in achieving an economic return on investment. Nevertheless, investments have not yet produced the kinds of returns and synergies that were originally envisaged. Global surveys by publications such as *Business Week* and *The Economist* have estimated that roughly 60-70% of M&A ventures have failed to increase shareholder value. Thus firms involved in future M&A transactions in China will need to carefully consider what can be done to maximize the value of these ventures.

A Best-Practice Framework

One reason for the mediocre record of M&A ventures thus far may be that companies often spend fewer resources justifying an M&A initiative in China, as the average deal size is relatively small compared to that of the U.S. or Europe. What is not taken into account, however, is that a failed M&A represents not only a loss of invested capital but also a lost opportunity to profit in the future from the rapidly expanding Chinese market.

It follows that companies seeking to make acquisitions in China need to devote greater time and effort to minimize the risk of failure. They must put the right process in place, given China's distinctive regulatory and business environment. In our experience, there are specific best practices that substantially raise the odds of success. These apply whether the acquirer is a short-term financial investor looking to quickly build value and then exit, or a corporate investor focused on the longer term and with a portfolio strategy in mind. Although each type of investor has different considerations and metrics for gauging success in a transaction, the process involved shares many similarities. Let's review each practice in turn.

The Planning Phase

1. Conduct extensive target screening to ensure strategic alignment. A company seeking an acquisition in China must design a rigorous process for screening and selecting acquisition candidates. Foreign companies under pressure to establish or rapidly grow their presence too often focus only on the largest or most prominent targets. Even seasoned executives have selected acquisition targets on the basis of simplistic factors such as "they understand Western culture."

To be sure, market leadership, a strong reputation, or a Westernized management team can be desirable traits in a target, but this should not be the starting point of the process. First, the prospecting firm's management needs to develop a strategy for achieving its vision in China, assess the capabilities required for that strategy's success, and identify capability gaps.

With this information in place, the company can develop an initial list of candidates to fill these gaps and winnow it down to a relatively short list of targets. The company can then initiate discussions to identify firms that share the same strategic vision and would offer complementary strengths. Next, these high-priority candidates can be slated for more in-depth examination. It is important to be discreet and to limit exploratory discussions to a handful of individuals, in order to avoid market rumors that more often than not result in higher prices and expectations of a deal being done. While this approach may seem time-consuming, one need only look at the many acquisitions that have unraveled as a result of having chosen the wrong partner.

One example of successful target selection is the acquisition of JHJ International Transportation by YRC Worldwide (formerly known as Yellow Roadway Corporation). In 2005, YRC was undergoing an international expansion and saw China as part of its future growth plans, since many of its customers were moving there. JHJ International Transportation was at the time the second-largest air freight forwarder in China and under severe competitive pressure because of its lack of sophisticated operational expertise. While YRC is an expert in global transportation, it lacked the domestic network and local know-how needed to operate in China, which JHJ could provide. In return, JHJ welcomed acquisition by a company that shared its vision and that could bring global best practices to bear on its operations. YRC thus identified a target that complemented its own capabilities, resulting in a stronger entity overall.

Another example is the acquisition by Anheuser-Busch of Harbin Brewery. Prior to 2004, Anheuser-Busch had made various investments in the domestic Chinese beer market, including taking a passive stake in Tsingtao Brewery, the market leader. In 2004, it successfully wrested Harbin Brewery, the fourth largest brewer in China, from the clutches of SAB Miller, giving it access to a 30% market share in the Northeast region. Anheuser-Busch now has a household brand and distribution channel in one region that it can use as a platform to further expand its presence in China, and that complements its already well-established position in central China (the result of an investment in Wuhan International Brewing Company). In this case, a targeted investment in a highly strategic candidate created greater value for Anheuser-Busch than its previous investments in a larger brand-name company. Although Anheuser-Busch had to outbid SAB Miller in this deal, the strategic value that it was able to derive from this acquisition was also significantly higher.

2. Choose the right deal structure. A wide range of deal structures can be considered in an M&A situation, including share deals, asset deals, contractual joint ventures, and majority equity joint ventures with either more or less than a two-thirds stake (the minority joint venture is another option not discussed here). Exhibit 2 provides a brief description of each of these deal structures, including their pros and cons.

Depending on the nature of the industry and the acquisition candidate in question, it is important to identify the structure that will be most advantageous to the acquirer. Key considerations include:

- *Regulatory requirements*. In some sectors, such as automotive manufacturing, foreign investors still face equity restrictions, so a 100% acquisition is not possible.

- *Degree of control*. Except for highly regulated industries, where a strong Chinese partner can be beneficial, most foreign investors in China prefer a deal structure that ensures they retain a high degree of control.

- *Importance of intellectual property*. A general lack of recourse for infringement of intellectual property rights means that foreign investors may be more likely to transfer their technology and know-how only if they have a clear controlling stake and operating control.

- *Importance of access to customers*. In sectors where direct customer access is critical to success, the acquiring company must choose a structure that will ensure it has sustained access to distribution channels and customers.

- *Management model and problem resolution*. Different deal structures will allow the

Exhibit 2 **M&A deal structure tradeoffs**

Deal structure	Description	Benefits	Drawbacks
Share deal (more than 50%)	• Direct acquisition of part or all of the equity interest, including full assets and liabilities of an existing company	• Less risk of minority party continuing in business as a competitor • Speedier access to market through acquired business	• Difficult to determine true picture or extent of financial liabilities (e.g., environmental) • Earn-out not permitted beyond one year (hard to retain key existing management)
Asset deal	• Acquisition of some or all of the business assets, typically excluding liabilities of an existing company	• Only selected assets are injected into new company (excludes those not required) • Greatly reduces the risk of legal liabilities tracing back to the new company	• Earn-out not permitted beyond one year (hard to retain key existing management) • Longer approval process if SOE assets are involved
Contractual joint venture	• New joint venture with a pre-determined timeframe • Profit split not based on equity	• Return can be based on other contributions, not just assets • Speedier negotiation compared to equity joint venture; less haggling over value of assets contributed	• More potential for conflict if return not based on equity split • Counter-party less inclined to agree to this if terms deemed unfavorable
Equity joint venture (less than 2/3)	• Controlling stake in a new joint venture • Profit split based on equity contribution	• Possess operating control and better protection of intellectual property • Can be consolidated into parent financials • Minority partner plays important role and has high degree of motivation	• Minority partner may not cede full operating control to majority partner • Future expansion may be hampered if capital injections not matched by minority party • Major part of profits shared, even though the partner becomes less useful over time
Equity joint venture (more than 2/3)	• Dominant controlling stake in new joint venture • Profit split based on equity contribution	• High degree of operating control and reduced risk (intellectual property, business ethics, financial) • Majority party has greater freedom to determine strategy and growth path	• May encourage minority party to engage in other competing ventures due to reduced motivation

acquiring company differing degrees of management control over the operations of the organization. The complexity of business operations will be a factor in determining the optimal deal structure.

- *Portfolio strategy*. The acquiring company must determine the ideal structure based on its long-term strategic vision and the degree of operational integration it desires.

Based on these and other considerations, the acquiring company will need to determine what would be the most suitable deal structure and then work with the acquisition candidate to gain consensus early on in the negotiation process.

3. Understand the regulatory environment; create competitive advantage by anticipating shifts. China is still heavily regulated, and one of the challenges foreign companies face is navigating this regulatory maze. Successful companies typically have a finger on the pulse of the regulatory environment and a knack for anticipating shifts before they happen.

An example of a company that has taken advantage of shifts in regulation to create strategic advantage is Carrefour SA. When the retailer first entered China in 1995, foreign retailers were barred from forming their own chains and could only operate through individual joint ventures on a local basis with majority Chinese partners. Instead of seeing this as an obstacle, Carrefour decided to be an early mover and carefully selected local partners who were willing to give Carrefour relatively free rein in terms of management, allowing it to gain a head start in understanding local market conditions and customer needs. By the time the regulation was lifted in December 2004, Carrefour had already opened 49 stores. The retailer then embarked on an aggressive acquisition campaign, quickly buying back control of some of its joint ventures. Carrefour now boasts of being the largest international food retailer in China, with 79 stores, and plans to acquire up to ten domestic retail chains in its drive toward second- and third-tier cities.

Carrefour's experience also illustrates that a company often has to take risks to benefit from regulatory shifts; the company made some missteps early on with respect to ownership structures and government approvals, but was ultimately able to benefit from adopting a bold strategy.

M&A activities in China's restricted industries or those requiring large capital investments also typically require approval from both local and central government authorities. Many high-profile deals have progressed to an advanced stage, only to stall during the approval process. In addition to recent provisions by the Ministry of Commerce and National Development and Reform Commission to protect national economic security, the China Securities Regulatory Commission also published a set of updated measures that gives the Commission greatly expanded powers to rule on takeover activity. This will provide the Commission with more discretionary control, which may in turn prove more challenging for companies seeking to acquire leading players in China. Companies conducting M&A transactions must assess the potential obstacles in the approval process and be fully aware of the various regulations and authorities that could come into play. It may take aggressive lobbying to obtain regulatory approval.

The Deal-Making Phase

4. Conduct extensive strategic and operational due diligence. In developed markets, due diligence usually consists of a legal team to verify the legal status of the acquisition candidate and identify potential legal liabilities, and an accounting team to conduct financial due diligence. In China, one must take a much broader and more detailed approach to verify the strategic and operational value of an acquisition candidate and expose potential deal breakers. In addition to financial and legal due diligence, some problematic areas for in-depth investigation include:

- *The overall business and market* to further confirm market potential and the competitive situation, as well as the candidate's capability to execute the strategy

- *Operations* to ensure overall operational effectiveness, as well as compliance with regulatory requirements

- *Sales and distribution* to gauge efficiency and control of the network. Additionally, soliciting customer and distributor feedback on the product or service offering can help highlight satisfaction levels as well as any questionable business practices

- *Suppliers* to confirm the sustainability of procurement contracts and supplier relationships after the acquisition

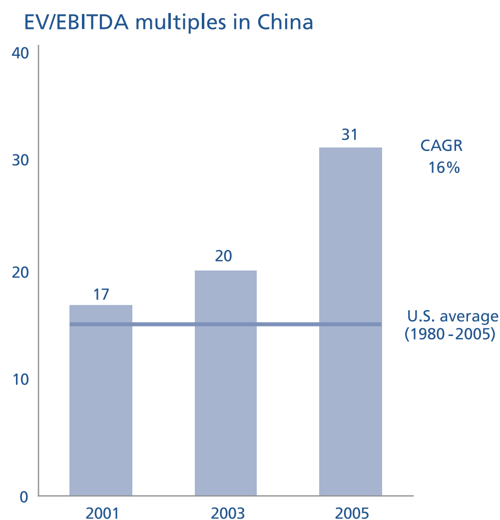
- *Human resources* to identify potential staff issues and ensure compliance with regulations and desired business practices

- *Key management* who will have a major role in the future operations of the acquired entity, to ensure integrity and identify potential "fit" issues

Extensive due diligence should uncover problems early enough in the M&A process for the acquirer to determine whether they are worth the time and effort to resolve, or if they are insurmountable and will kill the deal. Due diligence serves as a "sanity check" for the acquiring company, enabling it to re-assess and back up its initial interest in the target. Due diligence findings should then be incorporated into the business case and reflected in the expected return on investment.

5. Avoid paying an unreasonable premium. The premiums being paid for acquisitions in China have been increasing at an astonishing rate over the past few years, as shown in Exhibit 3. The multiple of enterprise value (EV) to earnings before interest, taxes, depreciation, and amortization (EBITDA) rose from roughly 17 in 2001 to over 31 by 2005. This represents a 16% yearly increase in average valuations. Contrast this with a historical average ratio for acquisitions in the U.S. of around 15, or the ratio of the Shanghai Stock Exchange, which is trading at a multiple of 11 to 15.

Exhibit 3 **Soaring multiples**

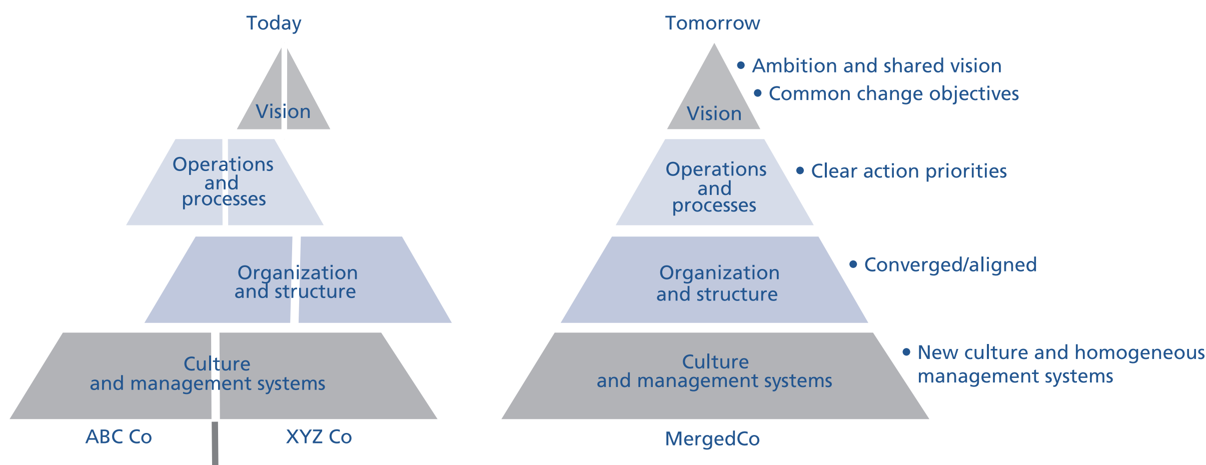


Source: Thomson ONE Banker, Stanford University Economics Department.

This dramatic rise in valuations can be attributed to growing investor confidence in prospects for the Chinese market, combined with the increasing scarcity of suitable investment opportunities in some sectors. While some of the increase in premiums paid might be explained by a shift in the industry composition of companies being acquired (toward those with presumably greater prospects for future profitable growth), the overall industry composition has not changed dramatically. The downside of high premiums is that they drastically reduce the potential return from an acquisition. But if foreign capital inflows and liquidity continue to rise while the pool of attractive and available acquisition candidates declines, it is likely that valuations will become even dearer in the future.

In light of this development, executives must avoid getting caught up in the thrill of the chase, establishing a ceiling price based on the lowest acceptable return on investment and then sticking with this position. They should be prepared to walk away from the negotiating table if prices soar, consider other options, and resist the fear of missing

Exhibit 4 **Post-merger integration objectives**



a "great deal," focusing instead on getting a price that is justified by the likely return on investment. It is also important to tentatively agree to a general set of terms with the acquisition candidate prior to investing time and resources in the due diligence process.

The Integration Phase

6. Develop post-merger integration planning in detail. As Exhibit 4 shows, the post-merger integration process should focus on combining two different organizations into one organization with a shared vision, operations and processes, a single organizational structure, and a unified culture and management system. The change processes involved are complex, so planning should take place as early as possible. Such planning will compel senior executives to rationalize the investment and acknowledge potential challenges.

Several principles are helpful here:

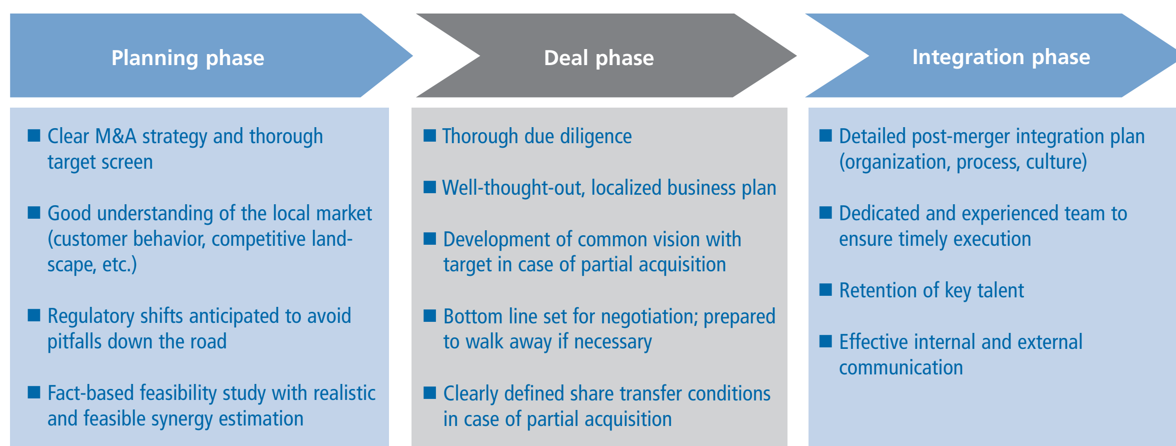
- Balance a focus on cost synergies with a focus on growing the newly combined company.
- Create a plan to retain key employees early in the process to ensure that employees do not leave en masse, especially for deal structures with one-year earn-out periods.
- Build a formal management structure to develop and execute the integration plan, which will ensure focused and efficient efforts.
- Make sure the integration plan takes advantage of the best initiatives and practices of both companies.
- Address employee issues in addition to structuring the formal organization, with an emphasis on effective and timely communication.
- Integrate the two companies quickly to ensure the effective transition of daily operations.

* * *

The stakes involved in successfully executing M&A transactions in China are only likely to rise in the future, as more and more companies enter the fray, shrinking the pool of desirable targets, pushing up valuations, and making it more difficult to get the level of return on investment needed to justify an acquisition. The companies that stand to win at this game are those that commit the resources and effort the M&A process requires and that minimize the inherent risks (Exhibit 5).

An M&A initiative is a complex undertaking at the best of times, requiring flawless execu-

Exhibit 5 **Key success factors**



tion from the initial planning and deal making through to implementation and integration. China's unique regulatory and business environment only adds to these challenges. But the rewards for succeeding can be large, given China's potential as a top exporter and the world's largest domestic market.