Chapter III Over-expansion Syndrome under Governance by the State: Case of Lenovo's Merger with IBM's PC Division

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1. Introduction

With a progress of the economic reforms and open door policy, there has been a considerable improvement in capabilities and competitiveness of the companies in China. They certainly outgrew a critique that the Japanese economist, Ryutaro Komiya observed —"there is no firm or company in China"— on his visit to China in the 1980s. Chief reasons for this substantial change are the up grade of the management skills and corporate strategies in order to grow in the competitive global market. On the other hand, regarding ownership, most of the state-run enterprises, where the state exercises' unlimited power without responsibility, were reformed into limited shareholding companies. Nevertheless, the state continues to be the major shareholder of these enterprises. China are rescheduling large-scale privatization, particularly with regard to the core companies in the most of the industries. Recent performances and strategies of major companies in China suggest that state ownership may have an adverse effect on opportunities of corporate growth, corporate values and interests of the stakeholders. This paper will address a case study based on the view of the corporate governance theory.

Good corporate governance is generally understood as the institutions and the practices that direct and guide actions of the management and/or controlling shareholder, who actually hold substantial decision-making power in the company, to make appropriate decisions in order to maximize profit. By doing this, investor can expect that the company can provide rational returns to the all of its stakeholders, i.e., shareholders, employees, vendors, customers, and even geographical neighborhood of the company.[1] Conversely speaking, bad corporate governance may provide an opportunity with management or controlling shareholders to siphon the resources of the company for their own personal consumption without any penalty. This case becomes serious, particularly if the expropriation has occurred at a expense of minority shareholders. Further, it damages public confidence that the company enjoys in the equity market and then prevents the company from raising funds. Thus, it has a negative effect on the overall economic growth.

Currently in China, the state owns a majority of shares of most of the listed companies, thus, effectively making the state to be a controlling owner of these companies. In this setting, it is expected that the controlling owner or the manager who follows directives of the controlling owner may not necessarily focus purely on a business agenda and might be substantially influenced by political goals and predilections. Thus, this may have an adverse effect on the long-term development of the corporate sector in China. Although privatization presents an ideal solution to these problems, the Chinese state sector is still hesitant to move ahead with this.

This paper describes a case involving such an "expropriation" of resources that occurred due to the actions of the state—controlling owner and management. Consequently, the company was exposed to a high degree of risk and this was done at the expense of the minority shareholders' interests.[2]

2. Lenovo Gambled!

On December 8, 2004, the Lenovo group announced that it will purchase IBM's personal computer division. Until this, Lenovo was not even recognized as a world class personal computer assembling company. However, as the news of this deal rapidly spread across the world, everyone was wondering "Who is Lenovo?" Thus, Lenovo attained global attention and fame in merely a day. The news that an emerging company from emerging China would acquire the personal computer division of IBM, the inventor of the notebook PC, reminded difficult market conditions in PC market and the emergence of China.

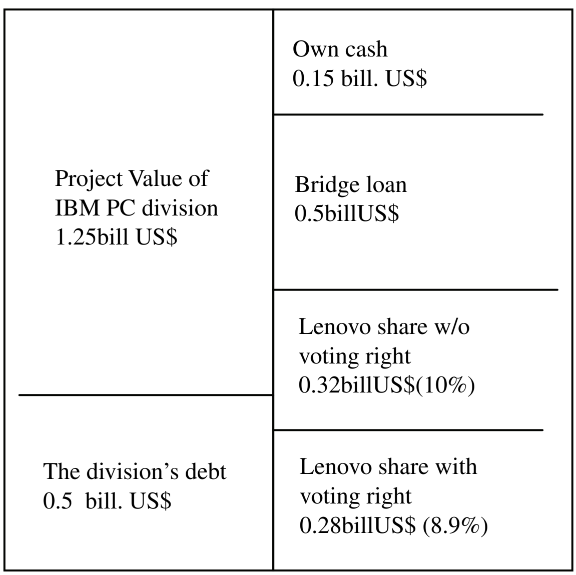
The deal comprised the following agreements: (1) Lenovo would acquire IBM's PC division, which enjoyed the 3rd largest market share in the world, and would establish a joint venture with IBM. (2) The new company would be privileged with own exclusive right to use the IBM Think series brand names, such as the IBM Think Centre and the IBM Think Pad for 5 years. The price of this merger with IBM's PC division was valued at USD 1.25 billion.

Lenovo committed to pay for this merger in the following manner. The first US$ 0.65 billion would be paid in cash and the remaining amount of US$ 0.6 billion paid by the shares of Lenovo. Moreover, of the US$ 0.65 billion cash, only US$ 0.15 billion was paid by Lenovo's own funds, while the rest, US$ 0.5 billion, was borrowed from a third party. Goldman Sachs Asia committed to provide this amount through a short-term bridge loan of 2 years with 2% interest per year. On the other hand, the payment of US$ 0.6 billion that was to be made by offering Lenovo's shares was equivalent to 18.9% of Lenovo's entire share, which comprised 8.9% of shares with voting rights and 10% of shares without voting rights. However, all these were newly issued shares that were recently added to the company's equity base; thus, according to the contract IBM was prohibited from selling these shares for the first 3 years. In addition to the US$ 1.25 billion that was to be paid for the merger, Lenovo also agreed to takeover a debt of approximately US$ 0.5 billion of IBM's PC division. Thus, the total cost of this merger was valued at US$ 1.75 billion.

This financing structure suggests that this deal was far beyond Lenovo's own capability. Lenovo could afford to pay merely an amount of US$ 0.15 billion through its own funds—less than one tenth of total merger value—and it mostly relied on borrowing from a third party and on selling the company's shares. Moreover, the shares offered to IBM included not only the shares without voting rights but also the shares with voting rights. Thus, it was clearly evident that Lenovo was scrambling for cash by all means that it could. However, it was doubtful whether IBM's PC division was worth this price. This was because the division had recorded a current deficit of US$ 0.258 billion in 2003 and had accumulated a total deficit of approximately US$ 0.975 billion since 2001. The value of this deficit, which implies the asset is not generating cash, was more than half of the total cost of this merger. Furthermore, both the current and accumulated deficits are far beyond Lenovo's own current profit or net worth. At least on the basis of Lenovo's current financial position, one cannot help interpreting this deal as being far beyond Lenovo's own capability.

Newly issued debt of US$ 0.5 billion and eguity of US$ 0.6 billion substan-

Figure 1 How Lenovo financed a merger of IBM PC division



Source: Author based on press releases by Lenovo and IBM.

Table 1 IBM PC division versus Lenovo

	To be sold		Buyer	
	IBM PC division		Lenovo Group	
unit: mill. US$	June 2004	Dec. 2003	June 2004	Dec. 2003
Sales	5,217	9,566	1,478	2,971
Sales to IBM	214	278		
Sales Cost	4,706	8,605		
Gross Profit	511	961	78	144
Operating Cost	555	1,078		
Pre Tax profit	-44	-117	81	128
Net Profit	-139	-258	78	130
Total Asset	1,534	1,458	1,175	1,069
Total Debt	2,509	2,045	548	533
Shareholder's interest	-975	-587	627	537
No. of Employee		9500		11408
Main Operating region	160 countries		Only Mainland China	

Source: Lenovo Group, Circular on Very Substantial Acquisition relating to the Personal Computer Business of International Business Machines Corporation (Hereafter abbreviated to The Circular), 31 December 2004: From Hong Kong Stocke Exchange Home Page (http://www.hkex.com.hk/listedco/listconews/sehk/20041231/LTN20041231122.pdf.)
No. of employee and operating regions are obtained from The Caijing Magazine, Vol. 24, 13th, Dec. 2005, p. 97.

tially inflated Lenovo's total asset value; however, amount of cash that the assets could generate had decreased. Thus, Lenovo's profitability was seriously damaged by this merger. As a result, as expected by the analysts, the company's share price dropped. At the end of 2004, the share price of Lenovo, at the Hong Kong Stock Exchange, dropped from HK$ 2.6 to HK$ 2.3 and it remained at HK$ 2.48 till the end of May 2005. This development resulted in extremely critical reports in the Chinese business media suggesting that "Lenovo gambled with its life."[3]

3. What IBM Wanted: Needed to Diet

What then was real motivations behind this deal? First, we analyze IBM's motivation. The personal computer division of IBM was the innovator of the notebook PC in 1981, however, the division has been reported to be up for sale since 2001. Some manufacturers in Taiwan and Japan were reportedly under scrutiny as the candidates for this sale. However, Lenovo was the first company to be approached by

IBM in 2002, and Lenovo and IBM reached an agreement after 13 months since the negotiations began.

The reasons behind IBM's decision to sell its PC division could be narrowed down to primarily a change in the total corporate strategy of IBM and the increasing competitiveness of the market for personal computers. Moreover, the severe market discipline in the U.S. that demands a high rate of return from companies was also an important factor in this decision.

3.1. Declining Profit Margins in the Personal Computer Industry

In recent times, the personal computer assembling industry has become highly competitive and the profit margins of firms have been declining. IDC survey figures reveal that in the global market share in terms of the shipment of PC's at the end of March 2004, Dell ranked at the top with 8.05 million sets, i.e., 18.5% of the world market share, followed by HP with 7.15 million sets, 16.2% share. On the other hand, IBM and the Lenovo group together shipped 3.15 million sets, 8.6% share and they were followed by Fujitsu-Siemens and Toshiba, with 1.73 million and 1.60 million sets shipped, comprising 3.9% and 3.6% of the market share, respectively. Thus, all these companies lagged far behind the two market leaders.

It was reported that among these companies, only Dell was able to make stable profits largely due to its strong competitiveness in the sales channel, i.e., direct sales to the consumer and aggressive inventory control by fully utilizing internet. Thus, without a thorough cost reduction in the intermediate operation cost, personal computer companies cannot make profits. This is because the price or cost of a PC is completely dependent on Intel for hardware and Microsoft for software. IBM continued to operate its PC manufacturing division maintaining a direct connection with the consumers, however, it had lost its cost competitiveness and the market share of ordinary consumers. Therefore, it was forced to cater to only a small market segment comprising a group of enthusiastic consumers. Thus, the market structure did not permit IBM to earn a sufficient profit from PC assembling.

3.2. A Drastic Change of IBM's Corpotate Strategy

Furthermore, a substantial change in IBM's corporate strategy in the 1990s prompted the separation of the PC division. Following a severe slack since the 1980s, IBM decided to develop itself as a service supplier that provides total solution and integration regarding information technology. In 2000, IBM's outsourcing services is aiming the target to let the IT division of the customers to move to IBM, who guarantees the first level quality and lower costs than home made. Recently, IBM stressed that they will be able to provide services to "banks with no IT systems for accounting" and also provide "insurance companies with an electric system to calcurate premiums." For example, Proctor and Gamble recently outsourced their personnel department to IBM, who undertook the functions of computing payments and employee welfare along with 800 employees of the department.[4]

Following its new corporate strategy, IBM started to outsource its application software, hardware for networking, DRAM, and hard disk drive divisions since the mid-1990s. Therefore, PC division became the only division that conflicted with the company's main corporate strategy. Louis Gerstner, the ex- CEO of IBM, stated that the decision on how to deal with the PC division was the most difficult for IBM. Although the PC division had not earned substantial profits since the 1980s and had deviated from the total corporate strategy of IBM since the 1990s, it had been awarded for its technology and humanware design on several occasions.[5]

3.3. Market Discipline Demands Smaller Assets and Higher Profits

The discipline from the equity market in the U.S. was an important factor behind this strategic shift. The shareholders of IBM and the analysts of the equity market not only criticized for the deficit that the PC division had built up but also were critical of the irrationally large size of the asset. Thus, the management of IBM eagerly desired to outsource the PC division as soon as possible in order to improve the return on asset or the return on equity.

From IBM's perspective, Lenovo was the most generous and ideal buyer; Lenovo offered a very high price for a loss-making division, and furthermore, it accepted the burden of debt. Usually in such a deal, debt would be cancelled out from net worth of the company and the merger value would be reduced. However, Lenovo agreed to provide an extra payment to cover the debt. Furthermore, they will also pay IBM a fee for any sales abroad. Thus, considering all the facets of this deal, it is clear that IBM would gain a net profit: since the accumulated debts of the PC division were fully compensated and IBM also earns the consultation fee that it charges Lenovo for providing product training to Lenovo's employees. IBM apparently won this deal.

4. Lenovo's Aims: Aspiring for Global Fame

4.1. Lenovo's Motivation

Why would Lenovo dare to undertake such a risky merger that threatened its own financial stability? According to the Circular on the announcement of the merger, the primary goal for this deal was to establish Lenovo as a global brand. Thus, the brands IBM Think and Lenovo Think would be set up under the umbrella brand THINK. This branding strategy would boost Lenovo as a worldwide brand.

The Circular also mentioned that IBM would advise Lenovo on its overseas marketing strategies, and a new CEO for the joint venture, Mr. Stephen Ward, would be transferred from IBM to Lenovo. Lenovo hired a tutor.[6] However, it is important to note that the priority was placed on establishing the Lenovo brand and not on sustaining the reputation of the THINK brand.

4.2. Can Lenovo Earn Profits with this New Venture?

Although Lenovo has set the above-mentioned targets, is it feasible for Lenovo to achieve these in reality? The more fundamental question is whether Lenovo will be able to turn the division into a profit-making project. The answer is the key to evaluate whether this merger was a right decision for Lenovo.

In order to analyze this problem further, let us look at the reasons behind IBM's PC division's losses. According to the Circular, the losses were mainly due to a huge compensation that was paid for troubled parts discovered in 2001. This seems to imply break down of Fujitsu's hard disk drive. IBM undertook a free replacement of the defected parts for the desktop personal computer products that were shipped between July 2000 and July 2002. The source for this accident has been reported to be an intense cost reduction in building the supply chain management system.[7]

Therefore, Lenovo has the following three choices: The first is to implement a further reduction of the cost, the second is to raise the price, and the third is to curtail number of products under the IBM think brand. With respect to the first choice, the accidents in the part looks unexpected. However, supply chain management usually aims to reduce the production cost by reducing the inventory through a timely supply system or a "just in time" method, or by maintaining the economies of scale through the management of global production. If the production system is well-integrated globally, then more number of factories will use the parts that are produced in one factory. In the case of Fujitsu's HDD, the defected parts produced in a particular factory were distributed globally; this resulted in an extremely high compensation cost. This story implies that IBM's PC division's cost reduction had already reached its limit. Therefore, any further cost reduction would only result in the deterioration of quality or increase the risk of similar trouble. Thus, the first choice does no appear to be entirely feasible for Lenovo.

With regard to the second choice, usually, the producer can raise the price of products only if the consumers indicate a high level of confidence or satisfaction in the quality or brand images of the products. However, it is often reported that most of the foreign consumers, particularly in Japan, which is the largest market for the THINK series, questioned whether Lenovo could sustain the quality and brand image that IBM has managed to build over the years. A chief engineer in charge of the notebook PC agreed that there was suspicion in the market (Interview with

Masaki Kobayashi, IBM's distinguished engineer, March 8, 2005, Nikkei Sangyou Shinbun). The quality of the products has been maintained by the engineers. Thus, the key for a successful price hike strategy lies in Lenovo's ability to maintain the motivation of the engineers from the IBM research institutes at Raleigh in the U.S. or Yamato in Japan in order to successfully develop innovative and attractive products.

Lenovo's competitive advantage in China was mainly due to their effective and strong sales channel and marketing and not due to an edge in technology. They did not themselves invest in the development of technology but rather opted to purchase the necessary technology from outside. In fact, this is a very common strategy that is adopted by many Chinese companies in several industries. As in the case of these companies, the corporate culture at Lenovo does pay little attention toward innovation in technology. However, one positive change under the Lenovo regime could be an increase in investment in the research and development of PCs, at least larger as compared to the investments under IBM. However, it remains doubtful whether Lenovo can afford to this since it has already spent huge financial resources and it is unclear whether it can finance these activities any further. Thus, at least in the middle-term, the second choice is also far from a realistic approach for the company to adopt.

The Circular on the merger does not mention anything about whether Lenovo has any interest in upgrading or sustaining the IBM or Lenovo lines of products; moreover, it does not address the question about investment in R&D. It appears that Lenovo is merely interested in popularizing its name from the fact that no reports or press releases in the U.S. or in Japan address the questions of investments in innovation and quality on the merger.

In summary, it appears to be extremely difficult for Lenovo to curtail the deficit of IBM's PC division by reducing cost, or raising prices. Thus, the third option seems to be the most likely approach for Lenovo, i.e., giving up IBM's high quality lines of products. However, this exposes Lenovo to an extremely high risk in the market. Thus, we cannot help but feel that in the end, Lenovo bought a toy that was too expensive for its management strategy and capability.

5. "Face Is More Important Than Profit" —But at Whose Cost?

5.1. Lenovo Fell under the "Winner's Curse"

On May 2, 2005, completion of the merger was announced. Lenovo Japan Ltd. was established in Japan on the same day and the head office of the company is located within the office of IBM Japan. On May 6, 2005, Lenovo announced that they had repurchased a part of the non-voting right shares (4.7% out of 10%) that were given to IBM as a part of merger deal. In order to finance this repurchase, Lenovo had collected US$ 0.35 billion in gross and US$ 0.15 billion in net by issuing further securities in the form of convertible preference shares and warrants through private placement; thus, further exposing Lenovo to a financial risk.

However, the question remains: Why did Lenovo dare to enter such a high risk merger? It may be natural for Lenovo to believe that they needed this merger to acquire new technology ensuring that they survive and grow in the extremely competitive market. In addition, several rival companies from Taiwan and Japan were reportedly competing to acquire IBM's PC division. However, as detailed above, it is extremely doubtful whether IBM's PC division deserved a price of US$ 1.75 billion. It is believed that the price offered by the Japanese companies was merely US$ 0.3 to 0.4 billion. Thus, Lenovo probably won the deal only because they offered the highest price that was based on an extremely optimistic or rather irrational evaluation of the project; however, if further losses and poor performance of the division continues, then Lenovo may actually fail in this venture. In their hurry to cash in on a precious opportunity, Lenovo fell under the so-called "Winner's curse." This implies that the winner of the bid is often the loser of the transaction because they eventually end up with a higher loss or lower profit margin as compared with the case wherein they fail to win the bid. The Lenovo's case is a typical one that results from a common defect in the corporate governance system adopted by the state in China.

5.2. Go Abroad Policy and the Beijing Olympic Games

Since the late 1990s, the Chinese Government started propagating companies to go abroad. Some Chinese companies followed this "Go Abroad Policy," and undertook oversized investments and mergers abroad. Most of these companies are those that are strongly influenced by the local or central governments, who are the ultimate owners of them. Moreover, the companies' growth and competitive strategies in the domestic market, rely heavily on their relationships with the government or their "political connections."

Haier, a home appliance assembler, is an example. It is one of the front runners with regard to investments abroad. In 2002, Haier purchased an old building in Manhattan, New York, which was originally built as the head quarter of a local bank. In China, this purchase was heavily publicized as an example of the growing success of Chinese firms. However, the building is rather old and has a limited capacity and is far from being an appropriate space for displaying the products of Haier. Moreover, it is extremely doubtful whether this investment would contribute to an increase in the corporate value of Haier. Furthermore, companies that internalize the government's "Go Abroad Policy" often set their corporate targets in order to rank in the "Fortune 500" list of companies. Thus, these investments and mergers abroad are primarily publicity stunts and have come to be regarded as the "Fortune 500 Syndrome."

For Lenovo, the ultimate majority owner is the China Science Academy (CSA) who is under the central government. Lenovo was established in 1984 by Liu Chuanzhi, and it received an investment of RMB 0.2 million from the CSA. Currently, the CSA owns 65% of the shares of Legend Holdings, which is a core company of the group and has two listed companies under it, i.e., Lenovo and Digital China Holdings. The ultimate owner has been an extremely silent owner. Liu Chuanzhi also stressed that Lenovo is practically independent from the authority of the CSA or the central government in terms of personnel, finance, and management. However, the CSA is the formal majority shareowner under the Company Law in China; thus, Lenovo is considered as a state-owned enterprise, with only a limited number of shares owned by the general public, without sufficient power to intervene the managements and therefore, certain political predilections can impact its decision-making ability. Particularly, with regard to a merger with a foreign company, Lenovo needs permissions from several bureaucratic offices of the government i.e., the State Asset Management Committee, which represents the state's shares, the Foreign Reserve Bureau, which is in charge of the capital account, the State Development Reform Committee, etc.

During the press conference for the announcement of the merger, Mr. Liu Chuanzhi stated the following: "First of all, I would like to express my deepest gratitude to the leaders of the State Development and Reform Committee." the State Development and Reform Committee was in charge of the supervision of state-owned assets and any deal, purchases of assets or the M & A, requires the permission of the committee He added that "The Committees generously treated this merger on urgent and completed the entire permission process as soon as possible." This speech indicated that this merger was strongly supported by the government.[8]

For Chinese Government, who is a part of the ultimate owner, it appears that this merger was important in order to save face of China as the host of Beijing Olympic Games in 2008. Lenovo has already become a sponsor for the Olympic Games and is expected to donate their PCs for the games. If a Chinese company provides the PCs for the Olympic Games and if those PCs are of world class quality, such as IBM Think, then China gets a big face. One cannot help but suspect that this was the real motive of the ultimate owner, Mr. Liu Chuanzhi, who will be retiring on the completion of this merger. This merger may mark the end of his career as a businessman.

Thus, this decision with a purpose of getting face, has been taken at the expense of the company and its minority shareholders. The company has been exposed to a huge financial risk, while the minority shareholders were forced to deal with this burden. Due to the financial arrangements in the process of this merger, the minority shareholders' interests have been substantially diluted. Moreover, the consumers who loved IBM's Think products may lose the opportunity to enjoy high quality PCs. Thus, the cost of this merger appears to be quite substantial and was burdened by the investors on the market, the minority shareholders.

6. Conclusion

After the announcement of the IBM-Lenovo case, another merger received a public attention. Shanghai Motors, which is a partner joint venture between GM and Volkswagen, reported that it is negotiating a merger with Rover. Shanghai Motors appears to be interested in engineers who can design automobiles. Recently, the Chinese Government stressed the need to develop the capabilities for the entire process of automobile research and development. Shanghai Motors seems to be responding to this pressure by merging with Rover.

However, it is reported that Shanghai Motors had offered 1 billion GB£ for 70 per cent of the total shares of Rover, whereas GM recently sold Rover to the UK Government at a price of only 10 GB£. This offer by Shanghai Motors was even criticized within China and was considered as rather. Consequently, the State Development and Reform Committee finally rejected the permission, although the British Finance Minister had actually visited China in order to promote this deal.

As evident from the discussion above, Chinese companies often and rather wastefully use their resources for irrational investments merely to maintain the prestige and image of the manager and the ultimate owner. The cost of such an irrational business decision is usually borne by the company and its minority shareholders. Thus, there is a massive waste of precious resources that happens very frequently and easily. This phenomenon is extremely prevalent and is the major problem of the current corporate governance regime in China. During the process of a gradual reform, the state ownership had several positive implications. However, it is now time for the government to seriously consider the policies and means to promote the privatization of the state-owned enterprises, while developing and maintaining a sound relationship between government, state, and the enterprise. This is an inevitable problem that Chinese industries and companies will have to address if they desire to grow into truly world class and globally competitive companies.

Notes

1 Tirole, Jean [2001].
2 A quantitative analysis based on theoretical model on this issues on listed companies in China in total was done in Watanabe [2006]. Basic statistics or econometric analysis are reported here.

3 The Caijing Magazine, Vol. 24, Dec 13, 2004. pp. 96–100.
4 Nihon Keizai Shinbun, April 5, 2005.
5 Gerstner, Louis V. [2002].
6 Mr. Ward, resigned CEO of Lenovo.
7 Nihon Keizai Shinbun, September 13, 2002.
8 Nikkei Sangyou Shinbun, December 9, 2004.

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