

MANAGEMENT & TECHNOLOGY

MANAGEMENT VIEWPOINT PANKAJ GHEMAWAT, FARIBORZ GHADAR

Testing the logic of cross-border mergers

Contrary to popular opinion, many industries are becoming less concentrated in the face of globalised markets

“Dinosaur economics” is the idea that a merger yields a more viable offspring than either of the parents. These days, it is finding expression in the belief that industries inevitably become more concentrated as a result of the globalisation of markets.

We decided to see if concentration really is increasing globally, and whether that warrants the recent merger and acquisition activity.

To answer the first question, we compiled data from industry sources on concentration levels over the last few decades. We used the “Herfindahl index” – the sum of the squares of the companies’ shares of global output. Our research* produced a striking conclusion: in the overwhelming majority of industries looked at, global concentration has fallen in the postwar period.

Cars are a good example. In 1950, the US was by far the largest car market, and General Motors dominated the oligopoly there. Since then, GM’s worldwide market share has fallen to its lowest levels in 50 years – with lost sales spread across an increasing number of competitors.

Even in the few industries that have concentrated, the trend is weaker than one might expect. In the semiconductor industry, the Herfindahl index rose from 0.04 in 1985 to 0.05 in 1999. Note that one of its chief segments, microprocessors, possesses a dominant company, Intel, that sets standards for the industry. This degree of control and the resulting pattern of concentration is unusual.

After the second world war, the US controlled most international industries, and US companies wielded great power in industries that were often highly concentrated. But between the 1950s and 1980s concentration in most industries declined.

This was due in part to increased innovation, the re-emergence of successful European and Japanese companies and governments using import-substitution to protect local businesses.

This last, admittedly, has come unstuck in recent years: the wave of trade liberalisation and deregulation in the 1980s and early 1990s washed away a number of inefficient, protected companies.

Although it led to some concentration, this same wave stimulated entrepreneurship. In telecommunications services, WorldCom, Qwest, Level 3, and Frontier, among others, emerged as low-cost specialists – known in industry parlance as piranhas.

And even some mega-mergers created opportunities for niche players. Thus, to secure regulatory approval for their merger, Exxon and Mobil agreed to sell 1,740 gas stations to Tosco, the largest independent oil refiner in the US. In sum, arguments that only the top few companies in each industry will thrive seem even further from the mark today than they did 50 years ago.

This brings us to our second question: do companies pursue cross-border consolidation even if it destroys economic value? Our research suggests half-a-dozen biases that contribute to such destruction.

An over-emphasis on increasing sales instead of profits is one of the most powerful biases. Think of the number of industries growing with gross national product at 2-3 per cent in which leading competitors have 10-15 per cent growth targets.

Another bias is today’s high level of stock prices, which tends to fuel merger waves. The high-tech sector in particular is remarkable for using a “strong currency” to finance global industry roll-ups.

Herding behaviour is a problem, too. Imagine that you are running a bank or insurance company in Europe and that many larger competitors have announced pan-European consolidation. Most managers in this position simply cannot resist the temptation to join the stampede. Sometimes this is to signal that they are “with it”; sometimes it is to “jam” the signal that they are not.

Personal commitments to cross-border consolidation at the top of an organisation can, if institutionalised, also drive strategy in this direction – even in the face of persistent performance problems. Thus, Whirlpool has stuck to the global-consolidation strategy initiated by David Whitwam after he became chief executive in 1987. This was despite probably having paid too much – more than \$1bn – for Philips’ European operations, delays in restructuring them, economic chaos in Latin America, and a retreat from China.

Whenever acquisitions are contemplated, we would advise managers to examine the motives of everyone involved. Speaking hypothetically, couldn’t the prospect of large fees from the merger influence an investment banker’s perceptions of what clients should do?

Think about alternatives to consolidation. At a minimum, try to be more creative than those running around saying economies of scale everywhere are increasing. Most of the time, they are wrong.

* “The Dubious Logic of Global Mega-Mergers” will be published in *Harvard Business Review* next month.

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