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Absorptive capacity and a failed cross-border M&A

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Abstract

Purpose – Chinese companies are increasingly using cross-border mergers and acquisitions (M&A) to source knowledge or strategic assets. For many, global acquisitions have proven to be highly problematic and value-destroying. The purpose of this paper is to address this critical acquisition failure issue from an absorptive capacity perspective.

Design/methodology/approach – Guided by the framework that focuses on how acquiring a firm's weak absorptive capacity damages its ability to assimilate, integrate and apply external new knowledge, one high-profile Chinese failed acquisition: TCL acquisition of France's Thomson's TV business in 2004 is analyzed empirically.

Findings – Acquisition performance of Chinese overseas M&A is found to be substantially affected by the acquiring firm's absorptive capacity at multiple dimensions.

Research limitations/implications – The absorptive capacity construct provides an insightful account for differentials in Chinese overseas M&A performance.

Practical implications – For decision makers interested in formulating and implementing overseas M&A strategy, appropriate evaluation of their own firms' absorptive capability should be the first step to take.

Originality/value –This is the first paper to apply absorptive capacity arguments to Chinese resource-driven M&A strategy, and will prompt business academicians and practitioners to think about M&A strategy in new and innovative ways.

Keywords China, Acquisitions and mergers, Organizational development, Assets management

Paper type Research paper

Introduction

Cross-border merger and acquisition (M&A) has become a dominant mode of entry for Chinese firms' outward foreign direct investment (FDI). In 2005 Chinese companies were involved in 274 cross-border M&As valued at $5.3 billion (UNCTAD, 2006), while in 2006 the acquisition value jumped to $20.7 billion (Economist.com, 2007). In the first quarter of 2008, M&A volume from China reached $28.5 billion, four times the year-earlier value (Xinhua, 2008). Although there are a variety of reasons, strategy asset seeking is an important rationale for Chinese cross-border M&A, that is, utilizing foreign M&A as the means to acquire strategy assets or knowledge so as to compensate their competitive disadvantage (Child and Rodrigues, 2005; Deng, 2007). However, such resource-driven M&A does not guarantee success particularly due to tacit and proprietary nature of knowledge. For many Chinese companies, global acquisitions have proven to be highly problematic and value-destroying (Economist.com, 2007).

In light of the growing importance and prevalence of China's cross-border M&A activities and a number of examples of acquisition failure, it is imperative for us to consider the strategic and performance dimensions of such M&As (Fan *et al.*, 1998). By drawing on theories of absorptive capacity, we intend to uncover some of the key firm-level factors and mechanisms that may cause foreign M&As to fail. Absorptive capacity literature (Cohen and Levinthal, 1990; Lane *et al.*, 2006; Zahra and George, 2002) highlights the importance of taking in external knowledge, combining it with internal knowledge and absorbing it for commercial use. Firms with lower absorptive capacity would have a weaker foundation to create knowledge, assimilate and interpret opportunities, and less effectively develop and apply explicit knowledge.

Building on the literature, we propose an absorptive capacity approach which argues whether and to what extent that Chinese companies can effectively acquire strategic assets and enhance their competitive advantage is determined by acquiring firms' absorptive capacity at multi-dimensional levels. Guided by this theoretical framework, we empirically analyze one influential M&A deal conducted by a leading Chinese company, TCL. For TCL, its 2004 acquisition of France's Thomson's TV business has proven to be highly problematic and is regarded as a typical example of Chinese company that "failed miserably in overseas expansion" (Economist.com, 2007). As the first study that applies the arguments of absorptive capacity to resource-driven M&As from Chinese firms, we aim to explain in detail why TCL's M&A failed, thereby prompting business academicians and practitioners to think about M&A strategy in new and innovative ways.

Absorptive capacity perspective: foundation and key components

According to the knowledge-based view (Grant, 1996; Kogut and Zander, 1992), knowledge, especially tacit knowledge, is the most important strategic asset and companies may use cross-border M&A to gain access to new knowledge and skills controlled by indigenous firms (Nadolska and Barkema, 2007). Using M&A for resolving knowledge deficiencies, however, does not necessarily result in superior returns because strategic assets often are tacit, specific and complex (Amit and Schoemaker, 1993). In addition, in the early stages of internationalization, firms tend to underestimate the complexities of foreign acquisitions and exaggerate the synergies from combination of the merging firms' strategic assets (Child *et al.*, 2001). To become successful in overseas acquisitions, firms need to develop the knowledge and routines so as to overcome these problems, that is, absorptive capacity (Zollo and Singh, 2004).

Absorptive capacity is widely defined as "the ability to recognize the value of new, external information, assimilate it and apply it to commercial ends" (Cohen and Levinthal, 1990, p. 1). It derives from stocks of knowledge within the firm and is a function of prior organizational problem solving (Kogut and Zander, 1992). The absorptive capacity construct has emerged as an underlying theme in global strategy management and has been used to explain diverse organizational phenomena such as strategic alliances, organizational learning, knowledge acquisition and transfer, and business performance (Lane *et al.*, 2006). It is generally agreed that absorptive capacity represents an organization's dynamic capability and it is a multi-dimensional construct; each dimension plays a different but complementary role in explaining how absorptive capacity influences knowledge acquisition and business outcomes. For example, Zahra and George (2002) conceptualize it as a dynamic capability with a multi-dimensional construct involving a firm's ability to acquire, assimilate, transform and exploit knowledge. Moreover, absorptive capacity itself is determined by a number of organizational antecedents which have differing influences on different components of absorptive capacity (e.g. Jansen *et al.*, 2005), thus helping us understand why certain firms are able to acquire and assimilate new external knowledge, but not able to transform and exploit it successfully. For instance, Kim (1998) has considered the level of prior related knowledge as the determinant of absorptive capacity and van den Bosch and his colleagues (1999) have demonstrated how organizational forms and combinative capacities influence the level of absorptive capacity.

In this paper, we propose an absorptive capacity model that takes into account the most important developments in the literature as well as the most relevant features in the cross-border M&A context. This model consists of three key components that shape absorptive capacity with each component determined by a number of organizational factors, as summarized in Figure 1. In the first dimension, antecedents of absorptive capacity such as prior knowledge are critical for the firm to recognize and understand the strategic assets to be acquired. The second dimension involves using of combinative capabilities to assimilate and combine newly acquired assets with the firm's existing resources. Finally, the last dimension focuses on how the acquiring firms effectively transform and apply the acquired strategic assets. In the following, we elaborate on each component by focusing on some of the key determinants, as shown in bold in the figure.

Ability to understand strategic assets and its key determinant: prior related knowledge

Recognizing and identifying the value of new external knowledge is the first step toward acquisition of strategic assets. Much of the literature has identified absorptive capacity as a knowledge base and specifically as the extent of prior knowledge in the firm (Kim, 1998; Lane *et al.*, 2001). Specifically, "[...]organization needs prior related knowledge to assimilate and use new knowledge" (Cohen and Levinthal, 1990, p. 129). A firm's prior knowledge contributes to its absorptive capacity as it helps the firm to understand the industry, products and customers that are related to the knowledge held by the foreign firm, thus facilitating knowledge absorption and development (Kim, 1998). Firms with a high level of absorptive capacity are likely to harness new knowledge from acquired firms to help their innovative activities; without such capacity, it is hard for them to learn or transfer knowledge from one unit to another (Szulanski, 1996). Managers can help develop their firms' absorptive capacity by building knowledge stocks through investment in internal R&D and carefully examining the potential target firm (Cohen and Levinthal, 1990; Lei and Hitt, 1995). For emerging market firms, the intensity of effort is a crucial element for accumulation of prior related knowledge, particularly about the potential target firms (Kim, 1998). In sum, the extent of a firm's prior related knowledge may determine the magnitude of M&A effect on knowledge acquisition and serves as an important stepping stone for learning how to handle cross-border M&A activities (Shimizu *et al.*, 2004). The logic of the above arguments and the evidence provided in existing literature suggest that the

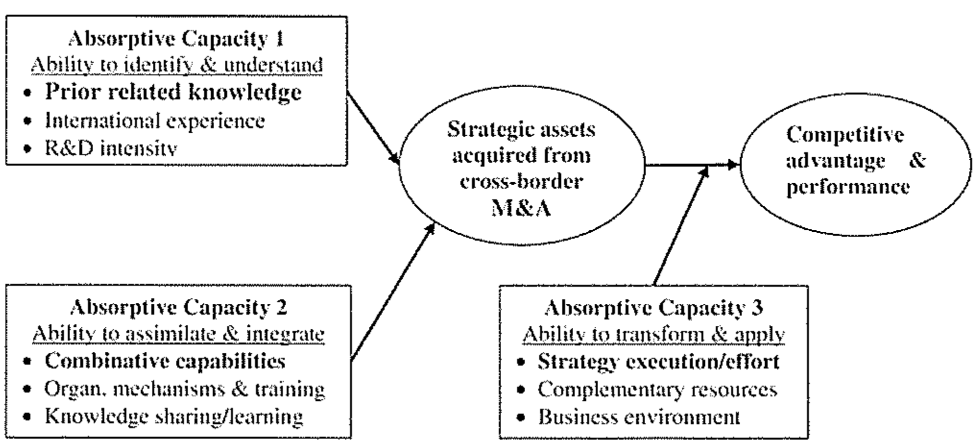

Figure 1.
An absorptive capacity model of acquisition of strategic assets via M&A

lower the prior related knowledge, the less likely it is that the acquiring firm will effectively acquire strategic assets.

Ability to integrate strategic assets and its key determinant: combinative capabilities
Mere exposure to related external knowledge is not sufficient to ensure that a firm will internalize it successfully. Companies need to develop combinative capabilities so that firms can synthesize and acquire new knowledge (Zollo and Singh, 2004). Common features of combinative capabilities involve coordination capabilities and socialization mechanisms, each provides specific ways of dealing with different dimensions of absorptive capacity (van den Bosch *et al.*, 1999). Coordination capabilities deepen knowledge flows across disciplinary boundaries and lines of authority and facilitate knowledge exchange by bringing together different sources of expertise and increasing interaction between areas of functional, or component, knowledge (Jansen *et al.*, 2005). Coordination capabilities also enable employees to combine sets of existing and newly acquired knowledge and provide an effective way of generating commitment and facilitating the implementation of decisions (Kogut and Zander, 1992). Socialization mechanisms, on the other hand, may influence absorptive capacity by creating broad, tacitly understood rules for appropriate action under unspecified contingencies and contribute to common codes of communication and dominant values (Zollo and Singh, 2004). The rationale underlying the above studies is that absorptive capacity in terms of combinative capabilities combines resources in new ways and serves as an effective governance mechanism, and if acquiring firms lack such capabilities, it is hard for them to assimilate and integrate the sought-after strategic assets.

Ability to apply strategic assets and its key determinant: strategy execution and effort
Acquisition of strategic assets does not automatically result in competitive advantage or high performance because "applying external knowledge involves the ability to diffuse knowledge within the organization, to integrate it with the organization's activities and to generate new knowledge from it" (Lane *et al.*, 2001, p. 1157). Previous literature has shown that an acquiring firm's post-acquisition strategies or what the firm does after the acquiring activity distinguish failure from success (Hitt *et al.*, 2001). Therefore, effectiveness of strategy execution by an acquiring firm is an essential factor that may influence levels of absorptive capacity and determines whether the acquiring firm is in a position to exploit the potential of acquired new external knowledge or not. That is, knowledge obtained matters, the acquiring firm's strategy execution appropriate for its competing market matters more (Hitt *et al.*, 2001). Accordingly, a central concern for emerging market firms is how to manage acquired knowledge and enhance business performance. Ineffective strategy execution is one of the primary reasons that acquisitions fail to create value for acquiring firm shareholders (Seth *et al.*, 2002). The problem is exemplified in the Daimler Benz acquisition of Chrysler, where the significant opportunity to achieve economies of scope has not been realized because of highly ineffective strategic execution. In short, increased absorptive capacity would provide a basis for more effective management (Narasimhan *et al.*, 2006). With subsequent increases in absorptive capacity there would likely be fewer errors, development of specialized and standardized routines, and increased execution effectiveness (Nadolska and Barkema, 2007). Therefore, the third theoretical argument in this study is the lower the level of acquiring firms' absorptive capacity in terms of strategy execution, the less likely they can apply the acquired strategic assets into successfully commercial use.

Absorptive capacity approach and cross-border M&A from Chinese multinational companies (MNCs)

Among a number of significant M&A deals from Chinese MNCs, the 2004 merger of TCL with the TV division of France's Thomson is one of the most high-profile cases. As one prominent Chinese company championed by the Chinese government, TCL is at the forefront of a new wave of Chinese MNCs which are globalizing their businesses (Deng, 2009; Morck *et al.*, 2008). TCL explicitly declares that its overseas M&A activities serve its goal of becoming the first-class multinational in the world. In the words of TCL's chief financial officer, the company aims "to be the next Sony or the next Samsung" (Deng, 2007). To achieve such an ambitious goal, TCL lacks globally valued brands, leading-edge technologies or genuinely innovative and admired business methods.

However, after acquiring Thomson's TV business in 2004, TCL suffered huge losses (with a cumulative loss of over RMB 6 billion or $680 million as of 2006) and sought bankruptcy protection of its European operations in May 2007. As the absorptive capacity construct explains why there are significant variations among firms in their ability to evaluate and utilize outside knowledge (Lane *et al.*, 2006), this framework may provide new insights into TCL's M&A failure. In the following, based on both primary and secondary data and information, we illustrate the theoretical approach by making an empirical study of this high-profile Chinese cross-border M&A deal in order to obtain insights into how TCL's lack of absorptive capacity damages its performance outcome.

TCL's M&A of TV business of Thomson: an acquisition failure

To shed light on the explanatory power of the absorptive capacity perspective, we collected two sources of data. The primary data were collected by interviews at TCL's headquarters during October and November 2007. Informed by the literature review, before the interviews, we had developed a set of open-ended questions focusing on their investment motivations and performances. Totally, approximately three-hour interviews were made with five senior managers who were directly involved in the acquisition. Participants were provided with anonymity and were requested to answer the M&A questions with respect to a specific acquisition that he or she was most familiar with. In addition, the interviews were supplemented with other sources of data, including observations, company documentation, intranet and internet data, and archival data. To increase the reliability and accuracy of our explanations, we consistently cross-checked information and data from different sources for triangulation purposes

As China's largest color TV and second largest mobile phone maker, TCL began to aggressively promote its brand internationally in 2000 (Deng, 2009). Its global expansion culminated in January 2004 when it struck a $560 million deal of merging its TV and DVD operations with those of French consumer electronics giant Thomson. The resulting venture, TCL-Thomson Electronics Co Ltd (TTE), in which TCL held a 67 percent of equity share, was put into formal operation in July 2004 and was totally acquired by TCL in 2006. When the TCL-Thomson deal was announced, it was praised as "the latest and most dramatic example of China's determination to put its own stamp on the global marketplace ... there's no company that has a better chance of becoming China's first truly global corporation than TCL" (*Business China*, 2004). As another indicator of the significance, the signing of the agreement took place in the presence of the French prime minister and the Chinese president. Unfortunately, the deal is now widely regarded as a typical example of Chinese company that "failed miserably in overseas expansion" (Economist.com, 2007). Due to its highly problematic and value-destroying European operations, during the two years of 2005-2006, TCL cumulatively suffered a total loss of

RMB 5.07 billion ($680 million). As a result, its stock was put on a "star" and became "*ST TCL", indicating that TCL's stocks are at the risk of being delisted. In November 2007, TCL declared its European operation "insolvent" and overhauled its TV manufacturing operations. The primary goal for TCL to acquire Thomson's TV unit was to obtain its technology, distribution channel, brand and network. With the massive restructuring, TCL has given up Thomson's original business model, distribution channel and even the Thomson brand. An absorptive capacity is one of the major constraints for acquiring firms to obtain new external knowledge and has a direct impact upon business performance (Lei and Hitt, 1995; Narasimhan *et al.*, 2006), the framework may provide us insights into why and how this important M&A failed.

Lack of related knowledge of the target firm

TCL had prior related knowledge about the global TV industry and served other emerging markets that have characteristics similar to the home market before moving into developed markets. In Asia, for example, TCL products are sold under its own brand, claiming a 14 percent share in Vietnam and 8 percent in the Philippines. However, TCL failed to recognize the true value of the acquired firm because it had not carefully examined Thomson brands and its related products and services. Hu Qiusheng, a former TCL senior director, was thoroughly involved in the entire negotiation process. He was firmly against the deal because of numerous ambiguities and unfavorable terms, including paying license fees by using Thomson's trademark in Europe after 2008. Consequently, he was not appointed as the first CEO of TTE when it was set up in July 2004. Moreover, during the whole negotiation process, TCL did not hire acquisition experts as its business and financial advisors. TCL did spend 10 million and hired Boston Consulting Group (BCG) to do the appraisal. Based on the BCG's appraisal report, the deal was not quite optimistic due to too much risk involved. However, TCL's chairman, Li Dongsheng ignored the so-called "pessimistic" report and decided to gamble the deal simply because the deal appeared attractive; it was considered as a marriage between TCL's cost advantage and Thomson's strengths in brands, distribution and research network in Europe and the US.

In addition, TCL's top management team merged Thomson's TV business without an appropriate financial and competitive justification. As said by one former TCL executive, "Our internal review did not articulate a rationale that fits the story line of the entire organization and also did not spell out the economic requirements for integration" (TCL, personal communication, October 2007). Thomson brand in Europe and its RCA brand in America are rather tired and dormant names. Thomson's TV and DVD operations lost more than $100 million in 2003. In addition, the deal was highly complex because the joint venture had to negotiate specific contracts for access to those parts of the business not being transferred to it, for example, the sales and intellectual property businesses from Thomson. To make matters worse, in late 2004, Thomson surprised the market by announcing that it was taking a small stake in Konka, a TCL rival. As one TCL executive admitted, "The international setback is mainly because we did not prepare well before the deal. We also are not familiar with the local business operations in Europe. We simply think about the overseas market in our Chinese logic. When we copy Chinese business model abroad, it does not work" (TCL, personal communication, October 2007).

Weak combinative capabilities

TCL not only lacked prior related knowledge about Thomson's business operations, but also lacked combinative capabilities to integrate and assimilate the acquired knowledge. The shortage of TCL managers with international experience and expertise in global marketing constitutes a major constraint. The new company did not work well with people from different cultures, with different experiences and different routines. Also, because of language issues and disagreements on compensation issues, it took a long period of time for the new company to develop a common production strategy. In the words of one TCL senior manager, "We fail to grasp and address the barriers that may hinder the level of integration we desire. In addition, we cannot understand and address organizational barriers that may obstruct the capture of cross-border value or risk destroying the sources of local and international value associated with the acquisitions" (TCL, personal communication, October 2007).

In addition, TCL wanted greater management and hierarchical cultural control of its European operations. Unfortunately, it imposed control structures that were suitable for China but not for France so that many French staff had to quit in frustration. For example, TCL executives were unhappy to find that when they planned a weekend meeting in France, which occurs regularly in China, TCL's French staff had turned off their cell phones. TCL managers also failed to understand changes in the industry initially because they repetitively tried to assimilate new external knowledge through their old cognitive models. Only after a series of failed assimilation processes did they change their domestically oriented cognitive structures. It is not in doubt that differences in cognitive structures, value systems and behavioral norms all contribute to the fact that the new company is less likely to acquire and assimilate capabilities. As one TCL executive commented, "Obviously, TCL was not aware of the cross-border opportunities and managers ignored the chance to collaborate with colleagues in the other parts of the new joint venture. Surprisingly, few people at the new company had the knowledge or perspective needed to consider truly cross-unit, cross-functional and cross-cultural approach" (TCL, personal communication, October 2007).

Problematic strategy execution

When the deal was done, TCL executives believed that the synergy of the M&A will benefit the company in the long term, through economies of scale, complementary resources, cost control and shared R&D capacities. But, the challenges and difficulties were much more serious. In essence, the deal went far beyond typical arrangements that shift a Western company's high-cost manufacturing operations to lower-cost China. Because of too many overlapped product lines and manufacturing facilities, it was not very useful for TCL to shift production easily to less expensive facilities in China and to realize greater economies of scale. In India, for instance, TTE products appear under both Thomson and TCL brands. It also is hard to save money by using common designs for chipsets and leveraging their clout as a bigger customer to get lower parts prices. On the other hand, the sources of TCL's competitive edge in China – its relationship, local knowledge, distribution networks – could not be transferred overseas.

Moreover, TCL's international expansion strategy was too rapid and too aggressive so that the company failed to develop its own absorptive capacity and did not have enough time to integrate the new knowledge and apply it into commercial end. Besides the Thompson deal, in September 2002, TCL acquired the German-based Schneider Corp. In 2003, it acquired GoVideo, an Arizona-based US company focusing on visual products and DVD players. In August 2004, it created another majority-owned joint venture, TCL and Alcatel Mobile Phones Limited ("TAMP"), to engage in mobile phone development, production, sales and services. In 2005, it set up a third majority-owned joint venture with InFocus Corp, South Mountain Technologies Ltd to produce rear-projection TV components. Since TCL appeared to expand to an unlimited international expansion, it was unable to learn from its prior experiences and apply them throughout the organization. Elements of an effective M&A should be ensuring that every deal supports the corporate strategy (Hitt *et al.*, 2001; Seth *et al.*, 2002). Unfortunately, most of TCL's M&A deals were only generally related to its strategic direction and the connections were neither specific nor quantifiable.

A major motivation behind TCL's acquisition of Thomson's TV unit was to accelerate its development of TV technology, but Thomson's CRT and projection TV technologies were quickly replaced by new technologies. As one of the TCL senior managers said:

> Acquisition of Thomson didn't help because its technical expertise lays in projection TV sets. We had expected to sell a breakthrough design by Thomson in large-screen TVs: a rear-projection model with a 61-inch screen in our traditional market, China, but the market simply goes for large-screen LCD TVs ... Our top decision makers also underestimated the sheer difficulty of getting hundreds of people to cooperate for a common goal. They do not have clear accountability and simply take a one-size-fits-all approach to all the M&A deals (TCL, personal communication, October 2007).

Finally, TCL not only failed to anticipate a boom in consumer demand for flat-panel TV sets, but also was very slow to respond to the shift in consumer preference. Flat-panel models became the majority of TV sets sold in the USA during the third quarter of 2006. Japan and Europe reached that milestone during mid-2006. When customers have started switching to new LCD screens and stopped buying old-fashioned CRT and projection TV sets, TCL's European operations faced major structural problems. In an effort to catch up, TCL announced plans only in 2005 to buy flat panels for its new flat-panel TV sets from LG.Philips LCD Co. Even so, it already lost a key US sales outlet when its contract expired with Best Buy Co in 2006. As its CRT and projection TV sales slowed down sharply, TCL not only lost its crown as the world's largest TV maker to Korean rivals, but also piled up big losses on the TCL and Thomson television brands amid a series of strategic missteps.

Implications and conclusions

Based on theories of absorptive capacity, firms are motivated to enhance their competitive advantage via acquiring strategic assets within the constraint of their absorptive capacity. Following this logic, we provide an empirical study of one prominent cross-border M&A deal from Chinese MNC, TCL and confirm that any attempt to explore a firm's strategic choice such as cross-border M&A requires an understanding and incorporation of an acquiring firm's absorptive capacity and its determinants at multiple dimensions. The calculus of acquiring firms' absorptive capacity captures the extent to which Chinese companies may utilize M&A strategy to acquire strategic assets and achieve superior business performance. Absorptive capacity arguments may therefore provide an insightful explanation for why acquiring firms facing similar competitive landscape may achieve substantially different outcomes. Firms like Lenovo with weak absorptive capacity are not able to acquire and transfer new knowledge from the acquired firm, nor change structures and practices which are suitable to the new markets, thereby destroying the source of their competitive advantage.

Our study also offers practical guidance for decisions makers interested in formulating and implementing resource-driven M&A strategy. A preoccupation with the seemingly positive contribution of strategic assets to competitive advantage alone is not likely to realize the M&A potential. Rather, decision makers' appropriate evaluation of their own absorptive capacity should be the first step to take. Only then can they judge whether, and if so how much, they can utilize cross-broder M&A deals as their global expansion strategy. Even if a firm may internalizes transactions through acquisition, with weak absorptive capacity, it may be unable to assimilate and successfully apply the acquired strategic assets, as shown in TCL's acquisition of Thomson's TV business. As the biggest practical challenge that most cross-border acquisitions face is getting not only the right deal, but also having the capability to handle the integration efforts productively, acquiring firms must invest to build their absorptive capacity as a pillar of their overall corporate strategy before launching an aggressive M&A agenda.

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