1.5 Growth and evolution

External growth

In contrast with internal growth methods, external growth methods involve another organisation. Partnering with another business can allow companies to realise their strategic objectives more quickly and efficiently. There are several different forms of external growth.

Figure 1. External growth means expanding the business with the help of other businesses.

Credit: laflor, Getty Images

Mergers and acquisitions (M&As) and takeovers

The terms mergers, acquisitions and takeovers can be confusing because they are often used interchangeably. The nuances in terminology will be discussed below.

Mergers, acquisitions and takeovers result in a fundamental change in structure to the companies involved. They cannot be reversed easily if things go wrong. Therefore, they are riskier strategies compared to strategic alliances and joint ventures, which will be discussed later in this section. Many observers have noted that between 70% and 90% of mergers and acquisitions fail. Thus, companies that engage in external growth with a large partner must proceed with caution.

Mergers

A merger takes place when two businesses agree to form a new business together. A merger may occur between firms that are considered equals in terms of power, where both businesses make changes to accommodate the fusion. But they can also occur between firms that are not equals, where one business dominates and requires that the other business change more substantially in the merger process.

Mergers are not always a success. Perhaps the best-known example of a merger that went badly is that of AOL–Time Warner. The 'perfect marriage' of old and new media did not realise its potential and the companies finally separated in 2015.

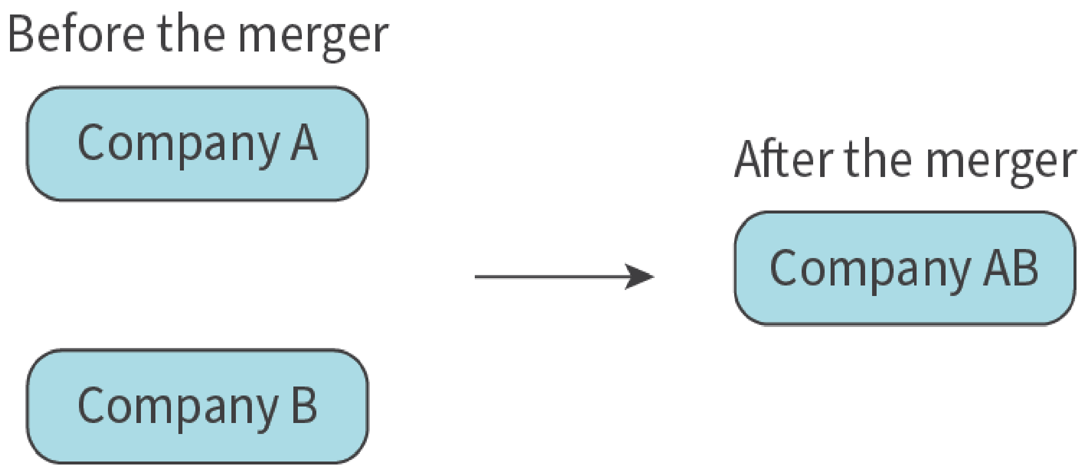

Figure 2. A merger is where two companies agree to fuse together.

Acquisitions

An acquisition on the other hand implies that one company purchases another company with permission of the board of directors. This is illustrated in **Figure 3**. Company A has acquired an ownership interest in Company B. Company A thereby becomes the parent company and Company B becomes its **subsidiary**. In some cases, Company A acquires 100% of Company B. In other cases, the parent company acquires a majority stake (over 50%), rather than 100% of the subsidiary. In any case, both companies continue to exist as legal entities, but A 'controls' B due to its ownership interest. An example of this is Pixar Animation Studios, which has been a subsidiary of The Walt Disney Company since 2006.

Acquisitions can be large or small operations. Meta (formerly Facebook) has purchased many smaller companies such as Instagram and WhatsApp in order to access technology and know-how that it did not have 'in house'. These were major investments for Facebook at the time; the company paid nearly 19 billion USD for WhatsApp. However, this was still a small sum compared to the value of Facebook itself. So had the acquisition been a failure, it would not have seriously jeopardised the future of Facebook.

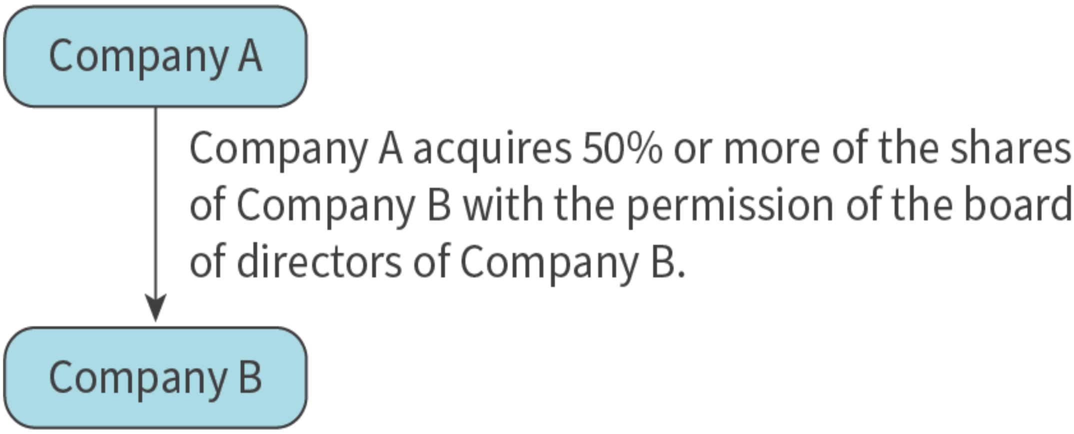

Figure 3. An acquisition, where Company A acquires Company B.

Takeovers

A takeover occurs when one company purchases another company without permission of the board of directors or the company. The purchasing company will usually try to purchase a majority of shares of the other company, either directly from shareholders or through stock markets. They may also try to take control of the board of directors with the approval of shareholders. This is called a proxy fight. Needless to say, for the purchasing company, a takeover will be more difficult and risky than an acquisition.

Concept

Change

Changes to a business often occur during a mergers, acquisitions and takeovers. Depending on the process, companies may be asked to change their values, culture, and/or business structure. Most of the time, the company that owns more than 50% of the shares will ask the other to adapt and change.

However, acquisitions and takeovers, where one company is dominant, do not necessarily require that the companies adapt to each other. It is possible for one company to completely own another and for the business being taken over to stay the same as it was before.

On the other hand, one business acquiring 50% ownership of another could require more substantial changes in the business being taken over. In a takeover or an acquisition, as opposed to a merger, one company is always dominant. This means there is always a possibility that the company being taken over or acquired has to adapt to the dominant firm.

Activity

Learner profile: Knowledgeable; Inquirers
Approaches to learning: Thinking skills (critical thinking); Research skills (information literacy)

In 2012, two South American airlines, LAN Airlines S.A and TAM Linhas Aereas S.A, merged into one business called LATAM. Currently, LATAM is the largest airline in South America, flying to five continents, with more than 45 000 employees and 310 aeroplanes.

- How might a merger of these two airlines enable them to experience economies of scale?
- Can you think of other examples of companies from your country which have merged, or where an acquisition/takeover has occurred?

Joint ventures

A joint venture is a new enterprise undertaken jointly by two or more businesses which otherwise hold onto their distinct identities. Joint ventures are a more flexible form of external growth than mergers, takeovers and acquisitions. The separate business entity can be dissolved at the end of a project, without compromising the businesses of the parent companies.

The companies involved in a joint venture split the costs, risks, control and profit that the project produces according to an agreement made by the parties. One example of a joint venture is the formation of Galvani Bioelectronics (https://galvani.bio/), a joint venture of the drug company GlaxoSmithKline (GSK) and Verily, a company owned by Alphabet. The joint venture is set to last for seven years, during which time Galvani Bioelectronics aims to combine GSK's knowledge of life sciences with Verily's experience and skill with software and electronics in order to develop bioelectronic medicines to treat chronic diseases.

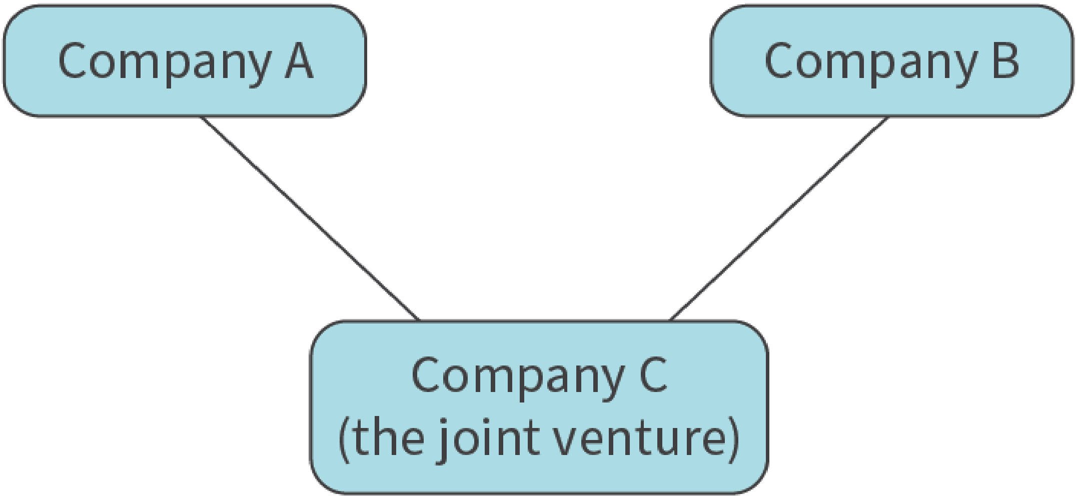

Figure 4. One possible configuration of a joint venture.

Strategic alliances

A strategic alliance is a situation where two or more businesses work together to achieve a common objective but do not create a new enterprise in the process. Strategic alliances are the loosest and least risky form of external growth. As with joint ventures, the members of the strategic alliance share the costs of the product or service that is developed. In some cases, forming a strategic alliance can be the beginning of cooperation between two companies, which later results in an even closer working arrangement through the creation of a joint venture or even a merger.

An example of a strategic alliance is Oneworld (https://www.oneworld.com/), formed by 14 airlines with the aim of providing travel to more than 1000 destinations in more than 170 territories as well as offering passengers an excellent flying experience. Customers who use airlines in this alliance can enjoy benefits of the partnership, such as their frequent flyer miles being valid for other airlines in the group.

Activity

Learner profile: Thinkers; Inquirers
Approaches to learning: Thinking skills (critical thinking, transfer); Research skills (information literacy)

ICICI Bank, India's largest private sector bank and Vodafone India, one of India's largest telecom service providers, made a strategic alliance to launch M-Pesa (https://www.vodafone.com/about-vodafone/what-we-do/consumer-products-and-services/m-pesa). M-Pesa is a money transfer and payment service that is now widespread in low-income countries.

This video shows the big impact that this strategic alliance had in Kenya, where M-Pesa originated.

Video 1. The impact of the strategic alliance M-PESA in Kenya.

- Why would a strategic alliance be an appropriate strategy for a service like M-Pesa?
- Research one other example of a strategic alliance and explain its purpose.

Evaluation of external growth

Table 1 shows some advantages and disadvantages of mergers and acquisitions, joint ventures and strategic alliances.

Table 1. Advantages and disadvantages of mergers and acquisitions, joint ventures and strategic alliances.

Advantages	Disadvantages
Often faster than internal growth.	Often riskier than internal growth, especially if borrowing on a large scale.

Advantages	Disadvantages
Potential for economies of scale.	Can be hard to realise cost reductions if the firms are too different or do not understand each other well.
Can create synergies, increase employee talent pool, widen range of expertise.	Possibility of culture clash between organisations.
In the case of merger, acquisition or takeover, a competitor may be eliminated.	In the case of joint ventures and strategic alliances, proprietary information and technology could be lost.

International Mindedness

External growth is always risky because of the need to integrate the company processes and business cultures of two or more organisations. External growth strategies can be particularly difficult when two companies from different countries decide to integrate. Cultural differences can create conflict that is very difficult for integrated companies to resolve.

Franchising

Franchising refers to an arrangement between two parties: the franchisor and the franchisee. The franchisor (also written franchiser) is usually a company with a successful and proven business model that wishes to expand. It is of course possible to do so through internal growth by setting up new outlets. But it may be advantageous for the franchisor to seek partners who would like to open, own and run these outlets themselves. In exchange, these partners, called franchisees, pay fees and royalties to the franchisor. Royalties are usually calculated as a percentage of revenues.

There are many advantages to this arrangement for the franchisor. Firstly, the franchisor's need for financing is reduced because franchisees usually finance the new outlets themselves. Because franchisees own and keep the profits from their outlets, they may be better and more motivated managers than employees working for a large company. Franchisees also provide local knowledge in operating their businesses. This can be particularly helpful in the case of international expansion.

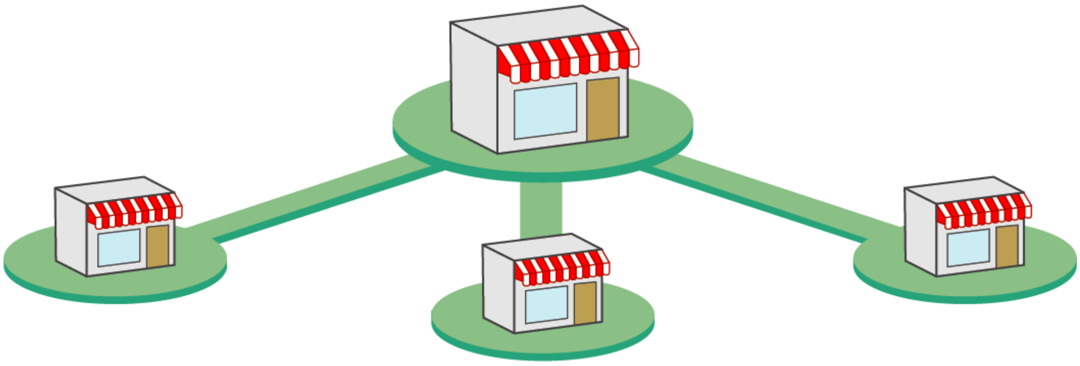

Figure 5. Franchising refers to an arrangement between two parties: the franchisor and the franchisee.

Franchisees also benefit from the arrangement. They receive the support of the franchisor in running the business. This help can range from legal advice to access to managerial software to best practices in food hygiene. Franchisees receive training and access to a proven business model and recognised brand. This limits the risk of becoming an entrepreneur. Franchisees can also benefit from economies of scale compared to individuals running smaller businesses.

The franchise model also has potential pitfalls, for both the franchisor and the franchisee . The franchisor loses direct control over individual outlets and must trust that its franchisees will maintain company standards. A single mistake at a single outlet can damage the reputation of the entire company.

Activity

Learner profile: Knowledgeable
Approaches to learning: Thinking skills (critical thinking)

Consider whether the following statements about franchising are true or false. Provide a response for each one and, for every false response, explain why it is false.

1. Setting up as a franchise allows the franchisor to expand their business more quickly.
2. One of the main disadvantages of the franchise for the franchisee is know-how that they receive when entering new markets.
3. The franchisee only needs to pay a one-time fee to the franchisor.

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4. The franchisee can create new products and processes.
5. The franchisor has complete control over the franchise outlets.
6. By using franchising, franchisees take on lower risks when running their business than they would with starting a business from scratch.