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Strategic Management

WHEN IT COMES TO STRATEGY, should companies focus on increasing market share, improving shareholder value, diversification, or some other goal? And how should the strategy be executed? Mergers and acquisitions are one option, but they are fraught with risks that could outweigh the rewards. Even when they pursue the latest strategy buzzword—innovation—firms often fail to sustain growth by finding the right balance between smaller, incremental improvements and more rewarding, but riskier, major initiatives. In the following articles, Wharton faculty and other experts offer their perspectives on managing strategy in a global business environment.

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Sustaining Corporate Growth Requires "BIG I" and "small i" Innovation

ALL COMPANIES, from major multinationals to startups, face a common challenge: how to grow their businesses so they can boost earnings and enhance the value of their shares. Far too often, however, firms find it difficult to sustain growth because they become risk averse and, as a result, opt for incremental product and service improvements instead of major initiatives, according to a study by a Wharton marketing professor.

Professor George S. Day, who also serves as co-director of Wharton's Mack Center for Technological Innovation, says companies can avoid lackluster growth by better understanding the risks inherent in different levels of innovation and achieving a balance between—using two terms he has coined—BIG I innovation and small i innovation. In his study, Day discusses how executives can properly assess risks and then seek creative ways to reduce risk exposure.

Day, a consultant to many Fortune 500 companies, says his research is the outgrowth of years of thinking about the problems that companies face in trying to set and achieve growth targets. Growth—particularly "organic" growth that comes from improving a company's performance from within rather than relying on acquisitions—is so important that it is at the top of the agendas of some 80 percent of U.S. chief executive officers, according to Day.

"These executives know that the expectation of superior organic growth is the most important driver of enterprise value in capital markets," Day writes in the paper entitled "Closing the Growth Gap: Balancing BIG I and small i Innovation." It is also a less expensive way to grow because a firm typically pays a premium to acquire another business. Yet studies have shown that only 29 percent of managers of major corporations are highly confident they can reach their organic growth targets.

A combination of factors can make organic growth hard to sustain. For one thing, firms often find themselves in saturated, price-competitive markets—pressured by customers who themselves are squeezed—and are forced to compete for incremental share gains with rivals who follow similar strategies. One answer to this challenge is to explore new "blue ocean" markets with new business models and offer a better customer experience. While this is an appealing growth path, the returns may not compensate for the higher risk and long delay before any returns are realized. This approach also does not account for the consistent growth records of Wal-Mart, Dell, and IKEA, which have been methodically leveraging their low-cost business models in closely adjacent markets.

In other cases, disappointing growth can stem from organizational impediments (such as short-term incentives that subvert long-term objectives), risk-averse cultures, and inferior innovation capabilities. Day says 80 percent of CFOs of major corporations would reportedly hold back on discretionary spending designed to fuel growth if they were likely to miss their quarterly earnings target.

Firms often find themselves in saturated, price-competitive markets and are forced to compete for incremental share gains with rivals who follow similar strategies.

The combined effect of these external and internal impediments to growth is that incremental small i innovation displaces BIG I innovation growth initiatives. Small i projects make up 85 percent to 90 percent of the average corporate development portfolio. These projects are necessary for continuous improvement but do not change the competitive balance or contribute much to profitability. By contrast, 14 percent of a sample of business launches that were substantial innovations accounted for 61 percent of profits, according to a study cited in Day's paper.

This bias toward safer, incremental line extensions and product improvements seems to be intensifying. Between 1990 and 2004, the proportion of "new-to-the-world, true innovations" in development portfolios dropped from 20 percent to 11.5 percent, Day writes. Even the less ambitious development of products "new to the company" dropped by a third.

Crippling Consequences

There are any number of reasons why companies are placing a growing emphasis on small i innovations. Long-established, incumbent firms may suffer from tunnel vision; that is, they miss early signals of market opportunities that offer openings for rivals. For instance, by the time of its initial public offering in 2004, Google was already a formidable rival of Microsoft, Amazon, and Yahoo. Why didn't they see the same opportunity sooner?

In other cases, firms may opt for "exploitation" activities over "exploration" activities. "There is a well-known organizational tradeoff between activities that exploit existing capabilities and those that explore new market spaces and create breakthrough innovations that stretch capabilities," Day writes. "This uneasy tradeoff is tilted toward exploitation by process management methods that emphasize the reduction of variance in organization processes. When the mindset and methods of business process reengineering, Six Sigma and ISO 9000, are applied to innovation processes, they tend to displace the inherently divergent and variance-increasing activities needed for creative exploration. Slowly—and perhaps imperceptibly—the choices of research projects to select and products to develop are steered toward the incremental and more certain opportunities."

At other times, companies may succumb to short-term thinking. Most financial yardsticks used to choose which development projects to fund are biased against the lengthy payoffs and uncertainty of BIG I innovations.

Finally, longer-term investments in innovation may decrease when companies use up scarce development time and resources to react to urgent, short-term requests from customers and salespeople. "These requests stem from fragmenting markets, demanding channel partners and new forms of competition that require a proliferation of product offerings and accelerated development cycles," Day writes. "Meanwhile, R&D budgets are being held constant or tightened to meet short-term earnings targets. This leaves firms with more projects than they can handle, and pressing small i projects get priority."

Most financial yardsticks used to choose which development projects to fund are biased against the lengthy payoffs and uncertainty of BIG I innovations.

Companies that avoid BIG I initiatives also believe that the potential rewards will be received too far in the future at too high a risk. But this risk aversion imposes costs that need to be understood and contained. For example, while the actual rewards may be realized far in the future, the equity markets account for them in their expectations of earnings. If the firm is viewed as mired in slow-growth markets, vulnerable to emerging technologies, and lacking a compelling story about its future growth thrust, its stock price will suffer.

Indeed, risk aversion may have even more crippling consequences. "Certainly the probability of failure goes up sharply when the business ventures beyond incremental initiatives in familiar markets," according to Day. "But this should not be an excuse for passivity. It's healthier to properly assess the risks and then seek creative ways to reduce the risk exposure.

McDonald's vs. GE

In his paper, Day includes a "risk matrix" diagram that can help firms assess the probability of failure of different growth paths and calibrate the risks of unfamiliar markets and technologies. In essence, the matrix shows that it is far less risky for a business to launch a new product or technology into a familiar served market than to adapt the current product to a new end-use market.

"Market risks are much greater than product risks because there are more dimensions of uncertainty, including competitors, channels, and consumers," writes Day. "If the market is entirely unfamiliar, the firm doesn't even know what it doesn't know—and the knowledge is hard to acquire. Market risks are not only less controllable than technology risks, they tend to be confronted much later in the product development process and are harder to resolve. A further complication is that an existing brand name has no meaning in a 'new-to-the-company' market. It is not simply a lack of awareness. Because the prospective buyers lack any experience, they view the new entrant as risky and have to be given special inducements to try the new product."

For example, McDonald's abortive effort to offer pizza in its restaurants was initially viewed as a "related product" for the current market. But pizza was actually a "new-to-the-company" product because it didn't fit the basic service delivery model. "No one could figure out how to serve a pizza in 30 seconds or less," according to Day. "This meant that service flow rates were disrupted, and pizzas couldn't be served through the drive-in window. The post-mortem of the failure revealed that the brand name didn't give them permission to offer pizza. They lacked credibility."

Day says GE is an example of a firm that has struck the right balance in working to achieve organic growth by growing on a number of fronts. After he replaced Jack Welch, CEO Jeff Immelt boosted the organic growth goal from 5 percent to 8 percent per year, which translates into finding an additional $3.4 billion in organic growth annually. Many moves were made within GE to encourage fresh thinking. These ranged from diversifying the top ranks with outsiders, in a break from the company's promote-from-within history, to keeping executives in their positions longer so they become immersed in their industries and then tying more of their compensation to new ideas, improved customer satisfaction, and top-line growth.

The leaders of each GE business were required to submit at least three "Imagination Breakthrough" proposals per year promising at least $100 million in additional growth. Day notes that such growth initiatives, which offer true breakthrough potential, are awkward to manage within the constraints of the existing organization. There will inevitably be conflicts over resource allocation, with small i initiatives gaining the upper hand. Yet the fledgling BIG I initiatives may need to share resources, such as brand presence, manufacturing expertise, or market access, with the established units.

An "ambidextrous" solution to the tension between small i and BIG I initiatives is to "house the initiative in a structurally independent unit with its own processes, structures, and culture but still integrated within the existing senior management hierarchy," according to Day's paper. "The lead role for the 'Imagination Breakthrough' growth initiative within GE was given to the marketing team within each of the 11 business units, while holding the business leaders accountable for results. This is a startling departure for a company with a belief that superior products and technology are what really count. Until recently, there were no marketers among the senior ranks and no coherent approach to marketing beyond building communication programs and designing product launches."

The "Imagination Breakthrough" effort aims to shift the balance toward BIG I growth initiatives by giving the organization permission to break away from the tyranny of past success and take calculated risks with departures from the way the business has been run. By early 2006, there were about 100 growth initiatives underway within GE, ranging from business-model innovations and new ways to segment and serve the global energy market, to products for new market spaces, such as bio-detection of security threats and small super-efficient jet engines for the next generation of air taxis, according to Day.

Preliminary projections were for an extra $33 billion to $35 billion of top-line growth from 3 to 5 years in the future. GE's 35 best projects are subject to monthly CEO reviews, a strong signal of commitment. This procedure also encourages the sharing of best practices and the further search for cross-division business opportunities.

The Praxair Case

Another company with a noteworthy approach to organic growth is Praxair, a Fortune 300 global producer of industrial gases based in Danbury, CT.

In 2003, Praxair set out to find $2 billion in revenue growth by 2008, Day says. One half was to come from acquisitions; the other half required double-digit organic growth of $200 million per year. This was far beyond the annual growth that could be realized from repackaging helium, hydrogen, oxygen, and other gases. So the company broke down its organic growth into actionable categories: The first 15 percent would come from incremental growth in the base business and new channels for serving current markets; the rest would come from new services, such as nitrogen injection of oil and gas wells, servicing the helium coolant used in magnets in magnetic resonance imaging machines, and developing new reactor cooling and nitrogen injection cooling methods for the bioscience industry.

"These initiatives grew out of intimate knowledge of changing customer needs that could be met with Praxair's existing capabilities," writes Day. "The lead role in exploring the market, articulating and screening the opportunities, and orchestrating the specific projects was assigned to marketing, with sustained top management support and oversight. As a clear signal of commitment, the CEO of Praxair spent 1 day per quarter reviewing the growth prospects for each business." Day adds that the payoff was immediate: The $200 million growth target was exceeded by $30 million in 2004.

Day says that the ideas presented in his paper began to come together several years ago when he attended a CMO summit conference on innovation sponsored by Wharton, McKinsey, and the Marketing Science Institute. "There was a persistent theme to the conversation: Our companies have scarce resources, and we're always pressured to think about the short term," Day notes. "At the same time, I had been reading about how process management methods, such as Six Sigma, tend to cut down on a company's willingness to take risks. It then occurred to me that maybe there was an increase in the tendency for companies to rely too heavily on what I call small i incremental innovations like product-line extensions, product upgrades, and feature improvements.

"If you have constrained budgets, these incremental efforts tend to soak up a lot of that budget at the expense of BIG I projects, which are risky and long term—so long term, in fact, that senior managers may no longer be with the company once the project finally is completed. Then I read a great study by another researcher, who demonstrated persuasively that there was a relative shrinking of innovations in corporate development portfolios. So the evidence was mounting that there was a trend working against BIG I innovation. That's when I asked, 'How can companies fight that tendency?'"

The antidote described in the paper, Day says, "is a disciplined process for realistically assessing the growth gap to be filled, expanding the search for opportunities, calibrating the risks, and using the latest thinking on screening, real option analysis, and partnering to contain but not avoid these risks." ■

Michael Porter Asks and Answers: Why Do Good Managers Set Bad Strategies?

ERRORS IN CORPORATE STRATEGY are often self inflicted, and a singular focus on shareholder value is the "Bermuda Triangle" of strategy, according to Michael E. Porter, director of Harvard's Institute for Strategy and Competitiveness.

These were two of the takeaways from a recent talk by Porter—entitled "Why Do Good Managers Set Bad Strategies?"—offered as part of Wharton's SEI Center Distinguished Lecture Series. During his remarks, Porter stressed that managers get into trouble when they attempt to compete head-on with other companies. No one wins that kind of struggle, he said. Instead, managers need to develop a clear strategy around their company's unique place in the market.

When Porter started out studying strategy, he believed most strategic errors were caused by external factors, such as consumer trends or technological change. "But I have come to the realization after 25 to 30 years that many, if not most, strategic errors come from within. The company does it to itself."

Destructive Competition

Bad strategy often stems from the way managers think about competition, he noted. Many companies set out to be the best in their industry and then the best in every aspect of business, from marketing to supply chain to product development. The problem with that way of thinking is there is no best company in any industry. "What is the best car?" he asked. "It depends on who is using it. It depends on what it's being used for. It depends on the budget."

Managers who think there is one best company and one best set of processes set themselves up for destructive competition. "The worst error is to compete with your competition on the same things," Porter said. "That only leads to escalation, which leads to lower prices or higher costs, unless the competitor is inept." Companies should strive to be unique, he added. Managers should be asking, "How can you deliver a unique value to meet an important set of needs for an important set of customers?"

Another mistake managers make is relying on a flawed definition of strategy, said Porter. "'Strategy' is a word that gets used in so many ways with so many meanings that" it can end up being meaningless. Often corporate executives will confuse strategy with aspiration. For example, a company that proclaims its strategy is to become a technological leader or to consolidate the industry has not described a strategy, but a goal. "Strategy has to do with what will make you unique," Porter noted. Companies also make the mistake of confusing strategy with an action, such as a merger or outsourcing. "Is that a strategy? No. It doesn't tell what unique position you will occupy."

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A company's definition of strategy is important, he said, because it predefines choices that will shape decisions and actions the company takes. Vision statements and mission statements should not be confused with strategy. Companies may spend months negotiating every word, and the results may be valuable as a corporate statement of purpose, but they do not substitute for strategy.

In the last 10 years or so, Porter added, companies have become increasingly confused about corporate goals. The only goal that makes sense is for companies to earn a superior return on invested capital because that is the only goal that aligns with economic value.

Recently, companies have developed "flaky metrics of profitability," he said, pointing to amortization of good will as an example. Some of these measures began as a way for managers to stay a step ahead of the demands of Wall Street. "What starts as a game for capital markets then starts to confuse the managers themselves. They [then] make decisions that are not based on fundamental economics."

> Managers often tend to let incremental improvements in operations crowd out the larger strategy of building a unique business that will retain its competitive advantage.

Porter said the "Bermuda Triangle of strategy" is confusion over economic performance and shareholder value. "We have had this horrendous decade where people thought the goal of a company is shareholder value. Shareholder value is a result. Shareholder value comes from creating superior economic performance."

To think that stock price on any one day, or at any one minute, is an accurate reflection of true economic value is dangerous, he noted. Research shows companies can be undervalued for years. Conversely, during the Internet bubble, managers whose motivation and compensation were tied to stock price began to believe and act as if the share price determined the value of the company. Managers are now beginning to understand the goal of their companies is to create superior economic performance that will be reflected in financial results and eventually the stock price. "We know there's a lag and it's ugly. But it's important that a good manager understands what the real goal is—not spend time pleasing the shareholders."

Corporate strategy cannot be done without strong quantitative analysis, said Porter, adding that each year students take his strategy course thinking they will have at least one class in which they don't have to worry about numbers. Not true. "Any good strategy choice makes the connection between the income and the balance sheet."

Right Time, Right Price

Companies hoping to build a successful strategy need to define the right industry and the right products and services. Bad strategy often flows from a bad definition of the business, said Porter.

He pointed to Sysco Corp., the number-one foodservice supplier in North America. Defining Sysco simply as a food distribution firm would eventually lead to a failed strategy. The industry is actually two distinct sectors. One delivers food to small restaurants and institutions that need help with finance and product selection. The other has large, fast-food franchise customers, like McDonald's, that are not interested in any additional services. McDonald's just wants industrial-size containers delivered on time at the best price. Sysco has developed two separate strategies for its two customers.

Geographic focus is another type of business definition that can trip up strategy. He gave the example of a U.S. lawn care company that developed a plan to grow through international expansion. The business, however, was not suited to operating on a global scale. The products were bulky and expensive to ship, and the company had to deal with different retail channels in different regions.

One more mistake managers make is confusing operational effectiveness with strategy. Operational effectiveness is, in essence, extending best practices. Good operations can drive performance, Porter said, but added "The trouble with that is it's hard to sustain. If it's a best practice, everybody will do it, too."

None of this is easy, he conceded. "The real challenge of management is you have to do these things together at the same time. You have to keep up with best practices while solidifying, clarifying, and enhancing your unique positions."

Managers often tend to let incremental improvements in operations crowd out the larger strategy of building a unique business that will retain its competitive advantage, Porter noted. To bypass this problem, managers must keep the competitive strategy in mind at all times. "Every day, every meeting, every decision, has to be clear.... Is this an operational best practice or is this something that's improving on my strategic distinction?"

He went on to describe key principles of strategic positioning, including a unique value proposition, a tailored value chain, clear tradeoffs in choosing what not to do, and strategic continuation or ongoing improvement. The underpinnings of strategy are "activities that fit together and reinvigorate each other."

Enterprise Rent-A-Car is an example of a company that stumbled onto its strategy more or less by luck, according to Porter. The company started as an auto-leasing firm, but customers frequently asked if they could rent cars for short periods. The rental car industry was completely geared toward travelers, with pickups at airports and a price structure suited to expense accounts or vacationers willing to splurge.

It is difficult to sustain the kind of strategic advantage Enterprise enjoys without a patent, Porter pointed out. Hertz has tried to connect with this business but remains geared toward the traveler and cannot compete with Enterprise in its specific market.

Porter stressed that continuity is critical to successful strategy. "If you don't do it often, it's not strategy," said Porter. "If you don't pursue a direction for 2 or 3 years, it's meaningless." Many companies start out with a good strategy, but then grow their way into failure, Porter continued. Research shows that among companies that fade in 10 years, many enjoyed phenomenal growth in the beginning but then put growth ahead of sticking to their strategy.

Dividends are one way to avoid the pressure to boost stock price with rapid growth, Porter said. Dividends also return capital to all investors, not just short-term investors who benefit from trading on gains in share price.

Leadership and Strategy

Porter cited some capital market biases that result in barriers to strategy. First, Wall Street tends to create pressure for companies to emulate their peers. He said analysts often anoint a star performer in each industry, which encourages others to follow that company's game plan. Again, this leads to the no-win approach of companies competing on the same dimensions, not on unique strategies.

Analysts also tend to choose metrics that are not necessarily aligned with true value or meaningful for all strategies, said Porter, noting that analysts apply pressure to grow fast and have a strong bias toward deals, which lead to a quick bump in the stock early on. Managers are made to feel like "Neanderthals" if they resist mergers and acquisitions or other financial market tactics, he added. "What happened in a lot of companies was that the equity compensation was [tied to share price], and people became crazed and very attentive to these biases. All the corporate scandals came from pressure to do things that were stupid."

Other barriers to strategy include industry conventional wisdom, labor agreements or regulations that constrain choice, inappropriate cost allocation to products or services, and rapid turnover of leadership. Increasingly, he is struck by how important leadership is to strategy. "Strategy is not something that is done in a bottom-up consensus process. The companies with really good strategy almost universally have a very strong CEO, somebody who is not afraid to lead, to make choices, to make decisions." Strategy is challenged every day, and only a strong leader can remain on course when confronted with well-intentioned ideas that would deviate from the company's strategy. "You need a leader with a lot of confidence, a lot of conviction, and a leader who is really good at communication."

Years ago, corporate strategy was considered a secret known only by top executives for fear competitors might use the information to their advantage, said Porter. Now it is important for everyone in the organization to understand the strategy and align everything they do with that strategy every day. Openness and clarity even help when coping with competition. "It's good for a competitor to know what the strategy is. The chances are better that the competitor will find something else to be unique at, instead of creating a zero-sum competition." ■

Forging a Steel Giant: Mittal's Bid for Arcelor

ALARM BELLS SOUNDED in the global steel market on Friday, January 27, 2006, when Mittal Steel, the world's largest manufacturer of steel, launched a whopper of an offer in that highly fragmented sector. Mittal made a hostile bid worth €18.6 billion for Arcelor, its main competitor.

The offer by Mittal—which is run by Lakshmi Mittal, the third-richest man in the world—is the highest in the history of the steel industry. It calls for exchanging four Mittal shares plus €35.25 in cash for every five shares of Arcelor. The offer values shares of Arcelor at €28.21 each, which means that it involves a premium of 27 percent over the closing price on the stock market the day before.

Arcelor's senior executives saw the offer as hostile from the very first moment. Its board of directors called an urgent meeting on the afternoon of Sunday, January 29, where it unanimously rejected the offer. In addition, Arcelor—which is itself the product of a merger in 2002 between Luxembourg's Arbed, France's Usinor, and Spain's Aceralia—recommended that its shareholders reject the Mittal offer. One of the arguments given by Arcelor's board to justify a rejection is that Arcelor and Mittal do not share the same strategic vision, the same model for development, or the same values. "Arcelor is not going to share its future with Mittal," Guy Dollé, president of Arcelor, told a press conference.

Coordination of the Sector

The deal left experts in shock because although Mittal is quite accustomed to expanding its base through acquisitions, it is now daring to confront a company that ranks second in the steel sector in terms of production and first in terms of revenues. In addition, notes Esteban García Canal, professor of business administration at the University of Oviedo (Spain), "What makes this deal unique is that this is the steel sector. Until very recently, this business was protected by the governments, and no one thought that companies could make hostile takeover offers on this scale, despite the fact that the sector was in the process of consolidation."

According to Wharton Professor Mauro Guillén, "Mittal wants to grow, to strengthen itself, and to eliminate competitors in a mature sector where costs are a fundamental factor." For his part, José Mario Álvarez de Novales, a professor of strategy at the Instituto de Empresa in Madrid, explains that Mittal's interest in Arcelor is based on the type of production each company is involved in. "Mittal produces low-cost steel, so it has factories in countries where labor costs are low, and its mills are located near mines and close to markets where there is a lot of demand. In contrast, Arcelor produces steel for industries that demand higher quality products, such as the auto sector." As a result, "Mittal's offer is an attempt to enter the higher range of the steel industry as well as new markets where the company does not have any production facilities," he adds.

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What would happen if the deal succeeded? It would create an enterprise with total revenues of some $69 billion, a market capitalization of some $40 billion, and a global market share of about 10 percent. The new Mittal would become the first steel company to produce more than 100 million tons of production a year, three times the production volume of its closest rival, Japan's Nippon Steel.

According to Victor Pou, a professor of management at IESE, the Spanish business school, "The deal is an attempt to make the two companies complementary." If it were approved, he adds, "Arcelor would bring innovation and technology, and Mittal would achieve greater geographic reach and have access to more raw materials. From the strategic point of view, there are many synergies between the two companies."

Beyond the fact that Arcelor is an obvious opportunity for Mittal to gain size and acquire access to new markets, "The European steelmaker [Arcelor] is Mittal's main rival, not only in the market but when it comes to making other deals for acquiring other competitors," adds García Canal.

European Politicians to the Rescue

In principle, there is no reason to believe that the deal could fail because of any problems involving its impact on competitiveness. "This deal does not mean any limitations in terms of competitiveness for other companies in the sector," notes Pou. "We are talking about the steel market, which has a very low level of integration and where there is a lot of room for this type of deal. If you add up the market shares of the two companies, you barely exceed 30 percent, so this would not have any impact on competitiveness in the market or on the activities of other companies." The president of Arcelor himself has also acknowledged that there are no problems regarding competition, especially if Mittal were to sell Canada's Dofasco, which Arcelor recently purchased, to Germany's ThyssenKrupp.

Nevertheless, Dollé has pointed out a serious challenge for the merger: The contrasting business cultures of the two companies could make it hard for the deal to succeed. Dollé believes that Mittal Steel's idea of good governance practices are not the norm in Europe. The Indian family itself controls 97 percent of the company's capital, and the son of the company's president is also its director of finance and its managing director. In addition, Lakshmi Mittal owns shares that have two votes each, which would guarantee him control of the resulting group. He would have more than 50 percent of the ownership rights and 64 percent of the voting rights. Moreover, in Luxembourg, where Arcelor has its headquarters, it is not permitted to issue shares that have double voting power.

Arcelor has also said that it is worried about the consequences this deal would have for its shareholders, employees, and customers. As a result, Arcelor has mobilized European politicians in an attempt to prevent the deal from moving forward. The three countries involved in the deal—Luxembourg, France, and Spain—have already rejected the acquisition offer. "It is the first time that I have seen a deal that seems to be so poorly prepared," said Thierry Breton, France's minister of economics. Breton also insisted that Arcelor should have a "European character."

Luc Frieden, Luxembourg's treasury and budget minister, and Jeannot Krecké, the country's minister of economics and trade, declared that "the social and cultural model of Arcelor has our firm support." Luxembourg is not only the headquarters of Arcelor, but it is the chief shareholder of Arcelor, owning 5.6 percent of its shares. The government of Spain, the third player in the deal, said that it would study the impact of the move on employment and activity in the 18 plants Arcelor operates in Spain. "We will act in consonance with the rest of the European countries that are involved in this operation, especially with France and Luxembourg," declared Pedro Solbes, second vice-president of the Spanish government.

The three European governments seem to have forgotten that Mittal Steel has its headquarters in Holland and that Lakshmi Mittal owns important businesses in the United Kingdom. His main residence is in London. In addition, they have been overlooking the fact that Germany's largest steel producer, ThyssenKrupp, would benefit from this deal, since it would be able take over Dofasco.

Although Luxembourg is the largest shareholder in Arcelor, Guillén believes that "it is a country that is very small when it comes to playing an important role." In addition, "the Luxembourg government's 5.6 percent [ownership stake] may not carry enough weight to prevent the takeover offer," notes García Canal. For his part, Alvarez de Novales believes "France can make a lot of trouble, given its tendency to rescue French companies, as it has shown on other occasions."

García Canal notes that "beyond the defensive maneuvers that the management of Arcelor can carry out with the backing of [European] politicians, the success of the deal depends on two other groups: shareholders [of Arcelor] and officials at the agency that enforces [European] competition laws. From the viewpoint of shareholders, Arcelor's high free float of 80 percent makes it feasible that Mittal could achieve the 50-percent level [of shares] necessary for taking control." Nevertheless, he adds, "The Indian steel manufacturer should convince institutional investors by making credible commitments to improve its [Mittal's] corporate governance, since the deal would take place largely through an exchange of shares. If the deal involved cash, it would be more attractive for shareholders."

A Company Formed by Writing Checks

Mittal Steel is the result of a long line of acquisitions based on a simple strategy: acquire money-losing companies owned by formerly public enterprises, make investments to reduce their production costs, and expand their capacity. "This strategy has always worked well for it, and shareholders have never punished the company on the stock exchange when it announced another acquisition," explains Álvarez de Novales.

This path to growth, notes García Canal, "is a common way to do things in sectors that are highly cyclical, since it means not adding new capacity to the industry during periods when demand contracts, and it enables a company to rapidly take advantage of growth opportunities."

Lakshmi Mittal has spent his entire life in steel. At the age of 21, he began working in the steel plant his father owned in India. Years later, he founded his own steel company in Indonesia. Over time, he added new factories in former Soviet republics and other emerging markets, creating his own empire of steel. Now the Mittal family owns 88 percent of the world's largest steel company. Its most recent purchase, last year, was International Steel, the U.S. company, at a cost of $4.5 billion. Mittal Steel is now using the same strategy to challenge the sector by presenting an offer for its closest rival. Mittal may already be the leader in the United States and Asia, but it could soon reach the top spot in the European rankings. ■

Indian Companies Are on an Acquisition Spree: Their Target? U.S. Firms

RELIANCE GATEWAY NET, VSNL, SCANDENT, and GHCL aren't exactly household names in the U.S., but they may be signs of bigger things to come.

These are only a few of the growing number of Indian businesses that have acquired U.S. firms in the past few years. And the U.S. merger-and-acquisition activity is just part of a bigger picture. Indian companies—usually quietly, but sometimes with media fanfare—have been on a buying spree in continental Europe, Great Britain, and Asia in attempts to become key players in global markets.

What accounts for all the M&A activity? Faculty members at Wharton and a New York investment banker who is advising an Indian firm on the acquisition of a chain of U.S. jewelry stores point to a combination of factors—means, motive, confidence, and opportunity.

"Over the last decade, Indian firms in various industries—most visibly in information technology but also in areas like auto components, the energy sector, and [food products]—have been slowly building up to become emerging multinationals," says Wharton Management Professor Saikat Chaudhuri. The outsourcing phenomenon, in which Western firms have hired Indian companies for call center work and other tasks, has reaped benefits for Indian managers, exposing them to Western companies and management practices and, at the same time, demonstrating to non-Indian firms that India is a reliable source of low-cost, yet high-quality, products and services.

Moreover, Indian firms are becoming more profitable—the result, in part, of an ever-booming economy—and can access significantly more capital than in the past. "Incomes have grown phenomenally in some companies in some sectors," says Anil Kumar, managing partner at Virtus Global Partners, an investment and advisory firm with offices in the U. S. and India. "But the biggest factor [in the growth of acquisition activity] is that suddenly, there's a lot more cash available in the Indian market than earlier on. Many companies are underleveraged; they don't have much debt. Their capacity to borrow from others is a lot better. They can borrow sizeable amounts of cash, which can be deployed for acquisitions."

> A combination of factors—means, motive, confidence, and opportunity—account for the recent Indian M&A activity.

A number of Indian firms see global markets, not the domestic market, as their chief pathway to growth. "If you are a large company, you have to have a good presence in the U.S," Kumar notes. Another factor: "India is much more confident now. Companies are taking a lot more risk than earlier on." Astute managers, he adds, "are realizing that taking on risk [can be] a good thing."

In addition, regulatory changes in India have made it easier for firms to acquire overseas companies. For example, World Trade Organization rules governing quotas on the importation of textiles into developed countries were lifted in 2005, sparking an increase in the ability of Indian firms to produce apparel for non-Indian markets, according to Kumar.

There is also an element of pride in Indian firms being able to make acquisitions in America, Kumar notes. "It means [Indian companies] have come of age and are better managed than they were 10 years ago. To acquire U.S. companies, you need to…have a good capital base and fundamentals in place. This is a sign that India companies can truly compete on a global basis."

Jagmohan S. Raju, a Wharton marketing professor, says that restrictions imposed by New Delhi on the amount of foreign exchange that was allowed to enter India have also been relaxed. "Now the country is flush with foreign exchange. Indian companies [that have acquired overseas firms] sell products in dollars and take part of that money to India, some of which ends up in government coffers."

Yet another factor spurring the acquisition spree: Indian companies have greater power to raise money in U.S. capital markets because investors have grown more familiar with businesses in India, says Raju, adding that in general, the increase in acquisition activity has less to do with the Indian government proactively encouraging it than with the government removing barriers to M&A deals. "The roadblocks are gone," he says.

An Array of Acquisitions

The increased interest in U.S. acquisitions by Indian firms comes against a broader backdrop of accelerated acquisitions by Corporate India of companies in many places. In the first 9 months of 2006, for example, Indian companies announced 115 foreign acquisitions with a value totaling $7.4 billion, according to *The Economist.* That is roughly a seven-fold increase from 2000.

A report by Grant Thornton India shows that the largest proportion of outbound deals (Indian companies acquiring international companies) in 2005 occurred in Europe (50 percent of deal value), followed by North America (24 percent of deal value). The report says that the IT sector saw the lion's share of outbound M&A deals in 2005, with 23 percent of the total number of international acquisitions, followed by pharmaceuticals/health care/biotech (14 percent). As for deal value, telecommunications led the way with a 33.6-percent share of deal value, followed by energy (14 percent), IT (8 percent), and steel (6.5 percent).

The Grant Thornton India report notes three significant trends in cross-border M&A activity by Indian firms in 2005. First, more than half the deals were cross-border: 58 percent of deal value, amounting to $9.5 billion, and 56 percent of deal volume at 192 deals. Second, there were more outbound deals than inbound deals both in value and volume terms. Third, while Indian companies "have acquired several businesses overseas to get an international footprint, most of these outbound deals have been lower-volume deals, showing that Indian businesses are treading carefully and minimizing their risks through value buys."

One major U.S. acquisition took place in February 2006 when GHCL, based in the state of Gujarat, India, acquired Dan River, a Danville, VA-based maker of home textiles for $93 million ($17 million in cash and the assumption of $76 million in debt).

Kumar calls the Dan River deal precedent-setting in that it may inspire other Indian companies to look for turnaround situations in their quest for U.S. acquisition targets. "Many companies have robust management and great operations, but their industry is not doing well—for example, the textile industry," Kumar notes, adding that Dan River had many mills inside the U.S. but was facing significant challenges and was competing with low-cost providers outside the country. "GHCL bought Dan River for more than $90 million, shut factories, and started sourcing [its raw materials] from India. A year later, Dan River is doing a lot better. It turned a profit in October."

Also making major moves in 2006 were members of the Tata Group, a major Mumbai-based conglomerate with interests in, among other things, steel production, transportation, software, and hotels. In June, Tata Coffee paid $220 million to buy Eight O'Clock Coffee, a venerable U.S. brand. In August, Tata Tea paid $677 million for a 30-percent stake in Glaceau, a maker of vitamin water in Whitestone, NY.

According to statistics compiled by the Mape Advisory Group, there were a number of noteworthy acquisitions by Indian companies of U.S. firms from January 2000 to March 2006. They include Reliance Gateway Net's acquisition of Flag Telecom in 2003 for $191.2 million; the purchase by Mumbai-based VSNL of Tyco Global Network, a submarine cable network, from Tyco International, based in New Jersey, for $130 million in 2004; and the acquisition by Bangalore-based Scandent of Cambridge Services Holding, a global outsourcing firm headquartered in Greenwich, CT, in 2005 for $120 million.

Diamonds: A Dealmaker's Best Friend

Many of Corporate India's cross-border acquisitions have involved such stalwarts as chemicals, IT, steel, and pharmaceuticals. But sometimes action in the M&A space can take a glamorous turn: Kumar is currently advising an Indian company in its negotiations to buy a chain of 100 U.S. jewelry stores. Kumar declined to identify the firms involved but agreed to discuss the reasons for the Indian company's interest in making a U.S. acquisition.

India has long been known as a center for the cutting, polishing, and manufacturing of quality diamond jewelry, which is sold to retail stores worldwide. Today, Indian companies are increasingly moving into the area of jewelry design. But India's diamond experts have worked largely behind the scenes, away from the eye of consumers. The acquirer Kumar is advising, however, would be able to place its name front and center before U.S. jewelry customers. The U.S. jewelry market is divided roughly into thirds among retailers. Department stores hold about 38 percent of the market, while mall chains like Zales have 35-percent market share and independent stores the remainder, Kumar says.

According to studies, companies don't pay sufficient attention before the merger to the post-merger integration issues that need to be addressed.

Competition in the diamond business is intensifying, and branding is one way to differentiate oneself. "China is becoming big competition for Indian companies," according to Kumar. "So Indian companies are saying, 'How do we go up the value chain?' Branding is one way to do that for customers who buy from Tiffany's and Zale's as opposed to an outlet store."

Kumar's client also is looking to increase its profit margins and improve its pricing power over what it sells. "You do this by selling [directly] to customers," he says. "This is the question our company has been facing. It's hard for them to compete with up-and-coming value-diamond suppliers. So they said, 'Maybe [it would be better] if we were right in front of a customer by buying a chain that will help us increase margins in our business.'" Kumar says the chain being acquired is a well-known brand, which allows them to charge higher prices than sellers of value-diamonds.

The goal of the acquiring firm is to keep the management of the acquired chain intact. "They will not try to shake the tree," says Kumar. "U.S. companies tend to shake the tree right away. Many times that's why mergers fail in the U.S."

Post-Merger Integration

Indeed, Indian companies may be excited about their cross-border shopping spree, but Wharton Management Professor Raphael (Raffi) Amit says enthusiasm is no guarantee of a successful merger.

"Whenever companies in India, Korea, Israel, or anywhere [do cross-border acquisitions], the problems they encounter are a different culture, different managerial norms, different compensation, and a different regulatory environment," Amit says. "Unfortunately, the literature shows companies don't pay sufficient attention before the merger to the post-merger integration (PMI) issues that need to be addressed. PMI is a major barrier that firms face as they try to operate as one entity."

Amit's advice to Indian companies considering cross-border mergers would be to "pay close attention to the issues associated with PMI before agreeing to buy a company. That relates to understanding the strategic considerations and the merits of such an acquisition; market considerations that relate to the process by which companies agree on the terms of the acquisition; and post-acquisition issues that deal with the degree and scope of the integration, compensation for executives, and managerial-norm issues."

Looking ahead, Kumar of Virtus Global Partners sees cross-border deals by Indian firms increasing in number and changing in nature. "Only the big deals get mentioned in the newspapers, but there are a lot of small- and mid-sized opportunities going on [in the $20 million to $60 million range]," he says. "We see a lot of those happening in the next 4 or 5 years." Kumar predicts more M&A activity in industrial products, packaging, auto components, and textiles.

Wharton's Chaudhuri says that, like the diamond company being advised by Kumar, Indian companies in many sectors will, in years to come, seek out acquisitions that help them move up the value chain.

"Look at pharmaceuticals," Chaudhuri explains. "Everybody's doing so much research and development in India you can imagine they're trying to come up with their own independent, research-driven drugs that could be blockbusters worldwide. You can make the same point about high-quality, skilled people [in the diamond business]. In the IT sector, the future will also see firms moving up the value chain by doing more consulting work."

Chaudhuri adds that India's confidence in pursuing such deals will continue to strengthen. "The success that has been enjoyed so far has been due to self-confidence. That will only increase over time. In fact, we now see a reverse brain drain taking place. People who left are going back to India to start up firms or head the Indian operations of multinational corporations."

Corporate India, as it accelerates its cross-border acquisitions in years to come, will resemble China Inc. Says Chaudhuri: "Look at the amount of capital going into India and how the accounting and governance practices of the West are being adopted in India, like they are in China, and how Indian investors perceive opportunities in foreign markets. There's an analogy between Indian and Chinese companies. My prediction is 15 to 20 years from now, Indian and Chinese firms will compete with Western firms in all sectors around the world. It's good for everybody. It's part of the integration of the global economy, and it's important for India to participate in that." ■

Scrambling for Control of Hutch Essar—and a Piece of India's Mobile Phone Market

IT'S HARD TO SAY where valuation math ends and acquisitive ego begins with the current high bidding levels for Hutch Essar, India's second largest mobile phone services provider, which currently has 22.3 million subscribers and Rs. 5,800 crore in revenues ($1.3 billion). [As of January 2007], active bidders include the world's largest mobile telecommunications company Vodafone, the Anil Ambani-led Reliance Communications, and the Hinduja Group. Verizon Wireless of the U.S. is also said to be kicking the tires of a potential deal.

Others in the fray are Japan's NTT DoComo, Egyptian telecom operator Orascom, and other big-name investment banks, including Goldman Sachs, Blackstone, and Texas Pacific. Over the last month, Hutch Essar's valuation has doubled to $20 billion—the enterprise value that Hong Kong parent Hutchison Whampoa likes for its 67-percent stake with partners. The other 33 percent is owned by the Ruias of the Mumbai-based Essar group, who seem open to either running the entire company themselves or in partnership with others.

At first sight, it seems obvious why Hutch Essar's valuations climbed so rapidly to such high levels. India's current high economic growth makes it an attractive market for foreign investors. Also, it is not every day that one gets to control a big player in a tightly regulated policy environment where entry barriers are high. What's more, the country's mobile phone subscriber base is adding 6 million new subscribers each month and is fast approaching 200 million, or a tenth of the world's subscribers. *India Knowledge@Wharton* interviewed faculty members at Wharton and the Indian School of Business and other experts to get closer to the valuation metrics and see what is in store for a new owner at Hutch Essar.

At least two theories are floating around as to why Hutchison Whampoa wants to sell its stake in Hutch Essar. One is that the company badly needs the cash since it has committed up to

$30 billion in investments across Europe. The other is that Li Ka-Shing, the Hong Kong-based shipping and real estate baron who controls Hutchison, wants to cash out. "He is a fairly astute entrepreneur and, in the past, he has been known to sell when he thinks valuations have maxed out," says Saurine Doshi, partner at consulting firm A.T. Kearney in Mumbai. India's FDI regime prevents Hutch from buying out the Ruias of Essar and gaining complete ownership. Hutchison, however, would have to settle a dispute with Essar that recently arose and now seems headed for the courts. Essar claims that under its partnership agreement with Hutchison, it has the "right of first refusal" in case the latter sells its stake in Hutch Essar. Hutchison says that right of refusal is not a blanket agreement and is good only in specific circumstances.

It is not every day that one gets to control a big player in a tightly regulated policy environment where entry barriers are high.

Of the several possible configurations under consideration, the two most popular are first, a Vodafone-Ruia partnership and second, Reliance Communications buying out both Hutchison and the Ruias and merging it with existing operations. India's policy regime doesn't allow much elbow room in those scenarios: FDI rules require Vodafone or any foreign player to have a local partner holding at least 26 percent; and Reliance or any other company cannot own more than a 10-percent stake in two different operators.

GSM and 3G

The quicker tempo being set in the race for Hutch Essar is a testimony to the appeal of the Indian opportunity, says Ravi Bapna, professor and executive director of the Center for Information Technology and the Networked Economy at the Indian School of Business in Hyderabad. "This is as strong a signal as you can get—for the valuation to double in 6 months [to more than $20 billion] is totally unprecedented; it was $10 billion in June [2006]. Part of what people are responding to is the growth rate of mobile phone subscribers in the market as a whole. No country in the planet is adding 6 million customers a month, and the cost of handsets is going down."

Those higher valuations could be justified only with a couple of significant assumptions, says Bapna. "The key for the underlying valuation is the hypothesis that the Internet is going to be played on the mobile phone in India. This implies higher average revenue per user (ARPU) for the mobile operators, which, coupled with the explosive growth and potential in the subscriber base, is a deadly combination." He says Hutch Essar's new owner will expect the subscriber base to double in 2 to 3 years and also a doubling of the ARPU from current levels of between $10 and $20 a month.

Two other big attractions for international players in Hutch Essar are the opportunity to gain a significant presence on the GSM technology platform and a 3G opportunity that is coming up soon, says Doshi. GSM is the fastest-growing and most popular wireless standard, with penetration in more than 200 countries, according to the GSM Association, a trade group based in London. Third-generation (3G) services on the GSM platform would be made possible when those licenses are issued by the Indian government next year. "Part of the reason the [Hutch Essar] valuation is high is you are [getting] an option to buy 3G licenses in 2007-08 when preference will be given to the existing operators," says Doshi, adding that while the 3G market has been slow to take off in Europe, this technology is the way to go in the future, especially with the convergence of voice, data, and video.

A Skeptical View

Wharton Marketing Professor Peter Fader senses serious disconnects between what he calls the "base behavior of our species" and the valuation assumptions made by both bidders and sellers of companies such as Hutch Essar. The revenue promise held out by Hutch Essar's existing and projected subscriber base is often seen as crucially linked to how the service is priced and the functionalities it offers. Here is where the deal makers may be off-key, says Fader. "When it comes to, 'Should I keep this contract or not?' often it's the silly little things that make you stick around or leave. They are not necessarily big, major, obvious factors like the pricing policy." He says it is precisely because the swings could take place due to seemingly small issues in a mobile phone service—like "a goofy design aspect"—that it is difficult to pinpoint specific drivers.

"When you boil it all down to individual behavior, whatever the device is that they are holding in their hand, their tendency to stick with it or switch to a new one—and other kinds of very basic behavioral patterns—will still be largely the same in 10 and 20 years as it is today, even though the functionality being delivered is different," says Fader. "That's a point I'm willing to stand by, and it's a fairly radical point."

Fader and Bruce Hardie, a marketing professor at the London Business School, did capture some of those behavioral patterns in a June 2006 study entitled, "Customer-Base Valuation in a Contractual Setting: The Perils of Ignoring Heterogeneity." They say in their paper that M&A deal makers have, in recent years, relied increasingly on extending the concept of customer lifetime value (CLV) to value a customer base. "The application of standard textbook discussions of CLV sees us performing such calculations using a single aggregate retention rate," the researchers write. But these retention rates typically increase over time due in large part to a "sorting effect" in a heterogeneous population. "Failure to recognize these dynamics yields a downward-biased estimate of the value of the customer base," they suggest.

In making such flawed assumptions, Fader feels sellers are "just being naïve; they're only hurting themselves and they are leaving so much money on the table when they do these valuations." Mobile phone customers are no different in their behavioral patterns than purchasers of other consumer products like magazine subscriptions, he adds. "There is enormous heterogeneity among customers in every contractual database I've ever seen. In other words, for every person who's going to churn the instant he is able to do so, there's another person who's completely, blindly loyal and foolishly will keep his contract forever. And so the real key here is to capture the variability across customers. Too often, what these firms are doing when they make their calculations is they are assuming an average customer. In doing so, and in ignoring the variability across customers, they end up systematically undervaluing the future value of the customer base, which is really what it is all about."

Wharton Marketing Professor Raghuram Iyengar has closely studied the impact of pricing strategies in the U.S. mobile phone services market. He says the concept of CLV, which combines profits per customer and the retention rate, gained currency as a valuation tool during the tech boom of the late 1990s. At that time, "a lot of companies in this space were not making profits, but they had big customer bases."

The key factors in analyzing the enterprise value of a mobile phone services provider include the ARPU, the retention rate of customers, the cost of capital, and the costs of customer acquisition. With a natural limit on the number of minutes each customer could conceivably use each month, the best opportunity to increase revenue per subscriber is in providing value-added services that command a premium. Having said that, it is the retention rate that has the maximum impact on the company's valuation, says Iyengar.

Pointing to a November 2006 report from Verizon for its latest quarter, Iyengar says the company is "extremely happy about the fact that its churn rate is 1.3 percent per month—one of the best in the industry—because it ensures that their customer lifetime value will be high." Verizon had posted the fourth consecutive quarterly drop in its churn rate, which measures defecting customers. The churn rate in the U.S. wireless phone services market is between 1.5 percent and 2 percent per month. Cingular Wireless last quarter reported a churn rate of 1.8 percent, up slightly from 1.7 percent in the prior quarter; T-Mobile's churn rate also edged up, from 2.2 percent to 2.3 percent, over the past two quarters.

Keeping Customer Churn Low

A. T. Kearney's Doshi says that, as with other global majors, customer retention will be the top challenge Hutch Essar's new owners will face. "Customer churn is high across the world for mobile users, but higher in India," says Doshi. "The only way [mobile phone services companies] do it globally is by strengthening customer relationships; price becomes a factor, in addition to service levels and dropped calls. Once you have parity on those dimensions with all others, you need to adopt an end-to-end customer touch model." Doshi says at that stage, the key issues include convenience in the billing and payment cycle, the resolution of customer problems, and "customer reach"—how companies proactively reach out to customers on an ongoing basis with new options and offers. "In sum, the big challenges facing Hutch Essar will be how to reverse the ARPU decline and how to put in place a leading end-to-end customer relationship model," says Doshi.

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He tempers an optimistic outlook with other, more sobering considerations. In the short term, he says, the challenges a new owner faces will be in customer retention and ARPUs. "While everything started with a bang [a few years ago], most operators have seen a decline in their ARPUs," he says. Hutch Essar's ARPUs of Rs. 375 a month ($8.50) compares with industry averages of Rs. 325 ($7.30), according to Doshi, who adds that Hutch Essar's current ARPU levels have actually fallen from levels of Rs. 450 about 18 months ago and that they have declined at a faster rate than those of others. "Initially, customers were thrilled with the mobile phone, but now they have started optimizing their use," says Doshi. "That is one thing that [any potential buyer] will have to deal with."

If trends in the U.S. mobile phone services industry could point to things to come in the Indian market, a simple expression that Iyengar employs to arrive at customer lifetime value is useful: "M" multiplied by "R," divided by 1+I-R, where "M" stands for the margin per customer, "R" for the retention rate and "I" for the cost of capital. The ARPU in the U.S. market is currently around $50 a month, Iyengar says. Assuming a margin of 45 percent and the churn rate at 1.5 percent a month (or 18 percent annually, meaning a retention rate of 82 percent), Iyengar arrives at $790 as the customer lifetime value.

If one applies those ARPU numbers, profit margins and retention rates to Hutch Essar's 22.27 million existing customer base, the total value works out to $17.6 billion. That, incidentally, is close to the $17.4 billion that Goldman Sachs believes is the appropriate break-even price its client Vodafone should keep in mind. Goldman Sachs further said that Vodafone would be overpaying if it valued Hutch Essar at more than $20 billion. Hypothetically, if one assumed a higher customer retention rate of 90 percent (instead of 82 percent), the enterprise value shoots up to $26.75 billion. In contrast, with other things being equal, a lower capital cost of say, 7 percent, pushes up the enterprise value to $19.5 billion.

Doshi feels Hutch Essar's price tag is on the high side: "At $20 billion, that's almost $1,000 a user," he says. He points to China Mobile's failed bid last July to acquire Millicom International Cellular SA of Luxembourg, a provider with then about 10 million subscribers across Latin America, Africa, and South Asia. (Its current subscriber base is closer to 13 million; and like Hutch Essar, it, too, is adding about a million subscribers a month.) By the time the deal talks failed, China Mobile had offered $5.3 billion for Millicom, or about $500 a customer. The company had the added attraction of licenses in 16 countries, including Chad, Bolivia, El Salvador, and Cambodia, with a combined market of 400 million people.

Hutch, Hunch, IRR, or Instinct

Fader suspects the valuation math in deals like Hutch-Essar is far from scientific, basing his assessment on statements in corporate financial documents. "I've never seen a case where a company has estimated customer retention—or at least admitted to doing it—in a manner that their shareholders should insist upon," he says. "They are using very crude estimates of retention; they are assuming that they are constant across customers or over time rather than capturing the huge dynamics that take place there."

India's mobile phone services market is quite different from that in the U.S., says Bapna, and he points to India's higher growth in data traffic as one example. "Voice usage levels aren't likely to increase dramatically; you can make more money from data and multimedia applications and from residential middle-class and enterprise users," he says. "Startup businesses are developing software for seamless video conferencing and other applications for the mobile phone. It's like taking a salesforce.com application and pushing it on the mobile phone."

Fader agrees that the mobile phone industry is in "a time of unique change" but is equally skeptical about the long-term projections floating around. "People who sit around and say what the landscape will look like, say, 10 years from now are fooling themselves," he suggests. "I think a lot of people have placed the wrong bets, if you look at the U.S. side. People talking about the nature and speed of convergence have been way off. It's really, really hard to say how it's going to play out." ■