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NEW PERSPECTIVES ON GLOBAL MARKETS

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CONSORTIUM STRETCHES THE LIMITS OF HOSTILE TAKEOVER

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WHEN REPUTATION MATTERS

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Manager Update helps the general manager keep abreast of the latest articles in specialist management journals in a number of key fields, such as strategy and organisation, marketing, accounting and finance, and human resources management, plus other contemporary issues (see Foreword, right).

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FOREWORD

THE BOP OPPORTUNITY

Chris Jackson
Head of faculty

Emma Riddell
Technical manager

The huge potential of countries such as China and India are regularly considered when developing a business strategy. The opportunities that they offer by way of newly affluent consumers and their educated workforces are well documented.

However, there is less discussion about the remainder of these populations (and those of other developing countries), ie, those identified as 'bottom of the pyramid' (BOP) consumers in our first article, *New Perspectives on Global Markets*. We found the examples of innovation in this article fascinating.

In *Finance & Management* 146 (July 2007) Joe Nellis predicted what would be the winning business sectors of the future. He discussed the blue ocean theory, as presented by Chan Kim and Renee Mauborgne, which identifies the advantages of concentrating on markets that are less aggressively exploited, ie steering clear of 'red ocean' markets, and instead seeking out 'blue ocean' markets that offer real opportunities.

It struck us that Ian Turner's article on page 4, which focuses on BOP consumers, identifies an interesting 'blue ocean' market. It suggests that some markets look much more attractive when consolidated. The example given, although contested, of low income households within emerging markets, totals an astounding $100bn.

Some companies have attempted to serve this untapped market by looking at how these potential consumers, with limited access to credit and with unique needs, can be catered for. For instance, in some impoverished rural areas, individuals cannot afford to own a mobile phone, but a village or family phone may be viable; one solution is the phone, developed by Nokia, that allows shared ownership on which several accounts can be run at the same time.

Other interesting issues include: the ideological divide between allowing customer choice versus the perceived exploitation of vulnerable customers; and the challenges faced when BOP individuals are enabled to become producers as well as consumers. Altogether, it is an interesting read and we hope you find this issue as stimulating as we did.

Finally, Roger Mills of Henley Management College, who has been closely involved with *Manager Update* as a contributor and later as an editor, has stepped down due to other commitments – we are very grateful for his consistently excellent work on this publication.

CHRIS JACKSON and EMMA RIDDELL

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NEW PERSPECTIVES ON GLOBAL MARKETS

Ian Turner, managing director at Duke Corporate Education (Europe & Africa) and visiting professor at Henley Management College

In *The World is Flat,* Thomas Friedman argued that 10 “flatteners” have created a shift in the world, including the creation of the web, outsourcing and ‘in sourcing’, HTML and ‘uploading’. Yet other writers have taken issue with Friedman’s theory of the “horizontalisation” of organisations – Richard Florida contends that the world is characterised by steep infrequent ‘peaks’ of global excellence in innovation and Pankaj Ghemawat suggests that most activity still operates at a local level. Furthermore, CK Prahalad recommends that companies challenge orthodox views about how to operate in developing markets, thus developing new business models that would both allow them to profitably address consumers at the bottom of the pyramid as well as contribute directly to the alleviation of poverty.

This article analyses the different approaches to economic development and looks at how to put ‘bottom of the pyramid’ (BOP) strategies into practice in the developing world and address the ‘poverty penalty’, so that the world’s four billion consumers who earn $2 a day or less can exercise more choice.

CONSORTIUM STRETCHES THE LIMITS OF HOSTILE TAKEOVER

Giampiero Favato, a director of the Henley Centre for Value Improvement

Last year witnessed the epic takeover battle between Barclays and The Royal Bank of Scotland Group plc for ABN AMRO, a landmark event in terms of the deal’s sheer size, despite group bidding having been used since the 1980s. Will the RBS consortium’s approach become a trend and thus open up potential corporate holdings that were previously thought out of reach? This article looks at the advantages and drawbacks of such an approach, such as the problem of diversification for conglomerates and the market’s tendency to value them at a discount to more focused companies.

The acquisition comes at a time when credit markets are in difficulty, limiting the ability to generate incremental business by issuing bonds for corporations. Consortium members Fortis NV and Banco Santander SA face a number of difficulties, as analysed by Moody’s who commented on the strategic fit with ABN AMRO’s businesses and the unstable rating outlook. It is important for the consortium to remember that if something goes wrong, activist shareholders will turn against their leaders.

REPUTATION IN THE PUBLIC SECTOR

Nuno da Camara, research fellow, The John Madejski Centre for Reputation, Henley Management College

Little has been published on reputation in the public sector, compared with the corporate and not-for-profit sectors. Yet despite the monopolistic nature of public service and the historically low levels of customer satisfaction in the public sector, the rise of efficiency targets has led to governmental institutions having to become increasingly performance-oriented. This article argues that the role of reputation and trust in improving stakeholder relationships in the public sector is being more widely valued.

The reputation of the public sector is closely linked to social legitimacy and levels of public trust, with almost everyone in the population being a stakeholder of public services. However, the ideal type of reputation in the public sector differs from the private sector: reliability and impartiality are more important than outward ‘success’ and one recent study advocates a ‘neutral’ rather than excellent reputation for public sector organisations. More research is required to gauge how best to measure reputation in the public service on both a qualitative and quantitative basis.

IAN TURNER

NEW PERSPECTIVES ON GLOBAL MARKETS

There are many opposing theories about the future of the international economy and globalisation. Is the world 'flat' or 'spiky' or does most of it still operate at a local level? How true of developing countries is the 'bottom of the pyramid' philosophy? **Ian Turner** assesses the different viewpoints on global integration.

The world is flat

New York Times columnist Thomas Friedman published his influential take on globalisation, *The World is Flat,* three years ago.[1] Although criticised by some for his overly journalistic and anecdotal approach to world trends, Friedman's book provided a compelling and coherent account of how the international economy and society is being shaped for the 21st century. Since the end of the Cold War, Friedman argues, 10 so-called 'flatteners' have created a massive shift in our world:

1 the fall of communism and the rise of Windows-based personal computers at the start of the 1990s democratised computing power and led to the near-universal adoption of free market economics;
2 the creation of the world wide web by Tim Berners-Lee and launch of the Netscape browser spelt the death of 'distance' by enabling people to connect irrespective of location at very low cost. For the first time, it enabled individuals and organisations to have a virtual, as well as a physical presence;
3 the emergence of standardised workflow software like HTML and XTML leading to the standardisation of key processes in organisations and enabling collaboration across organisational and national boundaries between members of the same team;
4 'uploading' – a phrase which Friedman has coined to describe the ability of consumers to create online communities like LINUX and Wikipedia, as well as more recent social phenomena like YouTube, MySpace and Facebook. This phenomenon also challenges the traditional approach to innovation in companies by substituting community-based open innovation processes;
5 the outsourcing of services to low cost regions like India – which were the main beneficiaries of the creation of fibre optic networks during the technology boom in the late 90s – enabling rapid growth of those developing or emerging countries that were able to tap into pools of educated talent;
6 the off-shore production of goods in low cost countries like China, Taiwan and Indonesia, where most products can be produced at a fraction of the cost of manufacturing in developed countries;
7 what Friedman terms 'supply chaining' as practised by the likes of Wal-Mart and Dell, where major companies are able to create a seamless global network involving collaboration between suppliers, producers and distribution channels to deliver, at low cost and with superior service, on-demand to customers, thereby reducing levels of inventory and making products available to a wide market;
8 'in sourcing' by logistics companies like UPS and FedEx who increasingly operate within their client companies to manage their supply chains more efficiently and accelerate the process of global specialisation;
9 'informing', where individuals are enabled to search for information and knowledge online quickly and efficiently through search engines like Google, which in turn make consumers better informed and more able to exercise their choice; and
10 the so-called 'steroids' of digital, mobile and virtual technologies which accelerate the flattening process precipitated by the first nine flatteners, reduce costs and empower consumers even more.

These 10 forces enabled the creation of global platforms to share work

Ian Turner, managing director at Duke Corporate Education (Europe & Africa) and visiting professor at Henley Management College.

Each of these forces individually, Friedman contends, is significant. Taken as a whole they represent what he characterises as a so-called 'triple convergence'. In other words, they created a tipping point enabling the creation of global platforms to share work irrespective of time, place or language. Second, they resulted in the 'horizontalisation' of organisations, enabling them to connect and collaborate within and across traditional boundaries, breaking down silos and creating more flexible approaches to innovation. Third, whilst all this is going on, three billion additional active consumers have joined the world economy from India, China and Russia – the new so called ‘emerging economies’.

The world is spiky

Inevitably, Friedman’s thesis attracted debate and criticism. One of the most prominent critics was Richard Florida. If Friedman’s approach is journalistic and impressionistic, Florida – as an economic geographer – favours a more analytical approach, developing his thesis from statistical analysis of data from population studies and other scientific research. In particular, Florida focuses on population statistics, which show where the world’s population is increasingly concentrated, on economic activity as demonstrated by satellite pictures of light emissions data, and on patent registrations and residency details for scientific citations.[2]

While Friedman and others argue for the decreasing relevance of national borders and governments, Florida draws our attention to the rising importance of urban concentrations. The statistics are startling. In 1800 only 3% of the world’s population lived in urban areas, but by 1950 this had increased to 30%. At present it is about 50% and rising. The more developed a country becomes, the greater the concentration of populations in urban areas. This concentration has resulted in the emergence of global ‘megacities’. But population on its own does not tell the whole story. When combined with a study of economic activity, this clustering of wealth and economic power into a few large peaks becomes even more pronounced. “The 10 largest US metropolitan areas combined are behind only the United States as a whole and Japan. New York’s economy alone is about the size of Russia’s or Brazil’s, and Chicago’s is on a par with Sweden. Together New York, Los Angeles, Chicago and Boston have a bigger economy than all of China. If US metropolitan areas were countries they would make up 47 of the biggest 100 economies in the world”.[3]

The geography becomes ‘spikier’ still when the focus shifts to innovation. A global map of commercial patent activity, for example, shows huge spikes in a few key Asian cities such as Tokyo and Seoul. There’s also a significant clustering in the East and West coast cities of the United States and parts of Europe. Outside these centres, activity is minimal. Take, for example, scientific citations, a metric for original research: the preponderance of innovative activity in the United States and Western Europe is striking.

For Florida, the world is not flat but characterised by steep infrequent ‘peaks’ of global excellence in innovation. These are interspersed with ‘hills’, where goods are manufactured, services carried out and support for innovation provided, but whose position as a location for economic activity is increasingly tenuous. Finally, there are vast ‘valleys’ of only primitive local activity, essentially unconnected with the global economy and the promise of future development. The implications of Florida’s geography are alarming. An elite global creative class of some 150 million people worldwide move easily between the world’s leading 60 regions and communicate routinely with colleagues around the world in places such as London or Tokyo. These ‘spikes’ are increasingly distanced from their immediate hinterland where impoverished rural areas are denuded of talent by the rush towards urban development. The emphasis on urban migration perhaps most starkly contrasts Florida’s thesis from that of Friedman and the other global prophets for whom globalisation heralded the ‘death of distance’. Florida, by contrast, maintains that talented and energetic individuals will increasingly migrate towards major urban areas where the infrastructure more readily supports their efforts.

There are vast ‘valleys’ of only primitive local activity, essentially unconnected with the global economy

Of course it is possible to take issue with Florida’s analysis as well, notably with his reliance on certain forms of data to support his arguments. Thus, as Kelly Davis has pointed out, innovation is not solely measured by patent or scientific activity.[4] Indeed, John Hegel’s work on co-creation and innovation in emerging markets would indicate that some of the emerging markets of the world have successfully adapted very rapidly to demonstrate extraordinary powers of innovation not captured by traditional measures. Hegel, for example, cites the Taiwanese original design manufacturers and Chinese motorcycle producers in Chongqing in this context.[5]

Why the world isn’t flat

Pankaj Ghemawat[6] is the most recent pundit to take issue with Friedman’s thesis. For him, the world is not nearly as connected as writers such as Friedman and Frances Cairncross[7] have contended. The real story, Ghemawat contends, is that most activity still operates at a local level. The total amount of the world’s capital formation that is generated from foreign and direct investment has been less than 10% in recent years. Only trade as a percentage of GDP would seem to exceed 20%. In fact, across a whole range of economic activity – ranging from charitable giving to revenue from phone calls and management research – the level of internationalisation is around 10%. Globalisation, Ghemawat believes, has been greatly exaggerated. Take, for example, the case of trade between close neighbours Canada and the US. Even after the NAFTA trade agreement, trade between Canadian provinces, ie within Canada, is still five times greater than the trade between

Canada and the US. These ratios only measure the level of integration for manufactured goods, whereas for services, which account for an increasingly larger proportion of the economy, the level of localisation is even greater. Nor do the so-called flatteners described by Friedman necessarily always promote global integration. As Ghemawat points out, web traffic within countries and regions has increased far faster than global communications: "People across the world may be getting more connected but they aren't connecting with each other – the average South Korean web user may be spending several hours a day online but he is probably chatting with friends across town and emailing family across country rather than meeting a fellow surfer in Los Angeles. We are more wired, but no more global."[8]

Surely, however, the trend towards greater global integration is inexorable? Not so, says Ghemawat. He admits that global foreign direct investment and trade has increased in recent years and economies like China, India and the Soviet Union have become more integrated. This, though, is a relatively recent trend and until the 1990s could be seen as a return to earlier levels of integration enjoyed before the First World War following long periods of stagnation and economic protectionism. In fact, Ghemawat sees signs everywhere that globalisation is under threat and the consensus around market economics is dissolving, notably in places like Latin America and the Soviet Union. In sum, the debate between Ghemawat and Friedman seems to revolve around how robust we think the trend lines are towards further global integration and the adoption of economically liberal policies and on how much corporate activity will be driven in the future by the continued importance of location, whether it's the urban clusters in Florida's argument or the time zones and proximity to market that Ghemawat focuses on.

The fortune at the bottom of the pyramid

Indian strategy guru CK Prahalad and erstwhile colleague Gary Hamel are responsible for many of the key concepts in modern strategic thinking, such as core competencies, strategic intent and dominant logic. A few years ago Prahalad, an academic working in the US, turned his attention to the issue of poverty eradication in developing countries. For Prahalad, the efforts of government-funded aid agencies to eradicate poverty over the last 30 to 40 years have failed: in vast parts of the Earth – such as rural areas of Africa, South America and Asia – millions of people remain stuck in poverty. If Prahalad was critical of government-backed initiatives, he was equally damning of the poverty of imagination exhibited by many businesses in emerging markets.[9] Too often companies in developing markets focus their attentions on the extremely wealthy at the tip of the social pyramid or more recently the rapidly emerging urban professional classes in places like India or China. Prahalad maintained that this focus was driven by false assumptions about the size and consumption patterns of poor people and that companies, by challenging orthodox views about how to operate in such markets, could develop new business models that would both allow them to profitably address consumers at the bottom of the pyramid as well as contribute directly to the alleviation of poverty.

Prahalad's thesis is based on the assumption that there are some four billion people in the world who earn on average two dollars a day or less. Thus, although their individual purchasing power is minuscule, their collective purchasing power constitutes a market that is difficult to ignore. Unfortunately, the bad news for the consumers at the bottom of the pyramid does not stop with limited income. Such individuals also suffer a so-called 'poverty penalty' due to local monopolies, parasitic landlords, inadequate access to products and services, poor distribution and powerful traditional intermediaries. To successfully address poverty in emerging markets, Prahalad maintains, companies have to create a capacity to consume at the bottom of the pyramid based on three principles – the so-called three 'As':

1. 'affordability' for consumers whose cash flow is typically unpredictable;
2. 'access', both in terms of location and times of day, to suit the needs of consumers who must typically work a full day before being in a position to be able to consume; and
3. 'availability' at the point when such consumers had cash available.

Prahalad then goes on to develop a philosophy for developing products and services to address the needs of the 'bottom of the pyramid' (BOP). The basic economics of success in such markets are based on the distribution of products like soap and medicines in small affordable unit packages. These are low margin per unit but, because of high volume and low capital intensity, generate a relatively high return on capital employed. Companies need to rethink their approach to product marketing in such markets and, in particular, move away from the traditional practice of marketing products from developed countries that have reached the end of their product life cycle to developing countries. Rather, success lies on the following principles:

1. creating, through new business models and technology, quantum leaps in price-performance to cater for low purchasing power;
2. deploying advanced and emerging technologies to generate radical hybrid solutions;
3. gaining scale by developing solutions that are transportable across countries, cultures and languages;

Companies have to create a capacity to consume at the bottom of the pyramid

4 reducing resource intensity through eliminating waste and packaging and maximising recycling;
5 developing products based on a deep understanding of the basic needs and social norms of consumers at the bottom of the pyramid;
6 focusing on process innovations such as developing logistics and distributions infrastructures;
7 designing products for consumers low in skills and education;
8 educating consumers on how to use products effectively;
9 developing products that work in demanding or hostile environments;
10 designing solutions/customer interfaces that are adaptable to differences in language, culture and skill level;
11 finding innovative ways of reaching consumers in dispersed rural markets at low cost; and
12 focusing on the broader architecture of the system or platform needed to address the bottom of the pyramid, so that new features can be subsequently and easily incorporated into the product offering.

BOP strategies in practice

There are many examples of BOP strategies quoted in Prahalad's book. To illustrate the issue let us focus on the challenge of extending mobile phone services to consumers in developing countries. More than two thirds of the world's population does not have affordable access to either voice or data communication. Mobile devices like phones have certain advantages over other forms of ICT when it comes to integrating these consumers in the knowledge economy. Users do not need to own a PC or have access to fixed line infrastructure, nor do they need to be computer literate. It is estimated that there are 680 million households in some 20 emerging markets round the world with incomes of less than $6,000, who are on average willing to spend 5% of their earnings on connectivity – equivalent to a market potential of more than one hundred billion dollars. With access to affordable handsets, shared usage and affordable tariffs, mobile communication can be made widely available, especially as many consumers use their mobiles to receive incoming calls only. Low top-up fees for prepaid services can be appealing to customers with less than a dollar to spend, but it must be simple for them to sign up and stay connected. Once mobile systems are in place, SMS messaging is also a popular service.

Many challenges have to be overcome to access this market. Service providers need to be able to operate profitably and lack of power and poor transmission can be a challenge in remote areas. Affordable handsets must be available for the market to grow and significant investment in infrastructure is required. For example, base stations in remote areas require innovative solutions like generators fuelled by locally produced biodiesel. Above all, for end consumers, it is critical to provide affordable and accessible start up packages. Prepaid offerings are required – no credit checks or contracts with simple ways to electronically refill subscriptions with small amounts are crucial to success. Above all, the take up in the market is dependent on the provision of ultra low cost cell phones available at end prices below $30 unsubsidised. By reducing the cost of phones a 'village' mobile phone can migrate to become a 'family' phone and ultimately a 'personal' phone. Some manufacturers of sets have already catered for this. For example, Nokia in emerging markets has a device designed for shared ownership where several accounts can be run at the same time on the same product.

Motorola, stimulated by a competition launched by the association of GSM networks in 2005, produced a number of handsets designed with the needs of emerging market consumers in mind. In late 2006 the company launched a product, which used innovative technology called electronic ink, which enabled the phone to be read even in bright sunlight. The phone appeared with a user interface that was easy to learn and use even for illiterate consumers with no proper experience, with voice prompt instructions that could be provided in local languages. With an ultra thin modern design the phone featured durable housing for optimal performance in exacting conditions, high volume for call clarity in loud environments and extended battery life. Critically, although modern in design and in appearance and using novel technologies, the phone was designed to provide only two key services – voice and basic SMS.

Although early days, the low cost cell phone, as produced by Motorola, Nokia and other providers, has the potential to transform the lives of consumers and producers at the base of the pyramid. Farmers can, for example, call ahead to find out the price their crops will fetch in advance of a long trip to market. Fishermen can check weather conditions before heading out to sea and small retailers can check the price of supplies more readily thus making them less dependent on monopoly suppliers.[10]

Misfortune at the bottom of the pyramid

Not everyone swallows the bottom of the pyramid proposition, however. Just as with the *World is Flat* argument, prominent voices take issue with Prahalad's thesis. Perhaps most vocal is Aneel Karnani, a Michigan colleague of CK Prahalad. Karnani contends that the BOP proposition is too good to be true and based upon false assumptions and arguments.[11] First, he argues, Prahalad and his colleagues have exaggerated the size of the market at the bottom of the pyramid. He thinks the market is much smaller and less attractive than Prahalad.

The costs for most companies of serving this market, he argues, will be so high that the products will either be too high for customers to purchase or too low for companies to make a reasonable return. Selling in smaller packages, he argues, is also no panacea. Whilst such approaches may make products more accessible to consumers on low incomes, they do not, he says increase their affordability as selling in this way does not reduce the price per use. It also incidentally has a negative impact on the environment. Nor, Karnani maintains, does providing easier credit terms to customers with low and unpredictable incomes improve their lot, since in the light of their low income they might be better advised to save instead of consume.

At the heart of the debate between Karnani and Prahalad over BOP strategies is the ideological divide between allowing consumer choice versus the perceived exploitation of vulnerable consumers. Prahalad maintains that consumers, even at the bottom of the pyramid, should be allowed to exercise their consumer choice for, eg, televisions and skin whitening products, which they regard as enhancing their well being. Karnani argues such consumers are typically unable to make their choice in an informed manner because of a lack of education and are thus subject to exploitation – consciously or otherwise – by BOP initiatives.

Karnani also doesn't hold out much hope for radical innovations. Consumers at the bottom of the pyramid spend over 80% of their income on staples like food, clothing and fuel. Clearly, these haven't benefited from the same technological changes as computers and cell phones. In such circumstances, BOP philosophy – which argues that is not necessary to reduce quality to lower costs – can actually damage the interests of the BOP consumers it's designed to promote. Low quality inexpensive products may not be the first choice of such consumers but they are often preferred because of limited disposable income. This recognition not only reflects reality but it also enables successful strategies in less technology sensitive areas such as soap, detergent and food.

Finally, Karnani takes issue with the assumption in BOP literature that the provision of microcredit to individuals in emerging markets can be made to be both profitable for providers as well as generate sustainable economic development. Contrary to Prahalad's assertion that the poor are resilient and creative entrepreneurs, he maintains that most of the clients of microcredit in emerging markets are caught in subsistence activities with little prospect of sustainable competitive advantage. Such advantage is only likely to accrue from larger economic entities that develop sufficient scale and competence to make them sustainable and in the process also provide employment opportunities as a way of taking people out of poverty. Investments backed by government in labour intensive, low skilled sectors like manufacturing garments and tourism will in the long run create more employment alleviate poverty in places like India better than focusing on rural entrepreneurs.

As Karnani argues, some of the evidence underpinning the bottom of the pyramid philosophy may be shaky. It is not always clear, for example, how profitable the strategies of companies mentioned in Prahalad's books – or indeed other companies that have subsequently followed this approach – are in reality. On the other hand, Prahalad himself has argued that the Karnani critique focuses too narrowly on the charge that the BOP treats the poorest solely as consumers. In truth Prahalad's book ranges quite widely and encompasses the role of BOP individuals as consumers and producers, as well as involving government and non-governmental organisations.

Similarly, whilst Karnani's critique of the impact of the microcredit initiatives in emerging markets should cause us to be cautious about the overall impact of small-scale economic development on wealth creation, he in turn almost certainly underestimates the transformational power of BOP initiatives like the provision of low cost cell phones and community PCs. Clearly, for us in the so-called developed world, access to knowledge through the internet and modern communications has transformed our power as consumers. How much more must this be so in developing countries where the social structures have traditionally conspired to impose a 'poverty penalty' on consumers at the base of the pyramid? ■

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CONSORTIUM STRETCHES THE LIMITS OF HOSTILE TAKEOVER

The takeover of ABN AMRO by the Royal Bank of Scotland, Banco Santander SA and Fortis NV in 2007 was a dramatic example of group bidding that brought within reach a tier of corporate holdings previously thought unattainable. **Giampiero Favato** discusses the nature of conglomerates, consortium tactics and the complex tasks the three buyers will face.

The RBS consortium

A merger agreement between ABN AMRO and Barclays quickly escalated into a Europe-wide takeover battle. A consortium led by The Royal Bank of Scotland Group plc (RBS), which also included Banco Santander SA of Spain and the Belgian-Dutch bank Fortis NV, stepped into the fray with an offer to buy ABN AMRO and break up the bank. They eventually claimed victory in a seven-month battle after their higher – largely cash – offer beat out Barclays. Originally, Barclays made a €66bn all-share offer, though that was later sweetened with cash. The offer still lagged behind the RBS-led proposal, which valued the Dutch bank at €72bn. Barclays rose 2.3% in London before its bid for ABN was to have expired on Thursday October 4 2007, leaving the RBS consortium as the only contender in the race to acquire the Dutch bank. RBS rose 1.6% and Fortis gained 5.4%. Trading in ABN AMRO was suspended.[1] The ABN takeover could become either a symbol of the exuberance seen in the recent M&A boom or a precedent to deals of a size previously thought out of reach in corporate finance.

Group bidding is not a new tactic in corporate finance: consortiums have been put together since the 1980s, mostly in Europe. They are rarer in the US because tax laws make it too costly to break up target companies efficiently. In 1988, General Electric Co of the UK became a pioneer by teaming up with Siemens AG to buy British electrical equipment manufacturer Plessey Co for $3bn. In 2004, the French drinks firm Pernod Ricard SA teamed up with the US's Fortune Brands Inc to acquire British Allied Domecq plc for $17.8bn and divide up its portfolio of brands. Earlier last year, Dutch chemical company Akzo Nobel raised its bid for British rival Imperial Chemical Industries (ICI) plc after joining forces with Germany's Henkel KGaA. Akzo Nobel's advances had earlier been rejected by ICI.[2]

The RBS consortium's approach might become a trend because it ignites the creativity of investment bankers advising corporate clients. M&A strategists have long dreamt of picking apart conglomerates and a consortium bid allows acquirers to pay a higher price and allocate pieces of the target to buyers who most value those assets. As a result, an entire tier of corporate holdings previously thought out of reach could become potential targets.

Size on its own is no longer a safety net

Conglomerates are companies that either partially or fully own a number of other companies that operate in the same or different industries. General Electric or Unilever are examples of such companies, with interests ranging from avionics to premium ice cream. What, though, are the advantages of such an approach? The case for conglomerates can be summed up in one word: diversification. Diversification results in lower investment risk because the business cycle affects industries in different ways, according to financial theory. Thus, a downturn in one subsidiary, for instance, can be counterbalanced by stability, or even expansion, in another venture. One example might be growth in GE's aerospace division offsetting losses in the credit division. General Electric's success, though, is hardly proof that conglomeration is always the optimal strategy. Peter Lynch uses the phrase 'diworsification' to describe companies that diversify into areas beyond their core competencies.[3] A conglomerate can often be inefficient. No matter how experienced the management team, its

A consortium bid allows acquirers to pay a higher price and allocate pieces of the target to buyers who most value those assets

Giampiero Favato, a director of the Henley Centre for Value Improvement.

energies and resources will be split over numerous businesses, which may or may not yield synergies.

For investors and financial analysts, conglomerates can be particularly hard to understand, and it can be a challenge to collocate these companies into one category or investment theme. Furthermore, a conglomerate's accounting can be complex and obscure the performance of separate divisions. Ultimately, investors' inability to understand a conglomerate's philosophy, direction and performance can lead to a share price that lags benchmark indices or competitors.

In addition, the so-called advantage of diversification can be elusive. If investors want to diversify, they can do so through 'pure play' companies rather than in a single conglomerate. Investors can do this far more cheaply and efficiently than even the most acquisitive conglomerate can. Clearly, then, the case against conglomerates is a strong one. Consequently, the market usually applies a discount to the sum-of-parts value – that is, it frequently values conglomerates at a discount to more focused companies.[4] The calculation of the discount can be exemplified by using a fictional conglomerate called InGlobe plc, which consists of two unrelated businesses: a media division and a fine chemicals division.

InGlobe plc has a market capitalisation of £4bn and total debt of £1.5bn. Its media division has balance sheet assets of £2bn, while its fine chemicals division has £1.5bn worth of assets. Focused companies in the media industry have median market-to-book values of 2.5, while pure play fine chemical firms have market-to-book values of 2. InGlobe plc's divisions are fairly typical companies in their industries. From this information, we can calculate the conglomerate discount:

Total market value InGlobe plc:
= Equity + debt
= £4bn + £1.5bn
= £5.5bn

Estimated value sum of the parts:
= Value of fine chemical division + value of media division
= (£1.5bn x 2) + (£2bn x 2.5)
= £3bn + £5bn
= £8.0bn

The conglomerate discount amounts to:
= (£8.0bn – £5.5bn)/ £8bn
= 31.25%

This multi-business company could be worth significantly more if it were broken up into individual businesses. Consequently, investors may push for divesting or spinning off its media and fine chemical divisions to create more value. Activist investors have been increasingly pushing for companies to break themselves up. Indeed, it was one hedge fund's letter to ABN AMRO, demanding the bank put itself up for sale in whole or in parts, that helped push the bank into play.

Then Peter Paul de Vries, the feisty head of the Dutch shareholder association VEB, successfully took ABN AMRO's management to court, accusing it of bypassing shareholders when selling one of the bank's most attractive assets, the LaSalle franchise in the US. The efforts seem to be persuading executives that they need to listen to shareholders or risk their jobs and control over their company. In an emotional outburst on April 28 2007, Rijkman WJ Groenink (ABN AMRO's chief executive), complained to a Dutch court that his company had become "a toy for hedge funds."

Senior executives are being pressured to deliver shareholder returns as their investment base shifts from passive long-term institutional investors to hedge funds that are more focused on the shorter term. Even though shareholder activism is generally considered positive because it makes companies more efficient and increases shareholder returns, some analysts argue the focus on short-term returns can lead to the neglect of important long-term goals. The three buyers of ABN AMRO, for example, will be under immediate pressure to prove they did not overpay for the deal or stretch their resources too far in pursuing such a complex corporate break-up.

Consortium tactic does not help to value synergies

RBS will take control of ABN's corporate bank, which provides trade finance, cash management and debt sales. Santander gets ABN operations in Italy (Banca Antonveneta) and Brazil (Banco Real). Fortis will take ABN's private bank, making Fortis Europe's third largest player in private banking, behind UBS AG and Credit Suisse Group. RBS could have drawn the shortest straw. While the corporate bank provides a good strategic fit for RBS's existing business in bonds and cash management, the acquisition comes at a time when credit markets are in troubled waters, limiting the ability to generate incremental business by issuing bonds for corporations. More important, RBS is not getting LaSalle Bank in Chicago, one of the assets that attracted RBS to bid for ABN in the first place. RBS sold the idea of the consortium to its shareholders partly on the premise that LaSalle would complement its current US operations in the Northeast and Midwest. ABN sold LaSalle to Bank of America Corp, a $21bn surprise move that RBS was unable to reverse.

A potential pitfall for Santander is that it will have to avoid ABN's failure to integrate its vast holding. The deal could be transformational for Fortis, whose current core competences are related to savings and insurance. According to Moody's commentary, Fortis and Santander

The focus on short-term returns can lead to the neglect of important long-term goals

emerged as clear winners from the successful takeover of ABN AMRO.

In affirming Fortis's ratings (Aa3 stable), Moody's noted the good strategic fit with ABN AMRO's businesses to be acquired as well as the expected reasonable impact of the funding package on the capital structure, capitalisation and underlying fundamentals of the group. "With this deal, there is a clear potential for Fortis to significantly enhance its franchise in the Benelux region" said Jose Morago, a Moody's assistant vice-president/analyst. "Our stable outlook is predicated on the expectation that Fortis will continue to deliver satisfactory operating results, maintain its risk profile and restore its capital position and financial flexibility in the coming months. However, there are material challenges in the short-to-medium term, given the size, complexity and amount of resource necessary for Fortis to integrate and extract value from the new ABN AMRO businesses" he said.

In its affirmation of the Aa1(P+) rating of Banco Santander, Moody's cites:

- the strategic fit of this acquisition, which is fully consistent with Santander's international strategy;
- the bank's proven strong track-record of integrating large-scale acquisitions and extracting cost efficiencies from them;
- the limited negative implications for pro-forma profitability, both pre- and post-provisions;
- the fact that the larger contribution from more volatile markets (Latin America) does not change the group's existing risk profile materially; and
- Santander's proven prudent management of its economic solvency.

"Although the acquisition will likely increase the group's leverage – core capital levels are expected to fall to 5.3% from 6.97% – we expect to see leverage levels restored within 12-18 months" said Maria Cabanyes, a Moody's senior vice president and regional credit officer. Commenting further, Moody's also cautioned about the challenges of turning around Antonveneta and integrating the Brazilian operations, which will double its existing size.

With reference to RBS, Moody's said that the maintained negative outlook on the ratings (Aa2/P-) reflects the integration challenges in relation to ABN AMRO's Global Wholesale Businesses and International Retail Businesses, as well as the negative short-term impact of the proposed transaction on the quality of RBS's capital and historically strong earnings as the bank integrates ABN AMRO's under-performing Global Clients unit. Moody's commented that, of the three consortium banks, the integration challenges are, in its opinion, greatest for RBS. The negative outlook also incorporates the ongoing uncertainty for banks involved in leveraged finance and related capital markets activities after recent market turmoil.

Nevertheless, notwithstanding the additional complexities presented by the integration of parts of ABN AMRO, Moody's recognised RBS's strong track record in integrating past acquisitions and the group's robust core earnings capacity and internal capital generation. The rating agency also acknowledged other transaction benefits including enhancing RBS's presence in Asia-Pacific and diversification of earnings, as well as expanding the reach of its corporate and institutional banking franchise. The enlarged group, the agency said, will have market-leading positions in products such as international bonds and cash management. Moody's cautions, however, that the increased contribution from wholesale banking operations could introduce a greater element of earnings volatility, which could have negative rating implications.

The future of the consortium

The RBS consortium outbid Barclays because its members believed they could derive more value from the divided assets than Barclays could from buying ABN Amro as a whole. Fortis projected an 11.2% return on its €24 billion investment, while Santander expects a 12.7% gain by integrating Antonveneta and Banco Real with its existing retail banking network. It will take until 2010 for the full benefits to emerge from the purchase, the consortium said in security filings.[6] Moody's said that progress in integrating ABN AMRO and rebuilding RBS's core capital and profitability in line with its current bank financial strength rating (BFSR) within 12-18 months could ultimately lead to the rating outlook being changed back to stable. Conversely, failure to resolve these issues within the same timeframe could lead to negative rating actions.

After the deal is approved, speed of execution and flawless implementation of the plan will be critical factors to create shareholders' value from the takeover. If something goes wrong, activist shareholders will turn against the consortium's leaders. "Let's do something about it ourselves and don't trust the directors to do so," said Roger Lawson, communications director for the UK Shareholders' Association.[7] ■

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NUNO DA CAMARA

REPUTATION IN THE PUBLIC SECTOR

A recent article on reputation in the public sector argues that a neutral reputation is more beneficial to governmental organisations than a good reputation.[1] The application of corporate reputation ideas to the public sector is only now being looked at in more depth, and promises to yield some interesting findings for researchers in the field. Below, **Nuno da Camara** reviews these recent studies.

Reputation as a market and user driven strategy

As a management discipline, corporate reputation has been driven largely by the strategy literature. Here, reputation is viewed as a competitive and market-oriented intangible asset. Similar disciplines – such as marketing and organisational behaviour – have demonstrated similar concerns. As a consequence, an abundant and vibrant body of literature exists investigating reputation and its related constructs within the corporate and not-for-profit sectors. By contrast, comparatively little has been published on reputation in the public sector; an area that has remained rather neglected.[2]

Some authors have argued that public sector companies do not need to use reputation to differentiate themselves from competitors like a private company. Since most public services are monopolies the question of brand shifting or a change of patronage becomes irrelevant.[3] Indeed, the monopolistic nature of public service means that its activities are set out in legislation and cannot be contested, except through the periodic democratic process.

However, maximising user satisfaction remains a prevailing target.[4] The homogeneous nature of public service means that all stakeholders are treated equally and satisfying all users at once is not possible. In addition, there is not the possibility of market segmentation as with private sector companies. In fact, marketing for the public sector is more often seen as a defensive strategy to minimise dissatisfaction rather than an offensive tactic deployed to attain very high levels of attraction and loyalty. A defensive strategy generally looks to improve the feedback systems from users and design services to attract lower level of complaints.

Reputation and trust are beginning to be more widely valued in public organisations

The changing public sector environment

With deregulation and the rise of efficiency targets, the environment for governmental and local authority institutions has become increasingly performance-oriented. Today, then, the public sector has often to do more with far less resources.[5] Although the ultimate objective may not be profit-driven, the constant pressure for higher service levels and increased efficiency means that the role of reputation and trust in improving stakeholder relationships and achieving performance targets is beginning to be more widely valued in public organisations.

Such factors are key to the recent interest amongst public sector organisations in reputation. It is, though, worth noting that the role of public organisations in providing stability in society means that reputation and trust in public sector institutions is a social and political aim in itself.[6] In this sense, reputation and trust have always been traditional objectives for the public sector, and in many cases public authorities have been keenly aware of the need to manage public confidence through proactive communication activities and attempting to steer public debate.[7]

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Reputation as a public service objective

Many argue that the reputation of the public sector in the UK is one of trusted and valued services mired in bureaucracy and ineffectiveness. Most studies in the area have found the total satisfaction scores amongst stakeholders to be low. This is also symptomatic of the lack of customer orientation in the sector.[8] In addition, the public sector – with the exception of some lobbying groups and political parties – has traditionally been reluctant to engage in reputation management and communications. In many respects though, the advantages or disadvantages conferred on an organisation by reputation are similar across the private and public sector: a positive reputation can help to attract and retain staff, lower transaction costs, and increase the organisational 'license to operate' within society.

The fact that an organisation depends on public funding also means that almost everyone in the population is a stakeholder through, for example, paying taxes, voting, or actively using public services.[9] This increases the responsibility for proper reputation management with stakeholders amongst local, regional and/or national governments and institutions.

Some academics however, have raised conceptual issues around reputation in a public sector context. If the distinctiveness and celebrity aspects of reputation[10] are not central for the public sector, concepts such as legitimacy and trust may be more appropriate.[11] Reputation and legitimacy, though, are linked in several ways and cannot always be easily distinguished.[12] Moreover, it seems that reputation (and legitimacy) are linked to levels of trust. In fact, Fombrun's 1996 model actually contains both a cognitive assessment of the organisation – the set of beliefs – and an emotional, trust-based component that is strongly linked to intended behaviour.[13] In this sense, as Luoma-aho states, reputation best describes the overall assessment made by stakeholders of public, as well as private, sector organisations.[14] Furthermore, reputation incorporates an overall judgement of people's experience of and emotions towards organisations – and this is as applicable to the public sector as it is to the private sector.[15]

Employee attraction and retention

Reputation has been identified as a key factor for potential applicants seeking to work at a particular organisation.[16] For example, people may feel proud to belong to an organisation that is believed to have socially valued characteristics eg, the NHS, the police, the fire services or the armed forces.[17] Fombrun[18] argues that reputation is of particular concern to people seeking employment in knowledge-based institutions, such as hospitals and universities, because the services they provide are largely intangible. Reputation, therefore, is crucial for attracting and retaining employees in significant parts of the public sector. To date, however, the impact of reputation on recruitment and retention of staff has largely been studied in the commercial context with relatively little attention devoted to the implications for public sector organisations.[19]

One in-depth qualitative study of the NHS by Arnold et al[20] amongst potential recruits in the nursing, physiotherapy and radiography professions found that the 'dominant' images of the NHS concerned its operational difficulties, understaffing and resource shortages, although its core mission of equal access to healthcare for all was also salient. Although the NHS's ideals were applauded, there was relatively little sign that informants personally identified with the NHS. In fact, the findings showed that three quarters of the dominant images of the NHS concerned its operational difficulties. Clearly, we would expect this to seriously affect people's motivation to work for the NHS. Images of teamwork, job security/availability and mobility opportunities were certainly present in the data. Although they were subsidiary themes rather than dominant ones, they were virtually uncontested. The authors therefore suggested that bringing these features to the fore in recruitment policy could be beneficial, instead of trying to deny negative images that exist. More in-depth studies of this nature are needed to identify key factors in reputation vis-à-vis recruitment and staff retention in the public sector.

If an organisation's reputation is too stellar then the risk of not delivering increases, especially if the law or funding changes

Aiming for a 'neutral' reputation

For the public sector, reputation is clearly of huge strategic importance but, in effect, the ideal type of reputation may differ from the private sector. It is important for public sector organisations to have a consistent and balanced reputation since its tasks cannot always be performed perfectly ie health and safety, medical care, policing. Reliability and impartiality are also more important than outward measures of total 'success', especially given that these may be unattainable. One recent study therefore defends the notion that for the public sector a 'neutral' – rather than an excellent reputation – is ideal, as neutrality enables a critical operating distance, and the resources for maintaining an excellent reputation are scarce.[21] If an organisation's reputation is too stellar then the risk of not delivering increases, especially if the law or funding changes. Thus, public services should be wary of over-promising on performance, as the consequences can be damaging to reputation and recovering a more positive image can take time. As such, "the target level of reputation should be a realistic and healthy one, that is, it should be high enough for the organisation to be trusted and taken seriously, but neutral or even low enough to acquire the necessary operating distance especially in times of crisis".[22] Indeed, Luoma-aho[23] found that the reputation of the public sector in Finland was indeed 'neutral' rather than positive or negative in line with her contention that a neutral reputation is an ideal target for the public sector.

Reputation measurement in public organisations

Public sector organisations often measure so-called intangibles with instruments designed for business – even while their raison d'être differs fundamentally from that of the latter.[24] Applying existing reputation barometers to the public sector can be problematic since the organisational aims of the public sector are fundamentally different to that of commercial organisations. For example, factors such as financial performance or competition may not be strictly relevant. In her study of 12 Finnish public sector organisations, Luoma-aho[25] found that five main factors emerged as key to reputation with stakeholders who had frequent interaction with those public services. These five factors are:

- authority;
- esteem;
- trust;
- service; and
- efficiency.

Interestingly, despite the differences between organisational aims and objectives in the private and public sectors, these factors closely resemble the Fombrun[26] Reputation Quotient (RQ) factors which were derived from studies of private sector companies. These six factors are:

- emotional appeal;
- products and services;
- financial performance;
- workplace environment;
- corporate social responsibility; and
- vision and leadership.

The major difference is the factor 'authority' which in the Luoma-aho study of the Finnish public sector is a measure of distance and bureaucracy.[27] The factors 'esteem' and 'trust' fit well with emotional appeal in the RQ however, as does 'service' with the RQ factor products and services. Finally, 'efficiency' can be equated with the performance element of financial performance and workplace environment to some extent. Conversely, it is salient that the public sector measures do not include corporate social responsibility for obvious reasons, but perhaps more worryingly, they omit vision and leadership. In a sense, the five factors identified by Luoma-aho[28] indicate that public services are not defined by opportunity or market strategy and are mainly evaluated by the efficiency of their service and the trust they instil in users.

Conclusion

Some advances have been made in trying to understand the different nature and conditions surrounding reputation in the public sector. A real understanding of how it operates and which factors are involved is, however, still lacking. The studies cited above are a firm step in the right direction, but more research is needed into reputation measurement in the public service on both a qualitative and quantitative basis.

Clearly, reputation in the public sector is just as dependent on stakeholders' interpretation of organisational behaviour as it is in the private sector. Yet the near-monopolistic environment found in the public sector can create very different conditions for the overall aims of reputation. Often, a main goal is achieving acceptable levels of trust and satisfaction in public services, rather than attempting to increase consumption of a product or boost market share. The key ingredients of reputation in the public sector therefore differ, with service efficiency and quality being of major importance. Although the public sector is engaged in less stakeholder segmentation than the private sector, one stakeholder group that is particularly sensitive to reputation is employees. Overall, reputation is increasing in importance for the public sector as many services come under pressure to increase efficiency and reduce transaction costs, as well as attract and retain quality staff. ■

The key ingredients of reputation in the public sector therefore differ, with service efficiency and quality being of major importance

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