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The IBM/Lenovo Deal: Victory For China?

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With the sale of IBM's personal computer business to Chinese company Lenovo Group Limited, two emerging trends quickly move front and center: The increasing commoditization of technology and the emergence of Chinese companies as global players. Wharton professors say both trends warrant watching and raise some key questions. Can Lenovo become a global player and integrate IBM's U.S. managers? Will IBM's PC customers defect to rivals like Dell Computer? Can state-owned Chinese companies become dominant in the international markets?

The deal, announced Dec. 7, is valued at $1.75 billion in cash, stock and assumed liabilities. Once the agreement is finalized in early 2005, Lenovo will have three owners - the state with 46%, public investors with 35% and IBM with 19%. The Chinese government currently owns 57% of Lenovo. The company, to be managed primarily by former IBM executives working out of New York, will have 19,000 employees, with 10,000 of them coming from IBM. Of those 10,000, 40% are currently based in China and 25% in the United States.

IBM benefits from the deal by getting rid of a business -- PCs -- that defined the company in the 1980s, but later became a drag on profit margins. Over the past decade, IBM has transformed itself into a services and software company, and set its sights clearly on China as a potentially huge market. It has shed disk drives, displays, desktop manufacturing and network processor businesses while adding PricewaterhouseCoopers' services firm PwC Consulting. IBM has also acquired software companies such as Tivoli, Rational and Informix.

"Overall, this deal is another indicator of how resilient IBM is," says Wharton management professor Mark . Mark J. Zbaracki, who was a staff industrial engineer at IBM from 1982 to 1991. "IBM's strength historically has been reinventing itself." The company has manufactured everything from timekeeping devices to card sorting machines to videodiscs to typewriters and printers, only to jettison those businesses later. "This sale is symbolic of something going away -- the PC business in the U.S.," says Zbaracki.

For Beijing-based Lenovo, the acquisition of IBM's PC business signals the arrival of China as a global player in key industries. Lenovo gains access to the worldwide PC market and quickly becomes a computer maker with more than $12 billion in annual revenues. It also gets exclusive access to the IBM logo for five years and permanently acquires the "ThinkPad" brand. "If you had to pick a U.S. brand to buy, this would be a big one," says Marshall Meyer, a Wharton management professor who has studied Chinese companies and traveled extensively in the country. "Public relations is a big component of Chinese management and a lot of people will see this as a victory for China."

Michael Useem, head of Wharton's Center for Leadership and Change Management, agrees. "This is a brassy move by both IBM and Lenovo," he notes. "It's untrodden ground for a Chinese company to make a sudden, big move to operate on the world stage." Useem says the biggest perk of the deal for IBM is that, by partnering with Lenovo, it gains better access to the market for services in China. In addition, stronger relations with the Chinese government can only boost IBM's standing. "Government relationships are key in China," he says. "IBM sees this as an alliance. Maybe the price wasn't as good as it could have been," but IBM gets a definite payoff in the form of "better relationships."

So the big question is: Can Lenovo acquire the third largest PC business in the world -- behind Dell and Hewlett-Packard -- and become a dominant player?

Offsetting IBM's Weaknesses

Clearly, for Lenovo's top management, the answer is 'yes.' At a press conference in Beijing right after the deal was announced, newly-retired Lenovo chairman Liu Chuanzhi noted that globalization is the only option for the company, which has very little growing space left in the domestic market. But he also adds that the deal presents risk in three areas: "One is whether the new Lenovo will be accepted by IBM's clients and the PC market; second is whether IBM employees will still be proud [employees of the new company]," and third, whether the two corporate cultures can be successfully consolidated. Indeed, critics have noted the challenges that Lenovo faces not just trying to combine two different cultures, but also managing highly complicated logistics and supply chains, and moving forward in an industry with shrinking profit margins.

During the press conference, Yang Yuanqing, Lenovo's new chairman, was clearly optimistic about his company's future. "Lenovo of China is going to be Lenovo of the world," he stated. "We won't be satisfied with the number three position. We will formally challenge the other two major competitors in the global PC market." Yang added that top management has "analyzed in-depth why there is no profit for IBM's PC business. IBM is a service-oriented company which focuses on products with high returns. But the PC business [is at a] stage where efficiency [brings] success, and that's why IBM's previous business model doesn't work … To reach high efficiency, there has to be big product scale. IBM only focuses on the big corporate clients, with less coverage for the middle size clients. This [hurts] IBM in the competition with rivals like Dell. Lenovo is strong where IBM is weak … and that is why we are confident about the future."

Lenovo isn't the typical state-owned company in China. Founded in 1984 by academics at the official Chinese Academy of Sciences, it was initially set up to distribute equipment made by IBM and other companies. By 1990 it was selling PCs under its own brand name. Although the state is the majority owner, the Academy of Sciences was designed to create startups and allow them to fail as they would in a capitalist society. Most of them did. "The Academy of Sciences spawned a lot of companies and Lenovo is the only significant survivor," says Meyer. "The company hasn't been sheltered and [it has been able to] keep the government at bay."

Recently, however, Lenovo has suffered some setbacks. It tried to branch out into new product lines only to retreat after it failed to keep focusing on its core business and lost market share in China. To reclaim lost share, Lenovo started a price war by offering the equivalent of $300 PCs at the expense of profits. Meyer says Lenovo was able to defend its domestic market share, but still needed economies of scale that the IBM deal provides to compete both in China and abroad.

Over time, Lenovo will have to confront shrinking profits in the PC business and perhaps follow IBM's lead by branching out into product development and services, analysts say. It will also have to navigate the challenges of acquiring a larger company. In addition to its larger workforce, IBM has $9 billion in PC sales compared to $3 billion for Lenovo.

In the end, however, Useem says this deal is likely to go down as a win-win. IBM gets the chance for more software, services and consulting deals in China, and Lenovo becomes a global player quickly. Meyer, while suggesting that Lenovo's management will need to learn the ways of Western-style capitalism, is confident that they will. Lenovo's executives, he predicts, will soon be in the top echelon of company management.

PCs: Today's Typewriter?

Perhaps the most surprising aspect of the deal to Wharton professors was the price Lenovo offered for IBM's PC business, especially since Big Blue essentially created the industry when it introduced its personal computer on Aug. 12, 1981, and brought PCs into mainstream usage (along with Apple Computer). "What's really remarkable about this deal is the price paid for the number three company in the PC market," says Wharton operations and information management professorChristian Terwiesch. "The PC market in general, and especially the segment served by IBM, is simply becoming more and more of a high-tech commodity."

For Wharton operations and information management professor Eric Clemons, the IBM sale to Lenovo closes the chapter on decades of IBM miscues and is an admission that Big Blue couldn't compete. "This probably is not a bad move," given the missteps they made in the past, explains Clemons. "The money comes from selling the chip and the operating system. But IBM gave (the chip business) to Intel when it had 20% of Intel and options on at least another 20%. Then IBM gave the operating system business to Microsoft. IBM will never be the lowest cost producer. So what was left for them?"

Clemons' conclusion is echoed by Wall Street analysts. "Having acknowledged the risks, we generally agree with IBM's decision," says Merrill Lynch analyst Steven Milunovich. "We have long held the view that the only sustainable profit positions in the PC value chain belong to Intel, Microsoft and Dell."

Yet despite IBM's struggles with the PC business -- which Zbaracki says the company viewed as a "nuisance" -- it did do a few things well that may be difficult for Lenovo to replicate, especially in laptop computers. Meyer, like other users of IBM's ThinkPad laptops, says Lenovo's ability to maintain quality and innovation for notebook computers will be key to the merged company's success. "The biggest selling point of IBM laptops is the warranty and service," says Meyer. "I wonder what the feelings will be about IBM if service is squeezed … The ability to retain market share in the U.S. will depend on the ability to maintain the quality and warranty of the product."

Meanwhile, the pressure to keep IBM customers happy is already mounting. In a research note, Gartner analysts stated that Lenovo "must retain the status of IBM's notebooks while developing a range of desktops that can challenge Dell's." The first goal, they added, should be to keep the IBM core business in enterprise notebooks and use the IBM brand in other geographies to grow volume business. Gartner advises clients to "use the potential risks of the deal to negotiate lower prices or better service levels from IBM" and be prepared "to switch vendors quickly if IBM's responsiveness drops."

On an investor conference call following the deal, IBM chief financial officer Mark Loughridge downplayed those worries, adding that Lenovo is getting IBM's research and development capabilities as well as employees who are behind such hits as the ThinkPad.

Ultimately, analysts expect Lenovo to be competitive in the PC market. "Lenovo has historically struggled to maintain profitability in PCs," says Prudential Securities analyst Steven Fortuna. "However, we believe that it could become a more formidable competitor as it grows in scale, expands its geographic presence, and invests in more efficient manufacturing and distribution processes."

The View from China

Within China, the deal has both its critics and its supporters. Fang Zingdong, chairman of blogchina.com and a well-know IT critic in Beijing, calls it "a magnificent acquisition … The new Lenovo becomes a major global player in the PC industry overnight instead of struggling for generations." Lenovo is getting "IBM's first-rate products, technology, brands, market, channels and management," he says.

Zeng Ming, professor of corporate governance and M&A at Cheung Kong Graduate School of Business in Beijing, is "cautiously optimistic" about the deal, saying it "symbolizes Lenovo's efforts to strengthen its competence in the global market." As for other industries in China that might benefit from such deal, he suggests that "it must be a mature, global industry where Chinese companies get the cost advantage and have no technical barriers."

Wang Fanghua, professor of strategy and executive vice dean of the School of Management, Shanghai Jiao Tong University, sees these types of future deals in the high-tech, retail and automotive industries where Chinese companies have achieved a certain size and are well positioned to enter the global market.

Lu Xiongwen, professor of marketing and vice dean of the school of management, Fu Dan University in Shanghai, thinks IBM is getting the most out of the deal. "It helps IBM achieve its strategy transformation of focusing its resources on IT service. The company loses nothing and gets what it wants by maintaining its brand and technology." Lu is more critical of Lenovo's end of the deal, questioning the company's ability to handle such a giant enterprise given that it has not yet had experience managing a complex global company. "Chinese IT companies should focus more on the next wave of Internet technology and what impact it will have on market demand. This deal has delayed the possibility of Lenovo becoming a super IT company," Lu states.

Dealing with Low-cost Rivals

Several observers have noted the cost advantages that Lenovo has over other computer manufacturers in being able to source PC production in China, where wages are low. Does this imply that the IBMs of the world have little choice but to enter into deals like the present one when confronted with Lenovo-like rivals? Hal Sirkin, a senior vice president and director in the Chicago office of The Boston Consulting Group, believes this need not be the case. "Competing against low-cost competitors does not mean giving up," he says. "It means carefully working through what can be done and what the options are. Here's how you might think about the problem. First, understand the threat. Consider how the low-cost competitors might attack. Are they going to price-up brands, or are they going to acquire brands? Where are you strongest?"

Sirkin suggests that the next step should be to answer the question, is doing nothing survivable? "If not, how do you evolve yourself?," he asks. "Does it mean going to the 'other side', and sourcing in, say, China, or even selling your company to the Chinese? Or does it mean finding ways to reduce your costs, manage your brand, and build a much stronger competitive position? You will have to make hard choices.

"Finally, act quickly," Sirkin says. "The threat is real - acting slowly can put you out of business. On the other hand, so is the opportunity - acting quickly may strengthen your position against both low-cost and traditional competitors. Indeed, sometimes making the choices that require layoffs or other hard measures are the best way to preserve jobs in the long run."

Challenges Ahead

How the IBM/Lenovo deal ultimately plays out remains to be seen, but if Lenovo quickly loses market share and sales it will be the first sign of trouble, says Meyer. One challenge is history: Mergers in the technology industry traditionally stumble. When Hewlett-Packard bought Compaq in 2002 it became the No. 1 PC maker, but could only hold the position for a few months. Why? Dell took advantage of "FUD," or fear, uncertainty and doubt, among HP and Compaq customers, to gain market share. In fact, some observers feel that Lenovo's biggest challenge will be fending off Dell, which has made significant inroads in China and manufactures there to eliminate the cost advantages of its homegrown rivals. "The real issue here is whether Lenovo can be competitive with Dell," says Meyer.

To make the deal work, Lenovo will have to find the answer to the most basic question, Meyer adds. "How will a company that's very China-centric swallow a firm IBM's size?" So far the answer seems to be to put IBM's executives in charge.

Stephen M. Ward, Jr., currently IBM senior vice president and general manager of IBM's Personal Systems Group, will serve as the chief executive officer of Lenovo following completion of the transaction. Yuanqing Yang, as mentioned earlier, will serve as the chairman of Lenovo, moving up from his current position as vice chairman, president and chief executive officer of Lenovo. Mary Ma, chief financial officer of Lenovo, will keep a top undetermined position at the company.

"At first it struck us as odd that IBM's Stephen Ward will run the new IBM/Lenovo PC entity, although it makes sense in the context of Lenovo wanting to guarantee a presence for its brand in the global PC market," says Milunovich. "Obviously IBM can feel more comfortable that the new entity will have friendly relations, with one of its own veterans running the firm."

Meyer, however, laments the fact that Liu Chuanzhi, stepping aside as chairman, will not be part of the new management team. According to Meyer, Liu is an "extraordinarily capable person" who was well versed in dealing with the Chinese government. "How the integration of the top team will play out is not clear." Furthermore, the average age of Lenovo employees is below 30, while IBM executives are older and more seasoned. Lenovo will have to blend executives who can manage the Chinese government and maintain a strong position in the United States. "What happens when IBM executives have to deal with the government?" asks Meyer. "You can't forget who owns this."

While the ultimate outcome of Lenovo's acquisition is uncertain. Meyer plans to keep an eye on two benchmarks: Lenovo's sales and ability to keep IBM's corporate customer base, and the speed with which the company integrates management. The deal closes in the second quarter of 2005.

Useem expects Lenovo to succeed -- if only because China is so committed to it. The PC maker could, after all, blaze a path as more Chinese companies become global players. "Lenovo, with the backing of the government, will be willing to do anything to ensure that this works," says Useem. To China, "It's too strategic a deal to let fail."