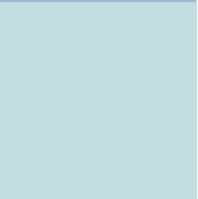
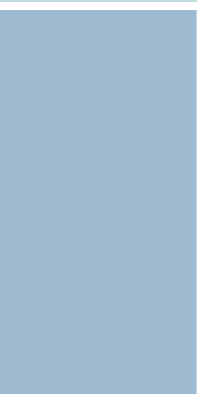
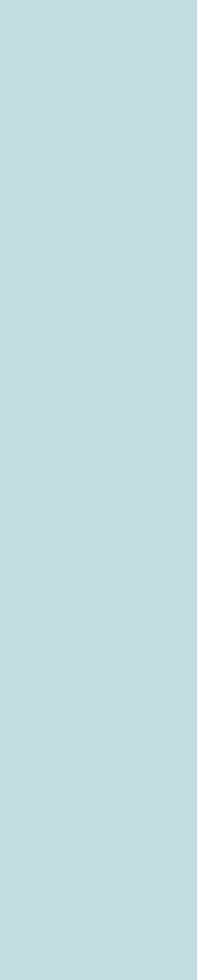


Corporate Groups

*How to Create
Opportunities and Value
for Shareholders*

JAN CHADAM

ToKnowPress



Corporate Groups



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Preface

Management of present-day, global corporations requires taking numerous investment decisions. It is when boards of directors and managers have to pose and ask the following questions: does the decision I am about to take make sense? Am I supposed to make investment or should I abandon the idea whatsoever? To what extent can proceeding with the project increase the value of the company and meet its owners' expectations? Watching the course of development and operation of contemporary corporations leaves no doubt that the key to their commercial success lies in achieving efficaciously seemingly discrepant goals: growth that arises from globalization processes and capital concentration as well as expectations one has from the market participants to exude agility and resourcefulness typical of smaller entities while taking decisions.

Formation of such entities and their management requires unique competences, which is not the only challenge. Given complexities of cultures that corporations have to operate in, diversity of legal regulations, and their volatility, growing impact that the level of intellectual capital has on achieving competitive advantage, and value increase for the owners, we cannot help concluding that the mosaic composed of mutually intertwined opportunities and threats seems limitless, and poses a genuine challenge for those who strive to navigate through it. It is worth underlining that the vast majority of present-day corporations is based on multi-entity organizations that are usually bound by capital relations. In such organizations, each entity emerged in its own particular way, for a particular reason, so as to achieve a particular aim, and in a particular geographical location. Many an entity is a result of acquisition processes in the corporate market. Giving rise to such multi-entity organizations entails taking decisions the outcome of which might be difficult to modify, which in turn will affect the entire organization's long-term value.

My extensive experience in business proves without a shadow of a doubt that the formation processes of multi-entity organizations are highly likely to ensure an effective increase in the value of the organization from the owners' perspective. What is important to remember is that a different case scenario – i.e. one when a decrease in value

occurs – may sometimes become the reality too. Despite tremendous progress in theory and achievements in practice, a competence gap has not been stamped out from this area. It is demonstrated by the discrepancy between the actual and the desired level of competences at the stage of both formation and very management of the organization.

Synergy happened to be the notion that seemed to justify a number of dubious or precarious capital transactions. Oftentimes I concluded that managers were inclined to use ambiguous terms which tended to be superficially interpreted. Financial decisions, though apt at times, were taken intuitively rather than on the grounds of relevantly identified circumstances. Some, unfortunately, led to the destruction of company value for shareholders. Misinterpreted or missed synergy opportunities lead to an inevitable demise of the corporation value, which M. Sirower (1997) related to as ‘synergy traps.’ They are particularly pernicious as mitigation in most of them is downright undoable or almost completely implausible. What is pivotal here is synergy management i.e. recognition, description, and identification of the conditions of the effective use of prospective effects the occurrence of which determines expediency of such organizations. On the other hand, however, corporate groups give a genuine chance for such organizations to achieve outstanding results that are better than the ones that unrelated companies usually yield in total. Thus what proves to be of utmost importance is to ensure that neither mishaps at the decision-making and implementing stage nor competence gap impair the chances of success that synergy entails. It is vital to understand that this notion has nothing to do with magic and thus cannot excuse abortive, fruitless decisions in the circumstances when there are no rational grounds for them.

It has been over twenty years since I have taken keen interest as a scientist and manager in phenomena concerned with formation and development of corporate groups in present-time economy. It is this realm of knowledge that I explored among other issues in my phd dissertation as the result of painstaking and thorough empirical research. In ensuing years, I continued research within this area, the results of which I published in scientific articles in renowned journals later on. Acting as an executive officer in supervisory boards and management boards of corporate groups I could do both, witness and influence the formation and operation of these organizations. I was

an active participant in many takeovers on the part of acquirers as well as the acquired companies that were being acquired. I partook in hundreds of discussions hand in hand with colleagues from parent companies and subsidiary companies during which both value creation as well as threats and opportunities that synergy might induce were debated.

This book is an amended and updated version of my earlier publication in Polish (Chadam 2012), which was based on in-depth analysis of the phenomenon of synergy dedicated to managers as well as business schools and university students in particular. It is an intricate study of synergy-related issues and their connection to value creation in corporate groups that comprises all theoretical aspects connected to this complex subject and gives practical recommendations for action. The book is meant to help find answers to the questions that management practitioners frequently ask themselves while pursuing the optimum development path for their company. It has two main objectives:

1. *Cognitive*. Definition, analysis, and classification of mechanisms that create and drive corporate groups as well as the factors that contribute to the generation of synergy effects and management of value growth processes in such organizations.
2. *Utilitarian*. Depiction of the principles of synergy sources identification and their subsequent and efficient implementation so as to achieve long-term value growth for shareholders.

Not only does the book serve as an example of scientific literature in the scope of management but it also provides business practitioners with tips and recommendations meant to foster the creation of the best case scenarios. Besides, the application of such practical guidelines is bound to help avoid synergy traps while taking investment decisions. The content of the book as well as the methodology used are subordinated to the aforementioned aims, and the reader may find herein a host of scientific and empirical research findings, theoretical, and practical conclusions I arrived at in the course of my extensive experience. On account of their complexity, the most valuable is the analysis of particular corporate groups' approach to issues they were faced with, as well as conditions and solutions which I depicted case by case. This book collates the knowledge in the area of synergy effects and value creation for corporate groups. I trust it will

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enable readers to dodge traps, and as a result stave off value decrease while taking and executing investment decisions.

* * *

But for help and priceless comments from many people this book would not have been completed. I hereby wish to thank professor Maciej Bałtowski for inspiring me greatly while I was conceiving the idea for the book, and Zygmunt Grajkowski, the owner of vBM Consulting, for his inestimable help and stimulating discussions about value management in business organizations. I also want to express my gratitude to my dear fellow, professor Zbigniew Pastuszek for his long-term collaboration with me in the field of science and tremendous help during the entire process while I was writing this book.

Lastly, my thanks go to my family. Had it not been for their understanding, I would not have succeeded in putting an end to numerous projects in my career.

Chapter One

Corporate Groups in Global Economy

Corporate Group or Group of Companies

In this chapter I intend to address the issue of value creation in corporate groups. A corporate group is a collection of parent and subsidiary corporations that function as a single economic entity through a common source of control. It is important to realize that every country offers corporate groups disparate measures under applicable law, in particular in the area of taxes. Capital structures and capital groups are but a few local equivalents of the term ‘corporate groups’ that we can encounter. Regardless of particular legal approaches, the very aim of value creation always remains the same, and is independent of local solutions. To ensure proper comprehension, let me explain what precise meaning is attributed to the notion ‘corporate group’ in the book. It is a collection of autonomous business companies associated by means of capital and ownership relations between the parent company and subsidiaries. Internal drive, resourcefulness, economic accountability and vast economic freedom that these entities enjoy are undeniable advantages of corporate groups. Their disadvantages are mainly related to a limited accessibility of parent companies within the scope of operational problems, lack of appropriate impact each separate entity has on business goals, and requirements of the entire organization. We may assume that corporate groups prevail in present-day economy. Identifying efficient ways to implement synergy in particular entities and increase value for the whole organization is a primary purpose that business renders relevant.

Corporate groups emerged as a result of companies attempting to work out the most commercially profitable size. On the one hand, they are meant to drive economic power on account of capital concentration, on the other to foster company’s efficient operation as they promote independent running of each entity within the group. Managers and scholars strive to rise to the challenge of tracking the best solutions to employ in management processes so they result in

the company value growth from the perspective of equity suppliers.

The first corporate groups were established in 19th century, in Belgium (1822), Great Britain (1886), Switzerland (1871) and the USA (1870). Nowadays, they prevail in global economy. While probing into the roots of the rise of corporate groups, I cannot help concluding that happenings of versatile nature trigger their appearance. I have identified five basic groups of factors that enhance the emergence of corporate groups:

1. Business entity size that determines the choice of tools used to expand the company's market share as well as larger autonomy of its particular organizational or functional elements;
2. Geographical location (local, national, international);
3. The scope of services that a business entity renders;
4. Strategic choices in terms of certain business areas, e.g. sale, clearance, winding-up;
5. Vertical or horizontal business integration.

Undoubtedly, corporate groups emerge as a result of persistent search for a model of a business organization that can guarantee most efficient operation in specific circumstances. In general, reasons why such organizations are created and methods used to achieve expected effects show numerous divergences and contradictions. However, a deeper analysis of these phenomena leads to the following primary conclusion: it is always an expectation of better financial results and value growth that triggers the rise of such structures, which is the essence of economic development and a means of economic growth in business.

Taxonomy of economic development based on ownership criterion is commonplace in the literature. According to this classification we distinguish internal growth and external growth of the organization. Internal growth is the case when development occurs with the use of the company's own economic potential. Corporate groups are formed through separating existing business activities from the parent company or through establishing new subsidiaries by the parent company. External growth occurs as a result of acquisition of external economic potential, by means of a takeover. Each model has its own peculiar advantages and disadvantages. Decisions in terms of the choice of the course of development are conditioned by a host of

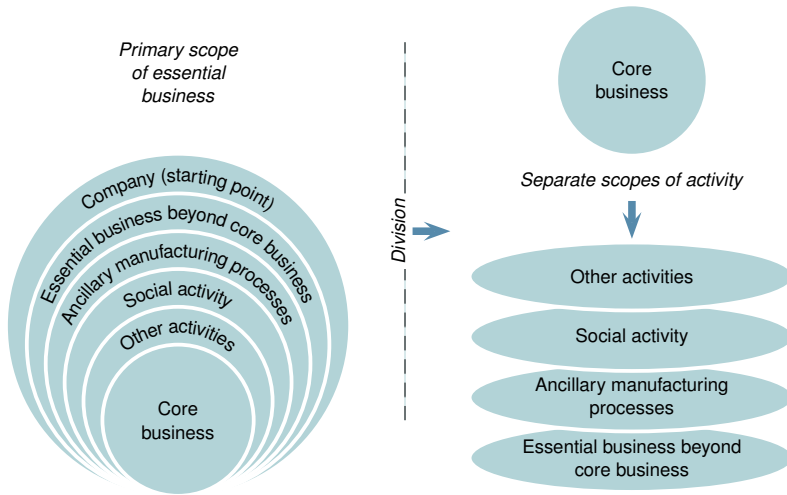


FIGURE 1.1 Formation of Companies as a Result of Capital Outsourcing

factors of strategic, commercial, financial and miscellaneous nature, for instance a business entity size.

Given potential economic effects, in general we may distinguish three basic models that corporate groups emerge within:

1. Through separating existing business activities from the parent company, which in turn forms an independent commercial law entities, so-called *spin-offs* (Model 1),
2. Through establishing new subsidiaries by the parent company, so-called start-ups (Model 2),
3. Through a takeover or acquisition of existing companies' shares, so-called spin-ins (Model 3).

The first two models are typical of internal growth processes within the organization, whereas the third one of external growth. Model 1 (figure 1.1) depicts the formation of corporate groups as a result of endeavors to find the most efficient company size, and transparent company structure. Corporate groups have always appeared directly owing to restructuring of current companies and the resultant emergence of new autonomous spin-offs. Potentially positive effects that are often observed derive from the fact that new, independent business entities generate additional activity and that the accountability of management boards of separate companies grows, which ensures

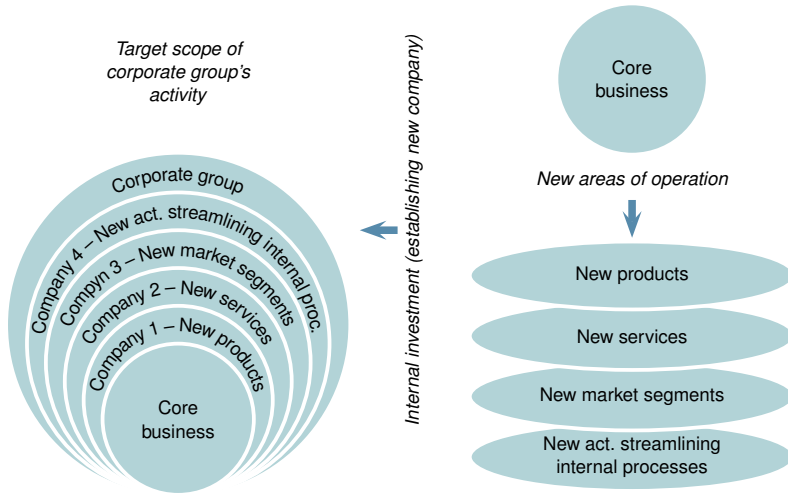


FIGURE 1.2 Internal Investment: Establishment of New Companies

improvement in the quality of their operation. The aforementioned business model is typical of many post-communist countries where state-owned companies underwent restructuring and privatization. These processes were intended to produce new formal and legal solutions indispensable to forge favourable conditions that would help end crisis and move on to the growth stage.

Anticipated results of such efforts are mainly related to additional activity of new business entities, and are meant to result in an increase in revenue, more effectual use of assets (in particular improvement in business activity index, i.e. fixed and trading assets productivity), an increase in profitability of business activity and equity, including a radical upturn in human resources productivity and efficiency indexes. Experience shows, however, that anticipated effects are not always achieved, and that these processes are contrary to the ones of mergers, which are oftentimes the next step after an acquisition has been completed.

Model 2 describes processes connected to the parent company's internal capital investments (figure 1.2). Their outcome results in the creation of new subsidiaries that subscribe to the concept of operations typical of the entire group. Most frequently it is corporate groups where parent companies invest financial surplus in new projects that, in turn, expand the scope of business activity (hori-

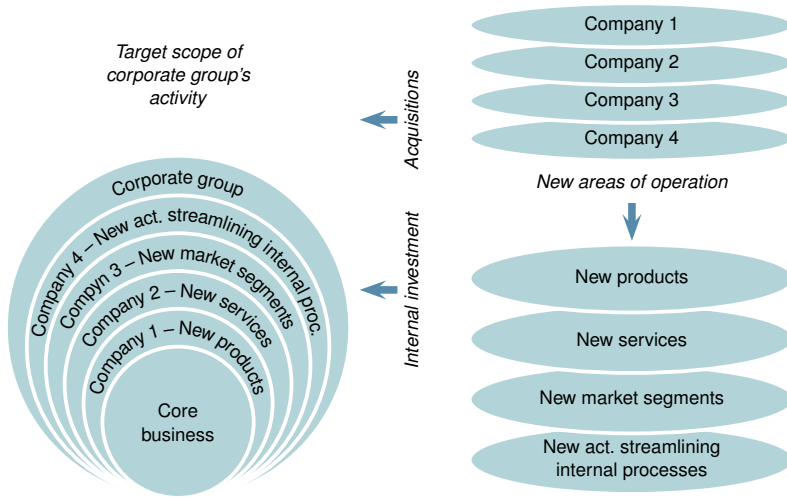


FIGURE 1.3 Acquisition Processes (Takeovers)

zontal integration) or improve the entire chain of processes between particular group members (vertical integration).

Positive performance of organizations of this kind stem from effective cooperation of individual companies in pursuit of mutual strategy assumptions of the whole corporate group (Weber and Dholakia 2000), which in the context of finance may entail acquisition of external financial resources at a lower capital cost, and optimization of investment process in the entire corporate group especially in the scope of more effective use of production and technological potential. Corporate groups that emerge as a result of executing this model run integrated activities in the area of remuneration strategies, qualifications improvement, and other meant to make better use of human resources in the entire organization (Chadam and Pastuszak 2005).

Model 3 depicts a concept whereby expansion of market share and economic power of a corporate group results from a free acquisition of companies and their inclusion into the potential of the corporate group (figure 1.3).

Investment wise this approach is quite risky but time wise it ensures a relatively speedy process completion. Company acquisition is a one-time decision and its downsides are frequently very difficult to mitigate. Lack of qualifications with regard to acquisitions is highly likely to inflict project failures that inescapably result in the com-

pany value destruction (Sirower 1997). Improvement in management efficacy is an effect of acquisition that is expected to occur in the first place. Frequently, a replacement of the management board of the company that has been acquired radically impacts its evaluation. Immediate results are observed in soft management areas i.e. decision making approaches, management styles, incentives, and corporate culture. Decentralization and downsizing are the two main tools that effectively ameliorate communication flow (Chadam and Pastuszak 2006). Implementation of ‘the better the company results, in particular, the higher the company value is, the higher the remuneration’ incentive scheme for managerial staff also proves very efficient.

Acquisition processes require unique qualifications from managers. They ought to comprise the entire bill of charges with regard to a particular acquisition. Statistics show increasingly high interest in this form of company value growth generation on the side of managers. A natural tendency to focus on the legal side of the transaction is a significant threat to such processes. Insufficient attention is given to economic aspects, such as cost and benefit analysis, and integration of the newly acquired company’s corporate culture with the parent company’s corporate culture. Instead of making an effort to give finishing touches to current acquisitions, managers tend to keep pursuing new transactions, which may have adverse effects as a result. Therefore, synergy related aspects should be discussed thoroughly before making business decisions, which should be followed by a detailed analysis made in the course of the entire process, i.e. prior to, during, and after the acquisition itself. The circumstances that corporate groups emerged in are pivotal in determining the course of action since some synergy effects present in the group that was formed on the basis of a particular case scenario may be entirely inaccessible to the other group, which was built on different fundamentals. Table 1.1 demonstrates a concise list of advantages and disadvantages of the aforementioned scenarios that corporate groups emerge within. To conclude, corporate groups are a combination of business entities and relations of subordinate and interactive nature that appear amongst them. They assume various forms in the scope of business activity itself, geographical area, work organization, division of labor, etc.

This book takes keen interest in corporate groups which consist of independent business entities that are interconnected by means of

TABLE 1.1 Advantages and Disadvantages of Scenarios That Corporate Groups Emerge within

Type	Advantages	Disadvantages
Equity Outsourcing (<i>spin-off</i>)	Lack of, or low investment expenditure; Market growth and efficiency potential; Process maintenance in a parent company (when ancillary processes are outsourced); High predictability of restructurization processes.	Subsidiary expecting from a parent company the assignment of standing orders; Compulsory adjustment to corporate culture typical of large organization that are inactive in the market; Expectations of regular financial support.
New company generation (<i>start-up</i>)	Transparent decision-making process; Integration in terms of technology, organization and corporate culture with the corporate group; Building company potential in compliance with needs and expectations.	The risk of failing to reach goals in the market; Relatively lengthy project completion time; Necessity to create proprietary <i>know-how</i> ; Relatively high risk of flaws occurrence in the course of project realization.
Takeovers; acquisitions (<i>spin-in</i>)	Relatively rapid project completion time; Market seizure and competition; Speedy <i>know-how</i> and competitive advantage acquisition in the new market.	Limited transparency in the scope of decision making processes, and potential threats related to it; Problems on the grounds of technology, organization, and corporate culture arising from integration; Risk of takeover of excessive staffing and assets; Overinvestment, and failure to achieve goals.

equity based relations. It means that mutual relations between them arise due to ownership, and as a result of pursuit of the optimum company size to ensure efficacy of operations. Organizations of this kind have tremendously grown in popularity since they enable generation of high efficiency through independent operations of each entity. Besides, they allow high equity concentration which is substantial in the present-day economy that is becoming more and more global.

Corporate groups are established as a result of internal and external growth. The former occurs when the group's own economic potential is deployed in the generation of further growth. The latter emerges through the use of external economic potential that was

acquired as a result of acquisition. There are advantages and disadvantages of each development path, and the choice ought to be made following an analysis of factors of strategic, market, and financial nature. Corporate groups often constitute a complex collection of business entities related to one another by means of capital and operational ties, owing to which the taxonomy based on various criteria, such as business goals, territorial area, ownership type, structure complexity, business affiliations, etc. may be applicable.

Business Relations in Corporate Groups

Corporate groups often mean complicated assembly of business entities that are financially and functionally interrelated. Thus, they may be classified according to the following criteria: sphere of business activity, industry, business aims, territorial range, ownership type, structural complexity, business affiliations, etc. The activity of business sphere criterion helps in identification of industry that the organization operates in. This distinction does not result in a clear-cut picture as companies run their diversified business activities in various industry sectors. Dissimilarity in business activity in both, or in the relations between entities may be observed. Although there are practically no companies that offer a singular product, which the literature on the subject underlines, some product or business activity features always override the other ones (Treece et al. 1994). It helps assign the company, and thus the entire corporate group to a particular type of a business activity. The fundamental business activity profile of the parent company seems to be the best criterion in this case.

Division with regard to relations amongst corporate group members is another classification criterion (figure 1.4). It shows the way in which corporate group members are integrated internally. Corporate groups are divided into:

- vertical structures, i.e. the ones that run activities integrated vertically, demonstrate relations of a cooperative nature, and by means of maintaining close business affiliations in the supply or sales scope by one company with another company or companies within the same corporate group,
- horizontal structures, i.e. the ones that run activities integrated horizontally, where companies from the same corporate group

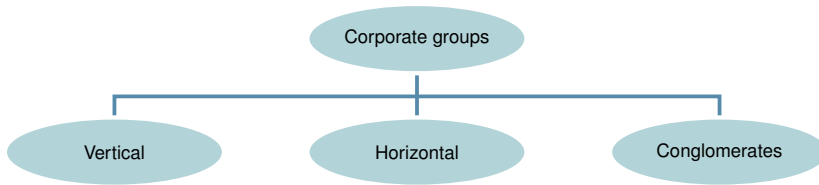


FIGURE 1.4 Classification of Types of Corporate Groups in Terms of Business Relations

that operate in different markets and run diversified activities strive to achieve similar or identical economic goals,

- conglomerates, i.e. the ones that run diversified activities that are either hardly integrated or nonintegrated at all, which run disparate business activities, and demonstrate no relations of a cooperative nature.

The manner of performing main management functions within organizations is a major distinctive feature. In other words, these notions describe management style employed with regard to either technologically linked or separate phases of supply, production, distribution, sale or other business processes within a single corporation or a corporate group.

Vertical integration of corporations depicts their stratified connection by means of a hierarchy where a common owner is the key. In vertically integrated corporate groups each member-company renders a different service or offers a different product and thus contributes to the satisfaction of entire corporate group's common needs striving to generate ultimate added value for the client. The level of vertical integration may be considered from the perspective of the extent (financially, organizational, or technologically) to which a particular corporation may be affecting other corporations within the group. Hence we can distinguish the following types of vertical integration (Perry 1988):

- *forward*, i.e. with a direct impact on companies that are located in subsequent elements of a common chain of supplies (upstream buyers)
- *backward*, i.e. the one related to the companies that affect the preceding elements of a common chain of supplies (downstream suppliers),

- *balanced*, i.e. the one that combines the aforementioned forms of vertical integration.

Generally speaking, vertical integration concerns a group of companies involved in manufacturing at various stages of the integrated process, for instance ore extraction, resource generation, semi-manufactured goods production, transportation, sub-assemblies manufacturing, etc. (figure 1.5). Contrary to vertical integration, horizontal integration is usually related to an internal or external expansion of the corporation that aims to attain the integration of companies that operate in the same industry, at the same level of value chain, or that offer similar products.

Horizontal expansion within the industry that the corporation is already present in is a basic means of execution of this integration method. It intends to expand the market share in a given segment of particular products or groups of products. The anticipated advantages of this form of integration are usually related to:

- gaining economies of scale. e.g. by means of geographical expansion,
- gaining economies of scope, e.g. by means of sharing raw materials used in product manufacturing,
- market power growth, i.e. impact on suppliers, distribution centres, and retailers,
- reduction of international exchange expenditures by establishment of companies operating in global or international markets,
- positive perception and recognition by target clients, e.g. brand stretching.

In general, horizontal integration is related to a group of corpora-

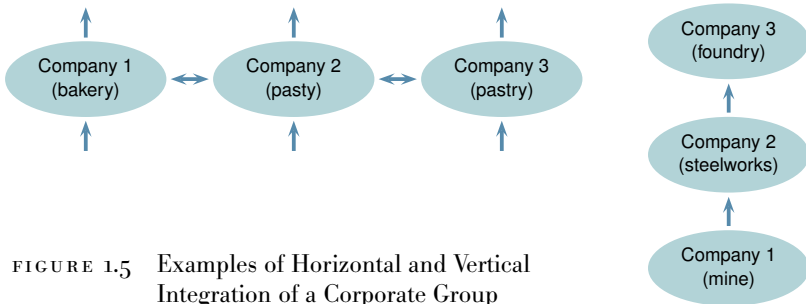


FIGURE 1.5 Examples of Horizontal and Vertical Integration of a Corporate Group

tions that are involved in business activity and multiple services in various markets, e.g. production of bread, pasta, confectionary items, etc. (see figure 1.5).

Special attention with regard to potential loss of company value should be given to conglomerates, i.e. diversified multi-entity organizations that are tenuously or hardly related. They may resemble investment funds where the domineering entity is concerned solely with its own shares neglecting the pursuit of mutual cooperation advantages (Lamont and Polk 2002). An attempt to limit group risk by means of diversification is a frequent excuse for external growth (Ensign 1998). This view has many opponents as the arrival of new entities does not minimize the risk for the entire corporate group. In fact, it may even increase it. Besides, branching out into new sectors entails a higher risk on account of power and asset deployment, which may be detrimental when a crisis in key business area strikes. Diversification distracts managerial staff from primary business activity, and forces them to tackle issues that require a different set of competences. Finally, it may turn out that corporate group diversification can result in a decrease in transparency of the new business entity for the capital market, which is likely to bring about a decline in the corporate group's share price.

Figure 1.6 demonstrates an example of such a structure in practice. Subsidiaries that were initially established as a result of the pursuit of various development paths (disinvestment, internal investment, and acquisitions) allowed the company to form a transparent business structure in the area of agricultural machinery. At a certain point, managers decided to invest in fruit-and-vegetable processing industry so as to diversify risk on account of diversification of their business area. The two entities acquired only seemingly met strategic objectives. After three years of corporate group's struggle against the odds, the two entities that it had acquired went bankrupt. A thorough analysis of the failure led to the conclusion that a lack of suitable competences, i.e. a competence gap that appeared at various stages of the investment process, such as group integration, and management after the group had been formed, was the cause of the dismal outcome.

Effective management of newly acquired companies required insights into the new market segment, specific business relations, a new approach to procurement process, and investment as well as fi-

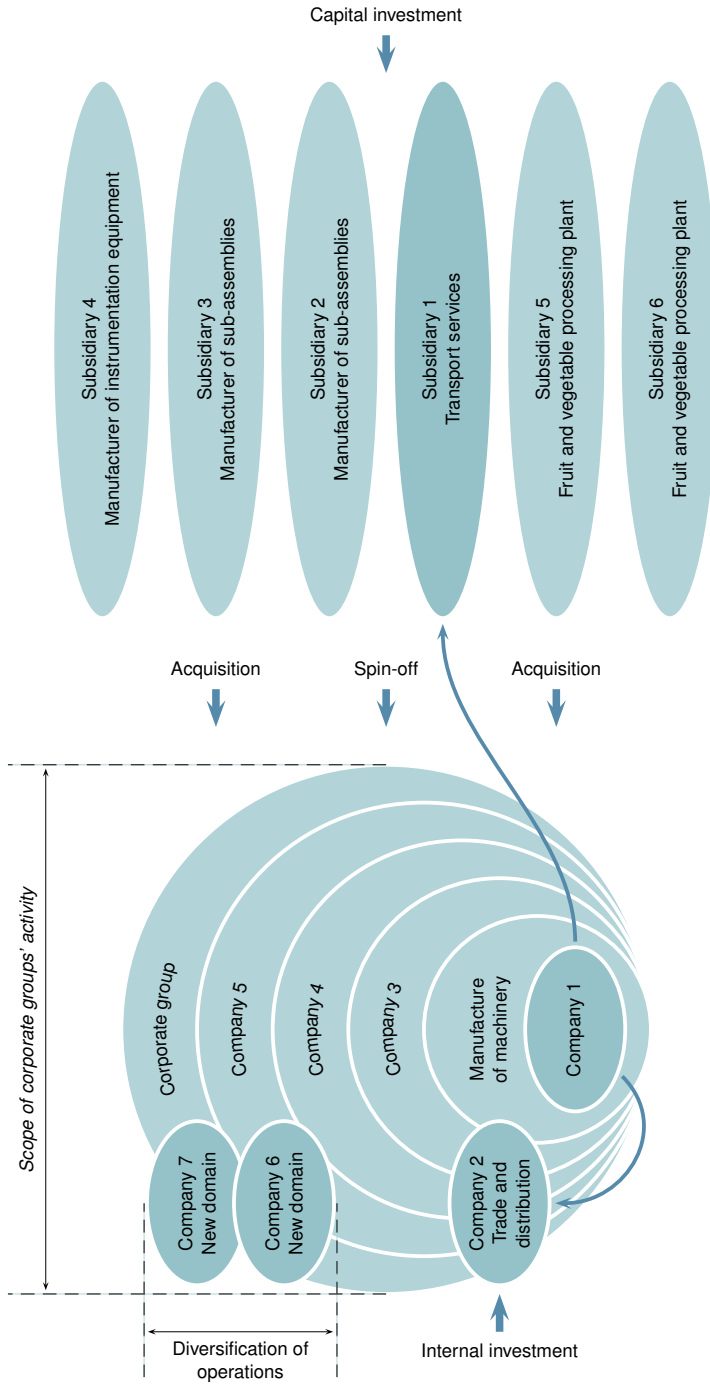


FIGURE 1.6 Business Diversification Process in a Corporate Group

nancing, etc. which differed tremendously from the knowledge the company had gained thus far. Therefore, despite promising results in primary business, the corporate group failed at the diversification attempt. The book will focus further on the impact that diversification has on the corporate group value in detail.

In conclusion, from the point of view of the synergy deployment criterion, the following two classifications of corporate groups are most important:

1. based on business relations amongst corporate group members,
2. based on the business activity of a corporate group.

The first criterion results in the establishment of vertical organizations, horizontal organizations, and conglomerates. The criterion based on type of operations and business aims within corporate groups leads to a distinction of operational, managerial, and financial structures each of which demonstrates a different susceptibility to synergy generation and follows a different path towards group's value multiplication. From the viewpoint of the parent company, each company within the group is in fact a separate investment project with a unique risk susceptibility and asset funding structure.

Corporate groups vary with regard to the potential for synergy effects generation, which is related to the degree of integration among the group members. Thus it will be more prominent for operational and managerial structures, and less prominent for conglomerates (taxonomy based on the criterion of business affiliations). Likewise, operational and managerial structures stand more chances for generating synergy effects than financial structures (taxonomy based on the criterion of types of operations) since primary processes, which form a value chain, are the main source of value creation. Synergy effects may appear in conglomerates and financial corporate groups too, on account of a more effective use of intellectual capital and integration of ancillary processes.

Types of Corporate Groups

Three basic types of corporate groups may be distinguished with regard to expediency of their creation, namely operational, managerial, and financial (figure 1.7). Each type shows a radically different propensity to synergy, and follows a different corporate group value growth path.

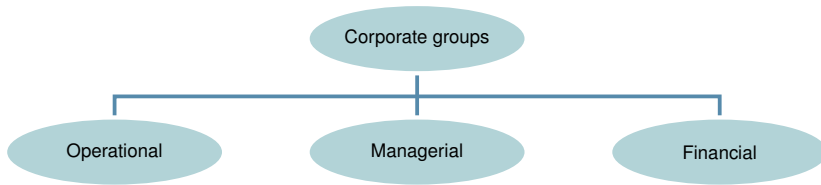


FIGURE 1.7 Types of Corporate Groups by Business Activity

The primary purpose of operational groups is to foster the parent company's competitive advantage in the scope of its operations by subsidiaries, as it creates the effect of concentration and specialization, and results in a tight group integration. This type of corporate groups, however, has a limited potential in the area of innovation, and tends to be quite inflexible, both of which impair the group considerably when demand fluctuates dramatically or when the group decides to operate in the markets that require flexibility. Managerial corporate groups aim to generate and discount synergy effects that appear as a result of cooperation between subsidiaries which run complementary business activities. Unlike operational corporate groups, parent company is not involved in any operational activity at all. It focuses exclusively on the management of the whole group, as well as on the management of its own, and subsidiaries' shares, which results in creation of operational synergy derived from the cooperation of subsidiaries and increase in innovation potential of the entire group.

Impediments to the execution of long-term, consistent strategies and in synergy effects management are the main hindrances that occur in this form of corporate groups. One theoretical advantage of corporate groups is the parent company's right to invest in subsidiaries that have a variable rate of return. Needless to say, every investment of this kind is prone to a different type of risk. In such instances the company that makes investment is entitled to diversify its own investment risk.

Investment risk diversification pattern (figure 1.8) is typical of financial corporate groups where the parent company is assigned a specific role i.e. it does not run an operational activity and is solely involved in managerial activities with regard to the management of its own shares and the shares of subsidiaries. The ensuing risk diversification results from the extent equity is involved in particular

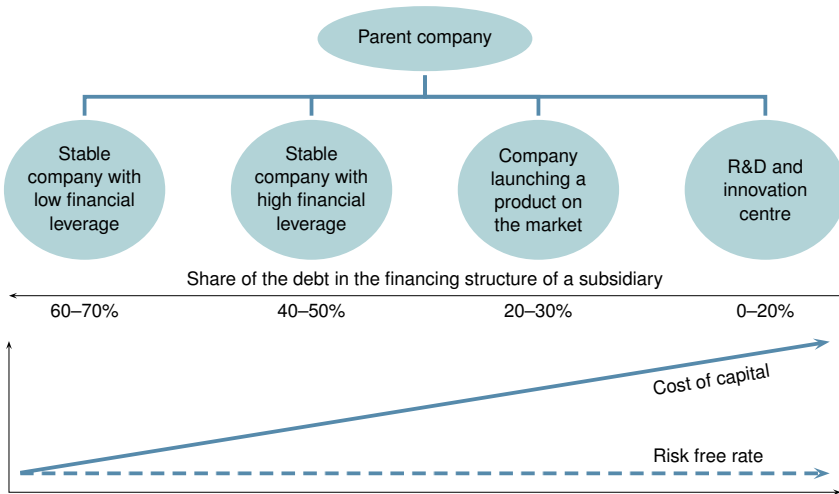


FIGURE 1.8 Investment Risk Diversification in a Corporate Group

subsidiaries. The degree to which equity is invested in subsidiaries is determined by risk diversification. From the parent company's perspective, each company is an independent investment project with a particular risk level, and a different system for financing its assets. A company with stable income structure and low level of operational leverage (high variable costs) requires lower equity investment owing to a lower level of risk. Basically, the expectation of a higher rate of return implies entails a higher level of risk. A parent company takes investment decisions according to the same criteria as any other investors:

- investors are entitled to make investment in risk-free securities, e.g. gilts, or shares, which pose more risk, at their convenience,
- a business activity that operates in the free market economy is prone to risk borne by investors. The risk is compensated by a respective bonus in the form of higher rates of return,
- if an investor does not want to bear a type of risk that is typical of a particular industry or company, they can diversify it and invest in companies in proportions that are comparable with their market share.

The main aim of managerial corporate groups is maximization of investment advantage that parent companies have as well as reduc-

tion of investment risk. Effective financial support, a transparent and flexible structure, high autonomy of companies within the group and their high innovation potential are undeniably key strengths of this form of corporate group organization.

On the other hand, entities within managerial corporate groups are tenuously integrated. Besides, the very group is incapable of generating operational synergy; both these features are the main weaknesses of this form of an organizational structure.

Operational Areas, Relations and Processes in Corporate Groups

Management in corporate groups is intended to generate synergy as a result of processes taking place in an organization. This approach requires integrated management of the group's operations, resources, and relations with regard to an array of processes which may be referred to as basic and ancillary processes according to M. E. Porter's (1985) traditional concept. Basic processes are characterized by a requirement of incremental know-how input, product innovations, knowledge management, the necessity to create flexible solutions and animated communication amongst all business partners (see table 1.2).

Ancillary mechanisms are indispensable for successful execution of primary processes. Knowledge that integrates human resources and infrastructural resources is pivotal in this respect. Supportive processes enable an effective transformation of company resources into up-to-date products. Besides, they contribute to an increase in the company's competitive position, and encourage synergy opportunities (see table 1.3). Due to the repetitive nature of ancillary processes, the cost synergy is more attainable owing to the integration of these processes in a corporate group.

Combining entities in groups enhances growth of all participants of an organization. Positive changes may concern parent companies as well as subsidiaries. Since parent companies usually have key assets and competences, they become an element of external environment for other companies that belong to one group, and are not as competitive or effective with regard to production, technology, human resources, and finances. Companies that are less technologically or organizationally developed are forced to make rapid progress to create a potential synergy opportunity for the entire group. On the

TABLE 1.2 Basic Processes in Corporate Groups

Areas of activity	Traditional organization	Corporate group
Internal logistics and production preparation	Processes are carried out according to demand and order analysis. Orders are placed by the sales network in a traditional form.	Internal logistic processes and potential production preparation are dependent on a type of a corporate group. In vertical structures these are characterized by intensity and wide range, while in conglomerates they are residual and often accompanied by outsourcing.
Production	Economies of scale condition the company's competitive advantage. Production cycle is sequential, discreet and determined by machine processes. Production bottlenecks are related to financial and human resources.	Competitive advantage of corporate groups stems from flexibility in terms of production scale and profile adjustment to market demands. It may result from production variety (conglomerates), a high product quality standard (horizontal structures) and a high logistic standard of customer service (vertical structures). Problems related to basic production processes – i.e. bottlenecks – result from potential disturbances in internal communication.
Services (non-core business)	Company is unable to render services in the area that is unrelated to its primary product.	Alternative and development opportunities pursuit fosters the approach according to which extra activities are an inextricable part of operation. It often becomes a prerequisite for improvement of the company's competitive advantage.

Continued on the next page

other hand, parent companies or more developed companies that join a new partnership, find new circumstances of the environment easily adjustable even though they understand that new conditions are usually more unpredictable and dynamic.

In order to maintain the position of the leader in a particular industry, market or structure they are forced to make further headway. Therefore, all participants of economic processes taking place within one group are developing steadily. Although the reasons for growth may differ, immediate consequences always include more effectual market relations that the group has with its business partners (both

TABLE 1.2 *Continued from the previous page*

Areas of activity	Traditional organization	Corporate group
External logistics	Products reach customers via its own distribution network. The process involves company's own transportation means, which has tremendous impacts on delivery time.	Sales and external logistics are determined by organization pattern and type of a corporate group. They make use of their own solutions and units, contractors who render complex logistic services, outsourcing processes of various degrees of intensity, or may be absent in some rare cases altogether.
Marketing, sales, customer service	Limited impact of marketing and advertising, high cost of advertising campaigns. Brand promotion occurs during occasional marketing campaigns, and sale by means of traditional channels, in particular via contracts with sales networks with the use of future sales forecasts. One-directional market regulated customer relationships.	The image of a company is enhanced by means of progressive marketing methods that require more expenses. Execution of primary functions in this area is delegated to either central organizational units that integrate all companies within the entire group, or each company's relevant units. External companies may be held accountable for this scope, too.

external and internal), which in turn stimulates its competitiveness and creates synergy potential. High intensity of integrative processes, especially in organizations that are related operationally (figure 1.9) that happen within corporate groups is what differentiates corporate groups from traditional companies that run business independently; this induces synergy mainly on account of assets sharing, integration, and increased management efficiency.

This phenomenon is more intense in corporate groups where synergy and added value are generated as a result of following this course of action. For approximately 20 years, M. E. Porter's (1985) classical value chain which concentrates on supply chain configuration, has been a source of inspiration for new concepts related to added value creation in various areas of business. Oftentimes, as new forms of business organization appeared and knowledge gained more signifi-

TABLE 1.3 Ancillary Processes in Corporate Groups

Processes*	Traditional organization	Corporate group
Infrastructure	Complex infrastructure and functions. Investment in development of productive assets intended to increase the production potential.	Infrastructure adjusted to the scope of needs of the entire corporate group. Investment in information systems and information technologies (IS/IT), which ensures group integration, plays the most significant role. Knowledge and information are group's main resources. Investment related to technical and organizational areas of cooperation amongst companies within a corporate group.
Human resources	Employees perform a substantial part of company's operations and provide labor force. Manual workers turn material resources into products. Work organization is based on rigidly defined scopes of duties, and requires limited qualifications.	Employees are company's most important asset, they shape organizational structure and impact company's growth. Knowledge officers transform knowledge into formal and informal structures. Knowledge resources are reflected in know-how, and generate innovation. Corporate groups demonstrate numerous traits of virtual organizations. Work organization is based on employees' qualifications, and formalization determined by the group type and degree of its internal integration.
Technology	Technological development mainly revolves around production area and is intended to improve economies of scale.	Emphasis is put especially on the development of modern technologies, IT in particular, as well as technologies connected to process management that aimed at enhancing efficiency of order completion, and growth in the competitive potential of the organization.
Knowledge	Knowledge is a tool and asset. Qualifications are deemed to help apply new instruments. Information becomes a means of control. Managerial source of power is a rank in the organization.	Knowledge draws business interest and helps create new values. Information is an asset and means of communication. Competences and expertise are a managerial source of power.

NOTES *And disciplines of business activity.

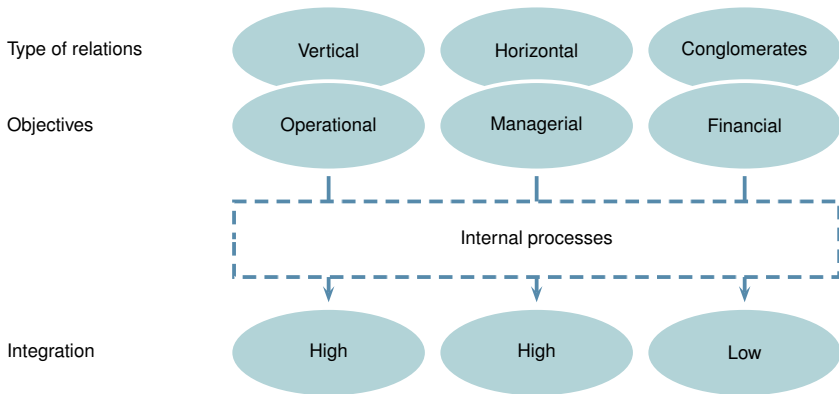


FIGURE 1.9 Synergistic Integration of Processes within Corporate Groups

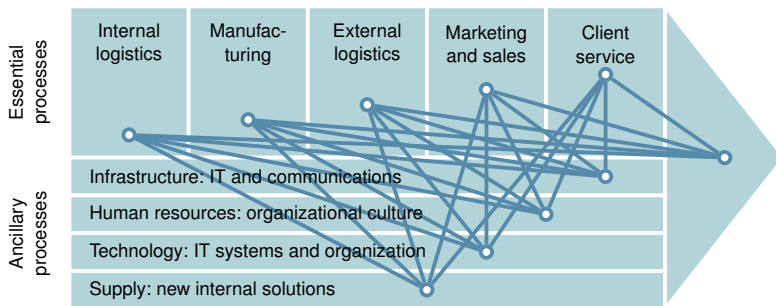


FIGURE 1.10 Traditional Value Chain and Relations within Corporate Groups

cance as an asset, catalyst, and the main product, internal and external logistics as well as material product manufacturing have become redundant. Naturally, new ways of value creation emerged, two of which – i.e. stores and value chains (Stabell and Fjeldstand 1998) – having gained the most popularity.

There are two basic reasons for loss of timeliness of the classical value chain with regard to corporate groups (figure 1.10). Most traditional companies underestimate the importance of ancillary processes that aid primary processes since these are the latter ones that are the source of the value chain generation. A completely different trend prevails in corporate groups, which oftentimes focus on meeting highly personalized and non-standardized expectations of their clients. In this case the significance of ancillary processes – both within the group, and with all stakeholders – increase.

Another aspect is the degree of complexity of relations within a corporate group, particularly between subsidiaries and the parent company. On account of these relations, corporate group's internal structure acquires the attributes of a regular network structure. Some elements become common for all companies within the group, some determine particular features of certain companies, and some are outsourced. All these phenomena are meant to lead to an increase in efficiency, and pave the way for synergy, and eventually value growth of the whole group.

Special Purpose Vehicle in Corporate Groups

Over the last 20 years, corporate groups have been developing as a result of deployment of *Special Purpose Vehicles* (SPV) which require very high outlays, with the expected return on investment in 10 years' time plus, the application of which is highly unlikely or entirely implausible in traditional structures. Companies that are assigned to use SPVs raise funds by means of the so-called *project finance formula* (Lambe 2009; Howcroft and Fadhley 1998; Adler and Smith 2009).

Special Purpose Vehicles are mainly formed in electrical power engineering, exploitation of natural resources, transport and gas infrastructure, etc. SPVs' main objective is preparation, finance management and project completion up to the moment of commissioning. The company designated to execute the project often becomes an operator after a successful completion of the project. However, the other project's participants play a vital role in the course of the process of project execution with the participation of Special Purpose Vehicle within the *project finance* formula, too (figure 1.11). The preparation of an optimum project financing structure is of utmost importance. On the one hand, it ought to suit all parties in terms of expenditure, on the other – receive a badge of approval from all project participants in terms of tolerated risk. The parent company in relation to SPV ensures indispensable equity capital and serves as a project sponsor. The actual equity capital level ranges within 20–50% of the entire project funds. Tighter involvement of the parent company in the project is a more reliable collateral for loans granted by banks and financial institutions, which makes the latter ones endeavor to involve the project sponsor more in the process in general.

On account of an increase in external investment, the active in-

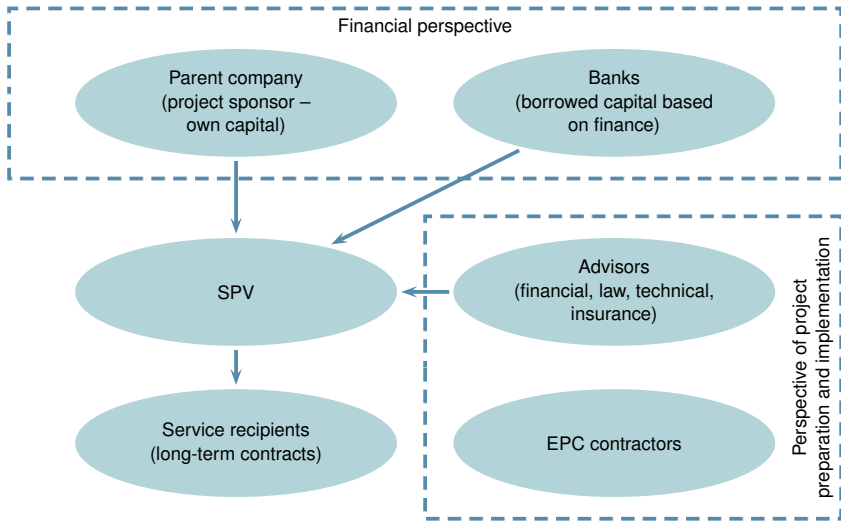


FIGURE 1.11 Simplified Project Finance Structure with SPV's Participation

involvement of banks at every stage of the project realization is becoming more significant. Unlike the case where a traditional bank loan is used to fund the project, it is not the lending credibility of the Special Purpose Vehicle but the assessment of profitability of the project itself and viability of incomes in the future, as well as debt repayment that are the main reasons for involvement in the enterprise. Thus, long term agreements with service recipients are so important. They are meant to ensure steadfast revenues and, consequently, debt repayment. Besides, potential claims on account of unsettled liabilities hold neither the parent company nor the entire corporate group accountable.

In fact, it is a contractual risk distribution agreed amongst all venture participants that makes SPV project finance so unique.

To sum up, designating a Special Purpose Vehicle within a corporate group, and the application of a *project finance* formula:

- enables the execution of investment projects that require massive input that exceeds financial capabilities of a single company, which is particularly important during the realization of infrastructural projects,
- conditions the collection of external funding on anticipated cash flow after the completion of the project,

- allows risk distribution amongst project participants,
- enables the arrangement of project financing based on off-balance sheet in relation to the parent company.

SPV and project finance based development strategy of corporate groups makes a very promising development path for multi-entity organizations such as corporate groups. Determination of the profitability of a project requires a diligent analysis of anticipated cash flow. From a bank's perspective, a project is viable commercially as long as financial surplus is sufficient to repay credit along with interest rates accrued. From the same point of view, projects within this formula incur higher risk than traditional loans, therefore financial institutions may expect higher bonuses to compensate for the risk. On the other hand, such a policy enables to maintain a good debt ratio and a funding structure as debt contracted by Special Purpose Vehicle is within off balance sheet financing formula in relation to the sponsor of the project i.e. the parent company.

The development of Special Purpose Vehicles is a complicated process that requires permanent management in accordance with project methodology (Rozenes and Vitner 2010). All project participants must be fully aware of its objectives, means of implementation, and each participant's scope of responsibilities.

Primarily, SPV based projects pursue two stages of development (figure 1.12):

1. the project stage that encompasses planning, preparing, and commissioning, and
2. the operational stage.

The exact and appropriate definition and assignment of roles is crucial for succeeding. Basically, the following roles may be distinguished:

1. *Steering Committee:*

- takes strategic decisions on the basis of consensus, not as a result of voting,
- its chairperson has a decisive say,
- is held accountable for the outcome of the project,
- is authorized to assign resources and initiate further action.

2. *Project Manager:*

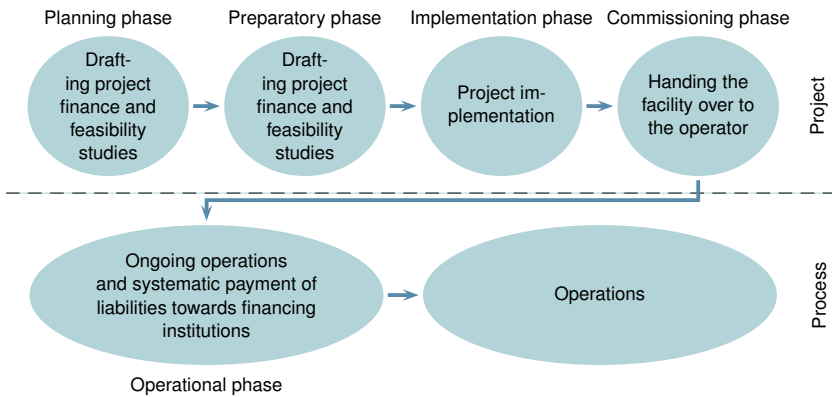


FIGURE 1.12 Development Stages of Corporate Groups Based on SPV Principles

- ensures that the project delivers products of the required standard within the assumed time and budget,
 - takes tactical and operational decisions,
 - plans, sets standards and guidelines, monitors and coordinates work,
 - reports to the steering committee.
3. *Project Supervision:*
 - sees to the execution of particular stages of the project.
 4. *Engineering Teams:*
 - are indispensable in big-sized projects that run in several geographical locations simultaneously, or when unique competences and expertise are absolutely necessary.
 5. *Project Assistance:*
 - provides administrative assistance for project managers, and managers of engineering teams.
 6. *Project Management Office:*
 - renders advisory services,
 - manages historical records related to completed and discontinued projects,
 - supplies instruments for project management.

Suppliers, recipients, and contractors (the so-called General Project Contractors) are key elements in the aforementioned types of projects. Suppliers are expected to provide steady supplies after the project

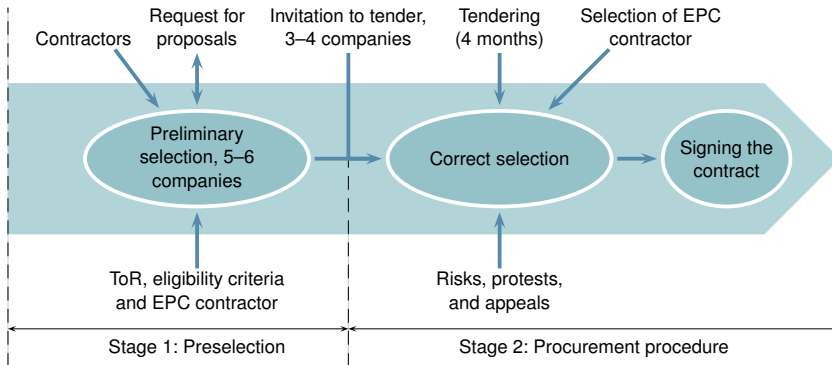


FIGURE 1.13 Standard Procedure of Contractor Appointment

completion whereas customers – unhindered consumption of services and cash to repay the incurred debt. Experience, reputation and market position are vital for General Project Contractor appointment procedure. Figure 1.13 shows an example of this process.

Appointment procedures are usually complicated and lengthy. General Project Contractor appointment process may last even several months. It is future GPC's competences and experience that are most significant in ensuring the success of the project; therefore investors are advised to pay utmost attention to this process.

Special Purpose Vehicle Funding Structure in Project Finance Formula

Building an optimum funding structure cost wise and risk wise is pivotal. Figure 1.14 depicts the main sources of SPV projects financing. Sources of SPV financing may be divided into:

1. *Equity* usually accounts for less than a half of the project budget. Since shareholders are the last to be paid off equity serves as a specific collateral for creditors who, naturally, strive to ensure as high equity in the venture as it is possible. The assumed level of equity ranges between 20% and 50% of the whole capital with subordinated loans (quasi equity), as long as their repayment depends on other liabilities settlement.
2. *Quasi equity*, also known as subordinated loans or *mezzanine finance*, is in fact an intermediary form between a debt and equity. It is paid off last before equity, and after the main debt, as

stipulated in a contract between parties. Such loans may be of the two following types:

- *general*, i.e. dependent on the repayment of all other liabilities,
- *particular*, i.e. dependent on the repayment of particular loans and credits that account for the senior debt.
- *Senior debt* is the main funding source for the project finance like ventures. It usually exceeds 50%, and oftentimes accounts for as much as 80% of the budget. Senior debt has an obvious advantage over other liabilities, namely its repayment is prioritized, and comes third after tax and salary liabilities. There are a few sources that it comes from, i.e. bank loans (syndicated loans in particular), loans granted by international financial institutions, corporate bonds, leasing and vendor financing to name but a few.

It is crucial to work out the optimum financing structure of the project (Lahdenpera and Koppinen 2009; Anderson, Byers, and Groth 2000). The optimization of project's financial structure conditions its successful completion (figure 1.15). Thus, at the preparatory stage certain actions are taken which are intended to:

1. Estimate expenditures necessary to spin the project off,
2. Estimate cash flow generated after the project has been completed,
3. Estimate project related risk,
4. Estimate discount rates,
5. Estimate profitability of the project,
6. Conduct a sensitivity analysis,
7. Conduct a simulatory, 'what-if,' analysis.

There are five main assessment methods used to assess investment project:

1. *Payback Period* i.e. time necessary for financial outlays to be completely balanced by profits that the project has generated. This method determines the time (in years) when investment will have been fully returned,
2. *IRR, Internal Rate of Return,*
3. *NPV, Net Present Value,*

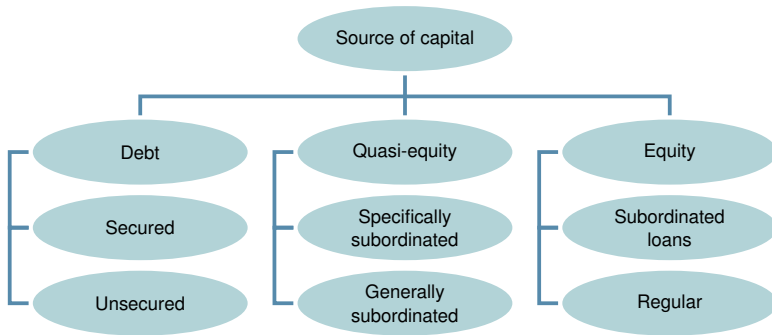


FIGURE 1.14 Potential Sources of Financing in an Optimum Project Structure

4. DCF, Discounted Cash Flow,
5. EVA, Economic Value Added rate, etc.

A relatively high level of risk shared by project participants is an important element of *project finance formula*, which assures a limited chance of recourse in comparison to the sponsor of the project. Owing to a natural risk-aversion, all project participants take action to reduce it by means of sophisticated risk management methods. Unfortunately, they entail certain consequences such as:

- Excessive cost generation which results from the project's scale and its complexity, number of funding participants,
- Time necessary to coordinate actions of a considerable number of project participants,
- Increase of the cost of debt, which stems from the readiness to bear higher risk by creditors, higher commissions, risk assessment, and risk compensation fees, as well as higher insurance costs.

In the case of long-term investment projects, potential risk identification followed by risk minimization is particularly significant (table 1.4).

Examples of risk taxonomy (Cagno, Caron, and Mancini 2008):

1. *Technical risks*. They arise on account of expenditure underestimates, project changes in the course of building, construction flaws, application of unsuitable technology, use of unverified technologies, low performance standards, loss of the key client,

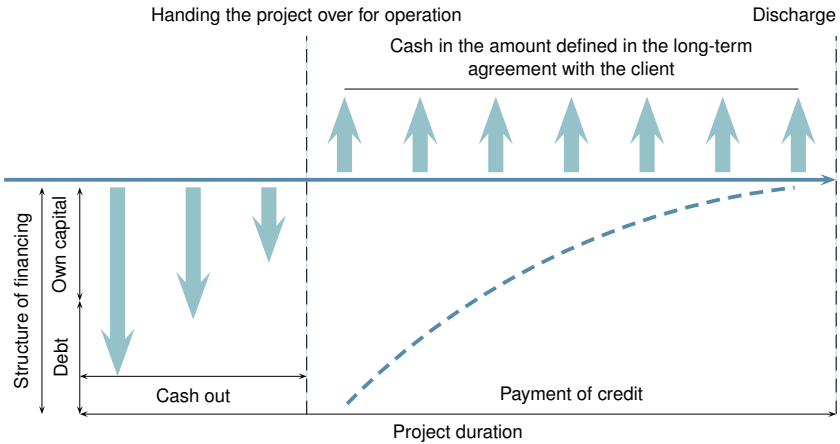


FIGURE 1.15 Cash Flow in Project Finance Formula

or a major contract change, infrastructure and supplies related hindrances. operational risk is a type of risk that can be classified as technical one. It occurs solely in the operational phase of the project, in other words after the commissioning of the project.

Additional disruptive factors to operations may include technical issues (e.g. equipment failures, and infrastructural problems), economic problems (e.g. raw material prices), organizational setbacks (e.g. performance), and other (e.g. legal).

2. *Economic risks* are considered with regard to two aspects:

- *Organizational*. Unlike the aforementioned technical risks, managerial and operational ones result from project mismanagement, poor workmanship or investment process organization as well as inadequate performance standards. Efficient project management techniques coupled with reliable methodology should be applied to reduce risk at the stage of project's realization. Besides, establishing project management office, customized staff trainings, and insurance against adverse effects of unsuitable equipment maintenance and service are of tremendous help in risk mitigation.
- *Financial*. Mainly occur in relation to currency exchange rate fluctuations, and potential securities-related risks. In project finance formula the assessment of credit repayment is con-

TABLE 1.4 Typical Risk Classification in *Project Finance*

Technical	Economic	Other
1. Delayed delivery	1. Managerial and operational activity	1. Political
2. Non-compliant operational parameters	2. Market risk	2. Force majeure
	3. Exchange rate risk	3. Environmental
	4. Collateral and repayment	

ditioned by the feasibility of incurring profits in the future. In some cases creditors can expect additional collaterals in return for the credit.

3. *Other risks* (political, environmental, acts of God) are beyond the power of the very project and its management; thus so as to minimize them project participants shall conclude appropriate insurance contracts.

Appropriate risk management requires the use of effective methods, which may cause a decrease in the cost of external capital. Besides, it may lead to persuading the bank (creditor) to lower the risk related premiums. To achieve it, a relevant methodology of risk management should be devised and implemented prior to the start of the project. The objective of risk management in the area of project finance is to ensure that each project participant bears acceptable risk individually, which eventually leads to risk mitigation in the project as a whole.

What may substantially contribute to the positive outcome of the project is the General Project Contractor's authority. Therefore, to mitigate potential risks, CPC shall commit themselves to submitting performance bond which must include the following elements:

- Risk of exceeding project costs,
- Postponement of project completion (the risk of project delay),
- Performance Bonds,
- Settlement of account in a local currency.

To eliminate the risk of exceeding project costs, the investor shall aim at concluding a lump sum (turn-key) contract which stipulates the final price of project completion. The price ought to be analyzed by experts who are unrelated to the contractor. To reduce the risk

delay in project completion, applicable liquidated damages for the event of delays ought to be stipulated in the agreement with the contractor.

Performance bonds enforceable in the event whereby the contractor fails to perform their contractual obligations is standard nowadays. On the one hand, bonds work to the advantage of project sponsors and creditors as they ensure compensation in the event of a failure on the part of the contractor. On the other hand, they attest contractors' reliability since it is only credible entities that are granted bonds by banks and insurance companies. Lastly, in order to minimize currency exchange rate related risk, accounts ought to be nominated in the currency in which the project is expected to be paid for, or to be insured with appropriate derivative financial instruments. It's necessary to stress that since project finance formula ensures the participation of the external entities in the project, it impacts positively its professional preparation, and management, which may be referred to as added value received on account of a practical application of this solution.

In conclusion, *Special Purpose Vehicles* (SPVs) play a vital role in synergy creating processes. They are established with the aim to organize and finance investment projects that involve high outlays related to e.g. electrical power engineering, natural resources, transport and gas infrastructure, and generate long-term return on investment. In such projects, in particular project finance formula based ones, the role of individual project participants who aim at risk reduction and therefore impact project preparation positively, is increasing. Owing to a relatively big involvement of external equities, the role of banks, which are engaged actively at every stage of project realization, is becoming more important too. Commercial viability, income and credit repayment feasibility are all determining factors that condition partners' decision to join the project as potential liability claims do not charge either the parent company or the entire corporate group but the very company that is engaged in the realization of the project. Special Purpose Vehicles that carry out investment projects within *project finance* formula:

- enable accomplishment of investment Project that require massive expenditures,
- condition outside funding raising on anticipated cash flow after

the project completion based on off-balance nature of debt in relation to the parent company,

- enable risk distribution amongst project members.

Deployment of SPV within Project finance formula is a complex process. Due to a natural aversion to risk, each project participant endeavors to limit it while securing their own position. Thus, to find a mutually satisfying compromise in such projects may turn out to be a real challenge. Oftentimes it results in the parent company engaging more profoundly in efforts to reduce risk for all project members. It usually means the parent company's equity's more extensive involvement or a repayment guarantee of some liabilities by the parent company. Therefore, to create the optimal financing structure with regard to both expenses and risk is key in the process of establishment of fund raising structure. Unfortunately, there are upsides to project finance formula too, namely high cost generation, time consumption, etc.

Observations included in this chapter lead to the following recommendations applicable in corporate business practice:

- corporate groups enhance resourcefulness and economic accountability, they also promote economic freedom,
- individual entities have a limited flexibility in the area of solution application with regard to operational setbacks, which often results in the appearance of disturbances in the integration of all subsidiaries and attempts to channel their efforts with an aim to aid the entire structure,
- excessive diversification within the frame of a single group ought to be avoided as it is likely to pose threat to efficiency on account of a potential failure to collect a plethora of indispensable competences in the scope of business diversification,
- the form the corporate group takes and relations between its subsidiaries ought to reflect realistic developmental strategies in particular with regard to synergy effects and competitive advantage,
- *Special Purpose Vehicles*, SPVs, designated to carry out big-sized investment projects within the frames of the *project finance* formula enable risk reduction on the part of the parent company. Participation of multiple entities in SPVs fosters efforts to pro-

duce the best case scenario at the preparatory stage of the project, which is this formula's main upside. Due to the costliness and lengthiness of this formula's application, however, it is advisable to consider its use mainly in considerably big-sized projects, the scale of which is bound to compensate for high expenditures at the preparatory and executory stages.

Chapter Two

Synergy in the Perspective of Company Owners

The Essence of Synergy

Synergy as a phenomenon may be related to many areas of life, fields of study, and science: biology, praxeology, medicine, physics, systems theory etc. Synergy means amalgamation of certain factors that result in a complex outcome which differs quantitatively and qualitatively from the basal effect, and has a higher value. Synergy is determined by the complexity of an organization. Synergy effect arises as a result of integrating processes and is conditioned by a numerous factors. In business practice, a complex outcome ought to be quantifiable. Besides, it should lead to increase in value and improved financial performance.

The term of synergy invokes lots of misconceptions and negative associations, therefore it should be thoroughly explained with regard to both theoretical and practical context. For multi-dimensional understanding, this phenomenon should be meticulously probed into with regard to issues such as resource sharing, perceptions of synergy and particularly the resultant net effects related to the cost of coordination. Synergy is a fundamental reason for the majority of investment decisions in corporate groups, and it entails an expectation that the value of companies that cooperate together is higher than the total of the value of each company operating separately.

The literature on the subject offers numerous definitions of synergy. According to Goold and Campbell (2000) synergy is derived from the Greek word *synergos*, which literally means *working together*. Business wise synergy means the ability of two or more units to generate higher value as a result of mutual effort than each unit would, were it to create the value individually. It is this understanding of synergy that other authors refer to as well (Harris 1981; Gruca, Nath, and Mehra 1997; Harrison, O'Neill, and Hoskisson 2000). L. Bertalanffy (1951), the co-authors of the systems theory, already at the start of the 50s made the following observation: 'the performance

of a particular element within the system is different than when it is examined in isolation. It is impossible to total the performance of the entirety by adding up performance of its each separate part. To understand the performance of each separate part, relations between subordinate and superordinate systems must be taken into consideration.⁷ In other words, synergy occurs when entities achieve more in the course of cooperation than if they could were they to operate on their own. Synergy receives credit owing to the positive effect accomplished on account of togetherness that differs from the aggregated result that separate and isolated factors would bring.

In business practice, however, synergy is not always the case. Not only does interaction between entities fail to result in creating added value, it may also lead to a negative outcome. Such instances are referred to as dissynergy, which in other words means synergy the value of which is negative. In common understanding synergy is associated with its effect, and related to by means of the following synonymous expressions: a combined effect, reinforcement effect, '2 + 2 = 5' effect, harmony effect. The occurrence of synergy effects is conditioned by the presence of the complexity phenomenon in the organization.

Recent academic research has depreciated synergy despite the fact that 'the synergy failure results from companies' inability to understand this concept correctly and apply it appropriately, not owing to the fault of the very notion' as Porter (1985) asserts. It is necessary to underline the inefficiency of application which led to the mistakes made at different stages of the process affect the end result and not yield the assumed synergy effects. Unfortunately, lack of proper understanding how synergy ought to be implemented creates the air of ambiguity around this phenomenon whereas literature on the subject is scarce. Theoreticians and management practitioners should strive to achieve important utilitarian goals by connecting synergy and its realistic results with the impact on the value of the organization, and the value for shareholders in particular.

Synergy as a notion is not abstract and therefore should not be treated as such. Its effects are achievable in practice. However, they often turn out to be illusory because either synergy execution is overly superficial or the procedures used to implement it prove to be inappropriate.

Despite the progress in theoretical approach to the issue, research findings merely offer practical guidelines on accomplishment of syn-

ergy only. Synergy identification and its anticipated effects as well as suitable implementation processes require a variety of managerial skills. In-depth theoretical knowledge and analytical skills must go hand in hand with intuition, experience, and open-mindedness.

Resources Sharing as a Determinant of Synergy

A desire to accomplish synergy leads to creation of corporate groups, acquisitions and partnership agreements. Oftentimes, however, synergy benefits are not fully utilized. According to international research findings, utilization of synergy advantages is possible solely when resource sharing (Pereiro 2002; Gruca, Nath, and Mehra 1997; Bornemann and Sammer 2003; Cornuel and Kletz 2001) comes into play. Resource sharing assumes that all external and internal resources that belong to the organization are applied by corporate group members in an optimum manner in order to improve competitive advantage. Resources may create geographical markets, production lines, client groups, etc. They may assume the shape of production facilities (investment synergy), client (sales synergy), supplies (supplies synergy), and management skills (management synergy). Lately, the definition of economic resources has widened the traditional triad, i.e. labor, capital, and land. Economic resources that belong to present day corporate groups include everything that may contribute to efficiency and productivity of the group, i.e. assets, organizational processes, information, and knowledge.

Resource sharing, though indispensable, does not suffice to achieve synergy. In some situations, shared resources do not make potential for synergy generation. In other cases, potential synergy may not be utilized fully. It may happen that synergy effects do not result in considerable competitive advantage for the company. T.S. Gruca, D. Nath i A. Mehra elaborate on the subject of how resource sharing may lead to creating a permanent competitive advantage. Their research proves that it is in fact a prerequisite for synergy, which may lead to one of the following:

1. accomplishment of the assumed synergy effects,
2. partial accomplishment of assumed synergy effects,
3. lack of synergy effects, which occurs if assumed conditions are not met.

The achievement of a permanent competitive advantage by an or-

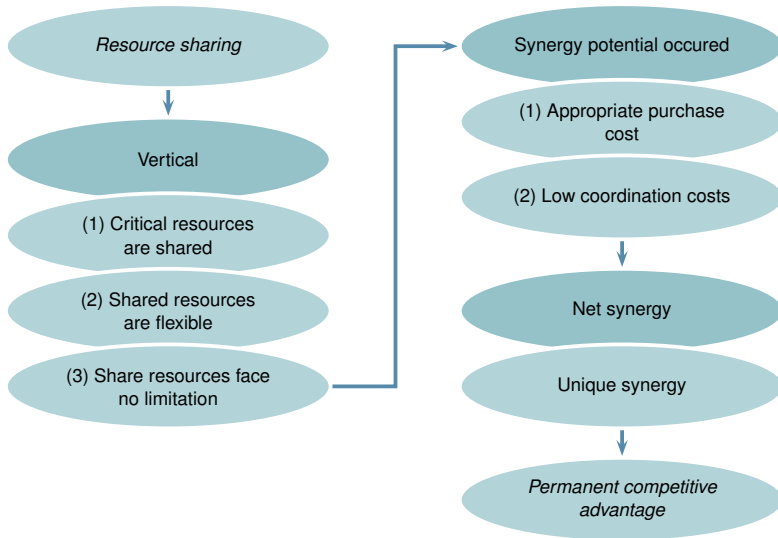


FIGURE 2.1 Competitive Advantage as a Result of Resource Sharing (based on Gruca, Nath, and Mehra 1997)

ganization requires more, though. It is important that communication within the organization is clear and leaves no doubt (McCann 1996). How mutual resources are utilized determines the synergy of the group, and its future value. Besides, in contemporary organizations, which operate in the era of information technology, sharing immaterial resources is becoming more and more significant. It is in fact immaterial resources that determine the condition and performance of companies operating in technological sectors where knowledge and knowledge management skills drive the company to gain competitive advantage, as described in the last chapter of this book. Figure 2.1 demonstrates the process of resource sharing that leads the organization to permanent competitive advantage. Although resource sharing is a prerequisite for synergy, it does not guarantee its occurrence, though. To attain synergy effects, shared resources must meet the following conditions:

1. be critical,
2. be flexible,
3. be unrestricted in terms of productive capacity.

It is solely the critical resources that enable companies to apply

strategies that result in increased productivity and profitability in the course of resource sharing. Besides, the more relevant the shared resources are for product value, the more indispensable they become. Since these resources bolster company's competitive advantage on account of generating higher company value, they are oftentimes referred to as basic competences. In order to ensure that shared and indispensable resources have a synergy potential, they must be flexible in terms of their capability to generate a variety of products. In other words, resources to use in a particular company within a corporate group shall not be shared and utilized in another company within the same group. This is why synergy is so difficult to attain in structures comprising various domains or industries. To illustrate it, we can use the aforementioned showcase where one entity within the corporate group produces fruit juices, whereas the other – single machines or industry items. For both entities that substantially differ with regard to business sector, to gain synergy in supplies, production capacity utilization or shared sales network is unattainable since these resources are not substitutes in merchandise production in all companies within one corporate group. This scenario contradicts, however, the situation when companies within a single corporate group operate in media related business sector, where information may be re-used by various distributors (press, online portals, etc.) and where publishers may utilize the same technology and distribution channels for their products.

Resource sharing must not be affected by productivity capacity limitations. This requirement leaves no doubt. Synergy cannot be attained in the situations when shared resources restrict the production capacity of other entities within the same group. Since the capacity of production machines is limited, sharing thereof ought to be similarly restricted. There are no constraints imposed on the use of a brand name and some know-how related items. In the case of such resources, resource sharing proves to be a useful means to achieve synergy and potential value increase. In the case of renowned companies, in fact it is the brand name that has considerable impact on pricing strategies. The brand image of high-end products and services increases the profitability of the operations, and leads to value growth of an entity and, as a result, of the entire group. If this situation is the case, synergy effects for a corporate group are highly plausible. To reiterate, if shared resources are indispensable, from the

viewpoint of corporate group participants they may be substituted, and are contained within the bounds of the group's productivity capacity, which inevitably creates potential for synergy.

Synergy arises if the conditions for resource sharing are met. Resource sharing entails expenses incurred for their acquisition and coordination. These expenses are expected to be lower than synergy effects that occur as a result of resource sharing. Only in such circumstances is synergy going to yield positive results. Besides, when resource sharing is carried out more effectively than in other companies, in particular companies within the same business sector, the process brings about a permanent growth in competitive advantage. Unless the sharing is outstanding and exceptional, the organization will not gain permanent competitive advantage.

The process of analysis and estimating net synergy comprises two basic stages, i.e. (see figure 2.2):

- synergy creation and analysis,
- synergy type selection and its implementation.

The key to creating accurate synergy estimates is net synergy, which includes the cost of synergy attainment.

There are two main types of costs incurred in the process of synergy creation, namely:

- the cost of coordination,
- the cost of compromise.

The cost of coordination comprises all expenses related to provision of uninterrupted deployment of common resources, for instance, production stage planning costs, commodity provision planning, adequate use of industrial capacity and knowledge sharing related expenses in the case of non-material resources. The cost of compromise makes a more significant component, mainly when material resources sharing comes into play in situations when resources applied by one entity could be utilized simultaneously by another entity within the same corporate group. In such cases managers must pursue a compromise, which frequently entails an extra cost, referred to as the cost of compromise.

The cost of compromise that arises in such situations as well as the cost of coordination shall not surpass the anticipated profits to ensure that resource sharing – which the prerequisite for synergy – makes

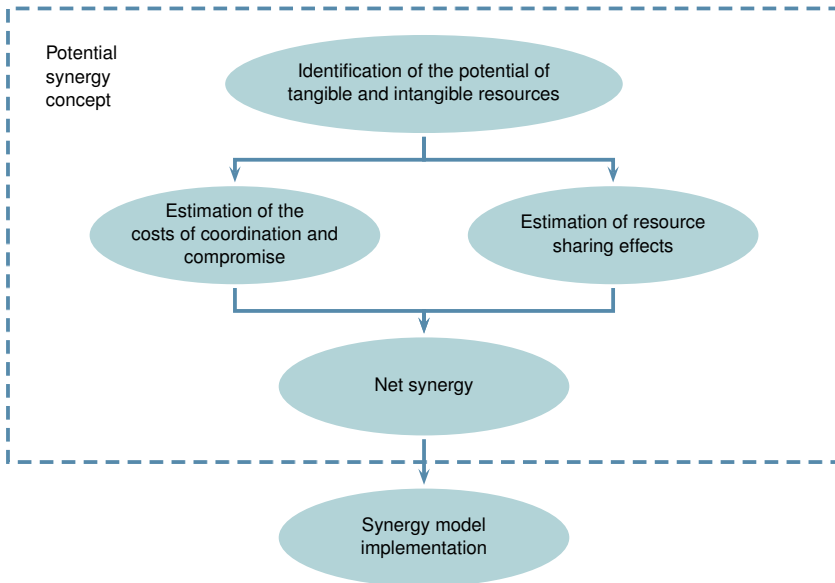


FIGURE 2.2 Synergy Implementation in Resource Sharing Model

sense. Rigorous appraisal of the costs lies in the hands of managers that are responsible for synergy processes in corporate groups. It is particularly challenging for new group members, as resource sharing prospects are often uncertain, their cost related nature and advantages – debatable. Managers’ analytical skills, intuition, and creativity are in such circumstances decisive in determining real profits that result from resource sharing. Clear advantages that arise from resource sharing phenomenon are easy to identify in automotive industry (Osegowitsch 2001). The cost of a new car model design is estimated at USD 3 billion, resource sharing (construction, technological records, know-how), as well as cost distribution among a greater number of cars is what conditions profitability of the operations in this sector.

The utilization of the same car parts such as chassis and driving components (engine, gears, axes) in a few car models may serve as the best example.

In conclusion, synergy creation and acquisition of competitive advantage by a corporate group requires special consideration of the following resource sharing-related factors:

1. Resource sharing in an organization:

- is a prerequisite for synergy to appear,
 - is not sufficient for ensuring synergy creation.
2. For synergy to exist, shared resources:
 - must be critical for value chain,
 - must be flexible in both sharing and utilizing,
 - must be free from constraints in the industrial capacity.
 3. Potential synergy emergence depends on:
 - acquisition costs,
 - coordination costs.
 4. For synergy to result in a competitive advantage generation:
 - resource sharing must be unique,
 - resource sharing template must not be easy to imitate by competitors.

If these prerequisites are sufficiently fulfilled, they contribute to building competitive advantage of the entire corporate group and result in synergy creation and consequently – in the increase in the overall value of the group.

Capital Investment: A Unique Instance of Resource Sharing

The analyses presented in the previous chapter show that synergy is rooted in the concept of resource sharing. However, to acquire synergy benefits by means of resource sharing, a number of conditions must be met. Every single instance of resource sharing entails extra coordination costs, the ultimate net value, however, ought to be in the black. The anticipation of additional synergy effects has become an important argument in favour of creating corporate groups. What is of particular importance, is the division of resources in assets of the company that chooses to make investment; this process results in the establishment of the subsequent subsidiaries in the corporate group. As a result, an entirely new organization with a permanently changing structure of assets is established. The new value of the parent company after the capital investment has been made may be described using the following formula:

$$V_1 = V_0 + I - Ca - Cc, \quad (2.1)$$

where V_1 is the value of the corporate group after making investment, V_0 is the value of the corporate group before making investment, I is

the value of the new element of the group combined with the value of synergy gained as a result of capital investment, C_c is the cost of coordination, and C_a is the cost of acquisition or creation of the new entity in the group.

Thus, the anticipated relation being a result of an investment decision can be expressed by means of the following formula:

$$I > C_a + C_c. \quad (2.2)$$

Only meeting this condition may result in a reasonable investment decision, resulting in a permanent change in the structure of assets of the parent company (figure 2.3), i.e. the appearance of a new asset.

Company owners expect the value of the company to increase as a result of the investment decision they have made. While analyzing the whole investment process, it is easy to conclude that they anticipate a rise in the value of financial assets resulting from the investment decision and either want this value to be higher than the value of the assets before taking and executing the investment decision or expect a positive impact of the investment decision on the value of the whole group. In other words, provided that the occurrence of a new participant in the corporate group follows an acquisition, this acquisition ought to contribute to an increase in the value of financial assets, which should be higher than the value of financial assets designated to make the acquisition or an added value for the entire corporate group should be generated as a result of the acquisition.

What ought to be generated is a new net synergy anticipated by company owners, and which should lead to an increase in the value of shares owned by shareholders. The value of synergy may be generated both in terms of the entity that has been taken over and the entire group. Figure 2.4 demonstrates potential variants of the change in the value of the organization depending on the value of synergy.

It is important to remember that it is net synergy value that we obtain, i.e. synergy calculated after deduction of the cost of coordination, and compromise, as well as the bonus paid in the case of acquisition. Chapter 3 will discuss in details the essence of the bonus and its impact on the acquisition outcome.

Synergy value does not always appear at the very moment of acquisition. Oftentimes, it takes more time as the value ought to be assessed accordingly. More importantly, the assessment ought to prove

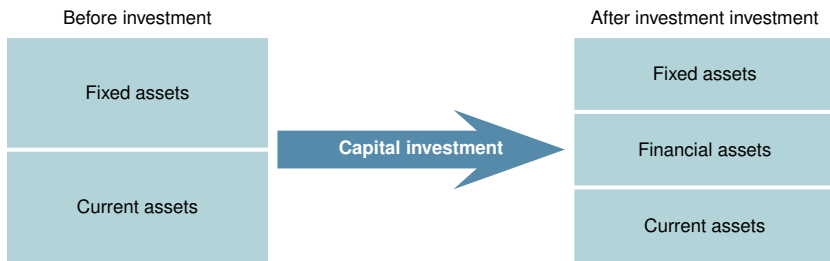


FIGURE 2.3 The Structure of Assets of the Parent Company as a Result of Capital Investment

that the value of the group after the investment decision has been executed is higher than before. Basically, the ensuing capital investments are supposed to initiate the process of sharing the tangible and intangible resources among group members. Group synergies will appear only and solely when positive cost related tendencies begin or when there is a rise in the income for the group as a result of resource sharing. Economies of scale, learning outcomes, improved use of productive capacity, increased credibility, and compatibility of the system solutions are but a few examples of synergy related phenomena. Decisions on changing assets of the parent company inherently result in the creation of a new structure and permanent changes in the organization, both of which impact its future value. Aptness of the choices made at this point is critical for future synergy effects and value of the organization. The value of the new corporate group will emerge as a result of efficacy of the relations between group members and their ability to share the group's tangible and intangible assets.

In conclusion, the value of a corporate group after acquisition may be either:

- higher than the value of assets of the parent company before the investment,
- equal or approximately the same as the value of the assets before the investment,
- lower than before the investment.

In the first case we may expect growth in the value for shareholders, in the second case, there will not be any change in the value of the organization. The third scenario entails a loss in the value of the group as a consequence of the inappropriate investment decisions.

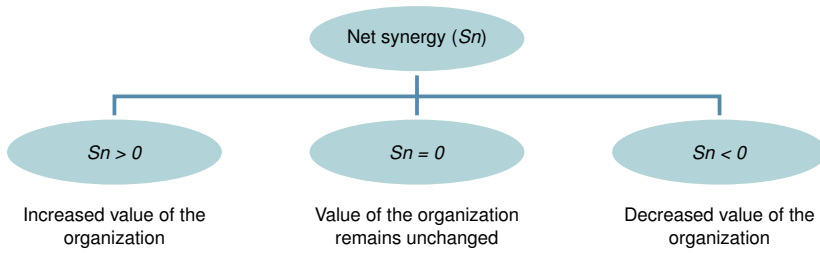


FIGURE 2.4 Net Synergy in Capital Investment

We must bear in mind that the establishment of a corporate group is a specific instance of resource sharing which causes a permanent change in the structure of assets on the part of the entity making investment decisions which lead, in turn, to the formation of more subsidiaries within the group. Owners anticipate a higher value of assets as a result of investment than the value the assets before the acquisition.

Synergy value appears within the entity that has been acquired as well as the whole corporate group. It is pivotal to remember that we are addressing net synergy value after the cost of compromise, coordination, and post-acquisition premium have been subtracted. Investment decisions initiate permanent changes in the corporate group and affect its future value. The correctness of choices is critical for potential synergy in the future since these choices are of strategic nature. Before the decision to establish a corporate group is made, what should be identified and scrutinized is the grounds on which synergy may occur, the potential for resource sharing, and outcome and costs of prospective resource sharing. A diligent analysis of the relations within the group and their potential for genuine synergy effects as well as of the viability of the success of the synergy model chosen ought not to be overlooked.

The emphasis should be placed on the implementation phase since it is when most setbacks occur. Besides, the attainment of real synergy effects is closely related to the ability of each company to share resources and activities within the corporate group. Profits that arise on account of resource sharing cannot be lower than costs that accompany them. The manner the subsidiaries emerged in as well as the relations amongst them considerably affect the ultimate synergy outcome.

Synergy Feasibility in the Scope of Activities Sharing

Synergy is not an automatic phenomenon. It is a result of a certain action on the grounds of resource sharing. In corporate groups, the sources of synergy may be derived from shared activities. For a particular group, some activities may be worth sharing, while other not. Whether cooperation performing activities creates value depends on particular group members that activities sharing is contemplated for. Sometimes it is difficult to determine which activities are worth sharing, as well as to anticipate which entities with may pose some difficulty at times. The potential of mutual relations must be properly recognized and suitably assessed. The probability of achieving synergy is supposed to be based on an honest appraisal made by the boards of particular companies and coordinated at the level of the parent company.

The relation of shared activities to the corporate group strategy as well as to competitiveness ought to be analyzed. For instance, the effects of shared activities related to strategy may entail the following:

- cost reductions in the scope of research and development,
- leadership in the area of quality,
- innovative, pioneering solutions,
- sales and marketing solutions,
- control reinforcement, etc.

The effects in the scope of competitiveness may include technological and marketing advancements, as well as the effect on suppliers and recipients to name but a few. The viability of interaction which stems from synergy to a large extent depends on the implementation processes. The combination of the elements that are assumed to generate value in theory may prove to be a challenge in practice. Activities shall not be randomly mixed, they must be properly interconnected to become a synergy generator, which is an important element that builds a corporate group and identity of a particular corporate group. In some cases matching employees who are responsible for different activities and the turnover in entities may help these particular entities to identify and attain synergy as a result of mutual operations. Some relations will materialize naturally and intuitively. Every strategy ought to take into account the current background and company record. What is important is the awareness

whether shared activities may stimulate the generation of a lasting competitive advantage. The cases of easily trackable activities sharing do not usually end in a success. Numerous examples show that for competitive advantage building, it is necessary to develop mutual relations that are not obvious or simple, since the aim is to create interdependency that is unidentifiable for competitors. The group's strategy should be constructed in such a way so as to impede rivals. Furthermore, both resource sharing, and shared activities have the potential to create a value chain. Common clients, distribution channels, and technologies provide opportunities for sharing activities, and, as a result, generating synergy and competitive advantage.

Porter (1986) distinguishes five types of relations based on activities sharing:

- infrastructural,
- technological,
- supply based,
- production based,
- market-based.

Porter (1986) points out that synergy potential which is attainable on account of the so-called skill-transfer based relations, allows for the transfer of know-how from one value chain to another. Know-how transfer is feasible even in companies that run dissimilar business activities. In other words, even the companies that cooperate under a corporate group by means of sharing various production processes may demonstrate similarities allowing for mutually beneficial know-how transfer within a value chain. This potential is particularly worthy of capitalizing on in corporate groups. Skills transfer requires a thorough analysis of relations and their background. Know-how transfer is derived from general similarities between business entities, such as:

- cost strategy,
- client profile,
- value network structure.

Even when business entities differ too much to support activities sharing relations, they may bear enough resemblance to enable know-how transfer. Know-how transfer of a single key element may

result in generating considerable competitive advantage, which is a rare case unfortunately. The last chapter addresses the chances of synergy generation in the scope of intellectual capital in greater detail.

Neither resource sharing nor activities sharing is cost free. The question that arises inevitably is whether the sharing related profits will exceed the costs that sharing incurs. As far as sharing activities is concerned, three different types of costs may be differentiated:

1. *Cost of compromise.* When activities are shared, making a compromise, which is never ideal for either party, becomes unavoidable.
2. *Cost of coordination.* To share activities, business entities must accept that in the course of prioritizing, planning, and resolving problems, additional expenses and human resources related costs, etc are often involved.
3. *Costs related with lack of flexibility.* Sharing activities may generate considerable costs because the ability of business entities to respond to competitors becomes limited.

Although these three types of costs have a direct impact on synergy value, the costs that arise on account of the lack of flexibility seem to most affect the success of synergy or lack of thereof in corporate groups. Like resource sharing related costs, the costs incurred by sharing activities may be unequally distributed amongst the companies, which impedes permanent maintenance of competitive advantage. These differences may restrict managers' abilities to build and maintain lasting activities sharing-related connections, which jeopardizes the pursuit of synergy. This issue requires the engagement of a parent company, which must manage it according to the principle of synergy for the entire corporate group. Each form of corporate groups creates different synergy opportunities in the scope of sharing activities. The real value of synergy depends on the identification of its sources, preparation of the appropriate program, and its successful implementation.

Synergy Prerequisites in Corporate Groups

Every type of synergy depends on the presence of certain common factors amongst components of the organization. From the viewpoint

of activities executed in business organizations we can expect synergy effects in the following areas (Ensign 1998):

1. *Commercial synergy* arises when manufacturers utilize mutual commercial administration, distribution channels, advertising, promotions or reputation,
2. *Operational synergy* arises on account of a more effective use of staff and equipment, cost distribution, and advantages that result from common learning,
3. *Investment synergy* arises from the joint use of factories, jointly conducted research, shared machinery, equipment and raw materials,
4. *Management system synergy* is a result of a combination of managerial strategic, organizational, and operational problem solving skills.

It is important to address social impact of synergy being the result of properly managed integration processes. We may observe it owing to the growth of efficiency, which occurs on account of an increase in job satisfaction, improvement in incentivizing schemes, trust, and a high level of capital relations in the group.

Though they may have the same effects, the anticipated synergy may substantially differ from the actual one and vice versa. Already in the 1990s, diversification was regarded as a survival mechanism of a company in the unsettling circumstances. Most research related to synergy that dates back to the 1990s referred to diversification, mergers, and acquisitions. When competitors were setting up new firms, diversification was often considered as a means to help them catch up. Companies chose to diversify so as to keep up with market leaders. Many a time such decisions were taken out of necessity (an attempt to assure survival) rather than as an independent choice. These decisions not always ended in successful diversification, especially with regard to diversification processes within the same sector. ‘What conditions success?’ used to be the fundamental question then. In another research managers were seeking the explanation for the processes that occurred in the companies that chose to diversify. Thanks to Rumelt and many other scientists whose research encompassed various diversification models as well as analyses of the impact of diversification and synergy level on business results of

companies, three main synergy types were identified (Rumelt 1974; Rumelt 1982; Pandya and Rao 1998; Baker 1992; Berry 1975):

1. *Operational synergy*, generated owing to relations amongst units based on technical or market interdependency (Bettis and Mahajan 1985; Christensen and Montgomery 1981; Datta, Rajagopalan, and Rasheed 1981);
2. *Managerial synergy*, based on techniques and managerial talents (Hoskisson and Hitt 1990; Jahera, Lloyd, and Page 1987);
3. *Financial synergy* (that was the result of ‘a bigger capacity to collect external resources and to ensure a better utilization of the company resources especially for the most promising enterprises’).

The research proved that most companies were endeavoring to achieve financial synergy in the first place, fewer strove to attain managerial synergy. A lot of companies diversified into unrelated conglomerates which were highly decentralized and where synergy effects were scarce. For corporate groups where relations resemble conglomerates, operational synergy generation is hardly attainable in practice. Synergy effect anticipated in the course of the corporate groups formation process may be considered in a variety of contexts. This chapter mainly focuses on endogenous traits of corporate groups and their approach to potential synergy effects as well as growth in the value of corporate groups.

Since relations amongst companies that belong to multi-entity organizations may demonstrate a diverse nature, the perception of synergy that is generated in the course of corporate group formation is dependent on the group’s background. In other words, all positive effects related to the operation of a corporate group may be analyzed and assessed using various criteria.

Interdependencies among business entities that belong to a corporate group may assume one of the following forms:

- *Concentric interdependency*, which occurs when there is a complete dependence of subsidiaries on the operations of the parent company;
- *Sequential interdependency* developed when there is cooperation within the corporate group during which corporate group members utilize results they have generated;

- *Reciprocal interdependency* occurs when subsidiaries cooperate within the same area of operational activities and there is little scrutiny on the part of the parent company;
- *Aggregated interdependency* occurs when subsidiaries operate within the area unrelated to the operations of other subsidiaries.

The aforementioned interdependencies may result in:

- *Positive synergy* gained in the course of the formation of a corporate group. This case demonstrates an increase in the value of the group, and can be considered a success.
- *No synergy* gained in the course of the formation of a corporate group. The value of the group remains unchanged, and the expectations of synergy may be regarded as nonviable.
- *Negative synergy* gained in the course of the formation of a corporate group. The case demonstrates the group's value destruction.

The cases presented above shall be examined as net synergy. Potential synergy effects are the main incentive that drives the creation of corporate groups. It is both managers and owners that expect them to appear. Managerial decisions ought to result in providing opportunities for successful resource and activities sharing among the participants of corporate groups. Resource sharing is about a mutual and optimum use of internal and external resources of the organization in order to enhance its competitive advantage. Resource sharing is a prerequisite but insufficient to ensure positive synergy effects. In rare cases, resource sharing may not provide enough potential to create synergy. Sometimes potential synergy effects are not fully attained or the synergy that has been acquired does not suffice to generate considerable competitive advantage for the group.

In contemporary organizations operating within the information society, sharing of intangible resources is gaining momentum. It is becoming increasingly important in generating synergy in particular in technological sectors, where knowledge, and knowledge management is a driving force in gaining competitive advantage. We must remember that resource sharing entails additional costs, such as the cost of funding, cooperation, and compromise. The value of these costs must be lower than synergy potential generated as a consequence of resource sharing. Only then can we observe positive syn-

ergy effects. Besides, unless one company has executed resource sharing strategy more effectively than other ones in the same sector, the process is bound to end in generating a lasting growth in competitive advantage. For synergy to result in the formation of competitive advantage, resource sharing must remain unique and inimitable.

Selected Aspects of Value Management

Dynamic changes in the global economy, increasing competitiveness and growing globalization are making companies strive against one another in the fight to remain relevant. In order to develop innovative technologies, or to launch new and competitive products and services and revamp distribution networks – companies need funds. To obtain new capital for continued company growth besides maintaining the size of the current equity is the main objective for management boards. This aim may be accomplished when shareholders begin to believe that they are highly likely to gain a higher rate of return on investment they have made than they would were they to opt for alternative projects with a comparable risk level. Every investor naturally endeavors to manage their funds in such a way so as to gain a high rate of return on investment with as low risk as possible. Likewise, identical expectations are shared on the part of shareholders of corporate groups. Hence an avid interest in the notion of continued value increase oriented management referred to as *vBM – Value Based Management*.

Market deregulation processes, equity concentration in the hands of professionals, speedy, and widespread access to information, in particular economic and financial information, have enabled uninterrupted flow of funds. More and more often, boards of managers define the primary purpose of management as maximization of the value of shares for their shareholders (Norton 2003). Institutional investors precisely assess economic environment that the company operates in, the depth of the market, and its particular components, competitive position, change tendencies and products' appeal. Besides, they scrutinize the company's profitability, as well as its financial situation. Since cash flows are thoroughly examined, an estimate of attractiveness of investment opportunities available in the market in comparison to anticipated internal return rate may be made. Therefore, numerous leading international corporations in the USA as well as plenty of global companies have implemented and applied

Value Based Management methodology. The increase in the company value is an assumed effect of synergy typical of multi-entity organizations such as corporate groups. It is unequivocal that the notion of synergy reflects attempts to pursue an increase in the value of corporate groups.

Value Based Management as a notion evolved as the complexity of structures within corporate groups and business processes grew (www.valuebasedmanagement.net). In the period preceding industrial revolution before 1800, companies were small and simple enough in terms of structure that the need to apply vbm did not exist at all. The beginning of vbm application dates back to the period between 1800 and 1890 mainly on account of the arrival of economies of scale which stimulated the development of numerous methods to achieve growth in efficiency and productivity. The 19th century brings further product and service diversification as well as multiplication of types of business operations, which laid foundations for the development of new theories related to management and investment project analysis, such as ROI, DCF, CAPM, MVA, EVA, ABC to name but a few. The start of defining the company value for shareholders go back to 1950's and 1960's, when economists like Markovitz, Modigliani, Miller, and Sharpe devised a revolutionary Capital Assets Pricing Model (CAPM) which has been commonly used until today (Sharpe 1964). CAPM combines a rate of return on investment for investors with risk assessment for a particular investment. The rate of return on investment is reflected directly in the cost of the company's own equity, and, consequently, Weighted Average Cost of Capital (WACC). WACC is a factor that discounts future cash flows for the company and has a considerable impact on the value of the company evaluation. It is an important element that determines the aforementioned evaluation in the most up-to-date and progressive methods such as Shareholder Value (SHV), and Economic Value Added (EVA). SHV as a notion was developed and explained in a plethora of works, including Alfred Rappaport's (1986), which is considered to be rudimentary in relation to company value creation methodology. A similar concept based on cash flows, i.e. Discounted Cash Flows (DCF) Copeland, Koller, and Murrin (1994) put forward, and Bennett (1991) coined a new evaluation-oriented idea known as Economic Value Added (EVA). The term Value Based management was first applied by McTaggart, Kontes, and Mankins (1994). The discourse related to the

value of immaterial resources, which is the foundation of theories on intellectual capital, was surfacing in scientific publication more and more frequently. Besides, Balanced Scorecard model, which enables conversion of missions and strategies into action plans, was gaining in popularity too.

The resurgence of Value Based Methodology began in the 2000s as a result of dot.com crisis and the downfall of Enron. The demand for practical vbm applications was so massive that Rappaport founded an advisory council, ALCAR, that specializes in the implementation of new management strategies in multinational corporations. Almost all international advisory companies that publish their experience offer similar services with *In Search of Shareholder Value* published by Price Waterhouse (Black, Wright, and Bachman 1998), *The Value Enterprise* by Deloitte&Touche Consulting (Donovan, Tully, and Wortman 1998), and *The Value Imperative* by McTaggart, Kontes, and Mankins (1994) who are leading consultants at Marakon Associates being just a few examples. The essence of Value Based Management is a recognition that long-term value generation is a principal goal (Christopher et al. 1999). vbm helps to define aims to strive for and identify resources to achieve them. It also provides managers with information necessary to take right decisions regardless of where they are in the hierarchy (Copeland, Koller, and Murrin 1995). vbm prevents conflicting interests from appearing and lays out one common aim, which guides all company's resources into the direction of sustainable development.

Its application often means introducing pretty radical changes in the company management style. The key to success in its implementation is commitment of as many employees, including managers, as possible, which enables initiation of appropriate changes in the corporate culture (Chopp and Paglia 2002). We may distinguish three vbm perspectives (Keuleneer and Verhoog 2003):

1. *Instrument*: vbm is a set of techniques and tools that assist management and control processes, it is a mechanism that integrates scattered resources and channels them so they help to achieve the aim,
2. *Methodology*: vbm is a defined manner of carrying out activities and a set of processes that make the core of every business decision,

3. *Aim*: vBM's primary purpose is the pursuit of the sources of value maximization throughout long-term development strategies and optimization of a company or corporate group.

Value gauging – in other words evaluation methods indispensable in management process – is another component that is inextricably linked to vBM. Value Based Management is impossible without making value assessment, the methodology of which has been comprehensively described in literature on the subject. Thus, this book concentrates solely on its few managerial aspects. Net profit based assessment methodology frequently plays a very important role even amongst market analysts. It is crucial to remember that this form of methodology is based on historical data, which in dynamically developing environment may be quite unreliable when making forecasts for the future. Additionally, company management boards may tend to choose short-term oriented strategies rather than long-term investments which are more likely to be profitable for shareholders. Net profit based value assessment does not always reflect company results in relation to cash assets, and disparate accounting standards produce different profit results even though the company value remains unchanged. This approach:

- does not consider risk present at the time a specific profit was made,
- does not consider investment rate required to gain a specific profit,
- does not consider dividend strategies,
- ignores money value in time perspective.

It creates an opportunity for assessment manipulation, which yields incomparable results on account of the use of different methodology (Rappaport 1986). To boost profits, companies often make costly capital or real investments such as M&A. Profit gained and earnings per share (EPS) rises but discounted cash flow (DCF) analysis shows that such investments destroy or minimize the value of the companies and are disadvantageous for shareholders. The highest valued are the companies which can generate profits from lower investment outlays comprising both fixed and current assets, considered as a meaningful indicator of management skills. Instances of companies that made profit which failed to cover an increase in

current assets required to cash in on investment are not infrequent at all. Such companies will always need subsidizing. Therefore, methods that take into account money value in time and equity invested in profit generation are favored over net profit based assessment methods, which Peter Drucker (1995) referred to in the following words: ‘economic added value is based on the principle we have known for a long time: what we related to as profit, money that remains to maintain ownership capital is not profit in its true meaning. Unless the company makes a profit that exceeds its equity capital, it will make losses. It does not matter it pays taxes as if it were making real gains, it still returns to the economy less than it takes in the form of resources. [...] It does not generate wealth, it destroys it.’ There is a number of methods of value assessment applicable in a variety of situation that are based on different pieces of information. They are comprehensively explained in the literature on the subject and therefore will not be described in this work in detail.

Free cash flows that may be allotted to equity and external capital providers speak volumes about the company value. As a result of its business activity, the company generates free monetary means, a part of which is allocated to creditors. What remains goes to the owners – equity suppliers. On account of debt repayment priority we may encounter many different case scenarios. The value of money to go in the hands of the owners depends on the amount of free cash generated by the company. Whether this amount is large enough to guarantee the anticipated rate of return on investment arising from the investment risk entailed in the nature of the project is another story. What is of tremendous interest for creditors is economic viability of the company they choose to invest in, which decides upon what value is generated in the company after the cost of loan has been covered, as illustrated by EVA. EVA is a notion coined by Stern & Co. in 1989 and which has been implemented in numerous leading multinational corporations all over the world (Stern, Shiely, and Ross 2001). EVA is not a mere indicator of company’s performance. It is a foundation for incentivizing systems and an efficient method used for company value assessment.

Value assessment based on EVA index shows clearly whether a specific company generates real value for shareholders. In most assessment models, the value of a company is directly affected by weighted average cost of capital (WACC). In the DCF model it serves as a fac-

tor that discounts future operational profits, which means that its growth causes a decrease in the value of the company. In the EVA model, on the contrary, the weighted average cost of capital (w_{ACC}) is a primary factor that defines market cost of the investment capital, and identifies threshold over which the company begins to generate added value. Roberto Giozueta, the CEO of The Coca-Cola Company, phrased a simple definition of the significance that w_{ACC} has for company value generation: 'We acquire capital to produce concentrate and sell it at an operational profit. We pay off the cost of this capital later on. Shareholders receive the difference' (Rappaport 1986). Therefore, the aim of value based management is optimization of weighted average cost of capital in order to maximize the value of the company. w_{ACC} is a weighted average total of all elements that reflect partial costs of financing which come from various sources. Thus, in the course of selecting financial sources for the operation it is advisable to fully use the least expensive ones such as interest-free trade credits, and relatively inexpensive bank loans, and strive to eliminate pricey forms of financing, e.g. issuing shares, or high-interest loans from external sources.

In order to resign from costly forms of financing, it is necessary to optimize the company's asset structure as well as the rate of fixed and current assets, which is achieved by constant scrutinizing and increasing profitability of company's assets and eliminating assets with lower rate of return than the cost of w_{ACC} . Besides the partial costs that account for total weighted average cost of capital, the structure of equity affects the value of w_{ACC} , which was thoroughly analyzed by many scientists who proved and described it, allowing managers to pursue such a ratio of debt to capital for which w_{ACC} takes the minimum value and, consequently, directly influences the maximum value of the company (Pratt 1998). This subject related works have contributed to practical application of theoretical conclusions and resulted in capital restructuring of numerous American companies. In their simplest version, the changes were about increasing financial leverage in companies on account of decreasing equity value. The company used its own current assets to carry out the project and either liquefied unprofitable fixed assets or – under most aggressive strategies – took out another loan (Johnson 1999).

Special attention shall be given to the percentage equity share in relation to the debt of the company. Establishing this rate on the

basis of balance sheet value, i.e. the ratio of company's equity to debt is a common mistake. Most theorists and practitioners believe that in order to calculate it properly the market value of equity as well as the market value of debt must be applied. Detailed assessment methods of market value of debt (Ogier, Rugman, and Spicer 2004) and market value of company's equity (Fama and French 1997) are comprehensively described in the literature on the subject.

Chapter Three

Corporate Group Formation: Synergy and Value – Key Aspects

Corporate Group Formation Phases

Creation of synergy and an increase in value for company owners is the essence and objective of capital investments. Ultimate results and synergy effects are conditioned by a number of factors all of which account for complex processes that require unique competences at all process stages. They are related to the very selection of the developmental path, new company creation or acquisition, as well as management of the entire corporate group. Synergy issues that are explained in detail in the preceding chapters are inextricably linked to resource sharing. A specific type of resource sharing may be observed in the case of capital investments on account of which a part of current assets or fixed assets is converted into financial assets such as shares in a new business venture. The main objective of such investments is value growth for the whole group; it depends – however – on many factors, and results from a complex investment and implementation processes.

The process of value creation in a corporate group has four main phases (see figure 3.1), i.e.:

- *Capital investment*, the process in which decisions about the choice of a developmental path and structure of a corporate group are taken. In the case of acquisition, due diligence of the company that is being acquired as well as a formal closure of the transaction should follow (Phase One).
- *Integration*, i.e. development and implementation of procedures and operation principles applicable in a new entity in the corporate group. By and large, it is a complex process of change management (Phase Two).
- *Formation and management of processes in a corporate group* intended to seize all synergy and value maximization opportunities for the entire group with process optimization for the group as the basic challenge at this stage (Phase Three).

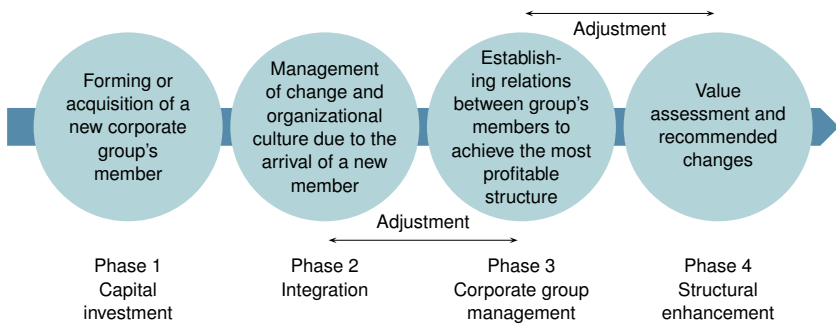


FIGURE 3.1 Stages of Corporate Group Development and Value Creation

- *Structural enhancement* meant to drive the creation of the organization with a strong identity, and recognition (Phase Four).

Phase One entails preparation and execution of an investment decision, i.e. creation of a new entity or acquisition of the one that is available. As a result of the investment, the corporate group assumes a new shape with a new number of group participants, new development opportunities, and asset structure. The manner of planning and executing capital investments determines subsequent stages of development and decides upon the scale of attainable synergy effects. Capital investment is irreversible, which means that the decision is irrevocable, and that its rectification is likely to entail serious financial consequences.

Phase Two – integration – a complicated process related to change management. New elements in the group must be appropriately integrated with existing ones. The main aim of integration is to enable the group to operate effectively and implement the devised strategies. From the point of view of the group value, however, the main goal of integration is to build an organization that is capable of synergy creation on account of cooperation, resource sharing capacity, and outsourcing redundant elements and processes, etc.

Phase Three is related to the optimization of corporate group management. We can distinguish various degrees of integration. Efforts in the scope of management at this stage are linked to optimization of basic and supportive processes in the entire group. It is highly recommended to deploy the concept of procedural management in this area.

Group and value management is inseparably connected with *Phase*

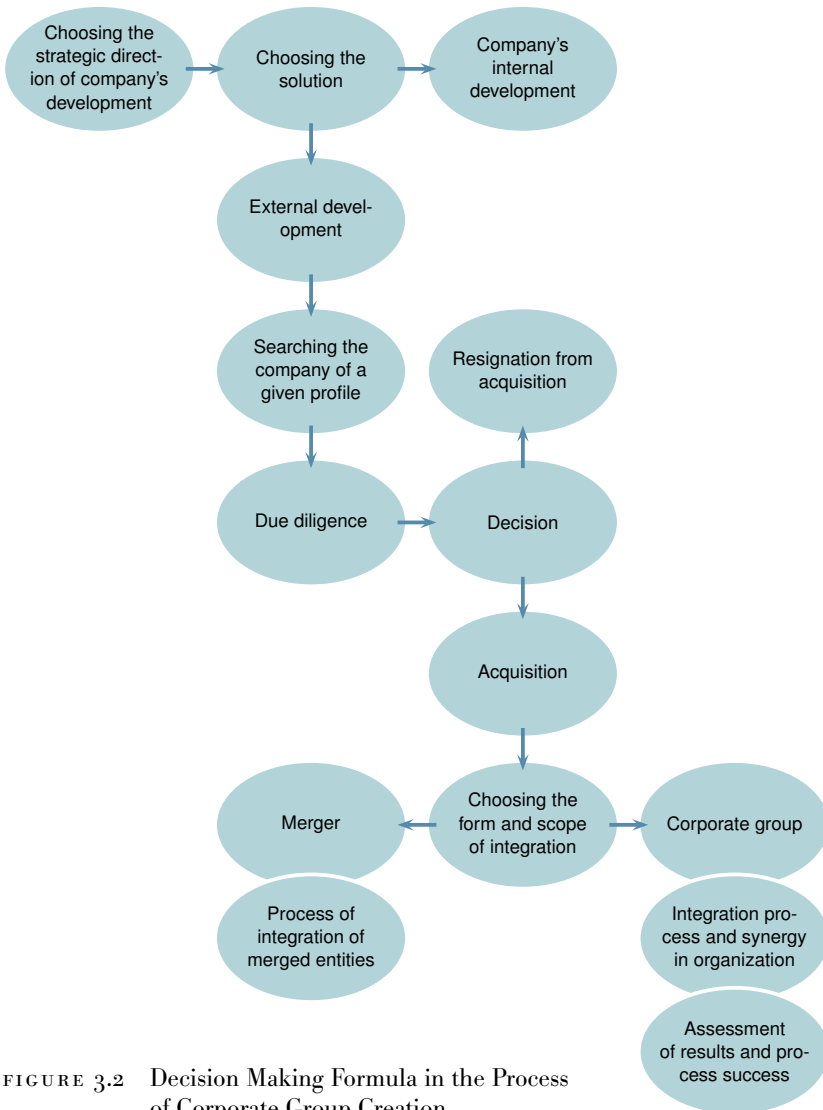


FIGURE 3.2 Decision Making Formula in the Process of Corporate Group Creation

Four, i.e. structural enhancement. The aim of this phase is permanent scrutiny of the scale of synergy as well as deployment of rectifying measures. In consequence of integrated actions, the creation of a strong, and coherent identity of the whole corporate group shall ensue. It is important to remember that the process of feedback is noticeable until phase two. Synergy revisions and results attained at

stage one, when capital decisions are taken, are either entirely unfeasible or hardly applicable (see figure 3.2).

It is noticeable that certain driving and jeopardizing factors occur in every phase of corporate group creation processes.

Capital Investments – Opportunities and Threats to Synergy

Depending on the arrangement style, corporate groups produce more or less synergy friendly conditions, which is determined by a degree of diversification of a particular corporate group. As demonstrated by empirical evidence, diversification destroys the value of the organization, and reduces synergy potential. Therefore, the knowledge within this area, as well as understanding of potential instruments and procedures that assist apt investment decisions are so important. Industry diversification and acquisition related situations which may impact synergy attainment will be described further in this chapter.

Diversification versus Synergy

According to extensive research results, companies that operate in many lines of business are usually worth less than the companies that specialize in a single field (Berger and Ofek 1995; Larry and Stulz 1994; Stulz 1996); this means that there is a negative correlation between diversification and company value. What is more, it has been proven that businesses that perform in unrelated industries have a lower value than those that do in related ones (Berger and Ofek 1995) which demonstrates that diversification has a negative impact on value. In accordance with the theory of ineffective internal capital markets, the companies that are diversified industrially make ineffective investment and either overspend on inappropriate fields of business, or underspend on the right ones, which results in value decrease of the entire corporate group. In conclusion, diversification of investment opportunities destroys value since it leads to the situations when companies transfer funds from the promising industries to the unpromising ones. There is more evidence to support this viewpoint. According to O. Lamont, when oil prices drop, oil distributors reduce investment in business sectors that are unrelated to oil industry (Lamont and Polk 2002). Scharfstein's analyses show that diversified companies overinvest in lines of business where efficiency indexes are low, and underinvest in industries where same indexes are higher (Scharfstein 1998), which results in the com-

pany value that is inversely proportional to the diversification of the investment.

Apart from the theory of ineffective internal capital markets, the confirmation of the accuracy of the thesis that operating in unrelated industries results in value destruction can be found in numerous of business cases. Competences are vital, and managers are incapable of managing disparate industries effectively. Likewise, when unrelated business sectors differ with regard to the management style of operational activity and business culture, effective management may be unfeasible. Examples of situations when diversification impacts business results positively, and when managers' competences and knowledge are substantially extended – although scarce – may be traced as well.

Value creation and destruction may happen in two ways. Assuming that the value of any company is a total of future discount cash flows, it may differ as a result of ineffective investment or discount rate changes. Unrelated businesses usually have a higher discount cash flow rate. Increases in discount cash flow rates and decreases in value are typical of acquisitions and brand new start-ups in unrelated industries. Diversification of operations may result in cash flows that validate the theory of ineffective internal capital markets since it is when potentially profitable sectors subsidize unprofitable ones. Diversified corporate groups have a lower value on account of ineffective equity distribution. Businesses may devalue their own worth as a result of diversification or they may choose to diversify in response to a decreasing value. Multi-entity organizations that emerged owing to disinvestment by the parent company, where elements of diversified entity arise and transfer competences that are indispensable to run effective operations are interesting exceptions in this regard. Self-reliance of the new group members leads to a better utilization of assets and value growth for the entire corporate group (Prescott 1998). Spin-offs may and ought to result in value increase as they adjust to the group easily and are capable of concentrating on business activities that univocally build competences (Comment and Jarrell 1995; Kose and Ofek 1995; Daley, Mehrotra, and Sivakumar 1997).

Investments made in a large corporate group that specializes in agricultural machinery that the book demonstrates is one of the cases I have analyzed thoroughly. The case is depicted in chapter one alongside the analysis of business relations within the framework

	Vertical corporations	Horizontal corporations	Portfolio
Centralisation	High	Diverse	Low
Number of HQ staff	High	Moderate	Low
Number of shared resources	High	Diverse	low
Number of functions to perform	High	Diverse	Low
Design making process	Hierarchical	Lateral	Autonomous
Type of control	Vertical integration	Horizontal coordination	Autonomy
Interdependency	Dependency	Interconnection	Autonomy

FIGURE 3.3 Nature of Selected Areas in Diversified Companies

of corporate groups, and shows clearly that owing to mistakes made in the course of investment making processes, diversification led to the value destruction for the whole corporate group. As a result of bankruptcy of the companies that were diversified, the parent company had no choice but to accept the loss the investment incurred. The failure boiled down to the lack of apt competences in the new fields of business the corporate group had decided to roll out into. Proper understanding of the organization and mutual relations is pivotal for synergy creation and the pursuit of value growth. Figure 3.3 shows the listings of features typical of corporate groups according to the criterion of interrelatedness between business activities, which determines the success of cooperation in each case scenario.

On the one hand, there is a vertical organization where the degree of dependency is high, which consequently impacts the development of resource sharing in a particular way. This type of organization may transfer resources between entities but since resource transfer is mainly one-way (i.e. vertical), it is incapable of recognizing all synergy opportunities. On the other hand, there is a diversified corporate group, in other words a traditional conglomerate, which is

highly autonomous, and where managers may be reluctant, or lack in competences to manage mutual relations so as to achieve synergy. This type of a diversified structure must introduce some pivotal organizational changes in order to develop mutual relations resulting in synergy. Synergy creation in corporate groups that are industrially diversified is indeed limited but not unachievable, and is related to the cooperation of resources in the area of supportive processes.

Unique features that corporate groups have shown that horizontally organized companies have the structure and mechanisms reinforcing and fostering the development of successful, mutual relations. They are able to coordinate activities, support resource sharing and arrange for mutual relations of interdependency. As M.E. Porter's (1986) research demonstrates, typical traits of horizontal organizations can help the company gain competitive advantage. Understanding of how a horizontal organization works helps remember that the structure and organizational processes are very important in the development of mutual relations that may result in attaining synergy and competitive advantage, which is mainly dependent on the efficiency of the coordination of activities in the organization.

In conclusion, although synergy creation in diversified corporate groups poses a challenge, immaterial resource sharing as well as the integration of supportive processes may prove helpful in its achievement.

Overview of Critical Stages of Acquisition

Acquisitions are another threat that jeopardizes synergy creation at the stage of making investment decisions. Synergy traps during acquisitions are particularly perilous. Friendly takeovers occur when the company that is being acquired is fully compatible with the strategic plan of the acquirer (figure 3.4). This type of strategic acquisitions becomes a part of a long-term plan aimed at attaining a lasting company value growth. On the other hand, however, a perfect acquisition target is hardly ever readily accessible, thus, plenty of companies choose to make occasional acquisitions. In both cases the ability to identify the right opportunity to make an acquisition determines its success. Besides, in order to achieve it, it is necessary for companies to identify their own acquisition strategy that includes key expansion paths in the area of three dimensional growth model as well as an acceptable risk level, acquisition budget and an afford-

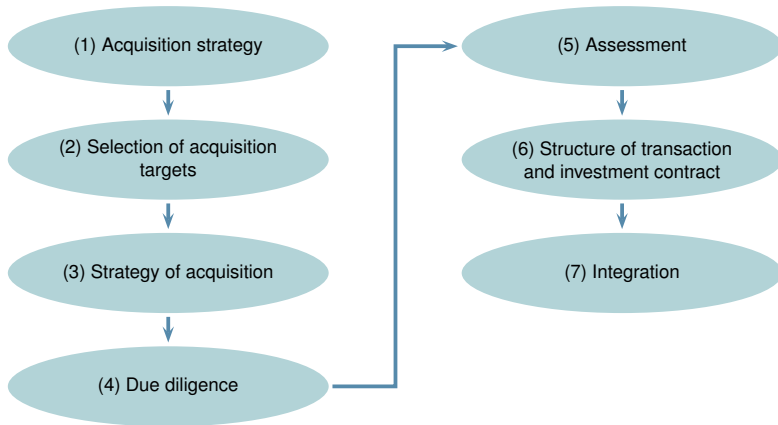


FIGURE 3.4 Critical Stages of Acquisition

able price per a single transaction. In short, an effective acquisition strategy identification helps to narrow down the pursuit of acquisition opportunities to the viable ones only. Many companies boast a precisely defined acquisition strategy and monitor the market focusing on a speedy identification of potential acquisition targets. Business practice shows that in order to begin an effective search for acquisition, it is best to acquaint the representatives of the so-called community of M&A practitioners with the intention to make an acquisition. The community of M&A practitioners includes investment banks, investment brokers, law firms, creditors that specialize in acquisitions, and consulting companies that specialize in asset pricing.

Apart from that, the company that plans to make an acquisition ought to launch its own search program and make an effective use of its own accounts and managerial expertise within the selected area. The search ought to be of active nature; according to research findings, around 20% owners of private companies are the so-called tacit traders, open to reasonable business offers but unwilling to instigate the sale processes. The search ends when identified acquisition targets have been thoroughly screened using acquisition strategy which includes investment criteria such as an acquisition target's optimum profile.

Once potential acquisition targets are short-listed, preliminary arrangements with regard to the subsequent acquisition stages are made using typically two types of documents, i.e. Non Disclosure

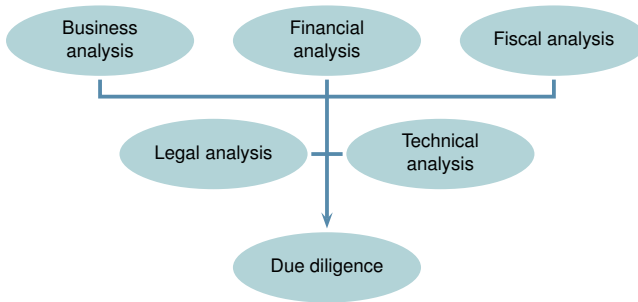


FIGURE 3.5 Elements of Due Diligence

Agreement (NDA), and Term Sheet aka Heads of Terms (HOT). Non Disclosure Agreement and the scope of audit are particularly important for the company that is a potential target for a transaction, since subsequent stages of the acquisition processes are likely to entail disclosure of sensitive data even despite the lack of certainty that the process will actually end in an investment contract. Breach of the contract allows either party to seek damages.

On the contrary, Term Sheet comprises preliminary declarations of intentions that the acquirer has regarding the company that is its potential acquisition target. Term Sheet's obvious advantages are as follows (Rankine and Howson 2006):

- acceleration of the very process of negotiations owing to a mutual consent regarding key conditions of the transaction,
- compliance with an array of binding clauses such as the clause that bans the seller from negotiating with outside parties and clauses that define the scope of liability regarding transaction related charge settlement conditions,
- assistance during the process of fund raising with the aim of transaction completion. Besides, Term Sheet is a document that banks often put forward as a requirement.

Term Sheet usually includes conditions of a full audit of the potential acquisition target, also known as due diligence. Its aim is to conduct a thorough business, technical, legal, financial and fiscal analysis of the acquisition target (figure 3.5), and its findings may result in the modification of the conditions that are included in Term Sheet. The duration of the analysis is arranged for by the parties and shall be neither too succinct so as to avoid making too general conclu-

sions, nor too lengthy. Investors have to assume they will not be able to produce a complete analysis of the target company or identify all its hidden results since resources, time and funds that are at their disposal are limited (Bing 2007). Therefore, identification of critical elements of the analysis is indispensable for producing a successful due diligence. Furthermore, implementation of proper methodology is equally important. Due diligence comprises five separate analyses: business, financial, fiscal, legal, and technical.

The choice of due diligence elements depends on the profile of a particular company that is being analyzed, aim of the acquisition, and preliminary recognition of potential risk. By and large, the analysis begins with its business component followed by financial, and fiscal ones. Business analysis is the most extensive part of due diligence. It includes an analysis of business environment, operational activity, human resources, managerial staff as well as intellectual capital and IT resources (Howson 2003).

A thorough analysis of the market environment is an inextricable element of a business analysis. It aims at increasing awareness of the market, clientele, and competitiveness of the company that is being analyzed. Size, market structure, growth dynamics, key growth factors, market trends, competitors' market share, distribution channels, pricing strategies, and the impact of innovation (Howson 2006) are typical investigatory subjects. Potential acquirers are particularly interested in finding out what potential the company has for future revenue generation, therefore customer relations that the company are of particular interest for them. In the first place, market segmentation is carried out in order to identify suitable ultimate segments which are then carefully scrutinized with regard to demography, psychography, and behaviorism. Besides, both purchasing behaviors and decision making process are meticulously analyzed. In the case of companies that operate on a business to business basis, due diligence comprises the same elements but – besides psychographic and personal traits – a typical end customer's profile is analyzed as well as the durability of customer relations, their repetitiveness, and loyalty. Next comes the operational activity in a business analysis of the target company. Its main goal is to broaden the understanding of the mechanisms that govern the company and thus enable to provide services and products to end customers. Insights into operational activities allow a preliminary estimate of the potential for future integration

within the corporate group, and help to identify operational risks at an early stage.

In many present-day companies employees and managers make the most valuable asset of a company. Thus, due diligence with regard to business analysis contains a detailed study of this area. Segmentation of the staff with regard to a variety of functional groups is carried out in the first place. What follows is the identification of the key employees and their competences. Already at this stage the acquirer ought to develop the strategy aimed at retention of these employees after the acquisition process has been completed (Frankel 2005). More and more frequently a study of intellectual resources becomes an inseparable component of a business analysis conducted within due diligence because it is in fact immaterial assets that generate value growth for knowledge-based companies. This analysis encompasses intellectual property, patents, licenses, brands, and the so-called relational resources, e.g. contracts, strategic alliances with suppliers, distribution channels, and strategic partnerships of technological nature.

Financial analysis is an obligatory part of business due diligence. It is important to remember that financial due diligence is by no means a historical audit that concludes an accounting year, and ought to focus on the future (Rankine and Howson 2006). An analysis of historical data is supposed to validate the accuracy of future results' estimation. Financial due diligence comprises particular items on the balance sheet and profit and loss account as well as cash flows. It is used to verify the accuracy of the asset and liabilities assessment and to determine a correct financial result on the basis of which future results will be estimated.

Fiscal due diligence strives to review a tax related situation of a particular company in a particular period of time and identification of potential fiscal risks and opportunities that would occur were the acquisition concluded. In general, this analysis is related to fiscal issues that directly impact transaction oriented decisions, transaction structure, pricing, and conditions. Therefore, it concentrates mainly on effective transaction structuring, shares related taxation, and tax base that the financial model rests on. The appraisal of the accuracy of tax liabilities in the future is important too. The aim of legal due diligence is to identify the aforementioned risks within the regulatory framework. It is usually conducted by lawyers who are not qualified

to analyze legal aspects with regard to their business implications on the transaction thus, a separate legal due diligence related to business aspects is indispensable too.

Technical due diligence mainly concerns two aspects: production potential and technological capacity. In the latter case, it is the compatibility of product parameters with product specification, development map of a particular product, security of the provision of processes and resources to assure continuity of production processes that are scrutinized (Howson 2008). Oftentimes, technology is included into the business analysis within due diligence as well.

Due diligence enables to collect all data that is indispensable to establish the company value. It is in fact the price that is supposed to satisfy both the seller and the acquirer, which is a critical factor for the acquirer in deciding upon whether to make a transaction or not. It is important to remember that both parties apply dissimilar methodologies to establish it.

Disregarding the very assessment based methodology, it may be said that the ultimate value estimation procedure consists of the following four components (Rankine and Howson 2006):

1. internal worth estimate,
2. estimate of real synergy effects that result from the acquisition,
3. identification of the value that potential acquirers have estimated,
4. negotiating the end price within the value range between the estimate that includes the value of synergy effects and the highest price offered.

Internal value ought to reflect the value of the company as a separate unit as precisely as it is possible (figure 3.6). In order to estimate it accurately, typical appraisal methods that utilize future financial results are applied followed by an estimate of an additional increase in value likely to occur on account of potential synergy effects, reflecting premiums that the acquirer is willing to pay to acquire assumed synergy effects. If more bidders participate in the process, it is necessary to identify what prices they quote to be able to recognize what synergy effects bidders assume are likely to ensue. To offer the price that is lower than quoted by competing bidders is bound to end in the offer rejection. Therefore, it's most recommendable to put for-

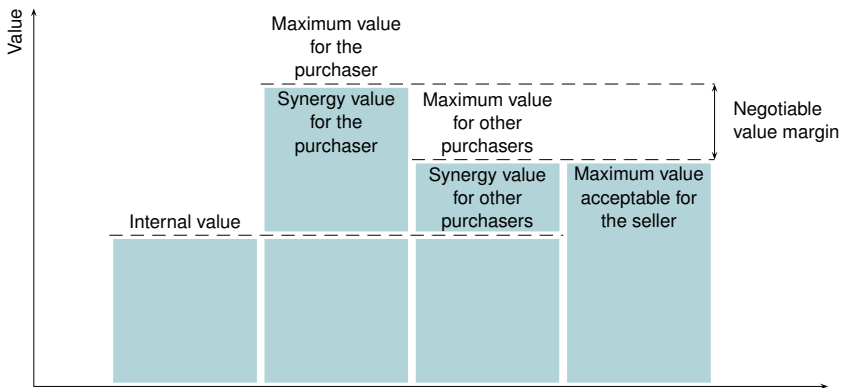


FIGURE 3.6 The Process of a Final Estimate of Company Value
(adapted from Rankine and Howson 2006, 116)

ward the offer that is within the range between the highest price that an acquirer is able to accept and the highest price that is offered by other potential buyers.

Bilateral agreement in the area of terms and conditions (term sheet) as well as value estimate are followed by the next stage, i.e. arrangement of a transaction structure. A typical transaction structure includes a schedule and the legal form of the transaction (acquisition, merger, management buyout, etc.), relevant accounting principles, fiscal issues, and methods of financing (Lajoux and Nesvold 2004). The aim of a transaction structure is to secure both parties against potential risks. For instance, a transaction structure may include arrangements related to the fulfillment of conditions connected to the remaining stages of transaction. Negotiations related to a transaction structure end in the conclusion of an investment agreement, which is a legal base for the execution of the transaction. The process does not end in the conclusion of the agreement, however, since it does not guarantee the attainment of the advantages that the merger assumes to yield. Therefore, to succeed it is necessary to carry out a thorough integration of the corporate group.

Practice shows that this phase is frequently underestimated, or even overlooked, which may be one of the reasons why so many takeovers fail. The basis of the integration plans ought to be outlined already at the stage of due diligence. The key to its success is to encompass all areas from activities that require immediate implementation, for instance dismissal of redundant staff and closure of

redundant divisions as well as assembly lines, and activities of secondary importance such as integration of human resources within the framework of mutual corporate culture and consistent incentive schemes.

More and more often the so-called ‘soft aspects’ are emphasized in the course of integrative processes implementation, in particular emotions that arise during takeovers. It is believed that turning a blind eye to them is one of the reasons why synergy effects fail to appear. The theory of social identity according to which every employee identifies themselves with their environment through adopting certain roles is applied in the management of emotions during M&A processes. Mergers and takeovers are processes that inflict radical changes in social identity of the staff (Kusstascher and Cooper 2005) which triggers a wide range of emotions, and halts integrative processes. Management of such emotions understood as eradication of the negative ones, and stimulation of the positive ones is one of the tasks of managers who oversee the integrative processes. The means they apply in order to carry out the project include apt internal communication and their own behavior.

In the course of integration process, partnership agreements with suppliers and clients, technology, IT systems, and brands prove to be equally important. Integration of brands or their repositioning is the process that is particularly prone to value destruction (Frankel 2007). Properly executed integration plans are pivotal for succeeding in synergy generation in corporate groups where multiple entities undergo integration process. This subject is analyzed in detail farther in this chapter.

The role of the body responsible for execution of integration processes is also worth mentioning. Mergers are interdisciplinary processes and require vast managerial, business, legal, and psychological expertise. Acquirers are hardly ever capable of carrying out plans for successful integration single-handedly, since they often lack in internal resources to do so, therefore, they resort to the use of external consulting firms. All active M&A participants, i.e. staff, external consultants and institutions (e.g. regulators) as well as media constitute the so-called ecosystem. Understanding the complexities of interactions between all members of the ecosystem considerably increases the efficiency of the processes, and facilitates the maximization of the value yielded in the course of integration. Likewise, misunderstand-

ing the interactions that appear on account of M&A processes may result in setbacks at the end of transaction or transaction that should not be finalized at all. Acquisitions are carried out when the target is highly autonomous, which substantially disables synergy creation opportunities. Efforts to integrate the entity that has been acquired may enhance cross cultural differences, and aggravate problems that have come to light in the course of integration (Weber and Dholakia 2000).

Synergy and Premium Dilemmas in Acquisition Processes

The anticipation of synergy effects in corporate groups implies the necessity to use the group's material and immaterial resources, which may generate additional expenditures. They may be either very low, or high enough to outnumber all advantages arising from resource sharing processes. Synergy analysis requires factoring in both investment costs and expenses that are related to its generation. Such expenditures are difficult to estimate, include spending, and lost opportunities too, besides. In the wake of it, synergy value ought to be perceived as net value after the inclusion of expenses made. Gaining and maintaining net synergy requires transaction cost, current owner supervision, monitoring of the situation, enhancement of value generating processes, and, most of all, strategic decisions with regard to subsidiaries. As mentioned before, synergy is not a self-activating phenomenon that occurs in a corporation. It is a result of resource and activities sharing between businesses.

Synergy assessment by potential acquirers determines the value of potential transactions in the M&A market. While making an acquisition, the acquirer assumes that the value of entity they purchase will surge on account of forecasted synergy. In case of increased competition among acquirers the price of the transaction may be higher than the market price of the company that is being taken over. The acquirer concludes the transaction, and the surplus they pay is related to as premium. In a standard approach depicted in the literature on finance, premium represents the expectation of synergy that arises after the merger. It means that acquirers pay the premium because the anticipated value of the entire company (after its inclusion to the group) is going to be higher than the expected value of the total of its separate parts. Given that company value undergoes destruction in the course of acquisition, which has been unequivocally proven, we

can conclude that such expectations are hardly ever met in practice.

Synergies that have been carried out prove to be a genuine improvement in company results when cash flows are higher (due to increased revenues on account of sales growth or higher prices charged and/or lower costs incurred) or when discount rate for projected cash flows decreases below the company share price before the acquisition. Although a discount rate is a variable that is adaptable in spreadsheets, it shouldn't be considered as easily managed. The value of the acquisition must be conditioned by genuine cash flows.

Investment process that is a result of an acquisition is described as follows:

$$V_1 = V_o - C_A + V_A + S_A + S_G - C_C, \quad (3.1)$$

where V_1 is value of a corporate group after acquisition of the A company, V_o is value of a corporate group before acquisition of the A company, C_A is the cost of acquisition, V_A is market value of the A company before acquisition, S_A is synergy of the A company after acquisition, S_G is synergy of a corporate group excluded from the synergy of the company A (SA), and C_C are costs of coordination and compromise in a corporate group that arise due to acquisition.

If we assume that the cost of acquisition by a corporate group of a new company is a total of its market value before the acquisition and the premium paid for the acquisition of the company A , which is beyond its market share (equation 3.2):

$$C_A = V_A + P, \quad (3.2)$$

where C_A is the cost of acquisition of the A company, V_A is market value of the A company before acquisition, and P is a premium paid as a result of acquisition of the company A , the price beyond the market value of the company, then the value of the organization after the acquisition of the new entity will assume the shape described by the equation 3.3:

$$\begin{aligned} V_1 &= V_o - (V_A + P) + V_A + S_A + S_G - C_C \\ &= V_o - P + S_A + S_G - C_C. \end{aligned} \quad (3.3)$$

Besides, assuming that the entire synergy in a corporate group after acquisition has been completed takes on the shape depicted in equation 3.4, i.e.:

$$S = S_G + S_A - C_C, \quad (3.4)$$

where S_G , S_A and C_C relate to the aforementioned synergies and cost of coordination, the value of the corporate group after acquisition of the new entity will amount to the following (equation 3.5):

$$V_1 = V_0 - P + S, \quad (3.5)$$

where V_1 is value of a corporate group after acquisition of the A company, P is premium paid as a result of acquisition of the A company, the price beyond the market value of the company, and S is synergy value of a corporate group after acquisition of the A company.

Since we assume that capital investment will result in synergy generation, the value of which will differ for both corporate group that makes an acquisition, and the entity that is being acquired, we ought to use the term net synergy. Net synergy describes an arithmetical difference between the synergy in the corporate group after the acquisition of the A company, less the premium paid for the acquisition of the A company, beyond its market share, see equation 3.6:

$$S_N = S - P, \quad (3.6)$$

where S_N is net synergy in a corporate group, S is synergy in a corporate group after acquisition of the A entity has been completed, and P is premium paid for the new entity.

Finally, the value of the corporate group after making investment in the new company is described in equation 3.7:

$$V_1 = V_0 + S_N, \quad (3.7)$$

where V_1 is value of a corporate group after acquisition, V_0 is value of a corporate group before acquisition, and S_N is net synergy in a corporate group.

I am now going to use an example to illustrate the aforementioned procedure used to establish the value after the acquisition of a new entity with regard to the synergy gained for a corporate group. The corporate group intends to acquire a new company (A) estimates that the market value of the latter stands at 100 contractual units. The acquirer is willing to pay the premium of 20 units above the estimated market value of the company A on account of the synergies the acquirer forecasts will be generated after the purchase. Thus the total

TABLE 3.1 Example Net Synergy Effects as a Result of Acquisition

Description	Symbol	Potential case scenarios during acquisition		
		1	2	3
Value of the corporate group before acquisition	V_G	500	500	500
Market value of company A before acquisition	V_A	100	100	100
Premium paid for company A beyond its market value	P	20	20	20
Acquisition costs	$C_A = V_A + P$	120	120	120
Synergy of company A after acquisition	S_A	25	10	10
Synergy of the corporate group excluded from company A (S_A) synergy	S_G	35	20	5
Cost of coordination and compromise in the corporate group on account of the acquisition of company A	C_C	10	10	10
Synergy of the corporate group after acquisition	$S = S_G + S_A - C_C$	50	20	5
Net synergy	$S_N = S - P$	30	0	-25
Synergy-premium ratio		$S > P$	$S = P$	$S < P$
Value of the corporate group after acquisition	$V_1 = V_G + S_N$	530	500	475
Effects of acquisition on the value of the corporate group		Positive	Neutral	Negative

cost of the acquisition equates 120 units. The remaining calculations are presented in table 3.1. As shown in this table, capital investment and development related processes in corporate groups entail having to settle acquisition premiums upfront, and accept that potential synergy effects will occur later.

Having said that, it is important to remember that there are three potential investment results:

1. *Synergy* \geq *Premium*. Acquisition results in positive synergies that were not assumed in advance and which exceed the value of acquisition related premium. This case scenario is regarded a beneficial acquisition. The number of synergies expressed in cash exceeds the premium paid for the target company that has

- been acquired. In case of undue positive synergies the value for shareholders of the acquirer is created, which is reflected in a profit increase in the company accountancy records.
2. $0 \leq \text{Synergy} \leq \text{Premium}$. Acquisition results in positive synergies that are worth less than the value of the premium paid. This case scenario requires more explanation since this result is likely to provoke ambiguous managers' reactions. Besides, it is the most frequent outcome of the acquisition. This case scenario is not necessarily disadvantageous from the point of view of cash flow at the company level since it includes positive synergies as well. Improvement in results that exceeds expectations is likely to occur. Return on investment, however, does not suffice to compensate shareholders for the premium paid. To conclude, the acquisition cost is excessive and shareholders experience a loss.
 3. $\text{Synergy} < 0$. Acquisition results in the lack of profits, in other words, negative synergies. It is a clear instance of sheer value destruction. Company results decline substantially after the acquisition, which causes a complete loss of the premium paid for the purchase, the so-called equity transfer to the shareholders of the target company. Moreover, it leads to further operational losses that are regarded as direct results of the acquisition. Thorough understanding of particular cases matters significantly, and is indispensable for the proper appraisal of the transaction.

As a result of a comparison of the actual synergy value with the value of the premium paid as well as compromise and coordination related costs, the value of real net synergy emerges. An increase in the value of a corporate group on account of acquisition appears when net synergy value is positive. The price of the target company before acquisition includes a considerable in-built value rise. The profit observed after acquisition has been completed does not necessarily have to be related with synergy. Besides, acquisitions may make substantial managerial resources deflect from the acquirer's other entities. Therefore, it is pivotal to keep an eye on what is essential to maintain the company value. When acquirers make organizational and strategic changes so as to generate sufficient profits to compensate for the premium, they risk both growth potential and group's value destruction.

Synergy is unlikely to be generated if strategic changes or cost cuts that are implemented are easily imitable. The acquirer must ensure that integrative processes will not cause rigidity that will impair their potential to compete with rivals successfully. Besides, the longer the acquirer defers implementation of strategies after acquisition has been completed, the more time competitors have to test the acquirer's business. Rivals will always find a way to respond to the acquirer's moves before repair processes begin for good. Transition to the stage of integration, which the following chapter will discuss in detail, ought to be swift and unhesitating. Otherwise, management of this transition will transpire to thin out the group's resources, make the acquirer even more vulnerable to their competitors, and turn synergy into a trap. It cannot be denied that acquisition renouncement may sometimes be a reasonable business decision. All things considered, acquisitions per se are strategic alternatives. The findings of empirical research based on several hundred acquisition cases that was carried out in the USA prove the following synergy traps and threats (Sirower 1997) related conclusions valid:

1. On average acquisition strategies destruct value for the acquirer;
2. Premium level has a strong negative impact on the business results for shareholders: the higher the premium, the higher the losses;
3. Acquisitions in the conditions of fierce competition result in higher premiums than acquisitions made in other conditions.

In conclusion, even acquisitions with low premium that are meticulously planned in advance – may end in a failure. Before managers justify acquisition-related premium settlement, they must be ready to answer plenty of questions, such as: what expectations the acquirer and target company have, where gains arise on account of the acquisition, which competitors it will affect, what milestones ought to be expected in the course of action implementation, what additional investment is necessary, which key managers are to be held accountable for action plan instigation, and why this particular transaction is regarded higher than other potential investment targets.

Integration of Corporate Groups

Absence of effective change management in the course of establishment and management of corporate groups is one of the main rea-

sons why synergy potential is untapped, resulting in the loss of value. In particular, it concerns takeover operations. Mismanaged and unsuitably prepared processes are bound to fail, due to either so-called competence gap, or oblivion to potential treats. It is important to stress the role of corporate cultures and increasing significance of intellectual capital in present-day business organizations.

Change Management: Its Essence and Meaningfulness

Before acquisition, companies carry out their day-to-day business. Once the acquisition starts, they are included into a new organization that makes more than employees, products, and definable variables such as mission, policy, strategy, and structure. To a lesser extent, it concerns businesses arising from internal development. In order to attain synergy effects and to retain them later on, it is important to neatly plan the process of change in relation to the entire corporate group, and care for coherent identity of the organization. Aptly prepared and executed process of organizational change in the context of integration of the group ought to encompass the following phases (figure 3.7):

1. *Involvement in change through a common review of the current situation.* This stage is about the establishment of interdisciplinary teams to represent all vital scopes of business activity of companies that are about to undergo consolidation. They should be engaged in active assessment of current and potential problems within the organization. As a result, a complete picture of the entities prior to acquisition emerges. Besides, factors that hinder and foster the very process as well as elements that require change so as to make sure that consolidation goes smoothly are outlined, too. Owing to these activities, executive managers of all entities within the project are committed to what is necessary for the process of change. Human resources management teams are of particular relevance in this phase.
2. *Creation of common vision for the new group.* While a newly formed staff in the group is engaged in a detailed analysis of the hindrances, top managers strive to acquaint employees with new solutions. It is important to build a new system of information flow, and communication in relation to the tasks carried out in interdisciplinary teams at various levels in the structure of the

organization. The introduction of such activities at early stages of consolidation process reduces subsequent problems that arise on account of cross cultural differences and incoherence.

3. *Preparation of the change introduction plan* pertaining to consolidation targets and direction setting as well as the choice of the most appropriate methods, establishment of the so-called change architecture, i.e. phases, stages, schedules, resources, and leader appointment, as well as information flow and communication.
4. *Adoption of the consolidation changes program and budgets.*
5. *Obtaining the approval for the new vision, indispensable competences and readiness for further action.* It appears that the inclusion of the employees into the process of creating new solutions does not suffice to counter their resistance to act in new circumstances. Since all employees cannot partake in the works and the program, participants themselves are incapable of predicting the development of the tasks, and necessary competences until the moment the new solutions are actually applied. Hence the role of management is critical at this stage of the process. It is much more difficult to achieve it when a hostile takeover is the case. It is important to remember that setting new modes of operation, assigning roles in the organization, and responsibility that follows may result in the attainment of new skills, competences, and experience.
6. *Prevalence of new solutions in the consolidated organization.* At this stage, some staff knows and accepts new solutions, whereas others are still skeptical about the process. Subsequent operations of the consolidated structure depend on successful involvement of the latter group in cooperation and their understanding of new roles, aims, and action.
7. *Institutionalization of the changes by means of formal structures, systems, and strategies.* Solutions that have been created at earlier stages of the process require consolidation. It concerns the new organizational structure, mutual strategy, program of creating new organizational identity and system integration. Overcoming lack of trust and resistance of staff is easier when they are aware of the inevitability of the changes.
8. *Monitoring of the change process and solving problems that arise.*

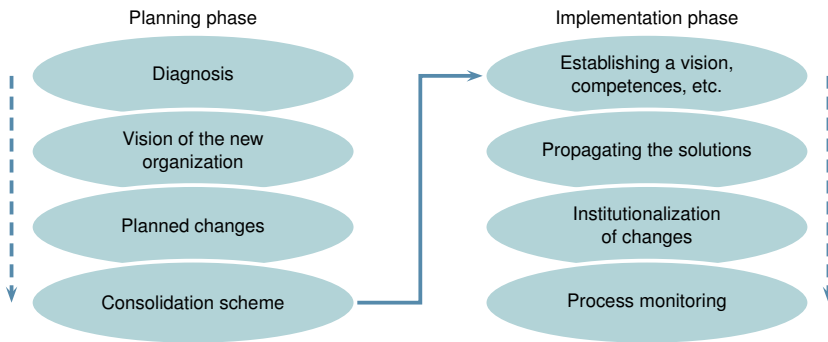


FIGURE 3.7 Change Management Stages in Integrative Processes

Consolidation, which always means a radical change in all organizational entities, is a complex process that takes time. Management's role is to permanently monitor its course and resolve problems in cooperation with employees who are directly engaged in the process. Basically, the entire change management project may be divided into two stages: planning and execution.

Practice of change management in corporate groups proves that there is no single policy for its implementation. Very frequently change related action is conditioned by circumstances rather than a systematic approach. It is particularly relevant when it concerns to changes that are introduced in multiple operational areas in a corporate group. Effective change management, however, often requires its complete restructuring. In the literature on the subject we can find numerous applicable approaches and concepts for succeeding in this area, with the prevailing two:

- *Top-down* approach, according to which it is managers who drive change in an organization (parent company in a corporate group) in areas that encompass initiative, project, execution, and evaluation. It stresses the role that entities and groups play in taking formal action, and validates the view that all subsequent adjustments are natural consequences of this approach's.
- *Bottom-up approach* which says change is initiated by subordinate entities, and which advocates a complex vision of aims and tasks that make a foundation for change arrangement, and principle setting within an organization. This view highlights the essence of the structure an organization has, its strategy, and

management techniques that are regarded as tools necessary to execute particular plans in a corporate group.

An integrative action plan requires a profound understanding group's corporate culture, the process in which a parent company plays a pivotal role. Only when a parent company is capable of devising and executing change management related processes, will the processes achieve the assumed goals. According to research in the field (Chow, Haddad, and Wu 2003), the most significant factors that affect the efficiency of integrative processes and change management are found in three basic areas:

- Corporate culture, with internal competitiveness, employees' resourcefulness, and degree of internal bureaucracy that matter most;
- Organizational structure, mainly company's potential to execute strategies, and a degree of standardization;
- Economic efficiency, share price, return on investment, impact that particular elements have on financial indexes.

Research findings indicate a positive influence of an organizational culture a corporate group has on its economic results with planning, innovation, determination in change instigation, team work, communication, goal orientation, a degree of integration of internal management processes being of utmost importance in this scope.

Corporate Culture Related Factors Determining Changes in Corporate Groups

The issue that needs addressing in the first place is the integration of all entities within a corporate group. Should this fail to happen, dis-synergy effects on account of conflicting principles, and norms of the merging companies will appear. Hofstede and Hofstede (2005) explain that a corporate culture is a collective phenomenon shared by people who either cohabit or cohabited in the same community, and which is a learned thinking pattern reflected in the behavior of the members of a particular community, which helps distinguish communities. However, culture-related problems that appear in a consolidated organization are natural and unavoidable. A corporate culture is in fact in the minds of people forming a corporation, which makes each corporate group so unique.

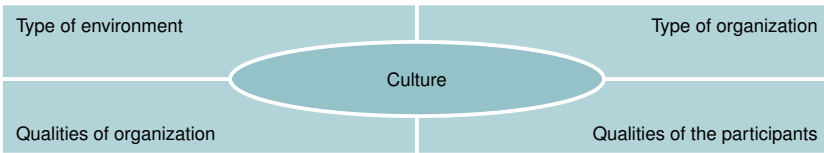


FIGURE 3.8 Corporate Culture Conditioning

A successful consolidation of a corporate group requires detailed identification and recognition of cultural differences existing between the merging companies. An action plan aimed at bridging the corporate culture related gap should be devised so as to establish mutual norms and principles. If the proposed changes do not comply with core values of either company, it is highly likely that their forced implementation will bring negligible results. An effective organizational change is supposed to lead to deeper changes in corporate culture of the group. We must never forget that spin-offs and start-ups tend to build their own autonomous corporate culture.

Corporate culture depends on numerous factors. These may be divided into internal factors entailing traits of members of an organization, and traits of an organization itself, and external factors encompassing the qualities such as a type of environment and type of organization (figure 3.8).

The qualities of group's participants constitute one of two groups of internal factors. Each employee has their own experiences, views, norms, and values. Education matters as well. Age of the members of an organization plays a vital role in forming a corporate culture. If the majority of the staff is older, the culture will revolve around values such as tradition, tranquility, security. Younger employees would often be more open to change and risk. They tend to be dynamic and creative. It is important to analyze the employment structure with regard to gender which reflects the type of cultural models that prevail in an organization. If merging companies substantially differ in terms of age, education, and gender, setbacks on the grounds of the aforementioned areas are likely to appear in the newly formed organization. Features of the very group affect its corporate culture as well. Besides, when forming a corporate culture, company history and business duration are of importance as well. Well-established organizations are inclined to be conservative and ritualistic, which is of less relevance in newer companies. Managers do also influence cor-

porate culture. Their mindsets, management styles, and overt preferences help shape particular cultural models, for instance an autocratic style makes the organization revolve around values such as discipline, loyalty and obedience, whereas a democratic management style promotes independence and individual accountability. Companies that are similar in terms of age, history, and management style integrate more speedily.

The other category of factors that impact the shape of corporate culture includes external factors such as type of environment. General environment affects corporate cultures directly and indirectly. A direct influence is demonstrated by inward transfer of values and cultural norms existing in a social setting. As far as indirect influence is concerned, culture impacts the type of interactions between the institution and its specific environment. Interactions are regulated by norms that function in general environment, such as economic tools, laws, political preferences, etc. Specific environment may exert direct and indirect impact on the shape of the corporate culture within a group. Values that the staff would adhere to and the way they will choose to pursue them are contingent upon how the employees perceive relations of dependency with a specific environment, and which aims are regarded as more relevant. Indirect impact of specific environment entails influencing the organization through imposing changes to formal arrangements within the organization. The more disparate the environment where entities operate is, the more difficult consolidation becomes. It is particularly apparent amongst multinational and multicultural companies where cross cultural differences and language barriers become main hindrances.

Corporate culture is also conditioned by the type of organization, market situation and competitiveness. In recession, corporate culture is usually more restrictive, whereas in the time of economic boom, it tends to be more liberal. Market sector and technology that the company applies impact corporate culture as well. Corporate culture may considerably bolster or weaken the process of change instigation. Change that happens in the organization is not a mere 'cause and effect' relation. It is a complex network of adjustments that influence the behavior of people in the organization, which is worth remembering as the readiness to embrace change is impossible to be created overnight. It is necessary for the staff to gain positive experience so that they can overcome fear, and shed the burden of the

past, i.e. the outdated corporate culture. To make change processes as effective as possible, they shall be combined with:

- *Creating a corporate culture that is based on learning, resourcefulness and drive.* Complacency after the process of change has been completed is companies' biggest flaw, which is often referred to as crawling restructuration. Only companies that develop a habit of constant learning from their own mistakes can succeed in change processes.
- *Full commitment* – readiness to embrace change is frequently a consequence of the conviction that it is the only possible course of action to be taken.
- *Common vision of the future organization* – during the process of change, the prospect of paradise ought to be created by a leader, which helps sustain commitment on the part of members of the organization even in the time of crisis and despair. The vision should be shared by staff otherwise it will not become a real incentive to promote change bound action.
- *Stipulation of the conditions necessary to sustain change at a desired level* – response flexibility, clear duty description, strategy and tactics related management balance, communication.
- *Common review of the problems within the group* – not only does involvement of the employees in troubleshooting enable to them to learn from their own mistakes but it also shapes their engagement in the process of change.
- *Reinforcement of people-oriented management style* – those who dare make changes tend to be self-confident, and assertive therefore managers of the companies that undergo change, also after the process has ended, should encourage management styles that reward success and goal achievement, where staff enjoy job satisfaction.

The importance of corporate culture in the process of change is undeniable. As long as it promotes efficiency, it fosters goal accomplishment. It is worth remembering that the least visible levels in a corporate culture resist change the most (basic premises). Managers often fail to realize that expectations that are contrary to the employees' vision of the future organization are the main reason for the process of change to fail. Corporate culture formation related

processes require the solutions aimed at the betterment of the organization. When they prove to be effective, the group consciously adopts values they choose to follow. Success determines the approval and adoption of these elements of culture. As time passes by, these values are accepted as natural, doubts and hesitation dissipate, and values become ingrained. Elements of culture, validated by experience gained in the course of collective problem solving, acquire the status of genuine components of group's culture. Changes in a corporate culture ought to be aligned with changes in strategies. They are particularly difficult in the so-called firm corporate cultures as such cultures protect organizations against short-term and fluctuating changes. Unfortunately, they may impair changes that are vital for the company's survival as well. On the one hand, corporate cultures may support the process of change, and on the other throw hurdles while reforms are being initiated. Therefore, change management should include change management in relation to corporate culture as well. While preparing the process of consolidative changes, we must take all aforementioned factors into account, specify corporate cultures in all entities, and identify the areas where differences are present. These areas will require most attention in the process of corporate culture consolidation. The next step entails devising a plan for change implementation in the corporate culture intended to build a homogenous structure of the entire group.

Transformation of a corporate culture may be either a revolutionary or evolutionary. Cultural revolution is followed by radical organizational changes (hostile takeovers, acquisition of companies that are in a bad financial situation). When this is the case, staff redundancies or staff replacement usually follow. Speedy makeover of a corporate culture often results in increased social costs (a decline in morale, disturbed sense of security, contesting present values and norms, resistance, loss of trust, etc.). Evolutionary approach assumes a gradual integration of cultural systems present in the merging companies, and smooth replacement of elements of culture that were relevant until change occurred with the new ones that are either derived from the merging entity or are created from scratch to meet the needs of the consolidated corporate culture in which case changes in a corporate culture are always preceded by a thorough analysis of the corporate culture carried out in all merging entities, and preparation for change implementation. This strategy corresponds with introduction

of gradual consolidation changes in the group. Corporate culture assumes a hybrid shape where new values are mixed with the old ones. On the one hand, it is unlikely to face resistance, since the staff are not deprived of their expectations, norms, etc. On the other, however, it is more difficult for employees to identify themselves with such corporate culture in the interim period. It requires more attention from superiors and open communication so that any doubts that arise on account of consolidation are addressed immediately. Thus, the principal who chooses a hybrid model mixes new elements with the old ones. The efficiency of such a manager depends on their understanding of the old culture, and responsiveness to the new situations.

For a change in a corporate culture to be effective, also the human factor must be taken into account. Transformation of employee behavior may occur in three areas: (i) intellectual (understanding of the why change occurs), (ii) emotional (approval of consolidative changes), and (iii) motoric (action). What is of utmost importance, is providing employees with up-to-date, reliable, and comprehensive information about the ongoing consolidation process (Fopp 1998). Otherwise, the changes will be hindered by psychological and social resistance, and managers will lose their credibility, arouse distrust, and lose control of the situation. Therefore, open communication:

- enables employees to learn the concept of changes, and vision of the organization after consolidation has been completed,
- informs about the course of the process,
- explains changes, and allows them to be suitably managed,
- promotes evolution of staff and indicates opportunities,
- helps sort out problems more quickly,
- disseminates behaviors and attitudes that foster change,
- meets interest of the environment that the group belongs to in the progress of change management.

Disruptions in communication and changes in reference to human factor follow the resistance demonstrated by employees when change becomes necessary. In the literature on the subject there are numerous guidelines, procedures, and recommendations for breaking such contention. Primarily, there are three types of psychological resistance:

- *Rational resistance*, which disappears after logical arguments are put forward, therefore considered as least perilous.
- *Emotional resistance*, which results from fear of the new. Since it is evoked by subjective view of the threats the change may entail, its eradication is time consuming, and requires a personalized approach to each employee.
- *Political resistance*, which arises from fear of losing of power and prestige. It is hardly ever overt, which makes it difficult to eradicate. It is particularly apparent when positions, especially managerial ones, must be downsized, which often happens after consolidation. It may lead to irrational conduct that is highly unpredictable.

To break the resistance, eliminate prejudice and stress, the individual customized approach to staff is advocated. Technocratic outlook, i.e. focusing only on external symptoms of resistance has proven to be ineffective.

Change Management in Acquisition Processes

Problems arising due to change instigation are particularly important in the internal development related processes that are invoked as a result of acquisitions. A renowned investor Warren Buffet once wrote in *The Economist* that business ends in a failure in practice, never in plans. This ironic statement depicts aptly the results of numerous M&A projects. Acquisitions total hundreds of million dollars annually. In spite of the scale of this activity, research clearly shows that 60% to 80% acquisitions end in a failure (Tetenbaum 1999). Despite overwhelming evidence that acquisitions do not yield assumed profits, and in many instances their negative impact on profitability, companies still view acquisitions as an easy solution to problems with growth. Research and experience indicate that it is necessary to treat acquisition as a large complex project from the moment of its recognition and negotiations to its end and full integration of the organization. The reality proves, however, that the moment acquisition is accomplished, managers and businessmen abandon cost cutting policy and pursue next transaction. The key to success is at the planning stage of acquisition and consolidation of business entities. When it is moved to financial-strategic dimension, and integrative processes are not addressed with due care, a failure in M&A projects is likely

to appear. Integration concerns all aspects of an organization: technology, politics, systems, and culture. Failure in consolidation, however, is mainly attributed to the lack of integrative plan for human resources management. It is people at the heart of an organization who must accept consolidation, combine cultures, and accomplish goals. Although human resources related problems make an important aspect of all acquisition processes, they still are not dealt with effectively during most M&A transactions. Transaction management is usually erroneously viewed as the realm of bankers, consultants, lawyers, and accountants. Finances are important but if there is a corporate culture clash which is not appropriately addressed, the acquirer may not achieve the anticipated results.

In the work *Beating the Odds of Merger & Acquisition Failure: Seven Key Practices That Improve the Chance for Expected Integration and Synergies*, T. J. Tetenbaum (1999) discloses the findings of his research and provides recommendations on their application in integration processes after acquisition. These guidelines are as follows:

- *Provision of data relevant for decision making process about acquisition* – synergy gained in the course of acquisition requires intense planning and data collecting throughout the entire process. Not only may the knowledge about a corporate culture collected in due diligence process help decide about acquiring a company, but it may also help identify potential problems during integration. Due diligence is supposed to point out potential problems and contribute to creating a plan to successfully bridge the gap. If these problems are identified correctly, the acquirer gains an advantage as they see clearly how to integrate the organization from the very start of the process. It helps recognize what changes will be necessary, what obstacles are likely to appear, how to remove them, and at what expense.
- *Creating grounds for company profitability* – profitability of an enterprise means that the right people have been appointed to execute plans necessary for the group to achieve assumed goals. Management of human resources involves three areas, i.e. retention, redundancies, recruitment. While redundancies matter in downsizing and cost cutting, recruitment is important in bridging competence gaps, and employee retention proves vital dur-

ing acquisitions. The main aim of acquisition is to purchase a company or a technology, but also to acquire its intellectual capital. Staff retention entails having to assign them suitable roles. All endeavors should be made in compliance with the corporate culture of the company, so as not to lose opportunities and to strengthen its value. Social aspect of a merger should be handled with full involvement of human resources department in decision making and executive processes, i.e. discussions and decisions about potential mergers, so that issues related to human resources were regarded as important ones from the start of the process. HR managers usually step in later in the process, e.g. during talks about redundancies, payroll, expenses, blanket agreements, pension obligations, etc. The earlier HR specialists partake in the process, the better they handle problems that may negatively impact business profits. It is important to recognize threats to the success of an acquisition related with culture compatibility of the acquired organization. Data about corporate culture gathered in due diligence will impact acquisition decisions, the choice of the best organizational arrangement, and preparation of an effective integration plan.

- *Strategic implementation of appropriate systems and procedures* – all systems and procedures that are to be implemented ought to comply with strategic intention underpinning the acquisition. Success is often rooted in autonomy of staff, their attitude to risk, and creativity. Confining them within structures and bureaucratic procedures often equates a loss of the value that the acquisition was made for. Integration committee is supposed to ensure that implemented systems and procedures are compatible in a way that builds a strategic leverage necessary to gain assumed productivity.
- *Culture management* – integration committee ought to identify the culture of the company that has been acquired (principles, norms, beliefs, behaviors), and find a way to maintain values relevant after acquisition. Regardless of how good finances and strategies are, without an efficient integration of corporate cultures, the success will be illusory. It is important to have a few spectacular successes to build credibility and inspire people to act. One of the most important decisions in the course of in-

tegration after acquisition is to appoint a competent, decisive, and success oriented leader of change. The role of the leader of the integration committee is crucial for the successful process completion, yet frequently this person happens to underperform. Given the complexity of this task, how much time it takes, the leader of the integration committee is best to be employed full time. The best candidate for the position should be a dynamic, insightful, credible and experienced manager who is capable of converting strategic intention into action. The leader ought to be decisive, and ready to assume accountability when necessary. Besides, they should be committed to the process, engaged in it from the early talks on so as to be informed about the intentions behind the acquisition, strategic leverages, and factors that contribute to success. They shall head the team responsible for supervision over integration of all administrative, organizational, and corporate culture related aspects of the consolidation. Each acquisition is a unique case, which does not mean there is space for any improvisation. It is important to remember that the process starts at the moment when preparations begin, not after the end of the acquisition.

- *Drift management after merger through a speedy management of the interim period* – interim period after acquisition is the time when the group can expect a steep decline in productivity (25%–50%). One of the reasons of such a standstill is trauma experienced by the staff. They are less driven to perform, and unless they feel secure again, they will keep underperforming. Jack Welch, a famous CEO of General Electric once wrote that a takeover of the company you work for is likely to be the worst that can happen besides the loss of a family member since your entire sense of security changes overnight. Fear and uncertainty that arise on account of this new situation weaken the staff's commitment, and slow down the pace of change after acquisition. During the drift period, companies tend to focus on internal issues and lose touch with clients, which results in a loss of their competitive advantage. The integration team is supposed to work with managers and employees in the organization so as to overcome drift after merger and achieve synergy. While pacing forward quickly, team members should treat employees with due respect, remain sensitive to their needs, and support them.

- *Information flow management* – communication with staff members is the key to a successful acquisition. Yet, it is regarded as least sufficiently handled aspect in the entire consolidation process. It is frequently underresourced, underestimated, and belated. Disturbed communication affects employees negatively and bolsters resistance. The team that handles integration should endeavor to ensure there is free bottom-up and top-down information flow, and that efficient communication with clients, business partners, and media is in place.
- *Preparation of a standard integration plan* – integration cannot be left to chance; it must be well planned. Companies that base their development strategies on acquisitions usually boast suitable procedures to manage these processes. If a company does not have them yet, the integration team ought to devise them beforehand.

In conclusion, managers who take acquisition-related decisions must appreciate the fact that it is employees who ultimately create company value, and synergy opportunities. Unless staff approve of strategic plans behind acquisition, there is hardly any chance for its success.

Competence Gap as a Determinant of Synergy Loss in Acquisition Processes

Creating and managing a corporate group requires a set of unique competences that are brought in as a contribution of many business entities forming the group. Thus, there is a higher probability of mistake when managing a corporate group than a single company. Building corporate groups entails investment decisions which consequences may lead to irreversible repercussions that impact the value of the entire group, including value destruction. Therefore, the proper understanding of a competence gap and implementation of mechanisms to bridge it is so important. The term competence gap assumes a lack or shortage of skills necessary to achieve goals that a corporate group has set, and which management board considers feasible with the use of current material and human resources. It also means the capacity to accomplish results comparable to those of leading companies within a particular market sector. In other words, a competence gap is a difference between the competences in place,

and the desired ones. Owing to a systematic introduction of learning processes and knowledge management, it is possible to bridge a competence gap. It is important to remember that despite ceaselessly growing interest in knowledge management, the perception of this phenomenon in various countries differs tremendously. Managers do perceive knowledge as a key to economic success (Little, Quintas, and Ray 2002), yet, they view the processes supporting knowledge management with skepticism. Identification and eradication of a competence gap in a corporate group is a complex process because it concerns a structure that consists of many member companies having disparate corporate culture backgrounds formed to attain different aims. As already mentioned, the establishment of a corporate group is related to a single, practically irreversible investment decision. The consequences of competence shortage when making an investment decision are particularly painful in acquisition processes. A competence gap may be reflected and result in ill-defined goals, inaccurately estimated values, lack of professionalism, synergy failures, and value destruction. M. L Sirower's research findings presented in his book *The Synergy Trap* (1997) clearly demonstrate how lack of competences during acquisition makes managers taking investment decisions land in traps. Unlike important R&D projects, capital investment related processes neither allow trial and error approach, nor funds suspension in the course of the project, investment cancellation, or their correction in the course of project completion. Thus, a competence gap resulting in wrong investment decisions is likely to result in value losses for shareholders.

Resource sharing related with capital investment leads to a substantial change in asset structure of a corporate group that has made an investment. Obviously, under a special acquisition agreement, liabilities may be included on the passive side instead of financial resources which reduce current assets (acquisition with an extended payment date), which does not change the nature of transaction. Research shows that an assessment of capital investment results, particularly as a result of acquisition, is merciless. Market never forgives managers' ignorance of how to meet objectives. Acquisitions made on unclear grounds usually result in failed business opportunities.

For a reasonable company growth, an additional net value should be generated. It means that the entire group ought to be richer on account of inclusion of an extra business entity. Unfortunately, it is not

always the case. If synergy does not appear some time after acquiring a company, managers have no choice but to justify why value destruction occurred. A better understanding of sources and threats to synergy is crucial for a positive case scenario to appear. Despite theoretical progress, nowadays science offers merely some guidelines to synergy creation. Synergy potential identification requires miscellaneous managerial skills, whereas analytical skills and understanding of theory must be coupled with intuition, experience and creativity.

Sirower's (1997) analysis of numerous business cases proves without any doubt that there is an extensive competence gap in this area. The choice of an acquisition target is frequently accidental, due diligence tends to be superficial, and potential synergy effects remain unidentified. Managers are supposed to have competences necessary to take decisions with regard to the manner the structure may be best integrated in, including whether it should merge partially or completely. Supervisory boards of the acquired companies often know the answer before even posing this question. Decisions to merge prematurely may often destroy what is most valuable, i.e. uniquely designed processes, flexibility of the organization, and customer relations, which ultimately results in a loss of clients, dismissals, dramatic decline in revenue, and value destruction. The complexity of integrative processes requires identification and meticulous planning of all activities so as to avoid disappointments. Playing by ear with respect to these processes proves to be very costly (Tetenbaum 1999; Chadam and Pastuszak 2006).

Corporate Group Management

Since processes make the foundation for operational solutions, the concept of process management is a method of actively backing managerial staff. It is highly applicable for the betterment of corporate groups in the area of basic and supportive processes.

Business Process Management in Corporate Groups' Value Creation

Business Process Management, BPM, is about coordination of the activities so as to optimize business processes or their adjustment to new market needs. Its main aim is to create a properly flexible internal arrangement that allows for a swift communication and process flow and effective decision making. The desired effect is to create a

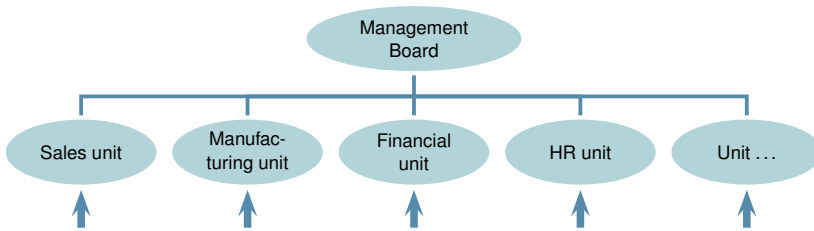


FIGURE 3.9 Functional Organization of a Company

structure with transparent business processes, and efficient control mechanisms would integrate all tasks with strategic aims of a corporate group and its subsidiaries. Process management promotes the realization of processes at the level of competitiveness required by its environment. Here, the question related to factors that trigger the essence of this phenomenon in multi-entity organizations appears. In a traditional company, its departments such as sales, production, finance, marketing etc., are clearly visible (see figure 3.9).

Each department handles its own processes, has its own budget, priorities, etc. When this is the case, a corporate group as a whole has limited potential to optimize functions. Besides, it allows for implementation of fewer strategic aims in comparison with the initial assumptions. The situation changes radically when business process management system is applied (see figure 3.10), resulting in the integration of all actions necessary to perform the fundamental pro-

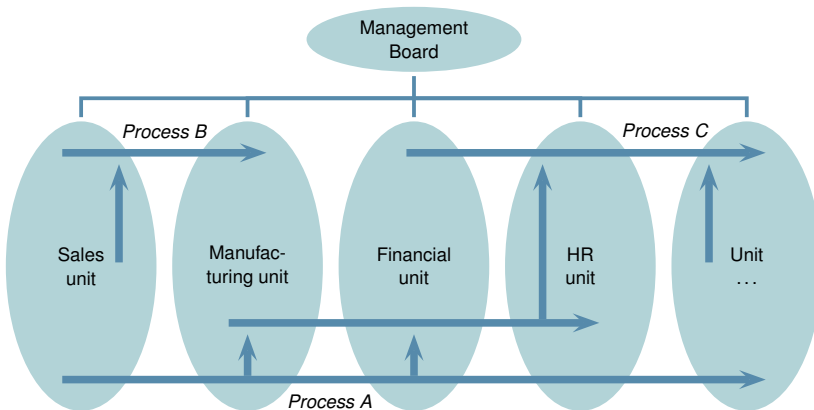


FIGURE 3.10 Process-Based Organization of a Company

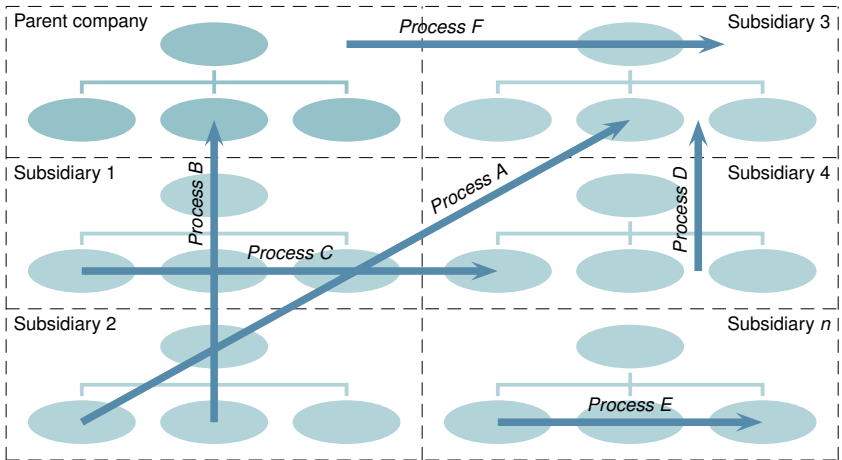


FIGURE 3.11 Processes in Corporate Groups

cesses, with the original structure remaining unchanged. In other words, process-based approach optimizes operations of the company, particularly in case of processes that are on the intersection of different departments, and functional areas. It enables acceleration of process completion, eliminates competence-based clashes, helps increase efficiency and accomplish strategic aims of the group. As a result, an added value of the company is generated. When relating business process management to corporate groups, we can clearly see an increase in the intensity of complexity and scope of organizational issues that management systems are faced with (see figure 3.11).

As a consequence of corporate group formation, the number of similar operational areas, processes, resources, and products is multiplied. To attain synergy effects and create an added value, it is necessary to apply the business process management based approach, which will eliminate irregularities such as inconsistency of processes, repetitiveness, and bottlenecks. A business process management based system that has been successfully implemented in a corporate group enables to view the entire organization through the prism of processes they handle; therefore it is possible to run them efficiently to the satisfaction of its participants (see figure 3.12).

As mentioned before, not only does business process management require a suitable process mapping and prioritizing but also an integrated approach of all its entities to the strategy pursuit, which en-

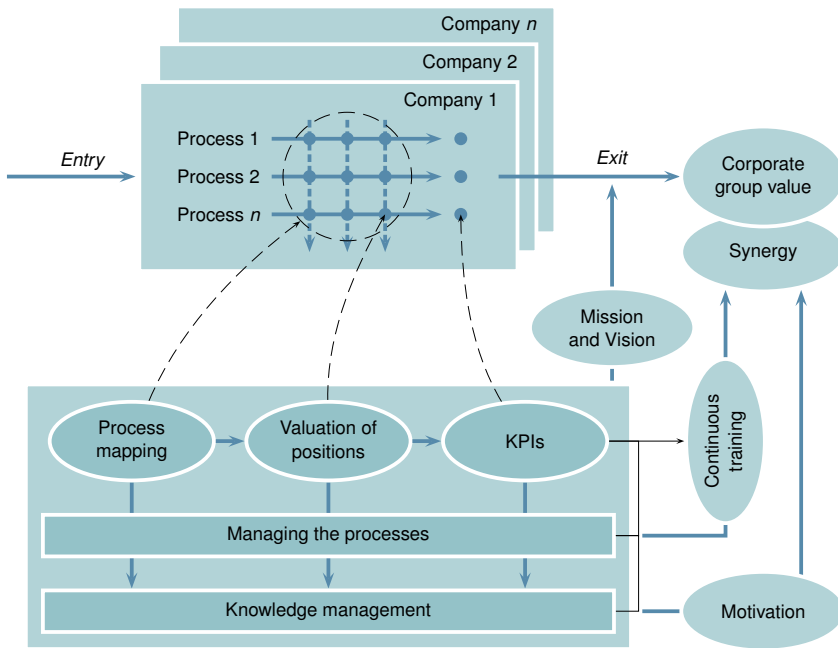


FIGURE 3.12 Complex Process Management in a Corporate Group

ensures an uninterrupted management system of the group. Knowledge management, trainings, incentivizing systems based on key performance indicators (KPI) are of particular importance.

Owing to a process based approach, a corporate group gains numerous advantages that may be looked at in terms of strategy and organization. Strategic effects result from an increased awareness of aims, transparency of competences that each entity within a group has, even distribution of tasks, improved monitoring of strategic goals, elimination of activities that are unlikely to produce benefits, identification of potentially most profitable activities, optimization of the utilization of financial, material, and human resources, better financial results, and a higher return on investment.

Organizational effects include raising and strengthening the awareness of roles and interdependencies between entities, employees, team work, knowledge sharing, conflict resolution, elimination of ineffective areas, utilization of underused supplies for growth, as well as creation of the conditions necessary to induce synergy effects.

Figure 3.13 demonstrates business process management in the or-

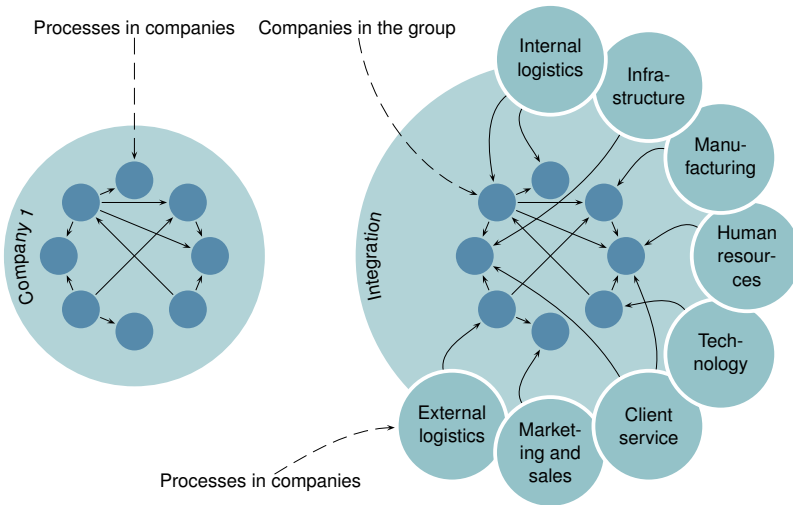


FIGURE 3.13 Business Entities and Processes Integration in a Corporate Group

organizational integration of the entities within a corporate group. Each company within a corporate group manages numerous internal processes so each is a separate system that processes input supplies, and makes products forwarded to other group members or end consumers. Merging individual companies into one corporate group always means having to pursue a certain strategy, and the use of its material and non-material resources. Obviously, a group seen as a collection of companies may suffer from process, function, and decision duplication.

Only groups that are capable of effective resource sharing are likely to achieve synergy effects and value growth. It is possible on account of internal processes management, coordination and integration as well as downsizing and an increase in efficiency of the group management to transform an organizationally and formally loose entity into a multi-entity organizations that offers products adjusted to market needs and that is highly efficient internally as a result of application of a business process management system.

Internal processes within corporate groups may be analyzed with regard to a particular product, specific production unit, company, and a particular process from the perspective of the entire group. Each process requires commitment, and is characterized by a specific complexity and involvement of particular organizational units;

in other words, functional areas from the perspective of some companies or the whole group. Each process shall be analyzed in terms of its preparation, execution, and management (information-decision processes).

Analysis of Business Process Based Approach in Corporate Groups

In accordance with the aforementioned view, business process management is a basic way of integrating planning, coordinating, and developing the course of processes in multi-entity organizations. Figure 3.14 depicts an analysis of the potential application of business process management methodology in such structures.

The first step is 'As-Is' Analysis which comprises the following actions:

- assignment of processes within the organization so as to enable their identification, course, etc.,
- identification of contact points inside particular companies (points of contact between organizational units), and at the level of the group (points of contact between particular companies),
- comparison against best practices – analysis whose aim is to establish the level of advancement and individual traits of processes applied in a corporate group with regard to the best business cases from a particular business sector.

The second step of the procedure is Process Optimization which is intended to reach the most desired processes in the perspective of long-term strategic goals.

This analysis consists of the following elements:

- measuring the time of key processes implementation,
- identification of inefficiencies that occur in group's processes, particular functions and individual units,
- developing maps of target processes,
- preparation of the so-called roadmap of change implementation in processes.

The outcome of the second step constitutes the basis for implementation of business process management system. It is the third step of the procedure, and consists of the following actions:

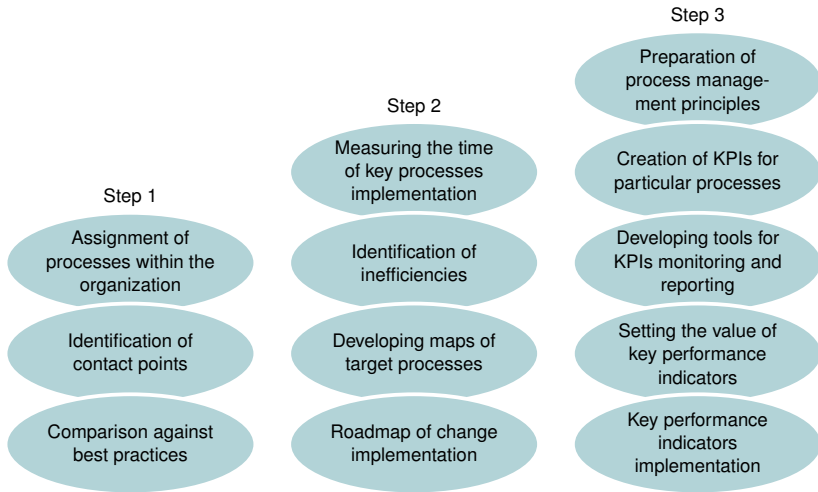


FIGURE 3.14 The Entirety of a Business Process Management Related Area (based on Deloitte Business Consulting SA’s training resources)

- preparation of process management principles to ensure high efficiency of the management system and integration with the group,
- creation of key performance indicators for particular processes intended to describe processes with precision and the use of indicative data,
- formulating the instruments for key productivity indicators monitoring and reporting,
- setting the value of key performance indicators, which is crucial from the group’s strategic goals perspective,
- key performance indicators implementation into the incentivizing system to ensure high integration of business process management with an incentivizing system, and a resultant a surge in employees’ interest in the application of the processes in the pre-defined form and scope.

As a consequence, a complex description of the processes applied within a corporate group and their relation to group’s resources becomes feasible (see table 3.2).

The aforementioned steps require the coherent combination of mission, group strategy, corporate culture, employment policies, quality, standards and procedures, as well as atmosphere within the

TABLE 3.2 Relations between Processes and Resources within a Corporate Group

<i>Organization</i>	<i>Processes</i>
<ul style="list-style-type: none"> • What are the roles and accountabilities of particular units? • How are the units organized internally? • What is the cooperation between the units alike? 	<ul style="list-style-type: none"> • How are the processes organized? • What is the documentation and information circulation/flow like? • Is the communication effective? • In the coordination ensured in timely manner?
<i>People</i>	<i>Systems</i>
<ul style="list-style-type: none"> • How many persons are engaged in particular functions? • Do persons from different units cooperate with each other? • What communication channels are used? • What are the critical contact points affecting the speed and quality of work? 	<ul style="list-style-type: none"> • What are the tools and the systems for particular business areas? • What is the quality of data/ information? • Is the necessary information available? • Is the information coherent and consistent? • Is the information precise and reliable?

organization, all of which result in synergy generation and growth in value of the group. Analysis and practical application of management systems in corporate groups validate business process management based approach. Naturally, it differs in terms of particular forms of corporate group organization. For instance, in conglomerates it is possible to capitalize on synergy potential solely at the level of ancillary processes, whereas in managerial structures the degree of its potential utilization will be dependent on the activity of companies within the group.

Identity Management in Corporate Groups

The last stage in the formation of corporate groups is the creation of a corporate identity. Until recently, the subject of a corporate identity has been virtually neglected. The interest in corporate identity issues has been growing in parallel to increasing changeability of business environment and norm. Corporate identity is often regarded as a collection of visual elements, which are used to promote the image of an organization. Originally, it was synonymous with organizational nomenclature, logos, the house style and visual elements, but, as time went by, visual identity and corporate strategy have become inextricably

cably linked. Corporate identity is considered to be the core of the organization's existence, incorporated in its history, beliefs, philosophy, technology, people, its ethical and cultural values and strategies. Corporate identity also helps determine the positioning of an organization in terms of its markets and competitors, and is not that easy to define. Every organization has its own identity. It articulates the corporate ethos, aims and values and presents a sense of identity that can help distinguish the organization from its competitive environment.

Corporate identity can be a powerful means of integrating many disciplines and activities essential to the organization's success, it can build understanding and commitment among its diverse stakeholders. This can be manifested in an ability to attract and retain customers and employees, achieve strategic alliances, gain the support of financial markets and generate a sense of direction and purpose. Corporate identity is a strategic issue. A clearly defined and positive corporate identity is of vital importance for success and growth. Corporate identity represents a combination of experiences and expectations of people who view a corporate group from various angles such as service and product efficiency, staff aspirations, public relations activities, corporate social responsibility activities, and so forth. It was Albert and Whetten who introduced the notion of corporate identity in 1985 (Hatch and Schultz 2005). It became the cornerstone for future works on the subject of corporate identity. According to this concept, the following features of the company must be addressed in the process of corporate identity formation:

- *main* – these features make the essence of an organization, and focus on important decision related activities within an organization,
- *permanent* – related to features that remain unchanged,
- *distinctive* – features that enable an organization to be one of the kind. Like an individual that has unique traits, an organization may focus on distinctive features. Identity is reflected in the essence of a company and helps it stand out.

This notion revolves around finding answers to the questions like 'Who are we?', 'Who do we want us to be?', and is indispensable for shaping a corporate identity. Many authors (Gioia, Schultz, and Corley 2000; Gagliardi 1986; Hatch and Schultz 2005) promote similar

definitions. According to the criterion of perception, corporate identity may be divided into:

- identity viewed by members of an organization, related to traits that are regarded as main, outstanding, and durable;
- interpreted external identity, concerning the way that members of an organization relate to views others have about their organization. It is a reflection of an opinion stakeholders or public have.

The differentiation of a *corporate identity* depends on its perception by members of a particular organization. From a sociological viewpoint, a corporate identity is defined as logics of collective activities of a company, which enables its differentiation from other companies. This logics shows up as time passes by, it gives the company continuity and enables identification with a corporation or a corporate group. Corporate identity is clearly an evaluative element that helps verify the company's operations. It consists of a plethora of elements that make the company appear unique, and strategies that are combined with the company history, which constitutes its essence. It is unparalleled since it is made up of unique corporate philosophies and convictions, properties, technologies, leaders' personalities, and corporate culture related values. More and more often, companies realize that visual identification is but a single aspect of a corporate identity. When corporate identity is appropriately defined, it ensures a competitive advantage therefore it ought to be related to both visual effects and harmonious relation within an entire organization and its environment. All company's actions impact the development of a corporate identity by either strengthening or weakening it. Apart from that, corporate identity is a kind of an objective assessment that reflects the awareness of the environment, and particular corporate groups. Its main aim is to help the company to achieve a certain market position. It helps staff identify themselves with the company, and combines adopted standards and norms with activities of particular entities.

All things considered, to create a corporate identity is a challenging task that requires a coherent strategy in value formation and management within a corporate group where historical conditioning pose additional difficulties during the process. A strong corporate identity (Caves and Porter 1977) enables an effective pursuit of as-

sumed strategies and a resultant synergy generation; whereas an ailing identity debilitates corporate group's operations questioning the reasonability of forming such an entity. Such negative trends may be prevented by:

- creation of common strategy philosophy,
- identification of basic values typical of individual entities, and creation of a uniform value system applicable in a corporate group,
- establishing a corporate mission which would support the pursuit of corporate mission and attainment of aims set by individual entities,
- articulation of a common organizational vision,
- identification of products and services that a corporate group offers and implementing common efforts to promote them,
- identification of staff standards and employee conduct,
- creation of coherent human resources strategies for a corporate group to integrate planning, recruitment, and employee development related activities,
- designing a project of corporate image,
- preparation of a marketing strategy for the entire corporate group,
- identification of new groups of stakeholders to address them suitably when creating a new corporate image,
- preparation of a mutual reputation and crisis management strategy for the entire corporate group.

Communication strategies play a vital role in change implementation and creation of a new corporate identity system. It is important to ensure an agreement between communication and a factual corporate identity application regardless of whether assumed aims have been accomplished. Moreover, a reliable assessment of adopted corporate identity, particularly in the context of its perception by the environment, is of utmost significance.

In conclusion, change management within a corporate group should be corporate identity oriented in order to allow staff, clients, suppliers, and stakeholders to recognize and address basic organizational issues, which is achievable when a corporate identity is accepted by the entire organization. It requires addressing such areas

as philosophy of action, vision, employee behavior standards, and communication marketing strategy with regard to the entire corporate group. Formation of a corporate identity is a complex process on account of the fact that conflicting interests of individual companies and their management boards need to be resolved.

Succeeding is by all means possible, though. A strong sense of corporate identity is likely to produce a sense of pride on the part of all group participants arising from group membership, which is particularly important in knowledge-based economy where utilization of intellectual capital determines long-term competitive advantage.

Chapter Four

Synergy and Value Prospects in Corporate Groups

Type of Value Growth in Corporate Groups

Corporate groups are predisposed to achieve permanent growth through combining internal growth with external growth strategy. Creating new companies and acquiring the ones that already operate may serve as the basis for synergy attainment and permanent corporate group value growth. On the one hand, synergy that is potentially attainable in a corporate group is a result of seamless ancillary and basic processes, on the other – efficiency of operations performed by each company within the group. Synergy effects in corporate groups are best depicted based on the concept of value generator map by Deloitte (see <http://www2.deloitte.com/us/en/pages/operations/articles/enterprise-value-map.html>). It applies a model used in individual units in a corporate group context. In this approach, three basic groups of value generators are distinguished: sales revenue, operational margin, and asset efficiency. Intellectual capital resources are specifically regarded in this model due to a growing significance of knowledge-based companies (see figure 4.1).

It shall be remembered that decisions in the area of capital investment must be based on a professional assessment of feasible synergy opportunities with regard to resource sharing in the corporate group. To achieve it, it is important to find out which groups of value generators are best applicable to investments which concerns opportunities of productive and non-productive resource sharing, including intellectual capital.

Considering the group of value generators that affects sales growth, it is necessary to assess realistic chances for market expansion and enhancement of competitive advantage related to clients. In highly competitive markets some assumptions may turn out to be simply inapplicable. The question which element of the corporate group, and why this one will decide upon the synergy gain in the area of assumed sales synergy effects must not remain unanswered before

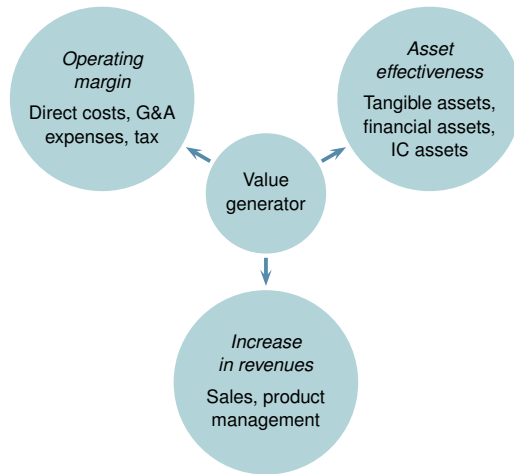


FIGURE 4.1
Corporate Group
Value Generators
(based on Deloitte
SA resources)

the final investment decision is taken. Operating margin wise, an honest appraisal of the realistic prospect of sales records improvement is indispensable. In acquisition processes managers frequently regard operating margin growth as a result of anticipated cost reductions. To be reflected in the reality, they must be grounded in a precisely devised program both at the implementation and conceptual level.

Corporate groups create viable opportunities to apply assets of the entire organization and maximize return on investment. Economies of scale and scope are a good basis for achievable synergy effects. Utilization and sharing of intellectual capital, however, is a whole new ballgame, and will be covered thoroughly in a separate chapter.

Synergy Effects Related with Corporate Group's Revenue Growth

Sales Related Synergy

One of the basic reasons for creating corporate groups is a desire to ensure steady growth through business activity expansion into new markets. There is a belief that a combined sales records, the so-called sales synergy, that companies within one corporate group generate should be higher than sales records generated by companies were they to operate single-handedly. In the analysis of value generators there are three main sales synergy types that are achievable in corporate groups (see figure 4.2):

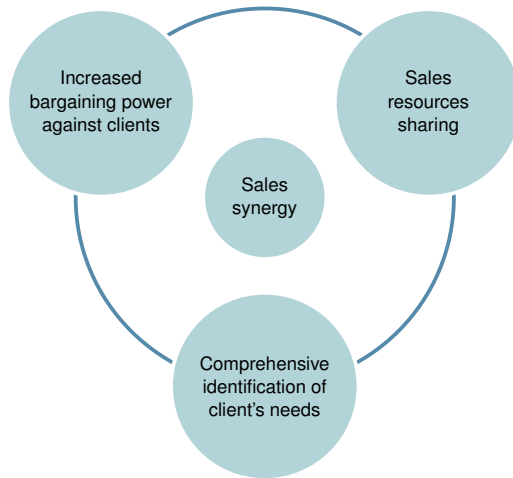


FIGURE 4.2

Sales Synergy Types
in Corporate Groups

1. Additional competitive advantage gain on account of a better understanding of customer needs;
2. Growth in efficiency of sales processes due to an increase in bargaining power;
3. An increase in sales records as a result of sales resource sharing.

Sales results are inextricably linked to marketing. Marketing related concepts date back to the 1940s, when James Culliton described marketing as a blend of compatible elements. This notion was elaborated further in the 1950s by Neil H. Borden, who distinguished twelve marketing elements he labeled as a marketing-mix (Groucutt, Leadley, and Forsyth 2004). In the following years, E. Jerome McCarthy (1960) came up with 4P concept, which since has become the most popular version of the marketing-mix, i.e. elements thanks to which companies affect the market. Despite wide recognition, it encountered covert criticism in the 1960s. In 1960, Theodore Levitt who coined the notion of globalization, published an article entitled ‘Marketing Myopia,’ (Lewitt 1960) where he indicated that as far as marketing is concerned, it is clients and client needs – not the product, price, and sales channels – that matter most. He proved his point by showcasing railway companies negatively affected by a growing number of alternative means of transportation, which, he concluded, had happened as a result of failing to shift focus from the very product, i.e. railways, to the main customer need, i.e. travel

(McCarthy 1960). Up-to-date marketing definitions place customer needs in the center of attention, for instance, a hundred-year-old Chartered Institute of Marketing in Great Britain defines marketing as a managerial process responsible for recognizing and meeting clients' needs and doing so profitably (www.cim.co.uk). 'Clientcentric' approach to marketing has given rise to value-based marketing that included this process into the basic value chain and, in other words, recognized its direct influence on generating value for shareholders. Value-based marketing consists of a few interdependent elements: in-depth understanding of customer needs, identification of differentiating advantage, and strong relations with clients, which is referred to as strategic marketing.

Proper understanding of value-based marketing and its ancillary processes helps yield tangible synergy effects. Traditional marketing methods, such as promotions that are applied at the level of operations, are closely related to the product itself and, therefore, located nearby; this renders centralization of the operating marketing in a corporate group incapable of significantly improving the efficiency. Moreover, since the relations with the product are severed, in fact it may produce negative effects such as the loss of a customized nature of marketing communication. The situation is different when it comes to strategic marketing, as companies within the group usually offer complementary products and, therefore, meet various needs of the same clients while competing with other businesses. In such circumstances, it is obvious that exhaustive knowledge about clients gives companies a significant competitive advantage. Experience gained by corporate groups shows that knowledge about clients is often scattered in many business entities and units, thus lacks a common structure and is difficult to track. The very process of data collection is usually informal, which leads to a myriad of bottom-up activities that help sales representatives gather knowledge single-handedly for their own needs, bringing no added value to the company. To make things worse, it often inflicts additional costs. To mitigate it, a formal centralization of strategic marketing within the corporate group should follow. This move does not require extensive organizational changes to generate synergy effects. It suffices to apply processes bolstered by proper procedures and instruments in the area of strategic marketing. To succeed in doing so, the group should define instruments, i.e. corporate databases, their types, and struc-

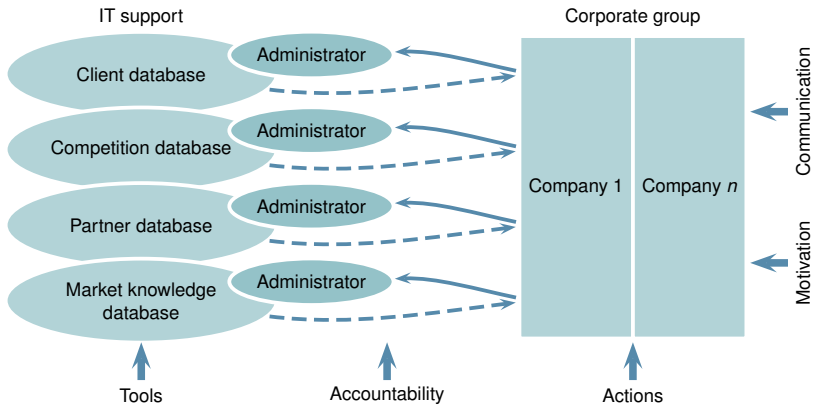


FIGURE 4.3 Strategic Marketing Processes in Corporate Groups (solid line – database feed, dashed line – authorised access to database; based on VBM Consulting resources)

ture (see figure 4.3). Client, competitor, business partner and market databases are most common. It is important to remember that a database structure should meet information needs of all companies within the corporate group. What follows is recognition of what the accountability for the process execution is within the framework of each company from within the group. The bigger the company involvement in the process, the higher the added value created as a result of the process. It is important that administrators are assigned to each database, responsible for database maintenance and data uniformity. Subsequently, this clearly defined data base model ought to be applied to a corresponding computer instrument. Access authorization ensures that each company can only obtain the information it is interested in. as a final step in this process, it is necessary to describe it by means of procedures and good practices governing such aspects such as recommended information sources, update frequency, and the flow of information from the source to the base. As practice shows, even when all stages are diligently applied, the corporate data base may prove to be useless due to irrelevance of the data it contains, which may be caused by lack of trust that companies have in one another, and reluctance toward regular knowledge transfer. Hence, open internal communication and a modified incentive system that rewards effective knowledge transfers should accompany strategic marketing centralization processes.

As long as these conditions are met, positive effects including steady growth of corporate database are highly likely to appear, which, in turn, facilitates the acquisition of necessary information. Comprehensive and uniform knowledge about clientele accessible to the entire corporate group helps avoid making hasty and disorganized business moves and to identify client's new needs.

According to M. Porter's Five Forces' theory (2008), suppliers' bargaining power is one of the forces that shapes the market. In an extreme case of monopoly it is completely overwhelming and it engulfs pricing and sales conditions, too. In a competitive environment, however, the bargaining power that suppliers have increases owing to a growing concentration of suppliers in the market (Hitt, Ireland, and Hoskisson 2009). The theory of a growing bargaining power in relation to clients that occurs as the scale of operations increases is supported by other theorists in the literature on the subject (Peng 2008). Some scientists suggest that bigger companies always have more bargaining power over clients, suppliers, and regulators as they have control over more resources, and on account of economies of scale and scope. Besides, bigger companies are capable of hampering new players' entrance into the market (Gupta 2004). Another theory raises the issue of a growing bargaining power in relation to clients which may occur due to control over the so-called unique set of complementary resources (Afuah 2009).

Each theory may be implemented by a corporate group that aims at increasing its business activity concentration in the market due to horizontal integration, which enables the group to generate unique complementary resources. Taking these stipulations into consideration, we can assume that the bigger the scale of a business activity, the stronger the bargaining power in relation to clients. Practically, we can differentiate an array of strategies meant to enhance this type of synergy effects, namely:

- reciprocal trade,
- mutual forbearance,
- image synergy,
- mutual development of new markets.

Primarily, reciprocal trade derives from the area of international affairs where special international pacts define a number of aspects

related to a bilateral exchange of commodities. Besides, they may include trade rates arrangements that are inaccessible for other countries. Such trade agreements are also used in business, e.g. between two relatively different corporate groups which mutually provide each other with services or products in dissimilar areas. When this is the case, smaller suppliers are naturally marginalized (Sudarsanam 2003), which fosters market concentration and increases bargaining power of the two aforementioned corporate groups. More and more often, however, legitimacy of such activities is questioned from the viewpoint of competitiveness protection, which makes activities of this kind become more covert. Pursuing contractors that serve as suppliers for one company within one corporate group and service recipients for another company within the same corporate group is a much more acceptable instance of reciprocal trade. Besides, new opportunities for additional impact on trade conditions within one corporate group appear. As a result, a higher income is generated, which is the essence of synergy.

Mutual forbearance is a related phenomenon. It concerns overt or covert agreements between two corporate groups that compete in a few unrelated markets either geographically or product wise. An open relation of this kind is forbidden by antitrust legislation in many countries, therefore, it mainly appears as an informal agreement based on a mutual understanding of two competitors' strategy. Business activity of both corporate groups are coordinated in a manner that excludes straightforward confrontation in certain markets or certain market segments so that both business groups can achieve synergy effects that arise on account of a growing bargaining power over clients. In subject literature, there are many examples of covert accords such as Michelin and Goodyear's, or BIC and Gillete's (Furrer 2010).

Image synergy of a corporate group is rooted in its reputation, legacy, and achievements of particular companies that are given recognition at the level of the entire corporate group, and which, in turn, is transferred onto other companies as a result of feedback, and the so-called halo effect. Investors tend to perceive bigger companies as safer and, therefore, reward them with lower discount rates. Likewise, clients and prospective partners perceive them as more reliable. Given this positive image effect, a corporate group can initiate plenty of activities in order to increase its bargaining power in relation to

clients. In general, corporate groups, in particular public companies, gain more trust than smaller companies. In terms of sales synergy, this effect may be used in marketing communication which ought to highlight a credibility factor as a guarantee to meet clients' needs. It is particularly significant with regard to smaller, more specialist companies that make a corporate group, and that are able to win contracts from big, and demanding clients, e.g. from public sector. Image synergy, and halo effect, in particular, is inseparably linked to synergy generated in the area of non-material resources.

Activities within a corporate group provide one more element that helps increase bargaining power in relation to competitors and clients; namely – synergy related to lower costs due to shared market expansion in the context of mutual development of new markets. This type of synergy may be created in two ways (see figure 4.4); either by using at least one company's local presence in the market to introduce more companies from the same corporate group, or by using a roll-out strategy, derived from project management domain. The former strategy utilizes all available competences and relational resources of the local company, for instance, its knowledge in terms of market needs, legal regulations, supply source accessibility, distribution channels, and clients. This is how a new group that enters an untapped geographical market is able to skip a few developmental stages, and generate profits shortly. The latter strategy means deploying particular activities such as the ones related to the launch of a new branch in another country. It also entails having to make a thorough analysis of activities so as to work out a methodology applicable abroad (Stadtler and Kilger 2005). This strategy enables a speedy market expansion on account of gathering, and replicating reliable action methodologies and procedures, which subsequently enables the company to gain new revenue sources faster.

An increase in sales records as a result of sales resource sharing within the framework of a corporate group is the third type of sales synergy. It is a typical operational synergy that results in generating higher revenue than it would, were companies to operate single-handedly. Cross-selling is the most natural form of sales resource sharing in a corporate group. This technique enables to offer the same client new products by applying sales records related knowledge (Thomas and Housden 2002). Cross-selling is particularly popular in banking, where bank assurances are gaining more and more popu-

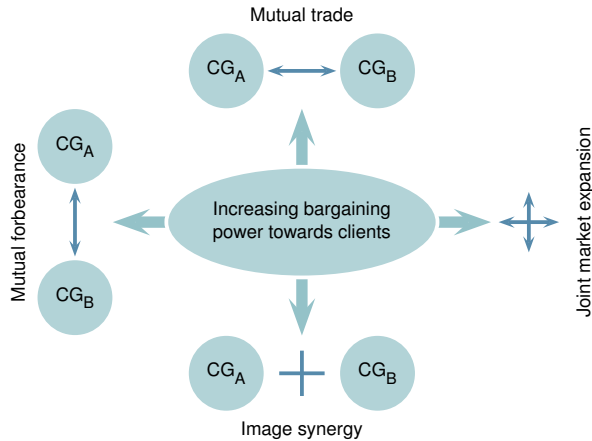


FIGURE 4.4
Sales Synergy
in the Area of
a Growing Bar-
gaining Power
over Clients

larity. A client is offered various financial services, such as accounts, credits, and insurance packages (Mishra 2010). Actually, any financial institution may supply each of these services. Cross-selling is successfully used by corporate groups, where each company offers products to the same client. It is important to remember, however, that to gain tangible synergy effects from cross-selling is not an easy task, and that we should not take it for granted that the client who has purchased a product from one company that belongs to one corporate group will buy another product from another company just because it belongs to the same corporate entity (Coe 2003). The key to success in cross-selling is an ability to forge lasting, and trust-based relations with clients (Ian 2010). It is necessary to recognize their needs and preferences thoroughly, which ought to be a result of a jointly executed strategic marketing. In particular situations cross-selling may produce dis-synergy, i.e. cause a complete destruction of relations with clients after having offered them unsuitable products or services that do not meet their expectations. Thus, it is important to remember that this strategy should be carried out very carefully and that it should always be based on client-related knowledge. Client type and client preferences determine the sales strategy as either a single sales channel and a single sales representative which constitutes pure cross-selling, or by means of multidimensional sales relations offered by individual companies. The latter case demonstrates the so-called lead-sharing, which means sharing information about prospective clients within the framework of a corporate group (Knoll

2008). This activity is most efficient in information and communications technology sectors. For this model to be effective and create synergy effects, certain conditions must be met. First of all, a platform for sales information exchange between companies from the corporate group must be established. Customer relationship management (CRM) like type of a solution that is common for the entire group seems most suitable. Second of all, it is crucial to stimulate knowledge and information sharing supported by a appropriate corporate culture model, and incentive systems that reward both, the sales person, and the staff who have tracked the information about the sales opportunities.

Sales channels are another sales resource that may be used in order to create synergy in a corporate group. Companies from the same group may be using the same point of sale, for instance, a store, or a web page. Sales channels based model is partially related to cross-selling. The difference is that, unlike in cross-selling, it gives clients a possibility to purchase many products in one place. It is crucial to bear in mind that the aforementioned strategies may be used interchangeably so as to create best synergy effects.

The strategy that is often executed is the one that combines efforts to increase bargaining power with sales resources sharing, which means inclusion of sales channels into a corporate group by means of integration. It is an alternative to developing group's own sales network. Its advantages are comparable to the ones gained on account of product development, and are applied by an array of corporate groups across the world.

Product Synergy

The issues related to product and price management in corporate groups, as well as impact of the aforementioned on additional synergy generation, i.e. product synergy, is the second group of value generators in corporate groups. Product and pricing are components of the marketing mix. From the perspective of a process, however, they are product management and sales management related notions.

Product management processes mean viewing the product as a profit generating element, and product manager's role as the one that maximizes profits (Morse 1998). Traditionally, product portfolio is managed on three levels: niche, product, and market (Gorchels 2003). Given the niche level, we talk about the management of one

product line targeted at one market segment. The product level resembles the aforementioned technological niche strategy, where one product line is targeted at many market segments. The market level is related to the niche level based strategy, according to which many product lines targeted at a single market segment are managed. In corporate groups we can observe each of these approaches separately, and one that combines them all, the management of which encompasses a few product lines aimed at many market segments. The last approach produces a number of upsides, such as an opportunity to multiply profits as a result of product synergy gain, as well as downsides, mainly related to internal competitiveness and risk of cannibalism. In order to stave off the negative phenomena, it is necessary to integrate product management processes in corporate groups. Product synergy may be achieved by applying the following strategies:

- price positioning,
- product bundling,
- shared solution development.

The first step in successful product management processes is the establishment of a proper pricing strategy. The theory related to price competitiveness strategy indicates that companies that compete in the same market generate higher profits when they create the so-called local monopolies (Hauser 1988), which is achieved on account of proper price positioning. Price positioning ought to include the following three components: price, advantages that product users gain, positions that competitors have taken (Brennan, Canning, and McDowell 2010). A classical approach to price positioning concerns situations when a company matches its offer in relation to competitors.⁷ Price positioning differs when applied in the context of corporate groups as it has to include price matching in relation to products that other companies from the same group have on offer. As a result, it is possible to take up a few positions, and generate an additional synergy value on account of sales maximization.

Sounding out what the market is like, i.e. identification of existing and potential price groups, should precede the elaboration of price positioning strategy. Identification of which price group the product belongs to is the next step to take in the course of the process. In practical terms, it means taking a certain position on a map that

includes two dimensions: price and quality. We can differentiate a few basic price positioning strategies, such as creating a new price group or entering the existing one that is either being serviced or not. To execute the aforementioned strategies we can use both established and new brands. A new price group is created usually when an empty spot is detected on the two dimensional map, and it is applicable in the following five situations that Kotler (1999) describes as:

1. *More at a higher price*: introduction of a higher quality product at a higher price in comparison to competitors' products, the so-called premium strategy.
2. *More at the same price*: introduction of a slightly higher quality product in comparison to competitors' products that is at a similar price.
3. *Same at a lower price*: introduction of a comparable quality product to that of competitors' products that is at a lower price.
4. *Less at a considerably lower price*: introduction of a lower quality product at a much lower price, the so-called price leader strategy.
5. *More at a lower price*: strategy that clients benefit most as it offers the highest available quality product at a lower price than competitors' products.

Price positioning is directly related to brand management within the framework of a corporate group. Repositioning of an established brand into a new price group poses a challenge as each brand has a certain image that resists change in a short spell of time therefore it is usually new brands that take new price positions.

Active price positioning plays another important role in a corporate group, particularly when the phenomenon of the so-called internal competitiveness occurs. It happens when several products are positioned in the same spot on the two dimensional map price vs. perceived quality, which results in the so-called product cannibalism. Product cannibalism means devouring a share of revenue that one product generates by another product from the same corporate group. To eradicate this negative phenomenon, selected products may be repositioned or in other words 'pruned.' To decide upon which product to prune, it is necessary to make an analysis as for where the revenues generated by this product thus far ought to be

transferred (Dalgic 2006). If it goes to the group's own product, pruning is justified. In case the analysis shows it will go to a competitor's product, the product ought to stay. The selection of a technique to reposition the product depends on its nature, and the market segment it is targeted at. For example, it is possible to raise the price, and dishearten clients as a result, lower the price to empty stock, or sell the rights to the product to another company (Gorchels 2003).

Product cannibalism may be applied as an intentional action plan by a corporate group, for instance, the co-called pre-emptive cannibalism, which makes sense when one product from the entire range has some flaws but is nevertheless popular with many customers. Since its recall is impossible due to its popularity, the introduction of a similar but defect-free product and positioning it likewise in the hope it will replace the faulty product is highly recommendable. This strategy assumes that it is safer when potential cannibalism happens on the side of products from within the same corporate group than the side of competitors (Harper 1996). It is forbidden to announce the introduction of a new product before it is ready as it may result in the suspension of all purchasing decisions related to the old product until the launch of the new one (Moore and Pareek 2006).

Corporate groups enable application of a few specific pricing strategies intended to eliminate competition and increase market share as well as revenues. Predatory pricing, which is one of them, is about either lowering the price so much that the revenue it generates hardly covers production costs, or going below production costs in extreme cases, which, in turn, coerces competitors to follow suit. It is only the biggest companies, e.g. corporate groups, that can survive in such circumstances, smaller ones have no alternative but exit the market (Koller 1978). As a result, the survivor group gains foothold and strengthens its position substantially enough to shape further pricing strategy freely while gaining considerable revenue growth. Application of this strategy in practice is often regarded as irrational (DiLorenzo 1992). In theory, however, it is easy to imagine its application in a corporate group that has produced a sufficient economy of scale to be able to lower the price below the national average.

Cross-subsidizing is another peculiar pricing strategy. It is about covering losses one product has made with profits that another one has generated (Bremmer 2001). According to M. E. Porter (1986) this strategy means selling the so-called basic products slightly above pro-

duction costs or at a loss so as to increase sales records of the profitable products. This strategy proves successful in retail, where supermarkets frequently lower prices of basic products, usually, of the so-called necessities, hopeful to lure clients to return to the store in the future and purchase more. In some situations this strategy may be applied in corporate groups as an element of a common product management strategy. Unless certain conditions are met, such as a strong relation between the basic and the profitable product, certain price sensitivity with regard to the former one, and price insensitivity when it comes to the latter one, this strategy will not succeed. The aforementioned relation must be strong enough to create a sufficient entry barrier in the range of profitable products for competitors. Synergy effects that arise on account of cross-subsidizing in a corporate group are possible to create after the application of the so-called product bundling strategy that consists of attractively priced basic products on the one hand, and unique profitable ones on the other. Product bundling is a widely used marketing instrument that combines a few independent products into one sales offer sold together by means of a variety of pricing strategies that mainly entail applying discounts in relation to the sum of unit prices. ms Office, which consists of a few independent programs, and McDonald's meal bundles (Breidert 2006) are typical examples of product bundling in B2C strategy. The notion of product bundling is applicable in the B2B trade mode, where IT and telecommunications companies are prevalent. The former ones create an offer that is customized, the latter ones make use of the phenomenon called a progressive convergence in the area of telecommunications so as to create a complex offer that combines voice communications, ICT and TV networks. Product bundling may be based on partnership that corporate groups thrive in as the interest of each company within one group is coherent. Adding complementary products to the sales offer frequently drives corporate group's instant growth. There are two basic approaches to bundled products: mixed and pure. The first one is more common; while mixed approach enables clients to purchase items separately, the pure one allows products to be sold in bundles. When a corporate group has a unique product on offer, it may increase its bargaining power substantially by offering pure product bundling, which will inevitably lead to sales volume growth as the unique product together with complementary items is then sold at a higher price.

What draws clients to bundled products is the fact the company offers a brand new, attractive item. Bundling allows producers to cut costs due to the centralization of trade relations with a single supplier, and the simplification of purchasing processes. This strategy bonds the client with the supplier in the long run as it increases exit barrier for the former. The bundled product related synergy entails an additional opportunity to increase revenue, while it reduces sales cost, including the cost of client tracking. Development of common solutions under a corporate group is the third product synergy maximizing strategy. This strategy is similar to the aforementioned shared product and service offer policy. Unlike the latter case, it does not utilize the existing product lines but implies active mutual planning of a corporate group's target offer. This strategy's aim is a coordinated development in particular companies with the group. Its primary flaw is the fact that bundling a few products does not always generate an added value for the client. When this is the case, some clients choose to negotiate the purchase of single products. In such circumstances competitors may come up with an alternative offer likely to result in the lack of synergy for the group. Developing common solutions, on the other hand, is a wider notion than a common offer, according to McKinsey. It is a combination of products, services, and knowledge that generates higher value for clients than these elements would do separately (Johansson, Krishnamurthy, and Schliissberg 2003). The unique feature and advantage of this solution is the possibility to easily modify it and integrate with other products and solutions. Sales of solutions enables to incur a higher operating margin and generates more lasting relations with clients (Belleflamme 2000). As a result, a significant competitive advantage is created that helps stave off price wars with competitors, because it enables the application of value-based pricing instead of cost-plus pricing. Value-based pricing is based on the clients' perception of the value that arises on account of advantages offered by a particular solution (Belleflamme 2010).

Prices are thus disconnected from production costs and require a detailed client's needs analysis. As a result, this approach enables higher prices to be imposed as each solution has many custom-made traits, which makes it difficult to compare to competitors' offer. The management of mutual solutions development in a corporate group requires application of an integrated approach to product development in particular companies. Development of a common concept

requires the ability target markets, scattered resources, and competences to be viewed globally. In the case of international corporate groups, it is necessary to consider international standards in projects. Devising a standard core, i.e. a common platform that consists of basic products that help develop customized solutions further, is another trait of a target solution. In conclusion, so that product synergy could appear, the process of common solutions development must be prearranged meticulously, later confronted with actual needs, and continuously coordinated and adapted to changing circumstances.

It must be supported by suitable corporate group's sales strategies, key elements of which were presented in the section on cross-selling.

Synergy Effects Related to an Operating Margin in a Corporate Group

Cost Optimization Related Synergy

Direct costs are all costs that may be directly assigned to a particular product or a service. Directly assigned means where the relation between a particular expense and a product is proven by a document, for instance a time-sheet or an invoice from a subcontractor.

Direct cost related synergy encompasses a few areas included in a corporate group's map of value generators. An increase in an operating margin occurs as a result of a decrease in external and internal direct costs, and improved utilization of material and intellectual assets. We can, therefore, talk about two types of synergy: process synergy and asset utilization related synergy. Let's begin with elements connected to the utilization of external material assets, economies of scale, and a range of material production assets deployment. We can differentiate three basic strategies aimed at synergy creation in the area of direct costs:

- increase in bargaining power over suppliers and subcontractors,
- consolidation of an operating margin due to backward integration,
- more effective utilization of material production assets as a result of economies of scale and scope.

The first strategy is related to the enjoyment of synergy resulting from better conditions in cooperation with suppliers of commodities, components, and subcontracting services, which is linked to the notion of Porter's (2008) Five Forces – an increase in bargaining power

against suppliers in particular. Gaining advantage over suppliers is much easier than in relation to clients, which is due to growing competitiveness in the market in general. The more divided the market of suppliers is, the weaker the position of suppliers becomes. Besides, supply itself gets commoditized, and price becomes a basic criterion for supplier selection. Advantage grows further as recipients grow in size, which is particularly common in case of corporate groups, as corporate groups tend to act as one service or commodity recipient that places larger orders than single companies do. Consequently, they are able to negotiate better terms with regard to prices on account of discounts, product quality, delivery time, promptness (Watson 2005) and extended payment dates. Results of this strategy are dependent on the type of a corporate group, which benefits conglomerates the least.

Purchase process optimization in corporate groups is one of the methods to increase a bargaining power over suppliers with order centralization and consolidation being at its core. Combining orders for many companies allows for serving a considerably bigger, bulk order, thus significantly decreasing supplier's bargaining power. This is how the so-called 'purchasing groups' work. They operate in many market sectors, such as retail, medical, and heavy industry to name but a few. Oftentimes they are super-regional to include national purchasing groups as well (see www.emd-ag.com/e/unternoo1.shtm). A corporate group where the purchasing process has been centralized becomes a natural purchasing group. Its potential is larger than of a regular purchasing group that consists of separate companies that frequently compete with one another. There is an array of techniques devised to increase order consolidation potential, each using commodity and product component standardization applied in particular companies from the group (Schuh et al. 2009).

In the context of various product lines, component standardization is the first method. It is based on an in-depth analysis of production processes within the framework of an entire corporate group, and component identification with regard to components that have identical or approximately the same nature. Later, a plan to standardize them by means of shared base platforms for various product lines must be devised. It is the type of action that is applicable in many sectors, e.g. automotive or electronic, and may be used in the area of current product lines as well as ensuing product generations. Volk-

swagen is a good example to illustrate this phenomenon. It is a group that comprises a standardized platform for similar car brands such as Skoda, vw, Audi.

Another method entails commodity standardization in manufacturing sites within the same corporate group. Under this strategy, analysis of production processes in terms of commodity parameters as well as potential modifications in terms of requirement standardization. Delivery globalization (Schuh et al. 2009), i.e. pursuit of suppliers in international markets is another means to achieve bargaining power growth over suppliers. The very process of supplier identification is relatively easy nowadays. Online catalogues, and customized platforms foster business relations and make networking easier. Supplier credibility assessment becomes a challenge though. Cross-cultural, legal and language differences additionally obstruct the process. Corporate groups may endeavor to use their company that operates nearest the prospective supplier as a communication channel, and minimize the risk owing to access to local knowledge.

Each market sector gives numerous examples to illustrate bargaining power growth over suppliers. Automotive industry being a classical one as car producers have a considerable advantage over semi-product deliverers, who usually operate on a much smaller scale. Car manufacturers are their primary clients (Hill and Jones 2009). So as to maintain low prices or negotiate substantial reductions, car producers inform suppliers that they are considering semi-product production themselves, which they are able to do due to economies of scale and production resources. Besides, they enhance competitiveness amongst suppliers by never allowing one to gain advantage in order to be able to change the supplier quickly once a need arises, which becomes an effective tool in price and higher quality component negotiations.

Wal-Mart, an American mogul in retail that uses all above mentioned strategies to maximize its competitive advantage over suppliers, is an interesting example to analyze. It generates its considerable revenue share through retail in the territory of the USA. Over 100 million Americans shop there weekly, which amounts to a third of the entire US population (Zimmerman and Hudson 2006). As the company grew, it changed its business model, and eliminated wholesalers from the value network by starting direct cooperation with producers, which was very progressive at that time. In the 1990s, Wal-Mart

gave their suppliers free access to turnover records, forcing them to offer Wal-Mart additional optimization of production and supply processes. Besides, it enabled the company to make savings in storage cost.

Operating margin consolidation due to backward integration (Swamidass 2000) is another strategy used in order to generate a direct cost synergy effect for a corporate group. The reason for implementation of this strategy besides operating margin consolidation is a desire to gain more control over accessibility, quality, as well as commodity and component costs. It is particularly important in case of constant production, where access to commodities determines the uninterrupted operations. There are numerous disadvantages of backward integration, with the increased risk on account of seasonal demand for particular services and components being most prevalent. In the case of clear seasonal fluctuation of demand, in-house component manufacturing or service provision may seem irrational from the economic point of view, even where an operational scale is considerable, the aspect which in fact triggered outsourcing on a massive scale and the establishment of plenty of smaller specialist companies in the USA in the 1980s (Reid 1993). Backward integration makes little sense unless an operational scale is large enough to minimize seasonality related risk. A supplier that is included into a corporate group has a chance to serve many companies from the corporate group while rendering services to external entities simultaneously.

A more effective use of production assets in a corporate group occurs as a result of implementation of the third strategy meant to produce synergy based on direct cost. It is related to the aforementioned effects of economies of scale and scope. This situation occurs especially when production assets are shared by companies from within the group, which is when resource sharing to achieve synergy effects takes place. A situation when it is more profitable to manufacture two products in a single factory than in two is a classic example of synergy creation that arises on account of economies of scope. As a result, some fixed costs are eliminated, and efficacy of production assets rises. For instance, if an efficient packaging line operating in a cereal production site is prone to seasonality, or the scale of production is restricted by demand, productivity of the packaging line exceeds the needs of a single company, which makes fixed costs elevate production costs, consequently the cereal price per unit. Given

a pasta producer operating in the same group, who has separated the packaging process, it is possible to utilize the same (cereal) packaging line for the pasta producer as well, and decrease production costs for both producers as a result. For synergy to exist, it is necessary to stipulate principles related to production assets sharing by companies so as to prevent the situation when one product blocks access to the line for another one (Davies and Lam 2001). Besides decreasing production costs per unit, an extra synergy effect related to the very production management process appears as a result of economies of scope. Additional savings may show up too owing to improved coordination between phases of production processes carried out in the same venue (Brennan, Palmer, and Martinez, 2002).

Economies of scale is another phenomenon related to advantages that arise on account of the size of the organization. Synergy effect creation is based on the rule according to which the larger the operation scale, the faster revenue grows in comparison with costs (Baumol and Blinder 2007). Telecommunications sector where the same infrastructure is used to provide service to a surging number of users is a classic example of economies of scale. Corporate groups are capable of utilizing effects that economies of scale generate due to the aforementioned sales and production. The phenomenon that combines synergy effects that appears on account of economies of scale and scope is called economy of integration. It is what companies look forward to the most.

Synergy Related to Overhead Expenses

It is generally assumed that overhead expenses, also known as general management costs, include all expenses related to the company as a whole. They concern management and administration processes in particular and pertain to a few areas on the map of value generators within a corporate group. Back-office related costs are a very important element of overhead expenses. They comprise accounting, finance, tax service, human resource management and payroll, administration, IT service, purchasing processes, marketing in general, and strategic marketing as well. In a typical corporate group there are many companies each of which runs their own back-office operations in the areas such as accounting, human resources, remuneration, and IT departments. In other words, each company within the group operates single-handedly, and is self-sufficient in the scope of

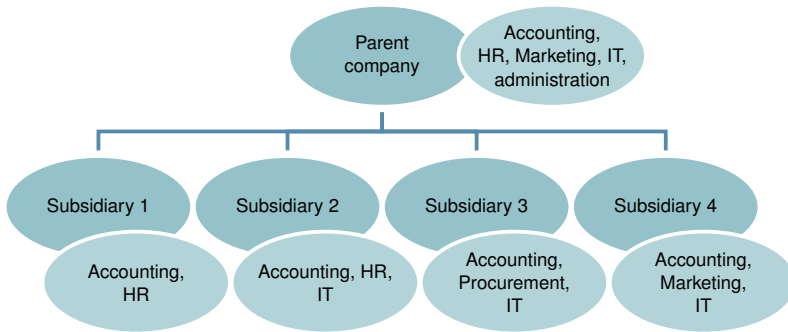


FIGURE 4.5 Structured Back-Office Processes in a Corporate Group (based on VBM consulting resources)

back-office processes. From the point of view of an entire corporate group, such an environment is extremely heterogeneous and prone to interchangeability. Heterogeneousness is reflected in the application of a variety of back-office related standards, different supervision models, report templates, and disparate IT systems. Interchangeability, on the other hand, entails application of the same procedures by human resources in various companies, which means that a global cost of these processes in a corporate group corresponds to their cost in a single company that is a part of a corporate group.

Back-office expenses that increase proportionally to the growth of the entire organization raise concern, as these costs are fixed. As corporate groups grew globally, managers began to pursue ways to reduce back-office expenses, which is how the notion of shared services was coined (see figure 4.5).

A shared service center may be defined as a strategy of cooperation between a few entities within the framework of which a certain group of operations and processes is concentrated in a single organizational unit intended to generate maximum efficiency, frugality, and quality in the scope of utilization of human and organizational resources (Bergeron 2003). Since a shared service center includes an array of processes from many a company, the processes it encompasses usually are not critical. They do not require key competences either. Thus, a shared service center is an environment for the concentration of supporting processes. The notion of a shared service center is based on the assumption that there are more recipients than one. According to it, a single unit that renders internal services

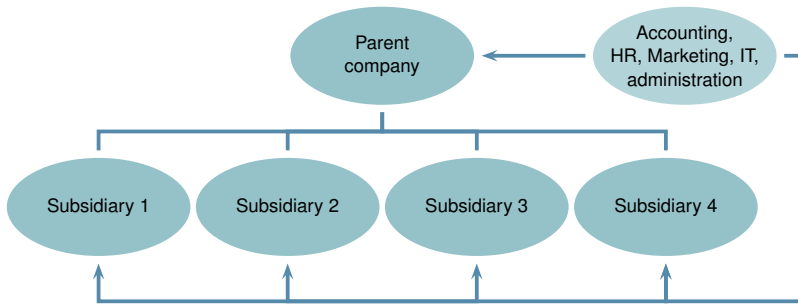


FIGURE 4.6 Shared Service Center in a Corporate Group (based on VBM consulting resources)

for one external client does not constitute a shared service center.

The concept of a shared service center shall not be perceived solely with regard to the centralization of similar activities. A change in organization must be accompanied by a change in mentality (Bange-mann 2005). This change should cause a shift in the perception of back-office as such, which becomes primary for the center. What sets a shared service center apart from centralization is its full accountability it holds for expenses and the quality of the processes carried out. A shared service center resembles a typical business with its own budget, fixed assets, managerial and operational staff, and development strategy. Advantages arising from launching a shared service center in a corporate group may be perceived from two perspectives (Bergeron 2003). From the standpoint of a corporate group, basic expectations are related to the reduction of back-office costs, improvement in the quality of the services, and an increase in a degree of concentration of particular companies on their primary business activity. The center that is orderly has an additional potential thanks to which it can serve as a service provider for clients from outside the corporate group. From the point of view of the shared service Centre, advantages occur as a result of process standardization intended to increase productivity, decreased demand for human resources, and economies of scale related effects. A relatively speedy and more reliable update procedures that pertain to IT systems that service back-office processes is another, oftentimes, underappreciated benefit that a shared service center generates (Travis and Shepherd 2005). It results from the unification and concentration of IT environment and systems such as F-K, surveillance, and HRM (see figure 4.6).

First shared service centers were founded in the 1980s. Currently over 70% of companies listed in Fortune 500 make use of them, for instance BBC, BP, Bristol Myers Squibb, Ford, GE, HP, Pfizer, Rolls-Royce, ArcelorMittal and SAP. They generate savings that amount to 45% of all expenses.

Account settling between shared service centers and internal clients is of primary importance. The way it is carried out has evolved as the notion of shared service centers developed. Initially, it was based on simple mechanisms of cost assignment to individual internal clients. As standardization grew, however, a more distinctive demand with regard to an anticipated quality level for account settling model differentiation appeared. An ideal accounting system must offer a choice of quality standards. Besides, it should be simple and transparent. Service Level Agreement (SLA), which defines the scope of every service in detail as well as conditions it shall meet with regard to time, quality, and place (Blokdijk 2008), is prevalent in the majority of shared service centers.

In conclusion, the introduction of the idea of a shared service center in a corporate group results in a myriad of synergy effects in the scope of back-office processes. Cost reduction is a primary synergy effect whereas an increase in efficiency and quality of the processes as such is an additional advantage. Further cost optimization in the framework of a shared service center is achieved as a result of uninterrupted optimization of particular processes, which takes place faster than in case of interchangeability related processes scattered across many companies as it concentrates all processes within one organization.

The very optimization is a cycle which entails the following phases: process analysis, efficiency assessment, comparative analysis, and upgrade and efficiency screening (Khalid 2010). Process analysis and its comprehension is the first basic stage of the undertaking. It shall be divided into separate tasks, with planned execution sequence. Furthermore, it is necessary to define relations between tasks, measure productive and unproductive time related to items such as waiting until the preceding task has been completed, as well as input and output in IT systems. Such an analysis lays foundations for efficiency measurement that includes a number of efficiency factors, from financial, e.g. the process and single tasks' expenses, to performance based factors. Primarily, two tiers of efficiency indicators shall be

distinguished, i.e. Key Result Indicator (KRI) and Key Performance Indicator (KPI). KRI is usually a complex financial indicator related with process costs (Parmenter 2010). It grants a more general view toward the results of a particular process. It does not, however, indicate the elements that require optimization. KRI is more applicable in management and preliminary process identification that need optimization. Thus, KRI is measured in a longer time perspective, e.g. monthly, annually, etc. Contrary to this, KPI is an operational indicator measured more frequently. It pertains to specific tasks within processes, and enables an assessment of efficiency of particular actions, e.g. a number of resolved tasks reported by IT department a month versus the entire number of notifications.

The use of performance indicators for process description enables benchmarking. Its essence is data collection about efficiency of processes in other companies and its comparison with company's own indicators. It is not meant for company's efficiency performance ranking but to help make observations and conclusions aimed at refining the company's own processes (Rolstadås 1995). Access to data related to other organizations is likely to pose difficulties while making a comparative analysis. Therefore, different groups of reference may be used instead, for instance corporate group's own entities, allowing for internal benchmarking in which the performance indicators between particular companies, divisions, and group's departments are compared. In the case of shared service center, internal benchmarking ought to be carried out prior to the launch of the center. It should include an analysis of back-office processes present in each member company. This analysis enables identification of differences in the scope of performance efficiency as well as of a desired efficiency standard for the shared service center. External benchmarking is the next stage while making a comparative analysis. Since it has back-office in the focus, there is no need to identify a reference group of immediate competitors. Partners or clients will do. It is recommended to request their consent to take part in the analysis as they will benefit directly after the group's efficiency has improved.

In most organizations, processes are a result of an evolution, and are hardly ever intentionally tailored. Hence, the aforementioned engineering approach is highly likely to cause a considerable increase in performance efficiency. Not only will the improvement stem from the refinement of business assignment execution but also on account

of better integration of processes. Automation of selected processes may lead to improved performance productivity too. It is possible by virtue of implementation of mutual IT solutions including a document circulation system by a shared service center. Implementation of constant performance efficiency monitoring closes the cycle of optimization of back-office processes. Suitable IT reporting instruments enable an uninterrupted assessment of the group's own indicators that have been selected to scrutinize. Any substantial deviation from established standards should urge to resume a detailed process analysis anew.

Tax Optimization Related Synergy

Tax allowances drive corporate groups to devise growth strategies as they entail the prospect of tax related synergy effects that are attainable (see figure 4.7). Taxable income in a corporate group is, in fact, the group's total revenue reduced by the losses generated by other companies in the same fiscal year, which causes a decrease in the entire tax base. The establishment of fiscal groups is reasonable only in corporate groups encompassing both profitable and less profitable companies. This solution creates plenty of additional opportunities that companies that operate single handedly do not have. For instance, fiscal groups may be used to enhance product and market expansion. Entering a new market or devising a new product usually means initially generated losses. When this happens in a corporate group, however, it is possible to single out the company from within the group that produces extra synergy effects besides losses. It is crucial to remember that legal regulations are not uniform everywhere, and that it is necessary to assess each company's potential for generating both gains and losses within binding regulations. Operating within a corporate group enables companies from within the group to set prices internally, which has no effect on a total tax base. Besides, corporate groups are entitled to apply internal support programs that offer preferential loans.

Fiscal corporate groups are not equally popular everywhere though, which is due to the fact that legal requirements that pertain to the organizational aspects of the notion of fiscal corporate groups tend to be highly restrictive.

Corporate groups are entitled to move their business activity partially to regions where lower tax rates are in effect, which helps to

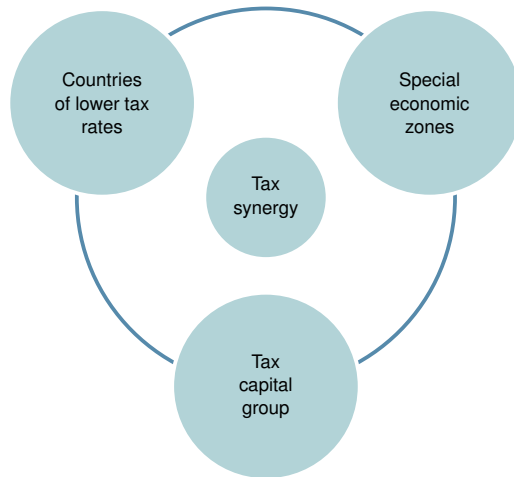


FIGURE 4.7

Types of Tax Synergy
in Corporate Groups

generate another type of tax related synergy. This may occur with regard to two locations, the so-called special economic zones and foreign countries.

The main aim of special economic zones is to revive economic growth in a selected region. Businesses that obtain a permit to operate in an economic zone also receive a number of preferential conditions, i.e. tax allowances the scale of which is dependent on the size of investment, a number of employees, and the sector. In order to gain more tax benefits, international corporate groups can resort to transferring operations partially to the countries with lower tax rates and more attractive tax systems in general.

Synergy Effects Related to the Assets Efficiency

Synergy Effects Related to the Efficiency of Tangible Assets

An analysis of tangible assets of a non-productive nature requires special attention. Economies of scope that enable an effective use of all resources lay a foundation for synergy effects, which will be further demonstrated using an example of assets in logistic processes in relation to the means of transportation and storage area.

Logistics costs make most part of all fixed costs incurred by companies, particularly manufacturing and trading ones. Operating within a corporate group enables application of actions aimed at optimizing costs owing to logistic resources efficiency maximization. The approach to the arrangement of logistic processes that companies have

changes every couple of years. Most companies start with building their own forwarding resources. They outsource them subsequently and, as years pass by, resume logistic processes in-house anew, especially after having realized that they are strategic for the efficiency of their business operations. Truck fleet equipped with refrigerators that distributes ice-cream in the summer time, and frozen foodstuffs in the winter is a classic example of synergy in the scope of transportation mode. It illustrates two synergy aspects, i.e. mitigation of negative effects of seasonality, and maximization of productivity with regard to transportation. Companies that operate in a corporate group usually develop their own transportation base. To optimize logistic costs they choose to reform the system. In the majority of cases the very reduction in the number of vehicles yields considerable savings. Further optimization is carried out in relation to transportation process management in the entire corporate group. The introduction of the notion of sharing transportation resources is its basic assumption. With respect to arrangements, in particular in the case of extensive fleet, it is possible to separate the so-called 'transportation base' by transferring it to another company from the same corporate group. Usually, however, it suffices to manage these resources by means of appropriate processes. Optimization of delivery routes with regard to all companies' recipients is another applicable strategy meant to increase synergy effects. Delivery routes are supposed to be optimized, as well as the packaging processes. The main aim of delivery route optimization is reduction of the so-called dry runs, and maximization of round trips. Transport fleet related maintenance processes undergo optimization too so as to increase synergy. If forwarding does not constitute corporate group's basic business activity, outsourcing this service to an external contractor seems an ideal solution as it gives the group a chance to make use of greater bargaining power over such service renders that they have in comparison to smaller businesses.

Reduction of expenses related to scattered storage space in companies may be achieved by an increase in storage service efficiency and cuts in transportation costs by means of closing intermediate points, in other words, the actions mentioned in the previous paragraph. Storage service centralization, or establishing so called hubs, is a popular trend nowadays. Its aim is to maximize purchasing and transportation costs. To succeed in economizing the purchasing costs, groups must increase frequency of deliveries, which is possible when

the main warehouse is conveniently located. They may be also reduced by a growing bargaining power over suppliers due to the increase in the number of orders. Further optimization of storage processes in corporate groups includes improvement in turnover rates.

Transport and storage optimization in an entire corporate group may be unworkable without the support of IT systems. It is best to implement a uniform system to enable electronic exchange of information about vehicle accessibility and localization, as well as active management of storage processes.

Synergy Related to the Efficiency of Financial Assets

Since synergy effects related to an increase in efficiency with regard to the management of financial assets in corporate groups have already been outlined this subsection will focus solely on synergy effects that pertain to the efficiency of financial assets, in particular:

- risk reduction on account of co-assurance,
- capital allocation in the financial market,
- advantages resulting from increased cash management efficiency,
- advantages resulting from financial economies of scale.

One of the basic financial synergies in corporate groups is connected to the so-called co-assurance phenomenon which entails reducing negative effects that the changeability of financial flows entails. This notion is particularly relevant for highly diversified corporate groups where business activities are characterized by highly non-correlated seasonality. Co-assurance related synergy is reflected in numerous positive phenomena such as risk level reduction, and creditworthiness on account of improvement in ratings. The more diversified corporate group's business activity, the larger co-assurance related synergy effect. Therefore, conglomerates where business affiliation between companies is tenuous, boast biggest advantages of this type of synergy (Gregoriou and Renneboog 2007). This, in turn, minimizes a positive, yet weak operational synergy effect that may be replaced by financial synergy accomplished on account of economy of scope that pertains to the utilization of positive financial flows (Schertzing 2009).

According to Markowitz's portfolio analysis, co-assurance effect enables the reduction of aforementioned risk in a corporate group,

in particular with regard to the so-called specific risk. In accordance with this theory, the risk of investing in the group of companies with negative correlation of financial flows is lower, than investing in each of these companies separately. Synergy effects arising from risk reduction comprise mitigation of bankruptcy risk, a decrease in the cost of capital, and an increase in creditworthiness of the entire group. Diversification of financial flows enables attaining a simple operational synergy in the scope of financial planning, mainly in the area of financial liquidity. The literature on the subject provides theories according to which the effect described by Markowitz may be enhanced owing to appropriate managerial initiatives (Knoll 2008). It is related to the accomplishment of operational synergy that could decrease general sensitivity of the group to external changes in the environment, which may be reflected in attractive product bundling thanks to which client loyalty grows, and the group becomes less sensitive to the seasonality of sales.

An increased tendency to make investment in the group on the side of various groups of interest is an important synergy effect, which is often underestimated. Stakeholders include the staff, suppliers, and clients who are inclined to take action so as to increase the value of the organization, due to reduced risk and greater stability. For instance, employees engage in getting to know the group's corporate culture, and establish a permanent network of internal relations, while suppliers are more willing to customize their products and services in order to tighten relations with the group, whereas clients who perceive the group as a credible partner, are more keen to sign long-term contracts. All these investments are of non-capital nature. They are based on a multidimensional network of social relations, and, therefore, are impossible to speedily replicate, which brings a significant competitive advantage.

Effective capital management on account of the establishment of the so-called internal capital market is another effect of financial synergy in corporate groups. A primary goal of capital market is to invest limited capital in particular ventures. Internal capital market works in a similar manner. It is limited to investments made within a corporate group. Groups carry out development projects that pertain to new products and markets. Managers supervise these projects and identify the ones that are most likely to yield highest return on investment, which helps take decisions as for where to transfer cap-

ital, and which projects to subsidize more profitably (Eckbo 2007).

The advantage that internal investors have over external ones lies in access to more detailed and up-to-date information related to particular projects, as well as more apt assessment of the probability of success (Hitt, Ireland, and Hoskisson 2009). Unlike external investors in the capital market, managers who supervise corporate groups are fully acquainted with data on negative aspects of the projects carried out, which is often omitted in formal bulletins and documents. Better understanding of potential operational synergy in a corporate group - which may increase the chances of succeeding - is another information advantage. Besides, internal capital market offers an opportunity to withhold selected information within the group and protect potential competitive advantage, which is particularly important in case of innovative projects. Publication of a memo or a business plan means the disclosure of some information that, in turn, becomes accessible to competitors, who, as a result, may take a suitable action aimed at copying a particular developmental strategy (Shipman 2002). Last but not least, it is important to remember that investment in internal capital markets - which tend to be more innovative - is inextricably linked to the strategy of permanent value growth of a corporate group. Start-ups receive funding in the internal market provided they are of strategic significance from the perspective of the growth of the whole corporate group, which guarantees its considerable competitive advantage over other companies that operate independently and that are in the initial phase of development. External investors are more considerably inclined to minimize risk, and aim at accelerating the return on investment by assigning financial resources to projects with a shorter time horizon.

The role of internal capital market increases additionally in the countries where external markets are prone to low efficiency, e.g. in developing countries where stock exchange and investment funds are in the initial phase of development, and where access to credible investor data is obstructed. As a result, potential investors are reluctant towards bearing investment risk, and therefore require extremely high compensating premiums. Hence, in radically inefficient external capital markets, internal financing is likely to be the sole source of growth funding. Financial synergy in a corporate group may result from blending the two aforementioned components, i.e. the phenomenon of co-assurance with the idea of internal capital

market. In a corporate group where one company has appropriate cash reserve, and another one offers a pool of projects which require funding and provide high return on investment, it is possible to invest slack cash in the other company's projects, which is commonplace in case of acquisitions of smaller, yet innovative companies by larger ones that are reputed as steady but less dynamic.

Another group of synergy effects is related to the reduction of expenses that arise in the course of funding current operations on account of effective cash management in a corporate group. Cash pooling is about concentrating cash resources of a few companies and compensating temporary cash shortage reported by some companies from within the group with temporary cash surplus reported by other ones. There are two main reasons for using common cash management strategy (cash pooling) in corporate groups (Mäntysaari 2010), namely:

- a desire to reduce demand for external funding on account of consolidating bank accounts and mutual bank account balancing in particular companies from within one group, which results in the reduction of a combined value of working capital, and reduced demand for cash;
- improvement in the situation of the group with regard to financial liquidity, as well as interest on deposit.

If the main account balance is positive, financial surplus may be invested further. The more surplus, the better conditions for investment (Coyle 2000). There are two primary cash pooling agreements, i.e. effective and virtual ones. The former one is related to genuine cash consolidation with the use of a corporate group's main bank account. Effective cash pooling may assume two forms:

- single legal account,
- zero-balancing account.

Single legal account occurs when financial resources are deposited in the main corporate group's account administered by parent company, whereas subsidiaries' subaccounts are memorandum accounts. Zero-balancing account, which is more prevalent, entails each subsidiary having its own bank account that is zero balanced daily, which means that its surplus is transferred to the main account of the corporate group, and debit is compensated with the resources deposited

there. Virtual cash pooling, also known as netting and interest pooling consists in charging interest on the basis of the balance on the virtual main account without the need to make real cash transfers between subsidiaries' accounts; in other words, on the basis of the total of positive and negative balance on subsidiaries' accounts with cash amount remaining intact in each account. The main advantage of virtual cash pooling is that banks are obligated to maintain asset back-ups which means that they must consider subsidiaries' account balance while estimating these reserves, even though they have been consolidated. Virtual consolidation effects are lower than effective consolidation effects because they are deducted by asset reserve maintenance costs. On the other hand, however, the lack of real cash transfers reduces transaction costs that pertain to the process of consolidation.

There is a third form of cash pooling that covers both effective and virtual cash consolidation, namely mixed cash pooling used in complex corporate groups where the choice of cash pooling model is made at various levels within the group. Financial economy of scale that occurs in corporate groups is the last synergy effect related to the efficiency of financial assets, resulting in higher creditworthiness of the group on account of reduced risk. The scale of corporate group's operations, which exceeds the scale of singular companies, has a direct impact on financial economies of scale. The advantages that financial economies of scale entail are as follows:

- lower transactional expenses connected to relations with financial institutions, e.g. insurers,
- access to new financial instruments such as swaps and forward contracts.

Consolidation of investment credits or mutual risk that pertains to foreign currency management (in particular in international corporate groups) is a standard operation that utilizes economies of scale. The bigger the business, the better insurance conditions it negotiates. Thus, it is profitable to apply a mutual insurance strategy in corporate groups. Economies of scale enable companies from within a corporate group to receive better evaluation on account of lower discount rates, since risk related to a small scale of operations and the so-called specific risks e.g. dependency on a single client – is substantially limited.

Chapter Five

Role of Intellectual Capital in Value Creation

Knowledge-Based Enterprise

Modern enterprises must operate effectively in market environment marked by dynamic and often revolutionary changes, for instance in technology. In parallel, the market is subject to progressing globalisation and is additionally prompted by developing technology. Consequently, business enterprise models are subject to changes in response to the fact that physical country borders do not determine the scope of operation anymore, and are no longer a pivotal obstacle to development. In this context of global competition, consumers whose expectations are even higher with easier access to information and alternative products and services shall be considered. Contemporary economy is often described as based on knowledge, thus it is the knowledge that may determine the survival of a company in this quickly changing market environment. Present-day organizations, including capital structures which intend to acquire a stable growth in value must be appropriately flexible, able to swiftly invest or deinvest, they shall also characterised by cooperative approach to market environment and first and foremost – possess specific intelligence. This intelligence consists in the ability to create value based on innovative and unique intangible resources which are difficult to copy and therefore constitute a basis for competitive advantage.

The answer to these new market circumstances is a new type of organization called knowledge-based enterprise in which knowledge becomes the major resource and the source of its competitive advantage. Contrary to the traditional models of management in which knowledge is accumulated at top levels of corporate group, a modern company resembles rather a dispersed neuronal network, by means of which the accumulated knowledge is distributed and coded within each segment of organization, thus determining the potential for company development. For this reason, knowledge becomes of pivotal importance for succeeding in business, and constitutes a

fundamental value generator (Chong 2000). Knowledge-based enterprises fully incorporate knowledge in their business models and it is the very knowledge that becomes a principal and fundamental component of goods and services they offer (Wickramasinghe and Von Lubitz 2007).

The notion of knowledge is often confused with information or data, while from the perspective of management process there are actually three tiers of corporate intelligence (Waltz 2003). Data represent the result of a single observation or measurement and thus are the simplest, basic component of intelligence called often 'raw' or 'unrefined' intelligence. On the other hand, information is a structured collection of data which was subject to screening and classification process. The substance of information is a combination of various data and its processing in a given manner. Finally, knowledge means information which was analysed, understood, properly interpreted often also codified and used to undertake an action. Wisdom is another tier of corporate intelligence which is often referred to. This feature is often attributed to humans, yet we may speak of wisdom in a corporate context when some organization has relevant knowledge and is able to apply it in practice – for instance to ensure permanent value growth and building competitive advantage.

Alvin Toffler in his book *The Third Wave* (Toffler 1980) describing the transformation of the developed countries from the Industrial to the Information Age, defines several characteristic features of knowledge as a corporate asset and distinguishes it from conventional tangible resources. The main feature of knowledge is dominance, or central and strategic importance for the company and its business model. Subsequent features mentioned by Toffler distinguish knowledge from tangible resources, as its characteristics comprises inexhaustibility, simultaneity and non-linearity (Buzzetto-More 2007). Inexhaustibility means it can be reused without any loss in its value. Moreover, a popular opinion holds it that in practice the process of using knowledge contributes to its development through gaining new experience. Simultaneity means a possibility of using knowledge by an unlimited number of users at the same time and regardless of their location. Finally, nonlinearity means there is no direct correlation between the volume of knowledge resources and the scale of advantages arising from its use; in other words little knowledge may be critical for competitive advantage of the company, while vast

resources of knowledge may prove to be completely useless in a given market situation.

From the perspective of accessibility, knowledge can be divided into tacit knowledge and explicit knowledge. When analysing of knowledge-based enterprises, a component which is easiest to identify is explicit knowledge which is formal, codified, systematized, archived in the form of documentation, databases or algorithms (Chatzkel 2002). A characteristic feature of explicit knowledge is that it can be accessed and used by any person having appropriate expertise and physical tools, e.g. a computer with access to particular knowledge base (Geisler and Wickramasinghe 2009). On the contrary, tacit knowledge may be described in the simplest terms as knowledge that cannot be codified, i.e. converted into explicit knowledge (Collins 2010). Tacit knowledge is based not on physical documents or databases, but on personal experiences and individual thinking patterns, thus being difficult to express (Busch 2008). The only means of sharing tacit knowledge is in interpersonal contact which usually requires an atmosphere of adequate confidence. It is worth mentioning that tacit knowledge is a source of explicit knowledge. An important distinctive quality of explicit and tacit knowledge is the fact that the former is owned by enterprises, while the latter is the exclusive property of individuals.

With the growing importance of knowledge in modern companies, more emphasis has been put on methods of classification and measurement of the knowledge value and assets resulting from its application. It is because knowledge is increasingly considered a key generator of company's market value. Such value, in many cases, may substantially exceed the traditional book value of a company. This widening disparity in valuation of companies based on knowledge is attributed to a category of intangible assets, absent from traditional balance sheets – known today as intellectual capital.

In the 1980s, Karl-Erik Sveiby together with a so-called Konrad Group comprising a number of Swedish enterprises made a pioneering effort to define intellectual capital. In their day-to-day work, managers within this group used a number of non-financial indicators in order to monitor the efficiency of intangible assets (Andriessen 2004). The 'Konrad Report' published in 1989 questioned the rationale of using the existing financial indicators to demonstrate the condition of a company and its competitive position, and rec-

commended using non-financial indicators instead. Owing to Konrad Group's works, Swedish companies soon became leaders in the analysis of intellectual capital resources. The achievements of WM-Data and Skandia AFS deserve special recognition in this respect (Sveiby 1997). After six years of applying non-financial performance indicators, WM-Data was the first company in the world to include a chapter dedicated to intangible assets in its annual report in 1989. On the other hand, in 1990 Skandia AFS, introduced into its company structure the position of Intellectual capital Director, whose task was to develop a methodology of presenting and management of intangible assets. The legacy of Leif Edvinsson – the first IC director in Skandia AFS, was the development of the so-called Skandia's Business Navigator.

In the course of numerous and often independent studies on intellectual capital, countless definitions of this term have been developed. Basically, it may be defined as a set of monetary and intangible resources allocated under total or partial control of the company and directly affecting the growth of company value (Roos, Pike, and Fernström 2005). In the next part of this chapter, the scheme of intellectual capital components will be discussed and subsequently used to examine synergy achievable in corporate groups.

To conclude, knowledge-based company is the business models of today's leading enterprises. Ability to use knowledge gradually determines the survival of businesses in a rapidly changing market environment. Business organizations must demonstrate a certain type of intelligence based on knowledge. Knowledge has become not only a key asset of the company and a source of its competitive advantage, but more frequently it constitutes a core element of products and services it provides and a primary generator of company value. In many cases, this value may substantially exceed the traditional book value of a given enterprise. In the course of investigating the sources of the growing discrepancy in valuation of companies, a set of intangible assets absent from traditional balance sheets was identified – known today as intellectual capital.

Classification of Intellectual Capital Assets

With the advancement of intellectual assets reporting techniques in enterprises, a classic and still valid classification of intellectual capital elements was developed. Intangible corporate value generators were

divided into three basic segments (Edvinsson and Michael 1997): human capital, structural capital and relational capital (figure 5.1). Human capital combines such components as skills, knowledge and experience of employees and the management personnel – in other words tacit knowledge which determines the intelligence of the entire organization. Structural capital consists of organizational and infrastructure support for the development of human capital as well as the organization's ability to accumulate and implement intellectual capital. Relational capital, originally recognized as a component of structural capital – comprises a set of business relationships with customers. Under subsequent concepts, relational capital was distinguished as a third, separate component complementing the human and structural ones, and further divided into customer capital and supplier capital (partner capital).

The standard classification of intellectual capital, as the very name suggests, refers to the liabilities section in the company's balance sheet which characterizes sources of financing the assets, in other words how the company obtains funding for purchasing or generation of assets. In this context, intellectual capital can be defined as a potential to generate intellectual assets. Such capital may refer to competencies of employees, which, once codified – become incorporated as intellectual assets and they receive legal protection, they are considered intellectual property (Sullivan 2000). Intellectual assets generate value by means of creating current or future cash flows. Investors are keen to invest in innovative companies at a price in excess of their current book value, because they try to assess the future value of cash flows generated by intellectual assets that are not recorded in the accounting balance sheet (Grajkowska 2011).

Modern approach to intellectual capital is becoming increasingly congruent with resource-based concept in corporate management theory developed in the early 1990s, following an article published by Prahalad and Hamel in the *Harvard Business Review* titled 'The Core Competences of the Corporation.' In this text, the authors present a company as a compilation of resources that make up core competencies of an organization on the basis of which end products and services may be provided to customers (Prahalad and Hamel 2001). Corporate resources are understood as any and all assets controlled by the company; including skills, organizational processes, qualities, information and knowledge, which contribute to enhancing business

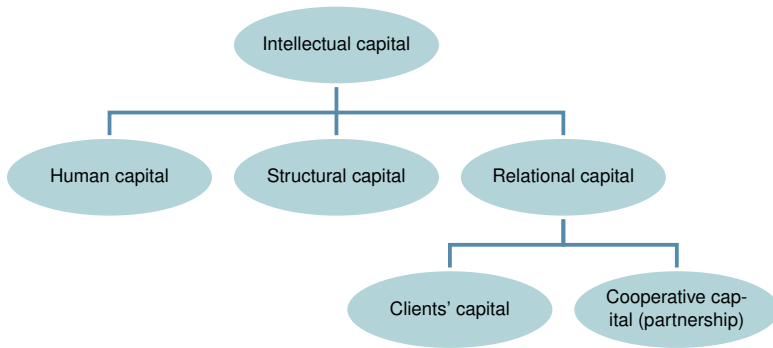


FIGURE 5.1 Standard Classification of Intellectual Capital Assets
(based on Skandia value model)

efficiency and allow for the implementation of the established development strategy (Barney 1991). The fundamental principle in the concept of resource management approach stipulates that the source of success of an organization lies in configuration of its unique resources and skills. The second objective in the resource-driven approach to management states that these resources shall generate appropriate value, which is the case if they are rare, difficult to copy and effectively organized. The final element of the concept assumes that competitive advantage – as a rule – is not determined by a single resource, but the interactions between many resources. In addition, the operations strategy must be formulated and implemented in concordance with corporate external environment, and thus it shall make use of external market opportunities and allocate resources accordingly (Grant 2005). For this reason, the organization having always greater chance for succeeding is the one whose resources are fully compatible with its business model and implemented strategy.

Typical resources of an enterprise encompass physical resources defined as tangible assets such as fixed assets, equipment, land and monetary assets defined as cash and receivables. Key competences mentioned by Prahalad and Hamel refer to knowledge resources scattered across an organization, or intellectual capital resources. Resources can also be divided according to another criterion, namely the possibility of selling them outside the company. On the basis of this quality, the resources were distinguished from skills with the latter being permanently ingrained in the organization and forming

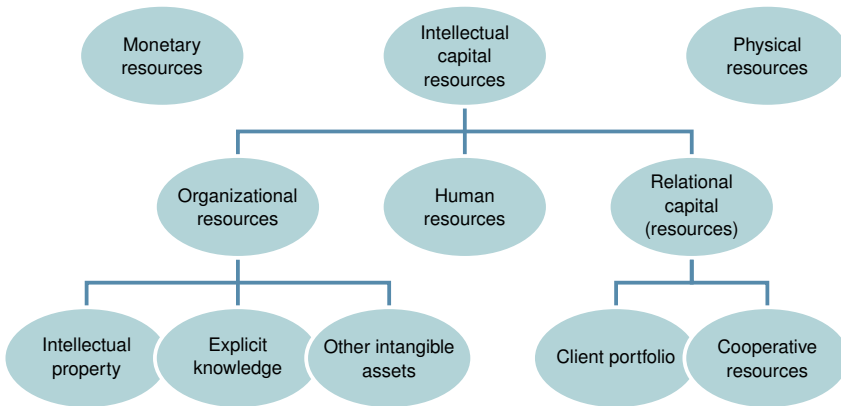


FIGURE 5.2 Classification of Intellectual Capital
(adapted from Grajkowska 2011)

the basis for the development of resources owned by the company, and therefore are liable to commercial transactions (Amit and Schoemaker 1993). This distinction is particularly important in the context of intellectual capital resources treated on a par with conventional counterparts in the classification of resources, and in the case of today's knowledge-based enterprises they are in fact key generators of value. According to the standard classification of intellectual capital they comprise human, organizational and relational resources, and the latter may be broken down into associated with customers and suppliers (Marr 2005). Furthermore, organizational culture is increasingly addressed in the context of the intellectual capital resource. Therefore, it may be assumed that the potential value of an organization is determined by physical assets, cash resources and intellectual capital resources with the latter having a material impact on the best utilization of the first and second category alike (figure 5.2).

Human resources shall be considered in the context of individual employees of a given company. However, their skills and experience that are not owned by the company. The value of human resources is not determined by the combination of these elements, but their dynamic incorporation in the so-called intelligence of an organization. Therefore the value of human resources increases, if employees develop their skills, which in turn may be used by the organization. The value of sharing employees' explicit knowledge throughout the orga-

nization can not be underestimated. One of the most popular classifications distinguishes three basic elements of human resources in the context of intellectual capital, namely competences, attitude and intellectual capabilities (Roos, Pike, and Fernström 2005). Competence is understood as the ability to carry out certain activities, for instance in the domain of sales, production, or administration. Attitude comprises aspects such as social skills including teamwork, willingness to share knowledge and readiness to develop one's potential. Finally, intellectual capabilities encompass human skills in the field of innovation, creativity and the ability to convert theory into practice.

The third group of organizational resources constitute other means not listed above, such as purchased software licenses.

Organizational resources may be defined as all intellectual assets which are assigned to a given organization and remain therein even if all employees resign. In other words, it is tacit knowledge of employees systematized in intellectual assets. Due to legal protection of organizational resources, they may be broken down into two categories. The first group of assets is legally protected, i.e. it comprises intellectual property rights. Due to such statutory provisions, the owner of such resources is protected by laws against unauthorized use of his proprietary assets by other organizations (Schwabach 2007). Typical intellectual property rights are applicable to copyright, registered trademark and patents. Copyright protects certain finished works, such as a source code of an IT system. A trademark is a characteristic sign or design which distinguishes a company or product from others, while a patent is a form of protection which may be granted to a new technology or an innovative recipe. The second group of organizational resources comprise intellectual assets exempt from legal protection such as documentation, procedures, training materials, databases and components of ready-made solutions.

Relational capital pertains to interactions between an organization and its environment (Roos, Pike, and Fernström 2005). Originally limited to customers, currently it also comprises the relations with partners in its broad sense, including suppliers, subcontractors, and even government and industry institutions. The distinctive feature of relational capital is the ability to exchange knowledge not only within the organization but also with market environment (Chatzkel 2002). The value of client resources increases proportionally to strengthening their relationship with the company. This can be demonstrated

in master agreements or higher loyalty index. Customers demonstrating increased awareness are vital assets of the company. They are a priceless source of external expertise applicable in such processes as testing new products or acquiring information about clients' needs (Al-Ali 2003). Cooperative assets include such elements as cooperation agreements (exclusive agreements are particularly valuable), strategic alliances, long-term contracts with suppliers, distribution and sales channels or franchise agreements as well as shares purchase options in partner companies.

The fourth element of intellectual capital resource is organizational culture. In the traditional mindset, some aspects of organizational culture may be identified within the framework of structural capital, yet nowadays this phenomenon is analysed separately and is considered increasingly important. In previous chapters, organizational culture was defined as 'a system of values, norms, symbols that are typical of a given organization, developed at a given time, resulting in patterns of conduct for the entire organization and an applicable hierarchy of values.' A concept that is increasingly associated with organizational culture is called 'organizational climate.' It is a behavioural reflection of a given culture and is manifested in workers' perception of the organization including their understanding of their role, a sense of acceptance and support, as well as the propensity for autonomous action (Kōno and Clegg 1998). Organizational climate is formed by organizational culture in modern knowledge-based companies, and more importantly – it may have positive or negative influence on the results of the entire organization.

Concluding the discussion on the meaning and classification of intellectual capital in the modern economy based on knowledge it is worth emphasizing that – in accordance with resource-based management concept – intellectual resources constitute a fundamental generator of value in many organizations and a basis of sustainable growth strategy. The key to success is to have unique resources and the ability to allocate (i.e. share) them most efficiently so as to take advantage of market opportunities. In many cases, capital structure – as a specific form of organization – may apply the dispersed resources of intellectual capital more effectively, and thus acquire additional value of synergy. The following sections of this chapter describe basic synergies arising from sharing the resources of intellectual capital in the corporate group.

When analysing the functioning of capital structures it is relatively easy to identify problems resulting from insufficient coordination within the organization. For this reason, managing capital structures may also put synergy at risk. In principle, synergy in the management process may be defined as the ability to increase the efficiency of each and every company and of the group as a whole by applying an integrated and coherent management strategy. As a result, each company gains advantages that would be difficult or even impossible to achieve if each of these entities was to operate separately. Therefore, efficient management and effective leadership in the corporate group is a prerequisite for the synergy to occur. The main objective of capital structure's management body is to generate additional value beyond the cumulative value that could be generated by each company alone. Consequently, the scope of management's liability is very broad and it includes such aspects as leading the process of creating group's strategy, influencing the strategies of individual companies, coordination of their operations and creating group's coherent identity (Grant 2005). The tasks assigned to top management may be divided into governance, support and optimization. Governance consists in ensuring sustainable growth of the entire group through investments, acquisitions, expansion and efficient allocation of resources. Support entails establishing coherence between overall strategy of the group and development strategies of individual companies. In practice, therefore, it involves verification and potential intervention in the governance process of particular companies. Eventually, optimization consists in providing communication and sharing resources between companies within the group. Selected aspects of capital structure management process of are presented in table 5.1.

In the context of actual effects of synergy one must not forget about additional costs. Actual net synergy may occur only if the benefits outweigh incremental costs. The basic costs of acquiring synergy include the costs of coordination, controlling and inflexibility (Knoll 2008). Coordination costs arise from the need of providing additional, non-standard cooperation between companies. These may include additional management expenses or the necessity to invest in new systems or system integration. Costs controlling stems from the need to ensure comparability of financial data of all companies in the group. This entails either the process of harmonization of fi-

TABLE 5.1 Elements of Capital Structure Management Process vs. Synergy Building

Ensuring sustainable growth	Leadership	Management processes	Organisation
<ul style="list-style-type: none"> • Formulating a vision, mission and a long-term group strategy • Defining the business model • Defining value generators • Adjusting the portfolio to market opportunities • Allocation of capital 	<ul style="list-style-type: none"> • Human resources management • Establishing appropriate organizational culture and climate • Management of change 	<ul style="list-style-type: none"> • Designing financial systems • Defining incentive systems • Maximizing operational efficiency • Supporting innovation 	<ul style="list-style-type: none"> • Designing the mechanisms of cooperation between companies • Providing clear and transparent decision-making process • Adjusting the structures to the defined strategy and business model

NOTES Adapted from Knoll (2008).

financial systems or requires additional work of financial controllers. Implementation of synergy in the entire group may also require abandoning certain activities of individual companies, and thus resigning from a certain part of their income. A similar situation may occur with respect to flexibility of individual companies. Implementation of synergies in the entire group may actually undermine independence of individual companies, and thus curtail their competitiveness.

To conclude, intellectual capital is usually defined as a set of intangible resources remaining under absolute or partial control of the company and directly influencing the growth of company's value. It encompasses human capital, structural (organizational) capital and relational capital (comprising customer capital and cooperative capital). According to the resource-based concept, these components may be called human, organizational and relational resources. For corporate groups, all these provide a complete matrix of resource sharing opportunities enhancing the conditions for synergies to appear. Unique sources of intellectual capital and the ability to effectively allocate (share) this capital in order to benefit from market opportunities is the key to success. Organizational culture shall be considered an important (fourth) element of intellectual capital resource set. Although in traditional perspective some aspects of organizational cul-

ture may be identified in the framework of structural capital, due to growing importance of this element in modern enterprises – especially in capital structures – regarding organizational culture as a separate phenomenon seems reasonable.

Synergy Effect in Intellectual Capital Resources within Corporate Groups

Synergy in Human Resources

Human resources are a key generator of value in most modern enterprises. Furthermore, in many instances the greater the contribution of an individual to the value entire company, the higher is the value of this individual, as he is intrinsically scarce, difficult to imitate or to develop organically. The acquisition costs are high and the process is time-consuming. Acquiring a good specialist from the market often requires the involvement of a recruitment agency, providing its services using a technique called ‘head-hunting.’ This form of recruitment is aggressive and challenging, risk-laden and costly. According to statistics, most employees hired this way decide to change job again within the period of one year (Watson 2008). On the other hand, it may prove to be the only method of hiring properly qualified and experienced professionals who are usually so-called ‘passive seekers,’ appreciated decently remunerated by their current employers (Hor, Keats, and Holmes 2008). Due to these characteristics of contemporary labour market of highly qualified specialists, in-house training in relevant competences and providing valuable experience becomes often a rudimentary form of obtaining qualified specialists; however, it is also expensive, and above all – is relatively time consuming. Capital structures acting as a group of many companies which are often diverse in terms of size and level of development are often in more favourable situation in terms of availability of human resources compared to individual companies. These advantages allow for implementation of a number of synergies and stem from the fact that the internal corporate group’s labour market is usually larger than in an independent company, and more importantly – is of more heterogeneous nature.

On the basis of the above-defined advantages, the possible synergies from sharing human resources in the capital structure are as follows:

1. Transfer of tacit knowledge between human resources of various companies within the group;
2. Co-sharing the human resources by the companies in the group;
3. Economy of scope in terms of human resources;
4. Reduced costs and risks related with the recruitment process by virtue of accessibility of the vast internal labour market.

As mentioned earlier in this chapter, tacit knowledge is the exclusive property of individual persons. Vast majority of tacit knowledge – in particular the one developed through many years of experience and employee’s internal development – is so complex and sophisticated that it is virtually impossible to be recorded in any documents or database. Therefore, the only possible method of sharing such knowledge within the organization – according to the model of knowledge transformation proposed by Nonaka and Takeuchi – is socialization, or passing it in unaltered form amongst the employees in the context of ordinary social interactions (Dalkir 2007). Any attempt of excessive formalization of the socialization process or integrating any mandatory elements into it will fail because this process is uncontrollable in practice (Chu 2010). It may inflict a situation whereby forced socialization will result in the transfer of knowledge which is too general or only random. To make the transfer of tacit knowledge between employees effective, two criteria must be met: ease of transfer and appropriate motivation (King 2009). The first aspect is related to providing organizational support for the transfer of knowledge, and it will be discussed in detail further in this chapter. The second aspect, refers to such elements as intrinsic motivation which originates also from organizational culture and climate promoting knowledge sharing as well as external motivation associated with properly formulated incentive schemes including different forms – not necessarily financial – of knowledge transfer recognition.

The socialization process shall not be limited to a single company and must take place also in the context of interactions between employees from different companies, operating in one capital structure where the transfer of knowledge should be (reasonably) exempt from all confidentiality obligations or those pertaining to protection against competition. Internal heterogeneity of the labour market in a capital structure – as already mentioned this chapter – is a source of synergistic effect resulting from the transfer of tacit knowledge.

Firstly, this synergy is a consequence of broader access to specific competencies resulting from involving more staff in the socialization process, including key personnel. Secondly, with access to an experienced group of specialists, smaller companies at earlier stages of development can substantially accelerate the process of organic development in the relevant field of expertise.

As already mentioned, transfer of tacit knowledge may be effective only if the process is uncomplicated. Organizations, including corporate groups, have developed a number of techniques to support tacit knowledge sharing process. One of the most common coaching methods consists in arranging a situation in which an experienced person (i.e. a coach) assists the other, less experienced employee in the process of solving problems related to the new role or position, by preventing inappropriate actions (Flaherty 2005) and thus motivating to knowledge development and increased efficiency (Emerson and Loehr 2008). A tool supporting the transfer of tacit knowledge in corporate groups, including the coaching process, is called *communities of practice*. A community of practice is a formalized group of people sharing professional interests in a particular subject and similar problems in their day-to-day work (Hara 2009). A special feature of this type of community is the fact that individual members do not work together on a daily basis, thus they may come from different companies and from different levels of the organizational structure, and the major source of motivation to participate in it are perceived specific benefits from the interaction in sharing and broadening tacit knowledge (Wenger, McDermott, and Snyder 2002). Communities of practice may assume different forms and have different goals, yet the most common are coaching communities which organize knowledge, establish best practice or develop innovative actions (Hasanali et al. 2002).

A specific example of socialization is the transfer of managerial knowledge ingrained within the capital structure. In particular, international transfer of tacit knowledge is predominantly focused on the management sphere and involves aspects of management practice (Tayeb 2005). As a rule, this knowledge is exported from companies operating in countries with higher management culture to companies operating in other countries. The most efficient method of supporting this type of knowledge transfer is temporary secondment for executives of beneficiary companies in companies with more developed

management culture. Such transfer of management practice shall not be confused with another type of synergy which may arise in a capital structure, namely the synergy in the management process. This issue will be discussed later in this chapter.

Besides particular methods and tools supporting the transfer of tacit knowledge, also adequate infrastructure must be provided. An interesting solution supporting natural exchange of tacit knowledge between employees of different companies within a capital structure may be e.g. appropriately arranged separate office space. A practical example is the solution implemented by the International Centre for Theoretical Sciences in India, which separated an area consisting of four rooms; so-called office space, discussion space, reporting space and leisure area (Hawamdeh, Strauss, and Barachini 2008). Office space is used to accommodate a given group of employees such as for example designers, IT specialists, etc. This may require e.g. access to a computer or the relevant IT system. In such environment, employees from different departments or company branches may exchange knowledge and best practices while performing their routine tasks. The second room is a discussion space where more people can freely exchange knowledge during discussions. Reporting space is dedicated to presentation of knowledge to numerous audience, as a unilateral form of knowledge transfer using multimedia techniques available. The last room is called leisure room and it may be used even for dining together. It serves an integrative role and enhances informal communication during which the transfer of tacit knowledge is also possible.

A similar situation may occur in the field of cooperation. Contemporary Internet technologies provide unlimited possibilities of two-way communication, from exchanging simple text messages through increasingly more complex audio-visual communication, to innovative real time holographic communication (Westbrook 2009). Therefore, it greatly facilitates establishing various project teams consisting of people based in any location without the need for their physical movement (Gadman and Richardson 2010). Creating this type of project teams requires adequate flexibility of the organizational structure. It works best in the so-called 'project organization structures' in which the traditional hierarchical organizational relations give way to purpose-oriented temporary structures. Usually, they are established based on matrix formula, combining hierarchical struc-

ture with project objectives dimension. The project structure organization consists of multi-functional teams involving the employees from different levels of the organization and whose primary task is the implementation of a specific project (Schermerhorn 2009). Modern technologies used more and more often in capital structures give grounds for the formation of so-called virtual project teams. In such teams, not only specialists in various fields, but also from various countries may work together on a given issue, e.g. developing a new product concept. Corporate groups such as HP and IBM for instance substantially benefit from virtual teams (Daft 2009).

The main advantage of this type of teams is the possibility of involving people who bring actual added value in the process of project implementation, i.e. the people with specific, relevant competences. Moreover, project teams introduce speed and flexibility in particularly complex capital structures. In turn, virtual teams provide many companies, including the smaller ones, with access to highly-qualified specialists and experts most suited to the subject matter of the project. Maximized productivity of expensive human resources is equally important advantage of this type of organization. On the whole, the increasing popularity of project structures and the growing Internet communication capabilities provide a source of significant synergy effect accessible for corporate groups. In particular, it is the possibility to share tacit knowledge and competences of human resources located in many companies and even different countries.

Another element often addressed when discussing synergy is the economy of scope. In capital structures, this effect also applies to human resources. When certain activities are carried out by individual companies within the group, one can imagine that they may be performed by the same teams. An example would be a corporate group consisting of a company specialized in building sports facilities and a road building company. Both companies need to perform general construction works, including preparatory, electrical or sanitation of works. Were these companies separate entities, they would have to arrange two separate teams or subcontractors to carry out necessary works. In a capital structure, though, a single construction team co-shared by these companies would suffice, provided that adequate and integrated project management is ensured. Another example, which directly translates into obtaining economies of scope in terms of human resources, is a shared services center concept described earlier,

in which centralized human resources provide support to all processes in all companies in the group.

The last group of synergies is associated with optimization of recruitment. The process of hiring new employees – particularly for highly specialized positions – is usually time-consuming and expensive. For this reason, more and more companies are using internal recruitment as a first measure. Internal candidates are not only able to work on the new position faster than any person hired externally, but most of all they have better understanding of the organizational culture of their company (Torrington, Hall, and Taylor 2008). Internal recruitment also increases employee loyalty, as such appointments are often meant as a path of promotion, and therefore they are perceived as highly motivating (Jackson, Schuler, and Werner 2008). Finally, internal recruitment helps minimize the risk for both parties concerned, because they have sufficient information about the capabilities and requirements involved (Taylor, Doherty, and McGraw 2007). The disadvantage of internal recruitment may be a limited number of candidates, as well as restraining the introduction of the so-called ‘fresh blood’ to the organization (Bach 2005). Business operations under capital structure allow for maximizing the benefits of internal recruitment, understood in this case as a recruitment within the group, while minimizing its drawbacks. The companies within a capital structure create internal job market with a far broader scope than a single company. An additional benefit of using internal recruitment is a faster and more efficient formation of a uniform organizational culture within the entire corporate group. It is particularly important in international organizations, where staff transfers between countries allow for a better understanding of cultural uniqueness of a given country and adjusting general organizational culture accordingly.

Synergy in Organizational Resources

Synergy in Brand Architecture. In the previous section, the strategy of increasing the bargaining power of capital structure in relation to customers was discussed in the context of the so-called *image synergy*, which means the combined result of reputation, achievements and history of individual successes of particular companies. A strong brand is a very important element of the phenomenon called *halo-effect*. It is one of the fundamental components of intangible assets

classified as organizational resources. Here we shall focus on selected synergies achievable by means of brand portfolio of a capital structure. Brand is often mistakenly perceived one-dimensionally and associated only with a typographic layout or (brand) name. A successful brand is an identifiable product or service, together with lasting values recognized by clients as appropriate. This definition contains key features of a strong brand, whose main objectives include enabling immediate recognition and identification of a service or product, by means of a trademark i.e. logo and a brand name. The element which distinguishes a brand from a trademark is the lasting functional value (e.g. reliability and timeliness) and emotional value (e.g. friendly service staff) associated with a given brand. These values are addressed to a client, therefore they must be appropriate, i.e. meet the client's needs to the greatest extent.

The growing importance of brands as strategic resources directly affecting company valuation has been observed since the 1980s. In the context of intellectual capital theory, a brand is best understood and most measurable organizational resource. Today's strong brands have a measurable financial value often calculated in billions of dollars, and at the same time they often prove to be the main generator of up to 70% of the total value of the company or corporate group. Annual report of most expensive global brands published by Interbrands pointedly demonstrates the strategic importance of this corporate resource as a value generator. For many years, Coca-Cola has been ranked the most expensive global brand valued at USD 70.4 billion in 2010 (see www.interbrand.com/en/best-global-brands/Best-Global-Brands-2010.aspx). Traditionally, the brand has been perceived as a value only in the B2C segment, while it has been completely neglected and ignored in the B2B segment. As a result of success achieved by other brands such as SAP, Boeing or General Electric, nowadays brands in B2B segment are also regarded as a potential source of competitive advantage and branding process is apparent in B2B to the same extent as in consumer segment.

Portfolio of strong brands may be a source of important synergies in a capital structure, and it may be achieved by means of so-called brand architecture. Brand architecture defines the relations between the leading brand of a corporate group and brands of other companies within the group or products they offer. It informs about specific benefits, their positioning and definition for the purposes of com-

munication. In a corporate group, a properly defined brand architecture is of particular importance, since this form of business may be vulnerable to the processes resembling the relations between competing companies, such as product cannibalism for instance. One of the most popular concepts of brand architecture based on research by Peter Doyle, distinguishes two extreme types of brands: corporate brand and individual brands. This concept is based on the following assumption; the greater the similarity between target markets and values they recognize, the more reasonable it is to build a corporate brand. Similarly, the greater the difference, the greater the benefits from developing a portfolio of individual brands. A well-designed brand architecture in a capital structure may become a source of operational synergies and synergies of a brand value. Let's focus on the following possible groups of synergies:

1. Image synergy from using a corporate brand;
2. Sales synergies from using a portfolio of individual brands;
3. Risk mitigation by using individual brands' portfolio.

Corporate brand defines an entity which is responsible for production and delivery of a product or service along with transfer of qualities and values of this entity (Sharma et al. 2010). However, the concept of corporate brand in capital structures extends also onto the relation between a parent company and its subsidiaries, and consequently the products and services offered. Corporate brand architecture may assume different forms according to specific identity and phase of group's development. In the initial phase of operations, every capital structure is built mainly in the course of acquisitions, thus the portfolio of individual brands results often from the said acquisitions. Consolidation within a group allows the subsidiaries to benefit from sharing a distinctive logo and other brand elements of a parent company. This communicates to the market that a particular entity belongs to a corporate group of a well-established and recognized business brand. In other words, the company uses the image synergy to announce its membership in a large and reliable organization and that it may receive its support if necessary. However, even this form provides for benefits of image synergy, by informing the environment of each member company about the fact that it belongs to a large, credible group and it may enjoy corporate group's support. In capital structures where individual companies operate in similar

markets, corporate brand architecture may assume a form of an umbrella brand. This concept involves the use of corporate brands in branding each product while maintaining a distinctive element of individual brand (Berger et al. 2010). A good example of a wide umbrella brand is General Electric which uses a corporate brand GE in branding each activity performed under the corporate group. As a result, positive associations with over a century-old tradition of energy industry and icons such as Thomas Edison extended onto such diverse activities as banking (GE Capital), production of aircraft engines (GE Aviation) and medical equipment (GE Healthcare). Another interesting example of an umbrella brand in the capital structure is Virgin, which – unlike GE – is not associated with long tradition, but with dissenting attitude which is its key distinctive feature. Dozens of independent companies with diversified scope of activity operate under Virgin Group. Any attempts of launching independent airline or hotel chain by Virgin would have ended in failure if it wasn't for strong image synergy. Interestingly, image synergy may extend beyond corporate group. Many former Virgin Group companies have been sold outside the group, however, they continue to use the Virgin branding as a franchise (Haig 2006). An extreme type of corporate brand architecture is a monolithic brand used in corporate groups, in which business relations between the companies are strong enough to substantiate a complete transfer of corporate brand value to all members of the group.

Capital structures which succeeded in building strong corporate brands that are more recognizable than individual brands may acquire a number of additional benefits as a result of image synergy. The main group of such benefits concerns sales synergy – described in detail in the previous chapter – which results from the possibility of increasing bargaining power in relation to customers. Another synergy effect is the increased effectiveness of marketing strategy. The benefits from marketing activities implemented by one company in a group are actually shared by other companies in the group. The advantage of image synergy may extend beyond the sphere related with customers. As a rule, a strong corporate brand in the group can increase bargaining power in relation to all players in the market, for example it may facilitate attracting new, valuable employees to the companies within the group and also increases their credibility in the perspective of investors and financial markets (Gregory 2004).

In highly competitive markets, capital structure may use a different brand architecture in order to increase bargaining power with respect to customers by intentionally abandoning the synergy of image. In the subsequent section, two types of sales synergy achievable using individual brand portfolio will be discussed. The first is connected with price positioning strategy, aimed at maximizing revenues and described in the previous chapter. A portfolio of strong individual brands positioned in different price and quality segments is a perfect tool for implementation of this strategy. In the early stages of corporate group development, different products and thus different brands may compete for the same customers. The objective of brand architecture is to define the process of repositioning individual brands so that the ultimate portfolio of brands would cover a wider share of target market. The use of individual brand architecture may enhance the synergy resulting from economies of scope in production. Optimization of direct costs in the group may actually result in consolidation of manufacturing process of several products under a single production plant. In the sales process, these products are still offered by various companies within the corporate group and use individual branding in line with the pre-defined positioning. Sales synergy is therefore complemented by synergy associated with optimization of production costs. In extreme cases, exactly the same product may be sold by different companies at different prices to different segments under different individual brands.

The second strategy based on a portfolio of individual brands to achieve sales synergies in a capital structure is a strategy of maximizing customer acquisition opportunities in the course of *fake competition*. This strategy is implemented in B2C and B2B segments alike. It is particularly applicable in B2B segment, where decision-making process is usually longer and includes analysis of at least several competitive bids. The strategy of fake competition entails launching several sales procedures for the same customer by several companies within the same group. The principle behind it lies in that each company may offer a properly positioned comparable product of a particular, individual brand. This strategy is applicable in groups where cross-selling rules were defined and incentive systems were properly established. The strategy assumes supporting the sales of a chosen product through fake competition from other companies, which are generally positioned unattractively from the client's perspective. In

other words, defects in other products are intended to highlight the advantages of one particular product. A good example of this strategy may be IT groups which have in their portfolio a range of comparable systems collected as a result of acquisition process, and which have retained their original branding. A specific variant of this strategy is the activity of capital structures on the public procurement market. By consensus, companies under one group submit several bids, of which only one is the most feasible, whereas other bids are intended as fake competition. In multi-stage public procurement procedures, a portfolio of companies with distinctive individual brands allows the group to participate in all stages of the project, which is impossible in the case of a single brand. It is particularly important in the public sector in which one company offering consultancy services may not be a contractor for the project at a later date.

The third kind of synergy in brand architecture in a capital structure is the possibility to minimize the risk of losing the market by *developing a number of independent individual brands*. This strategy also applies to B2C and B2B transactions alike. In the first case, an excellent example are food products and FMCG, such as Nestle or Unilever. Each individual brand product is exposed to reputational risk as a result of one-off events or competitors' activity. Such was the incident when glass particles were found in baby food produced by Gerber from Nestle group. Although this was a unitary event, it had a negative effect on the product image and resulted in significant reduction in sales. A portfolio of independent, parallel brands owned by a corporate group allows for minimizing the risk through natural migration of demand towards other brands, including the brands from the same group. In the case of Nestle, another individual brand alternative to Gerber is Nestle Junior. A similar situation may occur in the B2B segment if some contract proves to be a failure – when publicized by competition and in media may be detrimental to the image and brand of a given company or product. A group may then substitute a discredited brand with another, provided that it offers comparable quality and credentials.

Synergies in Other Organizational Resources. Synergy effect in sharing intangible assets contained in organizational resources occurs in the same manner as in the case of tangible assets. The main difference lies in the fact that intangible assets are inexhaustible and simultaneous, thus a potential synergy effect is many times greater

than in the case of tangible assets. More importantly, sharing intangible assets is not subject to the same restrictions as those applicable to material resources. The range of organizational resources is wide and industry-specific, therefore this section will demonstrate only several selected and virtually universal examples, including:

1. Synergy from sharing intellectual property and its development process;
2. Synergy from sharing the components of explicit knowledge;
3. Synergy from information technology systems;
4. Synergy resulting from knowledge base development.

One of the reasons behind building capital structures and strategic adjustment by acquiring new companies is the desire to access its unique resources by means of such acquisition. Usually such resources comprise intellectual property, e.g. patents for particular technologies. Intellectual property can be shared within a group, and consequently generate synergy resulting for example from economies of scale. Sharing may consist in licensing or provision of internal services using intellectual property. Licensing means allowing another entity to use e.g. a patent in exchange for so-called royalties, usually as percentage of revenue or profit margin from products developed using a given patent (Poltorak and Lerner 2002). The amount of royalties depends on internal arrangements, but the possibility of sharing a unique technology only within the group is the essence of synergy effect. Another method of sharing intellectual property is to provide internal services e.g. manufacturing patented goods by patent owner for other companies in the group. Such a practice is an example of economy of scope in the domain of intellectual property.

In the context of intellectual property, synergy effect consists in sharing the resources for the purpose of collective manufacturing process under the capital structure. Vast majority of innovative solutions and technologies require huge financial commitment in the concept, research and development phases. Even the greatest companies are unable to finance such projects alone. The second factor limiting the independent development of intellectual property is the level of sophistication and extent of modern technologies, requiring knowledge in many areas and comprehension of specificities of different customer segments and various links of the value chain. For

this reason, a single company usually does not have sufficient resources and competences allowing it to independently develop an innovative product with great potential for commercialization (Smith and Parr 2005). Consequently, strategic partnerships of several players interested in developing some kind of intellectual property are becoming increasingly common. The major disadvantage of this solution is, however, dispersion of ownership and rights to such intellectual property. A much more profitable option may be the implementation of R&D projects within a group with financial and content-related support provided to all companies involved.

In addition to the financial and subject-related aspect, the organizational side of the innovation process in the group is not of a lesser significance. Similarly to the shared services center described in the previous chapter, a group may delegate research and development activities to a separate entity which will consequently become a R&D center. Such a solution may prove to be highly rewarding. Firstly, through capital participation in the R&D center, companies within the group automatically become indirect owners of rights to intellectual property of the products generated by the R&D center. Secondly, the group can realize additional synergy effect through an optimal location of the center. More and more often, multinational companies and corporate groups decide to transfer their research centers to less developed countries in Eastern Europe or India. Another advantage of this solution is the opportunity to develop coherent and effective procedures and ingenious activities, such as *innovation funnel* described earlier, which significantly increases efficiency and reduces risk.

Not all intellectual assets can be converted into intellectual property. However, each organization owns vast resources of explicit knowledge in the form of documentation, studies or descriptions of processes and procedures. They may also contribute to additional synergies in the group. In particular, they can support synergies in areas such as sales, support processes, logistics and implementation. At the same time, sharing the components of explicit knowledge is much simpler than sharing intellectual property. For this reason, many corporations initiate the formation of organizational culture supporting knowledge sharing process by transferring explicit knowledge resources (Dixon 2000).

The third potential source of synergy are organizational systems. It

is hard to imagine a contemporary organization functioning smoothly without modern technology and information systems supporting all areas of the management process. On the other hand, inefficient IT environment which does not allow for reliable reporting may even prove to be an impediment to the development process. Information system synergy consists therefore in using a strong relationship between companies in the group to achieve a configuration that will ensure uniform information standards and maximum communication efficiency between the systems. This may be achieved by a number of measures. Starting with an ideal solution, in which all companies use the same system, through intermediate solutions in which specific functionality, e.g. financial, accounting and personnel records are performed using the same system, to other acceptable solutions ensuring full integration of all heterogeneous information systems. Another solution may be a shared services center where certain IT tasks of the entire group are delegated and performed using a chosen IT system. Moreover, other technological issues indirectly related to functionality of systems shall not be forgotten, namely database integrity, which consists in ensuring reliability, consistency and accuracy of data (Hernandez 2003) and full security of IT systems.

The strength of synergies in the field of information systems depends on several factors related to the type of a corporate group and companies operating within this group (Ward and Peppard 2002). The effect is far stronger if companies operate in similar markets, in particular, if they have the same suppliers and customers. This being a case, a single connection – such as EDI interface for instance – once defined, may be used repeatedly. The issue of great importance is whether companies in a group carry out transactions with each another. In such groups an integrated information system provides competitive advantage of speed and efficiency of information flow, and consequently a faster decision-making process. Another aspect affecting synergy is the cohesion of capital structure, and reporting policy would be its simplest example. If individual companies regularly report to the parent company in an agreed format and in accordance with a uniform corporate data model, a comprehensive IT system may relieve them from such an obligation by transferring this duty to a shared services center for instance.

Corporate knowledge base is a kind of intellectual asset developed as a result of existing information systems. The issue of knowledge

base sharing in a group was discussed earlier in the context of sales synergy, which may occur on condition that customer database is shared. In each organization there are many databases, but usually they are highly fragmented and incompatible. Contrary to this, consistency and integrity of knowledge bases in a group may initiate further synergy effect having positive impact on building sustainable competitive advantage. However, not every database shall automatically mean a knowledge base. The latter is the case if information contained in it has features similar to knowledge, and consequently it can be linked and interpreted. Knowledge base should therefore be of deductive nature i.e. allowing for data processing in accordance with defined rules (Vlahavas and Bassiliades 1998).

With respect to the synergy discussed above, understanding of knowledge bases extends far beyond the customer base. While there may exist technical, market, or product knowledge bases – depending on the nature of a group, in service-oriented groups, a database of projects with definitions of problems and solutions is the crucial intellectual asset. Likewise in IT systems, the strength of synergy effect depends on the degree of similarity or complementary nature of activities performed by particular companies. The basis for synergy is the same as for all other intellectual assets. Providing greater access to corporate knowledge increases the efficiency and competitiveness of individual companies which may benefit from the experience and knowledge of other entities within the group. On the other hand, a characteristic *flywheel effect* may occur, as companies subsequently complete the corporate knowledge bases with the results of their experience and research.

For a *flywheel effect* to occur, all the parties concerned shall be provided with two-way access to the knowledge base. This means both the ability to retrieve information from the database as well as the possibility to upload new data. Obviously, this would be impossible without IT support. Knowledge management systems have been evolving since the 1980s from simple collaboration systems towards sophisticated corporate portals. The previous decade brought particularly revolutionary technology. Through a simple interface, users may create and share content without the need of having thorough IT knowledge (Solomon and Schrum 2007). Technology has contributed to creation of such tools as Wikipedia and a number of social media platforms based on the principle of interaction between users and in-

formation exchange (McAfee 2009). This principle has been adapted by corporations and began to replace expensive and often inefficient knowledge management systems. This is an actual example of synergy arising from the use of combination of technology and development models intended to provide the users with necessary knowledge (Cook 2008).

Synergy in Relational Capital

Synergy in the Portfolio of Clients. Modern marketing and sales tend to withdraw from concentration on a product towards a focus on customer. At the same time, customers are being increasingly perceived as strategic resources, or even assets that are manageable, measurable and may be maximized. Existing customers are of particular importance and a strong relationship with them is seen as a key to success, because relationships with identifiable and familiar customers prove to be more predictable and efficient, and thus more profitable. A key element of customer resource is so-called client portfolio, defined as a set of mutually exclusive groups of current customers, who altogether constitute a general client base of the organization (Buttle 2008). In other words, client portfolio contains all clients grouped in segments based on specific strategic qualities, while each client can belong to only one segment. Building and increasing the value of client portfolio is based on maximizing the effects of bilateral relationship between the customer and the company, in which client generates value in the form of money, information and image, while the company provides elements valuable for the customer, i.e. products and services, relations, communication, as well as the image.

The efficiency of clients' portfolio management and maximizing its value in corporate groups may be higher than in individual companies. It results from two basic factors – better identification of customer's needs and wider range of products offered. The first factor was described in detail in the previous chapter when discussing the collective strategic marketing process in capital structures. It is worth mentioning that competitive advantage of corporate groups in this area consists in the availability of more comprehensive information about a client, derived independently by several companies offering various products and then integrated and processed in a common knowledge base, e.g. in CRM system. In turn, wide range of products or services offered belong to inherent characteristics of corporate

groups in which the diversity of activities is a pivotal aspect of operation. Using these two factors constituting corporate groups' competitive advantage, capital structures can achieve significant synergy in terms of growth in the value of the customer portfolio as a result of the following activities:

1. Maximizing additional sales;
2. Maximizing the value of customer life;
3. Maximizing the customer retention rate.

Introducing *ancillary sales mechanism* in a capital structure is a strategy allowing the potential of client portfolio to be used most efficiently. This subject has already been addressed in the context of sales synergy achieved through cross-selling techniques, but ancillary sales is a broader concept of cross-selling, as it is not limited only to products between which a specific interaction occurs. Ancillary sales allows for increasing the efficiency of customer portfolio by maximizing profit per customer. Higher final income from a client provides also an opportunity to invest more capital in winning new customers. Fostering good relations with current customers and transforming them into new orders and contracts is particularly important in groups where the possibility of generating additional orders is far greater than in individual companies. Profitability of ancillary sales for the group increases proportionally to the increasing use of modern information technologies as they allow for analysis of large databases in order to identify clients' needs better. Amazon has become one of the pioneers of modern ancillary sales for implementing customer's purchase history analysis providing information necessary to track individual tastes and to recommend additional products on this basis (Villanueva and Hanssens 2007).

A customer lifetime value (CLV) is a tool allowing for most efficient allocation of resources dedicated to the acquisition of customers, defined as net present value of future discounted cash flows generated by a given client segment in the course of their relations with a supplier. CLV is used to forecast revenues anticipated from a client from a given segment and to decide about acceptable cost of winning and keeping the client. The core concept behind CLV is therefore the idea that customer value is not derived from a single transaction, but is accrued throughout the entire period of customer's lifetime.

Some theorists also believe that the sum of revenue streams gen-

erated directly by a given customer shall be increased by the amount of indirect revenues from other customers gained by recommendation. Customer lifetime value should be therefore calculated for each segment of client portfolio and complemented with additional analyses of various criteria, such as the source of customer acquisition (DeBonis and Balinski 2003). The ability to calculate customer life value allows for designing and implementing specific strategies addressed to different customer segments is focused on maximizing the life cycle (Kumar 2008a) which consists of three basic phases: acquisition, retention and losing (attrition). Empirical studies prove that extending the phase of retention in customer lifetime cycle by 1% has far greater impact on the growth of CLV than increasing customer's profitability by 1% (Day and Moorman 2010).

A corporate group has all necessary conditions to extend customer life cycle and thus increase customer lifetime value. This approach is also based on better understanding of customer's needs and providing a client with wider choice of offered products or services. A good example would be a capital structure in financial sector combining entities such as online bank, retail bank, mutual fund, insurance company and a pension fund. A range of products offered by such a group allows for providing customers with services almost throughout their entire life while information about these customers collected at various stages of their life allow for their smooth migration between different companies in a group by offering customized products. This concept is presented in figure 5.3.

As already mentioned, extending customer life cycle in the retention phase brings substantial benefits in terms of increasing customer lifetime value. Loyalty programs are another strategy contributing to customer retention. Customer loyalty programs emerged in the early 1980s in airlines industry, when American Airlines introduced the first noteworthy frequent-flyers program called Advantage. Under this program, passengers could benefit from a free flight having bought a certain number of air tickets. Over the following decades, loyalty programs embraced various industries such as hospitality, grocery stores or financial services. Today, they may be found in almost every branch of commerce. Empirical studies, however, debunk many beliefs related to customer loyalty, including the most popular such as the idea that a loyal customer is cheaper in servicing, accepts higher prices and becomes an ambassador of the company (Kumar 2008b).

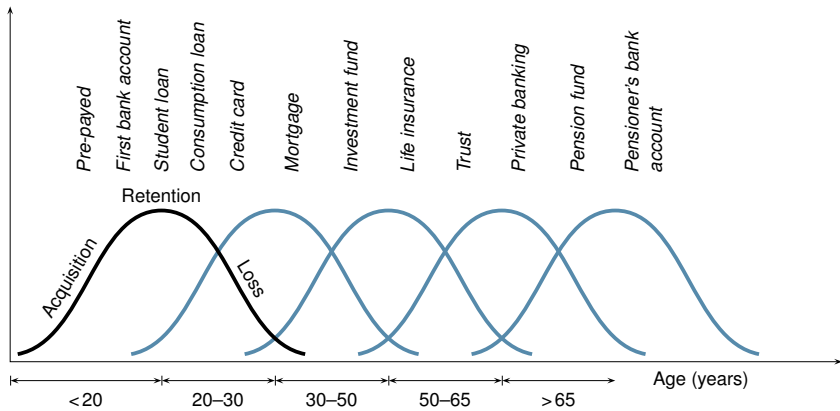


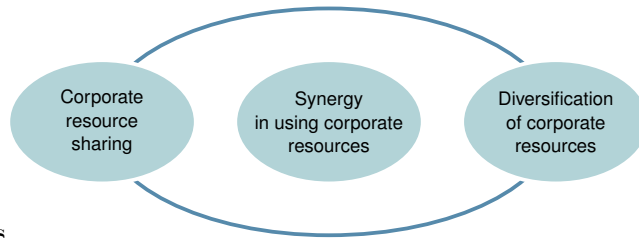
FIGURE 5.3 Extending Customer Life Cycle by Collective Management of CLV

The reason behind this apparent absence of significant correlation between loyalty and customer profitability proved to be inadequate loyalty metrics, based mainly on sales history. Modern loyalty programs should be based on assessment of the potential for future revenue streams from the client, and therefore should be fully integrated with e.g. concept of customer lifetime value.

Payback is an example of a popular loyalty program in Poland which consists in collecting points in exchange for purchase transactions carried out with partners to the program. Its characteristic feature is that most partners have no capital relations with others; therefore this program is hardly applicable to increasing customer CLV beyond a single phase of retention. A similar loyalty program implemented within one corporate group brings far greater opportunities. Combining the benefits from purchasing products from different companies within a group under a single program directly results in maximized CLV. At the same time, it is possible to extend customer life cycle by promoting specific products the client may be interested in under a specific program. Loyalty Card issued by a corporate group may be an example of such program of collecting points for purchases at any of the companies within a group, as well as for using of additional services. Points can be further exchanged for prizes and coupons for products offered by the group.

Synergy within Cooperative Resources. The simplest way to present the importance of cooperative resources and their impact on enterprise value is to give a hypothetical example of a newly formed com-

FIGURE 5-4
Synergy Effect
of Cooperative
Resources in
Corporate Groups



pany which was suddenly vested with the exclusive right to distribute Coca-Cola in a country. The market value of the company would soar dramatically from virtually zero to a very high level, and nearly 100% of this value would be derived from cooperative resource – the exclusive partnership agreement. Business partnership – and strategic partnership in particular – constitutes a source of synergy for both parties from sharing certain resources and combining complementary capabilities with the objective to obtain mutual benefits from economy of scale or scope (Ireland, Hoskisson, and Hitt 2008).

A partner company being a market leader in a given branch of industry not only provides its associated entities with a specific competitive advantage, but also increases their credibility in the eyes of customers and investors (Abrams 2004). In a capital structure it is possible to achieve additional synergy of cooperative resources by means of (figure 5-4):

- sharing cooperative resources,
- diversification of cooperative resources.

As a rule, partnership agreements may be regarded similarly to organizational resources, and consequently shared by all companies in the group as a source of additional synergy. An example of such may be sharing distribution channels, subcontractor database or business partners database. In this case, synergy effect consists in cost optimization of servicing, selection and verification of partners, which in turn results in reduction of risk. On the other hand, partner may take advantage of maximized productivity. Foreign strategic partnerships constitute core elements to minimize the risk of market expansion in pursuit of internationalization strategy. In such a case, a local partner is a source of knowledge about the legal and business background of the country of destination. A reliable local partner can assist other corporate group members in entering a new market. Another benefit

from sharing cooperative resources in a corporate group is a specific kind of image synergy allowing the companies in the group to refer to partnership agreements with other companies, and thus raising their prestige in the eyes of a customer or an investor. In addition to image synergy, sales synergy may also assume the form of a combined offer, containing a unique technology available for each company in the group under partnership or license agreement.

The second form of synergy is the ability to diversify cooperative resources. Many strategic partners require either formal or informal exclusivity and non-cooperation clauses in their dealings with competitive partners. Such conditions reduce the target market by narrowing down the range of offered products or services. Effective partners management process in a helps overcome this restriction through proper assignment of partnership agreements between individual companies in the group.

Synergy in Organizational Culture

An increasingly popular view stipulates that although business factors are the primary trigger for implementation of an acquisition-driven strategy, the primary cause of failures in its implementation are often the factors related to organizational culture (Gallagher 2002). This idea has been repeatedly mentioned in earlier chapters of this book. One can argue that prudent and competent management of organizational culture in a capital structure may also contribute to a number of synergy effects. A core objective in organizational culture management of a corporate group consists in harmonizing and integrating often very different types of cultures, while the objective of this process should not imply the replacement of one culture with another, but rather the formation of a single, common culture composed of best values derived from individual companies.

These values can be divided into several categories – in particular management style, communication style and so-called best practice. Organizations vary in management style just as individuals differ in personality. In some organizations autocratic style may prevail, whereas others may be governed according to democratic principles; it is hard to imagine the potential of synergy being exploited to capacity in a group which lacks at least partial compromise in this regard. In principle, the desired and final management style should be determined by the management of a corporate group. Communication

style is equally important. The process of internal communication is particularly relevant in the transition period, including the preparation for and execution of acquisition or formation of companies and the following integration process. In some companies, communication style tends to be very formal – almost bureaucratic – whereas in others it may be more direct and based on partner relations. In the course of organizational culture integration process within a group, all accepted communication styles shall be considered and the required elements shall be introduced gradually. This often requires additional elements to be provided such as communication tools and proper incentives. The third component in the organizational culture management of a corporate group is the so-called ‘best practice.’ On the one hand, management shall maintain the proven and effective practices of individual companies, on the other – new, necessary and desired elements shall be introduced throughout the entire group.

Essentially, synergy may be implemented in all the elements discussed above. This is most evident in the area of best practices and standards of conduct, as they actually constitute the essence of corporate culture. Organizational culture has significant impact on individual participants in the organization. If all companies within a capital structure regularly submit defined reports to the management of the group, probably each new company in the group would follow this rule shortly. Similarly, in the case of knowledge sharing, the new company – if it finds that such a process is not only natural, but also beneficial for all – it will join and contribute to the knowledge exchange platform. On the other hand, a sound organizational culture of a new company may be at risk of deterioration by an objectionable culture functioning in the group.

Obviously, joining the capital structure does not mean that its organizational culture is automatically accepted. The process of defining and implementing corporate culture is very time-consuming and must be pursued prudently. Here, some relatively simple techniques and tools may come in handy. Defining the desired organizational culture within the group is an obvious first step in this process. It must be remembered that uniform culture does not necessarily have to extend throughout the entire group to the same extent in all aspects. For example, in R&D company, the relevance of culture in the aspect of innovation is far higher than, for example in a shared services center, where operational efficiency is of utmost significance.

Once the target culture is defined, it is necessary to identify the key elements of change. This particularly pertains to organizational structure, including hierarchy of positions, responsibilities, management methods, systems of remuneration and incentives, available resources and competences. Subsequently, it is necessary to define the so-called leaders of change in individual companies. These should be the people having qualities which are most similar to the desired organization standards and necessary skills to coordinate the change management process in their companies. The whole process of change is monitored using appropriate tools. The results of such analysis allow the current type of organizational culture to be defined and further necessary changes to be identified.

To conclude, the management of organizational culture may substantially affect synergies, particularly in the processes of external growth of a corporate group. The main objective in the management of organizational culture in the group is to build a common culture using most rewarding values of individual companies. These common values are: management style, communication style and so-called best practice. Synergy can be implemented essentially in all the discussed elements. This is most evident in the area of best practice and rules of conduct, because in fact these constitute the essence of organizational culture. The ultimate goal is to form organizational culture which will be accepted by all members of the group and ensure maximum efficiency of the organization.

Conclusions

Modern economy has to combine relatively contrasting expectations: globalization and concentration of capital on the one hand, and efficiency and flexibility of business organizations on the other. Conjunction of those expectations has its fundamental goal and justification: increase in value to the benefit of business owners. The increase in value is currently – and will remain – the fundamental objective of business activity. With respect to the future of enterprises, several more distinguishing features may be identified. First – knowledge systematically replacing economic capital as the primary source of value generation. Second – human work increasing in complexity. It will mainly entail the cooperation of numerous entities and individuals, often having unique and expert competences. This applies both to internal cooperation within the organization, as well as the relations in turbulent business environment. Finally, sustainable competitive advantage will be determined by the qualities such as efficacy, flexibility and business efficiency. These qualities, in turn, depend on the level of intellectual capital throughout the organization. The form of business organization that corresponds best to the above expectations seems to be a corporate group. It allows for concentration of capital and operations in the global context, while providing the conditions for economic activity and flexibility of independent (i.e. smaller) companies tied by capital in a single group. Attainability of these targets depends largely on intellectual capital and resources of the organization; i.e. organizational resources (intellectual property, tacit knowledge, organizational culture and climate) and human resources (capacities and skills of employees).

Managing capital investment projects is an extremely complex issue and it requires unique skills and abilities from all people involved. All mistakes made at any stage of the decision-making process or implementation would certainly be verified in day-to-day practice. It leaves no doubt that mistakes are costly. Decrease in value as a result of bad investment decisions or poorly directed integration processes occur in approx. 2/3 of all merger and acquisition projects. Regretfully, from the perspective of my long managerial experience, I can only confirm these results. These failures demonstrate a material

deficiency in management science. The objective of this book is an attempt to systematize and extend the knowledge in this area.

In the management practice, the concept of synergy is most commonly used as a 'catch-all' when managers lack arguments to justify their decisions related to equity. What is often missed is the actual meaning of synergy, how to identify it, and in particular – what is the impact of actual synergy on the value of organization. Often-times, managers' associations with the concept of synergy are less than vague, which results in substantial depreciation of this term and its application with reference to issues of very ambiguous nature. Essentially, the failure to achieve real synergy stems from managers' inability of to understand this concept, and on top of that – lack of relevant competences allowing them to acquire synergy in implementation processes. Therefore, it is not the defective concept, but rather a competency gap at the level of implementation. Consequently, synergy remains an ambiguous term, while book references designed to help practitioners develop their knowledge of its practical effect are rather limited. Synergy can not remain in the realm of abstraction, on the contrary – it must become a well understood and identified concept and synergy effects must obtain a practical dimension. These are the main objectives of this book.

Corporate groups support synergy creation and value generation, but the competency gap often renders these processes ineffective and inefficient. Managers often fall into so-called 'synergy traps.' Corporate groups also promote the management of investment risk from the perspective of a parent company, and building optimum structure of equity to finance its activities. The very concept of synergy requires a thorough understanding of the resource sharing perspective in a corporate group. Only in certain cases and under certain conditions the resource sharing initiative makes sense and results in real synergy, and further brings competitive advantage as well as growth in value.

Formation of corporate groups may be pursued either by means of internal or external growth. External growth which is based on acquisitions in the business market is particularly exposed to investment failures. On the other hand, it is an opportunity for rapid development of an organization and growth in value. Among numerous errors that may be identified as a cause of the destruction of corporate groups, the most noteworthy ones include:

1. Excessive diversification of activities in a group;
2. Paying premiums exceeding the value of future synergies in the acquisition processes;
3. Unprepared and wrongly implemented process of corporate groups integration;
4. Insufficient and improper coordination of management of entities within the group.

The first case consists in the involvement of corporate group in activities in a variety of domains. The research conducted abroad, as well as my own studies prove that companies operating in many industries commonly have a lower value in comparison to companies focusing on activities in a single industry. Diversification is negatively correlated with value. This confirms the theory of inefficient internal capital markets, according to which there is a tendency to transfer funds from profitable sectors to underperforming ones within a single corporate group. This negative correlation may be observed in many practical cases. Competences play a vital role, too. Managers often do not have sufficient knowledge and are unable to manage different businesses effectively. Of course, it may happen that diversification will have a positive effect, when e.g. manager's personal knowledge in a given domain is extended to encompass other areas of the organization, thereby reducing information asymmetries. Such cases, however, tend to be quite rare.

The second case refers to a more common situation of 'overpayment' in the acquisition process. In other words, it is the instance when a buyer pays for a acquired company in excess of its real market value. A buyer assumes that the acquired entity will be worth more than before acquisition, due to anticipated synergy effects. With these in mind, the buyer is committed to pay a premium – the amount in excess of the market value of the company. This means that buyers pay premiums because the anticipated value of the entire business (once the entity is incorporated in the group) is greater than the expected cumulative value of independent companies. However, taking into account the experience and results of various research it may be concluded that such expectations hardly ever come true. The premium level in acquisition has a strong and negative impact on the results for the shareholders: the higher the premium, the lower the chances of an increase in value. Last but not least, acquisition

processes in competitive business setting result in higher premiums paid, than in other market conditions. Such cases require thorough analysis before the decision on the acquisition is made.

The third case refers to the problems arising in the process of corporate group's integration. This is of particular importance in cases of external growth. According to research, a corporate group shall be treated as a single organization with a shared mission, vision and strategy. Integration of all incorporated entities around common goals is the foundation of synergy. On the contrary, especially after acquisition process, executives leave the integration processes, cost cutting and boosting revenues to others, whereas themselves they get engaged in subsequent transactions. It is worth remembering that careful project planning and effective integration of companies is the key to success. Emphasising financial and strategic aspects while neglecting integration is one of the main reasons of acquisition failure. Integration covers all aspects of an organization: technology, policy, systems, culture, and in particular – the personnel. Transaction management is usually perceived as a domain of investment bankers, consultants, lawyers and accountants; but such a view is grossly incorrect and incomplete. Obviously, financial aspects are important, but if there is no harmonisation of cultures and the integration process is managed improperly, the acquiring company may not achieve the expected results.

The last and a very common cause of loss in value is insufficient coordination of management of entities within a corporate group. In business practice, there is still a number of cases where companies under a corporate group tend to compete with each other rather than cooperate. Individual ambitions of particular management boards, poorly coordinated by a parent company, result in that many activities are duplicated, and coordination costs of certain processes exceed the benefits achieved.

Avoiding the pitfalls of synergy is only a small part of a manager's job. Searching for solutions that create synergy and value from owners' perspective is not less important. These commitments boost the revenues, lower the costs and improve asset management within a corporate group. A special attention must always be paid to potential synergy arising from intellectual capital, which strictly corresponds with the expectations of modern economy.

My intention was to inspire further research by the issues ad-

dressed in this book, and to reduce the competency gap by the described and analysed phenomena. Consequently, management of synergy and value in corporate groups should gain more practical understanding, and the solutions and recommendations presented in this book are deemed to contribute to their implementation in business practice.

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Corporate groups are an attempt to reconcile two seemingly conflicting objectives which contemporary business entities must respond to – the requirement of incremental development arising from globalisation trends and concentration of capital on the one hand, and the agility, proactiveness and prompt decision-making – which are characteristic of smaller enterprises – that are expected from market participants on the other.

Establishing and managing Corporate Groups requires unique competences, since the consequences of decisions made in such enterprises are difficult or even impossible to be corrected. The cases of value deterioration resulting from wrong investment decisions or poorly managed integration process are nor infrequent, particularly in Merger & Acquisition projects.

Excessive acquisition premiums, unjustified sector diversification, poorly prepared and ineffectively managed integration, insufficient or improper group members coordination constitute the commonplace management errors which imply substantial competency gaps in this domain. This book endeavors to provide solutions to these quandaries based on applicable international practices, together with author's own research and over 20 years' experience earned in the management and supervisory boards of corporate groups. The book provides guidelines on how to effectively eliminate threats to Corporate Group projects, avoid synergy traps and allow for implementation of value creation scenarios in accordance with the shareholders' perspective.

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