CPI's Asia Column Presents:

Understanding the Driving Forces Behind OMO and M&A Wave

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The capital market experienced a boom at the turn of the year. There were many mergers-and-acquisitions transactions in the Chinese capital market in the past two months. Internet giants Alibaba and Tencent's vigorous trading are drawing widespread attention. Tencent recently has taken a stake in Heilan Home (a leading enterprise in apparel industry), soon after that Alibaba has announced its RMB 5.45 billion ($866 million) strategic investment in leading home furnishing operator, Beijing Easyhome Furnishing Chain Store Group Co Ltd. Furthermore, Tencent Holdings, partnering with domestic supermarket operator Yonghui Superstores in which Tencent has bought a stake, strategically invested in Carrefour China. This act delivers a clear signal to market that the Internet giants intend to extend their online competitive advantages to offline markets through investments in traditional retailers. A key feature of recent investment boom is that it is not occurred within industry but across industry, and mixed vertical integration with both on- and offline, rather than the division of industries.

This trend of online giant's merging or investing in offline corporates does not restrict to China. It also occurs in U.S. The most well-known M&A case in 2017 is the online retail giant Amazon bought the high-end grocery Whole Foods for $13.7 billion in cash. This is the largest acquisition deal ever for Amazon. "Millions of people love Whole Foods Market because they offer the best natural and organic foods, and they make it fun to eat healthy," Amazon CEO Jeff Bezos said in a press release. "This partnership presents an opportunity to maximize value for Whole Foods Market's shareholders, while extending our mission and bringing the highest quality, experience, convenience, and innovation to our customers," Whole Foods co-founder and CEO John Mackey said in the release.

While the on- and offline merges, integrated trading occurs among up- and downstream within traditional industry chains. Pharmacy retail giant CVS's $69 billion deal to acquire health insurer Aetna became the largest corporate acquisition ever in US pharmaceuticals retailing industry as well as the year's largest deal in global pharmaceuticals industry.

Another business trend in 2017 is Online Merger Offline (OMO). Dr. Kai-Fu Lee, CEO of Sinovation Ventures, in an article published on the 2018 special issue of *The Economist* on Nov 22nd 2017, explained his thoughts about the impact of OMO on commuting, retailing, education, and so on. He stated that there are four factors enabling the coming of OMO: rapid smartphone uptake, frictionless mobile payment systems, cheaper and better sensors, and advances in AI. He believes that China will be moving extraordinarily fast, and is poised to see the OMO future first in each of these areas.

The OMO business wave, in which the investments from online giants to traditional retailers or the integrated trading among up- and downstream within traditional industry chains, are spurring discussion among professionals and scholars. For such new business experiment that giants Alibaba and Tencent utilize their core competencies to explore new growth, some media claim that it is a new stream monopoly on network, and even a new Cartel.

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Undoubtedly, online giants like Alibaba and Tencent have a remarkable leverage over online market and highly customer stickiness. No matter consumers, competitors of enterprises invested by Alibaba and Tencent, or regulators, will wonder if the OMO and integration between upstream and downstream would lead to monopolization of the market and unfair competition, thus harming consumers and reducing social welfare.

It is too early to make an accurate assessment of the impact of OMO wave.

However, we surely can learn much from the researches on business history, strategy and economics.

Vertical integration among up- and downstream within traditional industry chains has a long history. Business school graduates should be familiar with the evolution of carbonated soft drink industry. As we all know that concentrate producers acquire or divest bottlers many times.

As the world's leading manufacturer of carbonated soft drink, Coca-Cola and Pepsi produce concentrates and syrups, and are responsible for branding and marketing initiatives. Their bottling partners then carbonate the concentrate, pack and distribute the final branded beverages worldwide. At first, independent concentrate producers and bottlers tried to bound into different contracts to build a sustainable business agreement to avoid conflicts of interest. In the 1980s, concentrate producers (Coca-Cola and Pepsi) found that the bottlers with which they cooperated do not have any capacity to invest and refurbish because of small scale.

So how did Coca-Cola and Pepsi tackle the opportunity? Concentrate producers switched strategy to vertical integration as acquiring and investing bottlers, changing the way bottlers operate, and demerging them. Finally, Coca-Cola and Pepsi got back on track of upstream-downstream contract-relationship after such overhaul.

In past decades, consumers' tastes are shifting towards healthy and less sugar so that energy drinks and sparkling water are getting more popular. Coca-Cola and Pepsi must step up investment to keep consumers spending. The bottlers also must upgrade the production lines to meet the various bottling requirements and distribution demands. Thus, Coca-Cola and Pepsi have actively encouraged the consolidation of downstream bottlers to ensure these bottling operations receive the appropriate investments, and then to demerge for returning to upstream-downstream contract-relationship.

This is an very important case in the business history and strategy, it showcases the importance of driving force behind the changes and redirect our focus from vertical integration or demerging. Such power might be generated by up-streams' efficiency requirements, or down-streams' inadequate investment needs, or consumers' changing tastes.

The rise and fall of telecom carriers is another good reference. In the era before social network and mobile payments become infrastructure, carriers were considered as dominators of communication because of license monopoly that give them nearly full control over the portals of phone calls, messages and value-added services. Everyone had agreed that telecommunication is a great business with the protection of license barriers in a billion-user market. It is still a good business today. However, the rise of the internet and social network set off a revolution in the way of interpersonal communication. Mobile social networking app WeChat has replaced the traditional phone texting as prior way to convey personal information. Facing severe survival problems due to narrow channels, the carriers are no longer the center of the major value chain.

The most important implication for both business observers and policy makers from these two cases above, is that there is no *One Size Fits All* theory for businesses. We need to investigate very carefully the driving forces behind the changes to formulate right strategies.

So, how should we see the OMO from the strategic perspective?

In regard with strategy researches, the core of vertical M&A is whether synergies could be achieved through OMO integration. In strategy synergy is about whether the value and performance of two firms combined will be greater than the sum of the separate individual parts. When corporate extends its competitive advantage within industry chain, it creates more customer value and competitive advantage. The most representative case of synergy effect is Disney's acquisition of Pixar. Animation juggernaut the Walt Disney Co. owning nationwide channel ABC Cable Networks Group has amounts of offline dealers around the world. Pixar, also referred to as Pixar Animation Studios, founded by Apple Inc. co-founder Steve Jobs, is an American computer animation film studio with unique capability of computer animation production and creativity. Disney eventually bought and used Pixar's animation technology for a better promotion, channel combination and branding advantage, to gain remarkable synergies and tremendous value.

However, synergy effect is the most misused and abused illusory theory in the corporate strategy and often contribute no actual effect in practice. For example, Alibaba Pictures is an important link in the entertainment and cultural strategic layout of the Alibaba Group Holding. Public tends to believe that Alibaba would hire top experts since it has a wealth of resources including sufficient funds, massive users and network traffic. With such belief and expectation, the stock price of Alibaba Pictures had been bid up to HK$4.9 by investors after its Hong Kong listing but recently falling to HK$1 by the close of Hong Kong trading on Feb 15th2018. And obviously, there is no strategic synergy or chemistry between Alibaba Pictures and its parent Alibaba Group, even though it has superior resources.

What we learned from the Alibaba's case is that business is complicated. Many assumed strategic synergy effects are not guaranteed in a complex business environment.

Another important background for recent trend of M&A is the rapid changing and increasing uncertainty in current business environment. It does not only embody in business models but also in transformation of traditional ways of creating values. An amount of industries is compelled to explore how utilizing current assets or to reorganize their assets in search of new profiting opportunities. This point can be seen from the case of CVS's acquiring Aetna.

We are aware that health insurance is a promising industry with massive business value and profit opportunities. However, which part is most profitable in this value chain? Is it pharmaceutical, insurers, hospitals or doctors? This question remains unclear to us.

When the business environment becomes increasingly volatile, we can't decide which part of the value chain could guarantee an effortless return. Hence, the best strategy for big names armed with abundant resources is to invest in each part of the value chain, then retain profitable parts and unloads unnecessary ones along with the industry grows as well as the environment changing. To some extent such strategies can be regarded as an insurance, which is to find and keep the core business at the expense of holding the whole chain even some of them may be proved worthless eventually.

Alibaba and Tencent's OMO investments also provoke another thought about industry value chain. Changes in consumer demands, innovations in technologies or new business models could all change the evolution of industry.

Traditional offline retail is prime example for this thought. In the past ten years, traditional retail experienced a continuing recession as a consequence of its weak adaptability to the rapidly growing of online retailing. These old-fashioned players clearly know that they must make change, but are confronted with a circumstance that requires substantive investment with uncertain returns. They have reason to worry in which their outflows would be inflows of someone else's. After all, no one knows whether their brick and mortar stores after upgrade would shrink to a showroom for irrelevant online stores. Obviously, it is better to sit on their cash rather than invest now with such a concern.

From a strategic perspective, both OMO and vertical integration could be seen as an attempt to solve the problems above. This merge or integration is especially effective in settling interest conflicts and insufficient capital.

We can clearly see this strategic consideration in the cases of both Tecent's investing in Yonghui Superstores and Amazon's acquiring Whole Foods. To insure a reasonable return on whichever part of the business, an action like this is in fact a response to the changes of consumers, technologies advances and new business models.

Such changes pose a big challenge for business observer and policy makers. We must better understand the business world and the driving forces behind these changes. Economic logic of vertical integration played a key role in shaping how we understand merging and acquisition in the past. We used to believe the motivation for merger is it can increase profits. But today, M&A decision is driven by much more complicated forces. The logic behind vertical integration is no longer the only condition for a successful M&A decision. Increased value of the new value chain and extra profit to the corporate are both necessary prerequisites, but it does not suffice to a successful merger or vertical integration.

Referring to Alibaba's deal to purchase shares of Wanda Film Holdings, both participants are looking forward to cooperating with each other strategically on customer drain and even on user data sharing for new value creation, based on their rich resources in cultural and entertainment businesses and on their advantages in film industry. They expected the deal to deliver additional business value and enormous potential based on massive trove of consumer data since Dalian Wanda is market-leading multiplex cinema operations in mainland China; however, they were unsure how the chemistry could be occurred. Alibaba, Tencent, or Wanda, can only look for an elusive answer through trial and error in a rapidly changing business environment. OMO is a certain commercial trend while nobody knows its real format mode.

In fact, the endeavor of Alibaba and Tencent's OMO strategies highlighted their platform leadership as a new competitiveness. It is the core competency in each platform company, for example, Microsoft operating system, Google's algorithms, Alibaba's mobile payment technology, and Tencent's social networking. Every business platform should cultivate its own core competencies to become an indispensable partner to their business partner.

Business is often like muddy water. When vertical integration is involved, corporates often presume the scenario that will lead to strategic synergies, which in many cases turns into a fact; however, in cases that does not, the strategic synergies are often overestimated or false assumption. In many of the cases, external environment changes rapidly and outdated the corporates' assumption.

M&A is a form of reaction that corporates perform to help them adapt to environment changes as strategic decision. Business decision could fail no matter how big and success a corporate is, and results of M&A decision is always unpredictable. Therefore, in assessing corporates' M&A activities, unless there is a clear and urgent reason for government to intervene, it is better to "let the bullets fly".