
UNIVERSITI SAINS MALAYSIA

Master of Business Administration

Second Semester Examination
Academic Session 2007/2008

April 2008

AGU610 - International Business Management

Duration: 3 hours

Please check that this examination paper consists of **FOURTEEN** pages of printed material before you begin the examination.

Answer **FOUR** questions. Question 1 is **COMPULSORY**. Choose **THREE (3)** other questions.

Question 1 (COMPULSORY) (40 marks)**Refer to the CASE: Lenovo in 2005**

- (a) Based on specific international business theory, what makes Lenovo acquire IBM's PC Division?
[8 marks]
- (b) Do you agree that Lenovo stop using IBM brand name Thinkpad and concentrate on Lenovo? Why?
[5 marks]
- (c) Yang Yuanqing is PC business unit general manager. His responsibility is to look after purchasing, manufacturing and marketing of all PC products. Is his decision to eliminate direct sales and switch entirely to distributor sales the best choice? Why?
[8 marks]
- (d) Global expansion offers Lenovo the opportunity to generate greater profits than companies that focus strictly on the domestic market. Would Lenovo be able to compete globally? Why?
[5 marks]
- (e) Explain how Lenovo would be able to ensure that the company work closely with the Chinese government and maintain a strong competitive position in the United States.
[8 marks]
- (f) "The IBM brand brings reputation to Lenovo. It removes a barrier to Lenovo's products-particularly outside of China. Lenovo now seems more reliable, more trustworthy. Even to customers who are fully aware that the product is no longer "made" by IBM, a stamp of approval from such a highly respected company means a lot in any market." Explain this statement in light of other competitors.
[6 marks]

Question 2 (20 marks)

The world's poorest countries are at a competitive disadvantage in every sector of their economies. They have little to export. They have no capital; their land is of poor quality; they often have too many people with the given available work opportunities; and they are poorly educated. Free trade cannot possibly be in the interest of such nations! Discuss and provide examples.

[20 marks]

Question 3 (20 marks)

Theories of international trade are important to an individual business firm primarily because they can help the firm decide where to locate its various production activities. Using Porter's theory of national competitive advantage, suggest how Proton can penetrate Indonesian market.

[20 marks]

Question 4 (20 marks)

- (a) Foreign direct investment (FDI) has grown more rapidly than world trade and world output. Most FDIs have been directed at the developed nations, and the United States, Japan, and the European Union have often been the favourite target for the FDI outflows. In 1990, some 47 percent of outward FDI stocks were in service industries. Discuss the shift in FDI from manufacturing to services. What is driving the trend?

[10 marks]

- (b) You are assigned to evaluate an investment in an automotive company in India. Explain the direction of such FDI either vertical or horizontal FDI, and the strategic behaviour you need to consider.

[10 marks]

Question 5 (20 marks)

- (a) You are approached by Starbucks to invest in the market that has not been tapped. You have suggested that Starbucks should invest in developing countries. However, Starbucks has its own belief about investing in other countries. "Starbucks has a strong commitment to coffee producers, their families and communities, and the natural environment to help promote a sustainable social, ecological, and economic model for the production and trade of coffee. Discuss the notion of social responsibility that you need to take into consideration. What does it mean for corporations?

[10 marks]

- (b) Discuss the cultural relativism approach to business ethics. What is the connection between this approach and the phrase when in Rome do as the Romans? How well does this approach hold up ethically?

[10 marks]

Question 6 (20 marks)

The choice of mode of entering a foreign market is a major issue with which international business must wrestle. Another major issue is the timing of entry when the firm first enters to a foreign market while others are not doing so. Explain the relationships between first mover disadvantages and pioneering costs. Provide example from the apparel industry such as Dockers, Calvin Klein or Ralph Lauren into Malaysian market.

[20 marks]

Question 7 (20 marks)

- (a) Discuss the implications of cultural differences between countries for marketing strategy. Provide examples in consumer products.

[10 marks]

- (b) How do levels of economic development affect consumer behavior? What are the implications for marketing strategy?

[10 marks]

**Lenovo in 2005****INTRODUCTION**

Lenovo, formerly known as Legend, was the largest personal computer (PC) maker in China. Legend Group Holdings, which was controlled by the Chinese government, owned a majority stake in Lenovo, which offered various products including low-priced computers, servers, handheld computers, imaging equipment, and

mobile phone handsets. Lenovo also provided manufacturing and IT integration and support services.

In 2004, Lenovo recorded sales of \$2,971.2 million and a net income of \$135 million and controlled about 2.2 percent of the global PC market and, in 2003, 27 percent of the Chinese PC market. In February 2000, Legend was ranked eighth in a survey conducted by *BusinessWeek*.¹ The following year, Legend was voted as Asia's Best Managed Company in a survey conducted by Finance Asia.

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¹The survey was called Global Information Technology 100.

On December 7, 2004, Lenovo announced that it would acquire IBM's PC Division (which has a 5.5 percent global market share) for approximately \$1.75 billion, to become the world's third largest PC maker with annual sales of close to \$12 billion. After a 45-day review by the Committee on Foreign Investment in the United States (CFIUS), the deal was given a green signal by the U.S. government and CFIUS on March 9, 2005.

Would the deal really take Lenovo and IBM to great heights? Could Lenovo become a global player and integrate IBM's U.S. operations? Would Lenovo be able to retain IBM's PC customers? These were the questions analysts pondered as 2005 got under way.

BACKGROUND

The Early Days

In 1984, Liu Chuanzhi, a computer scientist who became an administrative manager in the Computing Institute of the Chinese Academy of Science² (CAS) in Beijing, was given a mandate and \$24,000 to start a company to commercialize the institute's research results in order to fund its ongoing research costs. Liu, along with 10 colleagues, formed the New Technology Development Company, (NTD). They started operations in a small bungalow given by CAS free of cost. During the first two years, NTD acted as a middleman, acquiring products from large domestic distributors and selling them to government agencies and large state-owned enterprises (SOEs).

To overcome their initial funding constraints, they even tried selling television sets and electronic watches. At the time, as China had limited domestic PC manufacturing capabilities, almost all the PCs were imported. In addition to foreign products imported through formal channels, many products were also smuggled into China through gray channels. Since no tariff was paid on gray market products, they could be sold at much lower prices. As a result, many small distributors bought these products and distributor profit margins fell steeply. NTD felt the significant price pressure and realized that the company needed its own products to survive in the long run.

Almost all the operating systems (OS) were English and few Chinese spoke English. Recognizing the OS bottleneck, Liu decided to start his own product development by translating an English OS into Chinese. NTD was not alone in marketing Chinese-language solutions for PCs. But in contrast to rival software products, NTD's solution was hardware-based. NTD used a new pattern-recognition technology and developed the Legend Chinese Insertion Card (LCIC) in 1985, which was designed

to be inserted into PC motherboards. Unlike software solutions, Legend's card did not occupy significant amounts of costly hard-disk space. Duplicating the hardware was also more difficult than copying competing software products. This was a significant advantage because industry experts estimated that over half of all Microsoft DOS systems installed on PCs in the People's Republic of China were pirated. An important feature of this technology was "association" or "Lian Xiang" (Legend's Chinese name). The association feature enabled the system to prompt Chinese characters which could be used to form expressions and phrases with the character input. The development of the new product also convinced a few experienced scientists in the Computing Institute of the company's future prospects and enticed them to join the sales and marketing efforts. LCIC became a huge success within a year. NTD changed its name to Legend in 1989.

By bundling LCIC with the imported PCs, Legend's distribution business also made significant progress. In 1987, Legend signed a formal agreement to distribute AST PCs and Hewlett-Packard (HP) peripheral products. With HP, Legend started by distributing CAD systems and gradually expanded into HP printers and other peripheral products. Success in the distribution business allowed Legend to accumulate capital for future development and helped a generation of young leaders gain experience in the marketing and distribution side of the business. During the 1980s, distribution itself accounted for more than 60 percent of Legend's total revenue.

In the late 1980s, the Chinese government realized the need to build an indigenous PC industry. The Ministry of Electronic Industries (MEI) granted PC manufacturing licenses to a few firms it directly owned. Not being directly owned by MEI, Legend was not granted a manufacturing license in China. Therefore, it decided to manufacture abroad. The company chose Hong Kong as its base for operations. In 1988, Legend established a joint venture with Dao Yuan³ and China Technology Transfer Company (CTTC), which was jointly owned by the Bank of China, China Resources, and two other well-connected mainland firms.

Legend began its Hong Kong operations with distribution. It utilized Hong Kong's geographical advantage to penetrate the growing Chinese market during the 1980s. Legend's relationship with AST⁴ was the most successful example of this strategy. AST distributed its products through several Chinese companies, including Legend, but experienced difficulties in communication and coordination while dealing with mainland firms. For

³Dao Yuan was a Hong Kong trading company.

⁴AST was a U.S.-based computer manufacturer. In the mid-1980s, AST was a second-tier PC manufacturer well behind industry leaders IBM and HP.

²A Chinese government institution in Beijing.

Part 5 The Strategy and Structure of International Business

example, AST had to translate nearly all correspondence with its mainland Chinese distributors. Many mainland companies turned off their fax machines after work hours. After establishing a presence in Hong Kong, Legend Hong Kong took over all contract negotiations and import/export transactions with AST, while Legend Beijing carried out actual distribution, sales and service in Mainland China. Since Legend had been in the distribution business for several years by that time and its sales force had accumulated considerable experience from distributing HP, IBM, and other foreign vendors' products, Legend was instrumental to AST's success in penetrating the Chinese market. With Legend's help, AST became the number one vendor of PC products in China by the early 1990s, accounting for 29.3 percent of total unit shipments in 1992.

While the trading and distribution business grew quickly and became very profitable, Legend Hong Kong continued to look for an opportunity to enter manufacturing. In late 1988, it acquired Quantum Design International (QDI).⁵ Legend aggressively marketed QDI motherboards overseas using a low-price strategy.

It was not until the 1989 World Fair held in Hanover, Germany, that Legend finally caught the attention of the Chinese government. The Chinese delegation at the fair consisted of senior officials from several ministries regulating the trading and manufacturing of electronic products in China. After Legend demonstrated its manufacturing prowess at the fair, the MEI sent a special delegation to Hong Kong to thoroughly inspect Legend's R&D and manufacturing capability. In 1990, after MEI was satisfied with the inspection, it granted Legend a license to manufacture PCs in China.

By 1995, Legend had become the fifth-largest manufacturer of motherboards in the world and one of the three board manufacturers performing beta tests on each new generation of Intel CPUs (the other two were Taiwanese companies, Acer and Gigabyte). The company had established more than 30 overseas sales offices throughout the world to market its motherboards.

Reorganization

In 1994, having resolved to be in PC manufacturing, Legend conducted a detailed analysis of its PC business to identify areas that needed improvement. One such area was a misaligned incentive structure and uncoordinated internal decision-making process. Legend's PC business was organized on functional lines, such as purchasing, manufacturing, and marketing. Each area was determined by its ability to meet functional targets set in the annual planning process. To solve the problem, the

management decided to consolidate all Legend's PC-related businesses into a new PC business unit (PCBU) in 1994.

Yang Yuanqing, who was just 29 years old then, was appointed the unit's general manager. Yang had joined Legend in 1988. He had completed his master's degree in computer science from the University of Science and Technology. Most of the senior managers of the company were older than 50, and did not have much experience in working in a market environment, or in a rapidly changing PC industry. On the other hand, Yang had demonstrated his management capability in his first few years with Legend. He also had more front-line operation management experience than most other young managers.

After taking over, Yang looked after purchasing, manufacturing, and marketing of all PC products. He was given the freedom to determine new-product launches, channel selection, and pricing strategies based on market conditions. All the functional managers were evaluated on both departmental and BU results. For example, the purchasing manager was evaluated on purchasing-related performance measures, regardless of the accuracy of marketing forecasts provided by the marketing manager. Even if inventory turnover was slow due to inaccurate market forecasts, the purchasing manager had to take some responsibility.

Before 1994, Legend sold its PCs through both a direct sales force of more than 100 sales representatives and hundreds of local distributors. Channel conflicts were many. The first major marketing decision Yang took was to eliminate direct sales and switch entirely to distributor sales. Legend was the first domestic manufacturer to take this decision. Yang cut the sales force to 18 people, just enough to manage a distributor network.

The PCBU also focused on controlling costs and improving manufacturing efficiency. To ensure timely collection of receivables, Legend required all distributors initially to pay cash up front. Credit was granted only after the distributor earned a good track record with the company. Legend also tied most of its distributor incentives, such as price discounts, quarterly rebates, and co-op advertising fees, to cash collection history. This information helped Legend maintain an accounts receivable turnover of less than 30 days, compared to the industry average of around 90 days in China.

Realizing that prices were falling rapidly in the PC market, Legend also attempted to improve its inventory turnover. For the popular standard products, the company maintained abundant levels of inventory to ensure shipment within one week. For less popular products, Legend adopted a built-to-order model. Yang felt that since the national logistics and delivery system was underdeveloped in China, a complete built-to-

⁵Quantum Design International was a motherboard manufacturing company in Hong Kong.

order model would not work. With tightened control, Legend managed to improve inventory turnover to seven times in 1995.

The reorganization quickly paid off. In 1994, the second-quarter PC sales went up by 152 percent when compared to the same period in 1993 and the PCBU made a profit. Through its channel development efforts and improvement in management efficiency, Legend was successful in increasing the PC sales and capturing 5.7 percent of the market in 1995.

Although Legend focused more on manufacturing its own branded PCs, its separate distribution business continued to grow. Legend's agreement with HP stretched into PC products in 1994 and into servers in 1995. Legend became the unique distributor for Toshiba laptops in China. It also started distributing PCs and related peripheral products for Apple, Sun, IBM, and Canon.

By 1996, Legend had increased its manufacturing capacity to around 500,000 units a year. In addition, Legend was able to reduce overheads to about 20 percent of total unit cost. The management decided that by lowering prices, Legend could increase its sales volume, which would in turn lower unit overhead costs and improve Legend's entire cost structure.

Legend's management had noticed a mismatch between market demand for the latest technologies and the new-product introduction strategies of major players. Because of low consumption levels in China and the relatively high prices due to tariffs and transportation costs, foreign multinationals launched PC products into China about four to five months after they have been launched elsewhere.

While slashing PC prices by 30 percent, Legend also became the first to market new technologies. Early in 1996, Intel had launched its Pentium chip. In China, however, the PC makers were still selling 486s priced at around \$1,800, which included a 15 percent tariff. Following a detailed analysis, Legend noted that total material cost, including tariff and transportation, for a Pentium-based PC would work out to \$1,100. Falling component costs and potential lower unit overhead costs resulting from volume increases meant that Legend could break even or even make a small profit by selling Pentium-based PCs at \$1,200. Legend implemented this strategy in March 1996.

Legend's sales volume increased drastically, and so the unit overhead costs fell to 16 percent of total cost. The global component costs also continued to fall and Legend reduced the prices by 25–30 percent on its latest models twice more in 1996. By early 1997, Legend sold almost 140,000 desktop PCs, capturing the number one position in China with a 9.4 percent share, slightly ahead of IBM's 8.4 percent.

By 1999, Legend felt that the Internet could pose a serious threat to the way that traditional business was con-

ducted in China. Rapidly growing Internet portals and business-to-business (B-to-B) e-commerce start-ups were attracting large venture capital funding and going public. Even bureaucratic government agencies were moving online, spurred by a highly publicized campaign by the Beijing government.

Furthermore, potential conflicts of interest between Legend's own PC business and its distribution business became increasingly evident. Although its distribution business had commanded 30 percent annual growth in the past, it became increasingly difficult to reduce its costs while using the traditional distribution model. China's impending accession into the World Trade Organization (WTO) was apt to increase domestic competition, threatening Legend's competitive position in the domestic market.

Legend's management realized that a significant rethinking of the company's business and organization was crucial for future success. Responding to the threat from the Internet and global competition within China, Legend announced a major restructuring of its organization to take effect April 2000. Legend Holdings was restructured into two essentially independent businesses with full decision-making authorities: Legend Computing System (LCS) and Digital China. LCS became responsible for all of Legend's computers, software, and newly formed Internet businesses offering connectivity and content. Digital China took Legend's distribution business into a B-to-B marketplace and developed its new networking business.

During late 2000, Legend stepped up its efforts to capture a significant share of the corporate PC segment. In November 2000, Legend launched two models of commercial Internet PCs—Doctor of Business 6000 and Doctor of Net 2000—targeted at small and medium enterprises (SMEs) in China. The models were designed to meet the office automation requirements of SMEs. The company also launched Luna P4, China's first branded PC equipped with an Intel Pentium 4 processor.

In December 2000, Legend launched second-generation Internet PC models called Conet II and Tongxi. Conet II was equipped with an AV workstation, which allowed users to record videos. Legend launched four new models of home PCs—Tianhui for children, Future Pioneer for high school students, Tianlu for adults, and Tianle for middle-aged and elderly people. The Future Pioneer model was equipped with a multimedia and digital audio system and a 3D accelerated display card, which allowed students to play 3D-video games.

In 2002, Legend entered the software consultancy business. The company acquired a 51 percent stake in Han Consulting Limited⁶ to jointly offer IT consultancy

⁶A leading management consulting and IT services company in China.

services to medium-sized and large enterprises in China. During mid-2002, Legend entered the mobile handset business through a \$150 million, 60:40 joint venture with Xiamen Overseas Chinese Electronic Company Limited.⁷ The two companies agreed to integrate their research and product development efforts to develop and market mobile handsets in China.

The domestic market where Legend generated more than 90 percent of its business was proving increasingly tricky as local players such as Founder sharpened their attack. At the same time, price-cutting by international rivals such as Dell and Toshiba was eroding Legend's share of the world's fastest growing PC market.

Expanding into the international markets for Legend became inevitable with the globalization of the IT industry and to assure Legend's future. During 2002-03, about 5 percent of Legend's turnover came from overseas markets, including Europe, Asia-Pacific, and North America.

In April 2003, Legend adopted a new logo and the English brand name Lenovo. Lenovo meant innovation and creation. The Le in the name connected with Legend, while novo linked to innovation and novelty. The decision to create the new brand was also prompted by the fact that other users in a number of major markets had registered the Legend name. However, the 19-year-old company continued to trade as Legend Group, and used its Chinese brand name in combination with the Lenovo logo in its home market.

Yang remarked:

Although our business focus is still on China, expanding into the international market is an inevitable path with the globalization of the IT industry and for Legend's self-development. Having made reference to the successful experience of well-known brands, we decided to choose a single brand structure to concentrate our resources on the accumulation of our brand value.⁸

In March 2004, Lenovo joined the Olympic Partner Program of the International Olympic Committee (IOC). Lenovo was the first Chinese company to become the computer technology equipment partner of the IOC for 2005 to 2008. Between 2004 and 2008, Lenovo would provide computing technology equipment (including desktop computers, notebooks, servers, and desktop printers) funding as well as technological support to the 2006 Turin Olympic Winter Games, the 2008 Beijing Olympic Games, and over 200 national Olympic committees around the world.

THE IBM DEAL

In December 2004, Lenovo announced it was purchasing IBM's PC manufacturing business. After the successful completion of the deal, Lenovo would locate its PC business worldwide headquarters in New York, with principal operations in Beijing and Raleigh, North Carolina, and sales offices throughout the world.

Lenovo would gain ownership of IBM's PC design facilities, including an R&D lab in Yamato, Japan. In addition, Lenovo would either acquire outright or get licensing rights to a large portfolio of IBM patents. The PC manufacturing portion of the International Information Products Company (IIPC) in Shenzhen, China, which was co-owned by IBM and Great Wall, was included in the transaction. However, IIPC's IBM eServer xSeries manufacturing was excluded.

After the merger, Lenovo would have a combined annual PC sales of approximately \$12 billion and volume of 11.9 million units, based on 2003 business results—a fourfold increase in Lenovo's PC business. Lenovo's new PC business would benefit from a powerful worldwide distribution and sales network covering 160 countries.

IBM would be the preferred services and customer-financing provider to Lenovo. Lenovo would be the preferred supplier of PCs to IBM, which would offer a full range of personal computing solutions to its enterprise and small and medium business clients.

IBM's existing enterprise sales force of approximately 30,000 professionals and the Web site *ibm.com* would provide marketing support and demand generation services for Lenovo products, some of which would be sold through IBM PC specialists who would join Lenovo. IBM Global Financing and IBM Global Services (the number one IT services organization in the world with powerful existing enterprise channels) would be preferred providers to Lenovo for leasing and financing services and for warranty and maintenance services, respectively.

The deal, officially announced on December 7, 2004, was valued at \$1.75 billion in cash, stock, and assumed liabilities. IBM would receive at least \$650 million in cash and up to \$600 million in Lenovo Group common stock, subject to a lock-in period expiring periodically over three years. Lenovo would assume approximately \$500 million of net balance sheet liabilities from IBM. The cash portion of the consideration would be funded through internal cash and debt.

Once the agreement was finalized in early 2005, Lenovo would have three owners—the state with 46 percent, public investors with 35 percent, and IBM with 19 percent. The Chinese government owned 57 percent of Lenovo. To be managed primarily by former IBM executives working out of New York, the company would have 19,000 employees, with 10,000 of them coming from IBM. Of those 10,000, 40 percent were based in China and 25 percent in the United States.

⁷One of the leading electronics products companies in China.

⁸Sharon Desker Shaw, "Branding: Legend Creates Lenovo for Export," *Media Asia*, May 16, 2003, p. 10.

EXHIBIT 1

Lenovo: Financial Highlights

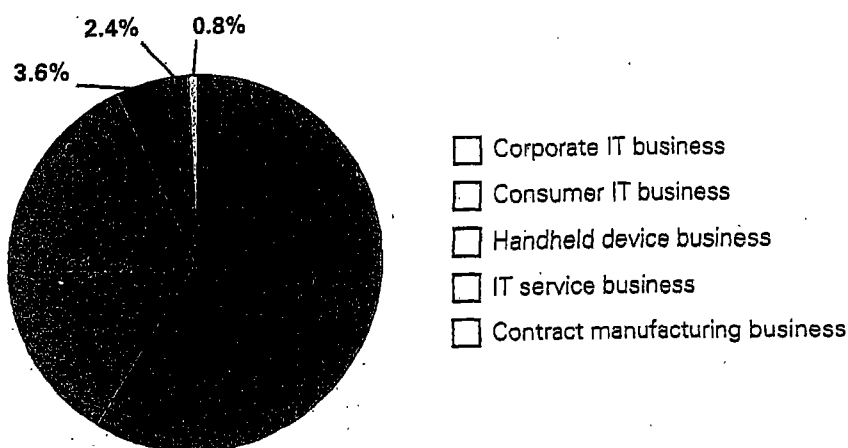
Source: Lenovo Annual Report 2004.

	2004	2003	Increase/ (Decrease)
	(HK\$m)	(HK\$m)	
Operating Results			
Turnover	23,176	20,283	14.5%
EBITDA	1,125	1,175	(4.3%)
Profit attributable to shareholders	1,053	1,017	3.5%
Earnings per share—fully diluted (HK cents)	13.99	13.64	3.3%
Financial Position			
Total assets	8,342	6,756	23.5%
Cash and cash equivalents	2,650	2,808	(5.6%)
Shareholders' fund	4,489	4,189	7.2%
Financial Ratio			
ROA (Return on assets) (%)	12.4	11.5	10.7%
ROE (Return on equity) (%)	24.7	25.6	(3.5%)
Current ratio (times)	1.9	2.1	(9.5%)
Others			
Interim dividend (HK cents)	2.0	1.8	11.1%
Proposed final dividend (HK cents)	3.0	3.0	—
Special dividend (HK cents)	—	5.2	N/A

EXHIBIT 2

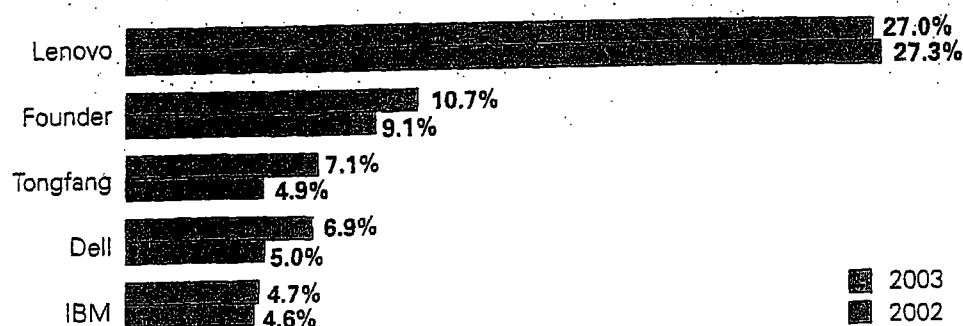
Lenovo: Turnover Analysis by Business Segment

Source: Lenovo Annual Report 2004.

**EXHIBIT 3**

Market Share of Top 5 PC Brands in China

Source: Lenovo Annual Report 2004.



Part 5  The Strategy and Structure of International Business

	2004		2003	
	Turnover	Contribution to Operating Profit	Turnover	Contribution to Operating Profit
	(HK\$'000)	(HK\$'000)	(HK\$'000)	(HK\$'000)
Corporate	11,925,249	777,698	10,803,311	742,153
Consumer IT	7,760,668	466,814	6,822,633	363,527
Handheld device	2,050,164	(74,565)	1,440,328	29,612
IT service	547,780	(58,009)	183,800	(61,405)
Contract manufacturing	892,092	(96,208)	983,218	138,554
Gains/(losses) on disposal of investment	-	47,558	-	(26,802)
Amortization of goodwill	-	(26,274)	-	(7,463)
Others	-	(22,000)	-	-
Total	23,175,922	1,017,814	20,233,290	1,049,581

EXHIBIT 4

Lenovo: Turnover and Contribution

Source: Lenovo Annual Report 2004.

Lenovo hoped to leverage IBM's powerful global brand through a five-year brand licensing agreement as well as through ownership of the globally recognized "Think" family of trademarks. IBM's PC business generated over \$9 billion in revenues in 2003 and offered a full range of desktop and notebook PC systems. The acquisition would provide Lenovo access to the worldwide PC market and enable the company to generate annual revenues of more than \$12 billion.

Yang was clearly optimistic:

Lenovo of China is going to be Lenovo of the world. We won't be satisfied with the number three position. We will formally challenge the other two major competitors in the global PC market. The top management has analyzed in-depth why there is no profit for IBM's PC business. IBM is a service-oriented company, which focuses on products with high returns. But the PC business [is at a] stage where efficiency [brings] success, and that's why IBM's previous business model doesn't work... To reach high efficiency, there has to be big product scale. IBM only focuses on the big corporate clients, with less coverage for the middle size clients. This [hurts] IBM in the competition with rivals like Dell. Lenovo is strong where IBM is weak... and that is why we are confident about the future.⁹

According to IDC figures for 2003, the combined unit market share of Lenovo and IBM's PC businesses worldwide was approximately 8 percent. The transaction would dramatically strengthen Lenovo's global presence in the fast growing notebook PC marketplace.

Despite the optimism expressed by Liu and Yang, many analysts believed that the deal presented three uncertainties: acceptance of the new Lenovo by IBM's clients and the PC market; retaining IBM employees; and integration of the two corporate cultures. Lenovo would have to manage highly complicated logistics and supply chains, while moving forward in an industry with shrinking profit margins.

Meanwhile, the proposed deal had raised concerns among U.S. politicians. In mid-January 2005, three Republican congressmen expressed concerns that the deal could transfer advanced technology and corporate assets to the Chinese government, along with licensable or export-controlled technology, and might result in some U.S. government contracts involving PCs being fulfilled by the Chinese government. In the letter they stated:

Given the relationship between so-called "private companies" in communist states and their government, we believe that it is manifestly in the public interest to extend the time for review.¹⁰

⁹"The IBM/Lenovo Deal: Victory for China?" www.knowledge.wharton.upenn.edu, January 14, 2005.

¹⁰Charles Forelle, "Lawmakers Ask for More Scrutiny of IBM Unit Sale," www.online.wsj.com, January 27, 2005.

EXHIBIT 5

IBM: Revenue by Classes of Products or Services (dollars in millions)

Source: IBM Annual Report 2004.

For the Year Ended December 31: Consolidated			
	2004	2003	2002
Global Services:			
Services	\$ 40,517	\$ 37,178	\$ 31,290
Maintenance	6,696	5,457	5,079
Systems and Technology Group:			
Servers	\$ 12,460	\$ 11,148	\$ 10,047
Storage	2,898	2,849	2,581
Microelectronics OEM	2,131	2,142	3,226
Technology services	424	325	323
Networking products	3	5	18
Enterprise Investments:			
Software	\$ 1,131	\$ 981	\$ 910
Hardware	37	72	85
Others	12	12	3

EXHIBIT 6

IBM: Geographic Information

Source: IBM Annual Report 2004.

For the Year Ended December 31:				
	2004	2003	Year to Year Percent Change	Year to Year Percent Change Constant Currency
Geographies				
Americas	\$ 40,064	\$ 38,078	5.2%	4.5%
Europe/Middle East/Africa	32,068	29,102	10.2%	0.8%
Asia Pacific	24,276	19,317	25.4%	4.2%
OEM	2,885	2,634	9.6%	9.3%
Total	\$ 96,293	\$ 89,131	8.0%	3.4%

Responding to these concerns, the U.S. government decided to examine whether the deal threatened national security interests.

Lenovo's Chinese parent company and largest shareholder was closely tied to the CAS. The extended review of the deal was conducted by the U.S. Treasury Department's Committee on Foreign Investment in the U.S. (CFIUS), an interagency panel that was chaired by John W. Snow. After the review (which lasted for 45 days), a report had to be submitted to the U.S. president, who would have 15 days to announce the final decision.

In February 2005, Yang clarified that the deal would not pose a national security threat to the United States:

Probably there are more PCs sold a year than TVs throughout the world. Therefore, you know and I know of the technology content embedded in the PCs, therefore I don't think that we will pose any security

threat to the U.S. Our transaction will add a lot of benefits not only to the bilateral relationship between the two countries but also the commercial relationship between U.S. and Chinese companies. And I know that a lot of Chinese companies are also thinking about doing business in the U.S., and we hope that we can provide a good and successful example for them.¹¹

He said that the deal could be "beneficial" to Sino-U.S. ties as more Chinese companies sought to grow overseas, particularly in the United States.

The committee was comforted by a plan to house Lenovo's Raleigh operations, post-acquisition, in a separate, three-building complex. Lenovo's corporate headquarters with a head count of about 100 would move to

¹¹Hasan Jafri, "Lenovo CEO: Deal with IBM Doesn't Pose Security Threat," *www.online.wsj.com*, February 2, 2005.

Part 5  The Strategy and Structure of International Business

EXHIBIT 7

IBM: Research, Development, and Engineering (dollars in millions)

Source: IBM Annual Report 2004.

For the Year Ended December 31:

	2004	2003	Year to Year Change
Research, development and engineering			
Total	\$ 5,673	\$ 5,077	11.7%

EXHIBIT 8

IBM: Employees and Related Workforce

Source: IBM Annual Report 2004.

For the Year Ended December 31: Percentage Changes

	2004	2003	2002	2004-03	2003-02
IBM wholly owned subsidiaries	329,001	319,273	315,889	3.0	1.1
Less-than-wholly owned subsidiaries	19,051	18,189	22,282	4.7	(18.4)
Complementary	21,225	17,896	17,200	9	2.6

New York from Beijing. Finally the deal was given a green signal by CFIUS on March 9, 2005. CFIUS did not call for any limits to be put on Lenovo's ability to sell PCs in the United States, allowing it to bid for government and military contracts.

In March 2005, there was news that Lenovo would need more funds to cope with the deal. Three private equity firms—Texas Pacific Group, General Atlantic LLC, and the Newbridge Capital LLC affiliate of Texas Pacific and Blum Capital Partners—seemed to be close to taking a stake in Lenovo.

On March 30, 2005, Lenovo officially announced that it had received a \$350 million investment from Texas Pacific Group, \$200 million; General Atlantic LLC, \$100 million; and Newbridge Capital LLC, \$50 million. Lenovo would use about \$150 million towards the acquisition of the PC operations of IBM and add the remaining to its working capital.

The company would issue to the firms a total of 2.73 million unlisted Series A cumulative convertible preferred shares at HK\$1,000 each and unlisted warrants for 237.4 million shares. The firms would have about 12.4 percent stake, assuming full conversion of the preferred shares and exercise of the warrants, and including the issuance of shares to IBM in the \$1.25 billion PC unit transaction.

These new investors would give the company expertise in helping it carve out the IBM PC business from its former parent. In addition, they would play a role in helping merge two diverse cultures. The new investors also would take 3 out of the 12 seats on the Lenovo board.

The new investment changed the payment terms. Originally, Lenovo thought it would give IBM shares valued at \$600 million and cash of \$650 million, which

it obtained through bank loans. But under the changed circumstances, Lenovo had decided to use \$150 million of the money from the private-equity firms to boost its cash payment to \$800 million. It would issue shares valued at \$450 million to IBM, which would then be left with a 13.4 percent stake in the combined firm. The remaining \$200 million from the private-equity firms would be used for working capital.

THE ROAD AHEAD

Legend's diversified business portfolio included consumer and corporate IT, handheld devices, IT services, and contract manufacturing businesses. Under the Lenovo brand, it had also extended its product line to include mobile phones. To counter sluggish domestic sales, the company had shifted its customer focus to companies where it was likely to be able to charge a premium. However, Liu stressed that Legend's marketing activities would continue to be focused on the consumer market.

China, which accounted for 42 percent of PC shipments in the Asia-Pacific region excluding Japan in 2003, grew at 7.8 percent in the fourth quarter of 2002 and it was expected to continue to drive regional expansion in 2003.¹² Legend posted double-digit percentage gains year-on-year. HP retained its second spot in the region with a relatively small growth rate, while IBM, which stood at the third place, reported positive year-on-year gains. Dell, placed fourth, similarly posted year-on-year gains in most countries.

Although Lenovo faced increased competition, the multinational brands continued to lag behind. Indeed,

¹²According to IDC.

Lenovo's 27 percent market share overshadowed both local and foreign competitors—Dell and IBM, and HP at 3 percent. Even Founder lagged far behind at 9.4 percent.

Following the successful deal with IBM, both Lenovo and IBM would profit from Lenovo's access to emerging Asian markets.

Liu commented:

In the past three years we set up a road map to achieve diversification. However, things did not go well with our plans. We were too anxious to achieve our goals, we did not think through our plans clearly, and we did not succeed. As a result, for the next three years we have developed a new strategy. We will focus on the PC industry first. Of course, this is just a three-year plan—we do not intend to focus just on PCs forever. We are now working on plans for globalization as well as new ways of diversification, but we haven't reached any conclusion yet.¹³

How the IBM/Lenovo deal would play out remained to be seen. To make the deal work, Lenovo had decided to put IBM's executives in charge. Stephen M. Ward, Jr., currently IBM senior vice president and general manager of IBM's Personal Systems Group, would serve as the CEO of Lenovo, and Yang would serve as the chairman. However, Liu, who was an extraordinarily capable person and well versed in dealing with the Chinese government, would step aside as chairman and not be part of the new management team.

Meanwhile, the average age of Lenovo employees was below 30, while IBM executives were older and more seasoned. Lenovo would have to blend executives who could manage the Chinese government and maintain a strong competitive position in the United States. Would Lenovo be able to meet these challenges?

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