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Hey, Deutsche Telekom: Bigger Isn't Necessarily Better

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After word of its pending merger with VoiceStream leaked out, Deutsche Telekom's market capitalization declined by about $50 billion—equivalent to the purchase price of VoiceStream. The market's reaction is pretty typical of major mergers. So why are CEOs still feeling the urge to merge, even if their stocks are punished in the process? Maybe the markets are just being short-sighted. But, in most cases, it's more likely the CEOs who are mistaken.

Merger mania has spun out of control. Last year, mergers and acquisition worldwide totaled $3.4 trillion. In the oil sector, there's Exxon and Mobil. In the automobile industry, Daimler-Benz and Chrysler. In media, AOL-Time Warner. The list goes on and on. Many of these mergers, like that of Deutsche Telekom and VoiceStream, also cross national borders, since companies now feel it is no longer enough to dominate their home markets.

These huge and expensive deals are occurring in the belief that industries will inevitably become more concentrated as the world's markets become more global. Companies are told that, in order to create economies of scale in marketing, manufacturing, and research and development—as well as to scare off potential competitors—they have to be one of the biggest players in their industry. Thus they view mergers as a do-or-die proposition.

This idea has an established pedigree. More than 100 years ago, Karl Marx wrote, "One capitalist always kills many," meaning that a constantly dwindling number of capitalists would eventually monopolize everything. This theory has persistently dominated business, though usually in less pernicious terms than Marx used.

In the 1970s, Boston Consulting Group formulated the famous rule of three: A stable competitive market never has more than three significant competitors. Jack Welch's widely quoted dictum that General Electric must be either number one or two in its various businesses is consistent with this thinking. In the 1990's Mercer Management Consulting popularized the plight of the silver medallist: Companies are either number one, Mercer argued, or they are nobody.

It is no doubt arguments like this that are behind the Deutsche Telekom and VoiceStream boards' approval of their merger, valued at more than $50 billion. Given VoiceStream's 2.3 million subscribers, that works out to $21,000 per subscriber. However, Deutsche Telekom must see a huge potential in the market.

CEO Ron Sommer must be thinking: If I just spend an extra $5 billion or so on VoiceStream, I will make Deutsche Telekom a more attractive provider of wireless telephony for European customers, since VoiceStream uses the GSM standard popular in Europe. This will allow Deutsche Telekom to follow in the footsteps of larger European wireless firms like Vodafone AirTouch and France Telecom. And look at all those potential customers in America! Calculated this way, the VoiceStream acquisition looks much more attractive. It works out to just $275 per potential customer—a bargain compared to the $339 per potential customer that Vodafone paid for AirTouch!

David Smith

Ron Sommer
Trying to buy VoiceStream

Only time will tell whether such optimistic projections will pay off. They haven't paid off in the past, however, because their foundation is shaky. The global economy is not winner-take-all. If that were the case, how would you explain how young upstarts like McCaw Cellular or Nextel could run rings around established giants like AT&T? Or how could a software startup run by a Harvard drop-out best mighty IBM?

Globalization does not require a few megafirms to swallow up an entire industry. Our research, published recently in the Harvard Business Review, has shown that there has actually been a steady decrease in industry concentration in the post-World War II period. All 20 industries we studied showed this result.

The automobile industry, for instance, has become a more global business since World War II but it hasn't become more concentrated. General Motors' worldwide market share is at its lowest point in more that five decades. Some recent mergers, such as the Daimler-Chrysler deal, have slightly increased concentration, but only to a modest degree compared with the past half-century. Even high-technology industries, such as computer hardware, computer software, and long-distance telephony, have seen market-share erosion. The share of worldwide sales for the top five companies in each of these industries declined from 1988 to 1998, according to Standard and Poor's Compustat data.

Many attempts to bring companies together have failed. Consider for a moment the major telecommunication alliances that were forged between 1992 and 1996 to compete for the profitable business of multinational corporations. First, Unisource was created by major telecom companies in Sweden, the Netherlands, and Switzerland and was later folded into the World-Partners alliance, which involved 25 telcos. Then there was the Concert alliance, which started out as a partnership between British Telecom and MCI, and grew to include almost 50 telcos by 1998. Finally, there was Global One, launched in 1996 by Sprint, Deutsche Telekom, and FranceTelecom.

By the end of the 1990s all these alliances were in disarray. BT had partnered with AT&T, WorldPartners was largely defunct, and Global One was wracked by disagreements between its German and French parents over Deutsche Telekom's unsuccessful bid for Telecom Italia.

Executives need to break free of the biases that lead them to pursue larger and larger deals. There are less expensive and more profitable strategies for dealing with globalization. Companies could take advantage of the Internet and other technology to deliver services better and cheaper. Or they could focus on only a slice of the market and work on achieving unassailable customer loyalty. It is by pursuing such strategies that Nextel and VoiceStream have appeared on the horizon, and it may be how smaller firms like ePhone rise in the future.

Smaller companies are often more nimble than their behemoth competitors, able to deliver better products to customers and a higher return to shareholders. Companies don't need to be big to succeed. They do need to have good business models. CEOs should resist the M&A temptation.

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