ACQUISITIONS AND JOINT VENTURES AS ENTRY MODES: EXAMINING RELATEDNESS AND EXPERIENCE EFFECTS

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ABSTRACT

A common argument suggests that acquisitions and joint ventures are appropriate for a firm to enter low related industries because of the difficulties inherent in internal development of all the necessary resources. Empirical evidence, however, offers little support for such an argument, rendering inconclusive the level of relatedness that makes an acquisition or a joint venture an appropriate mode of entry. In this study we find that acquisitions and joint ventures are most appropriate as an entry mode at middle levels of relatedness between a firm's current activities and a new entry. In addition, whereas experience in acquisitions does not significantly alter the level of relatedness at which acquisitions work best, experience in joint ventures affects the level of relatedness at which joint ventures are a more appropriate mode of entry.

Keywords: Entry mode, acquisitions, joint ventures

INTRODUCTION

A common argument suggests that a firm that enters a low related industry is unlikely to possess the key resources needed to successfully compete in that industry and thus will likely opt for the acquisition of an existing company rather than trying to develop all those resources internally. Such a view, however, has found limited empirical support (Chatterjee, 1990; Lee & Lieberman, 2010; Yip, 1982), and thus the level of relatedness that makes an acquisition more appropriate for a new entry remains inconclusive. Research on joint venture as a mode of entry has also addressed the case of entry into low related industries. Taking an asymmetry of information perspective, it has been suggested that a firm is likely to have difficulty in assessing the resources of a low related acquisition target and thus may over value it and pay too much for the acquisition. As such, a firm that enters a low related industry might be better off opting for a joint venture because it enables the firm to synergize with the target company without committing to a full acquisition (Balakrishnan & Kosa, 1993; Reuer & Koza, 2000). While such an approach may limit the initial entry costs, however, concerns have been raised regarding whether synergies are likely to be realized between joint venture partners from less related industries (Garcia-Casarejos, Alcalde-Fradejas & Espitia-Escuer, 2009; Koh & Venkatraman, 1991). Thus, joint venture research is also inconclusive on the level of relatedness that makes joint ventures an appropriate mode of entry.

Further complicating the picture are insights indicating that experience in an entry mode matters. On the whole, research in acquisition and joint venture experience suggests that from experience firms might develop special capabilities that enable them to become more or less effective at acquiring or joint venturing with other firms (Barkema & Schijven, 2008). Given this, then experience in an entry mode might alter the level of relatedness that could make an acquisition or a joint venture the most appropriate mode of entry when carrying out a given move.

Our purpose in this research is to contribute to the clarification of these issues surrounding acquisitions and joint ventures as modes of entry through an examination focused around two inter-related questions. First, *what is the level of relatedness at which acquisitions and joint ventures, respectively, are likely to work best?* And second, *how does experience in the corresponding mode of entry affect the level of relatedness that could make acquisitions or joint ventures a more appropriate mode of entry?* Overall, our study contributes to the body of knowledge in mode of entry because we find that it is at middle levels of relatedness between a firm's current activities and a given new entry that is likely to make acquisitions and joint ventures appropriate modes of entry. Our findings indicate that when firms have low experience in the chosen entry mode, acquisitions are a more appropriate mode of entry than joint ventures.

THEORY AND HYPOTHESES

As reviewed above, it has been argued that acquisitions are likely to be an appropriate mode of entry when a firm goes into an industry which has resource requirements that are different from the resource base that it already possesses. However, the purchase of the assets needed to compete in an unrelated industry could bring severe complexities for the firm. When a firm tries to acquire a target company whose resources are highly different from its own, the acquisition target is likely to enjoy an information advantage concerning its resources' real potential for value creation (Balakishnan & Koza, 1993). Given its information advantage, an unrelated acquisition target can opportunistically misrepresent the value of its assets and thus the acquiring firm could end up over paying for the acquired resources and might never get real benefits from the acquisition (Balakishnan & Koza, 1993; Reuer & Koza, 2000). Overall, this line of reasoning suggests that a firm may be unlikely to see an acquisition as the most appropriate mode to enter a low related industry.

In contrast to acquisitions pursued to enter low related industries, acquisitions employed to enter middle related industries could face less complexities. When a firm uses an acquisition to enter an industry that is medially related to its current activities it is not trying to acquire all of the necessary resources for the industry. That is, the firm is likely to already possess some key resources that are fungible in that other industry, but lack some other critical resources needed to successfully compete there. Given some degree of resource similarity between the acquiring firm and its target, the acquiring firm is therefore likely to more accurately evaluate the target's resources potential for value creation and avoid overpaying for the acquisition (Balakishnan & Koza, 1993). A synthesis of the above arguments suggests the following hypothesis.

Hypothesis 1. Acquisitions are a more appropriate mode of entry at middle rather than at high or low levels of relatedness between a firm's current activities and a new entry

Even though acquisitions may work best at middle levels of relatedness between a firm´s current activities and a new entry, this does not rule out the possibility that joint ventures could also be an appropriate mode of entry at such level of relatedness. Balakrishnan and Koza (1993) argue that, because of the valuation problem, a joint venture is likely to be a more appropriate solution than an acquisition for entering into low related industries. However, concerns have been raised as to whether resources from unrelated domains can actually be combined to create synergies (Kho & Venkatraman, 1991; Garcia-Casarejos et al., 2009). Thus, firms that use joint ventures to enter low related industries might not face the valuation problem associated with an acquisition but may find it difficult to generate significant value from the partnership. Unlike firms that use joint ventures to enter low related industries, firms that use them to enter middle related industries may therefore be more likely to actually realize synergies. The previous arguments suggest the following hypothesis.

Hypothesis 2. Joint ventures are a more appropriate mode of entry at middle rather than at high or low levels of relatedness between a firm's current activities and those of its venture partner

Experience in the corresponding diversification mode, however, could make a difference in the relative effectiveness of both entry modes. In the case of acquisitions, the primary challenges are valuation of the acquisition target and the integration of the acquisition into the acquiring firm. Skills in each of these areas are likely to be improved with experience in the acquisition process (Barkema & Schijven, 2008). Haleblian and Finkelstein (1999) suggest that low and high experience firms are likely to perform well in dissimilar (non-related) acquisitions. This is so because inexperienced firms cannot wrongly generalize prior experiences to new acquisitions that differ from prior ones, while highly experienced firms already possess enough expertise to avoid generalizing prior experiences to settings where they are just not appropriate. If both low and high experience firms can effectively deal with dissimilar targets, then both types of firms could actually find that acquisitions are an effective mode of entry at middle rather than high or low levels of relatedness (Haleblian and Finkelstein, 1999, 2002).

In the case of joint ventures, however, it is possible that only high joint venture experience firms could find that joint ventures are effective at middle levels of relatedness. Joint ventures differ from acquisitions in the important regard that they entail the ongoing management of a relationship with an independent company. The management of the relationship with the venture partner is critical for a firm to realize the collaborative objectives of the venture (Park & Russo, 2006). Firms need experience for, over time, developing a capability to become effective at designing governance mechanisms to deal with their venture partners (Anand & Khana, 2000), and thus be more likely to synergize with them (Schreiner, Kale & Cortesen, 2009). Given that each of these challenges is likely to be exacerbated the less related are the joint venture partners and the resources that are trying to be combined, highly experienced firms may be better at using joint ventures to enter middle related industries effectively, while low experienced firms might not do so because they lack abilities to deal with a variety of differently related joint venture partners. Taken together, the previous arguments suggest the following hypothesis.

Hypothesis 3. Under conditions of low experience, acquisitions are more appropriate than joint ventures to enter middle related industries.

METHODS

Sample

In this study, an acquisition and a joint venture announcement, as reported by the SDC Platinum database, is the unit of analysis. Due to data limitations only those acquisitions and those joint venture deals involving two partnering firms announced during the years 2000 to 2003 were included in the sample. Moreover, only those acquisition deals in which the acquiring company is a U.S. based manufacturing company, and those joint venture deals in which at least one of the partners is a U.S. manufacturing company (SIC codes 2011-3999) were taken into account. Sampling U.S. based public firms ensures data availability on stock market reactions to a firm's acquisition or joint venture announcements. Sampling manufacturing firms controls, in some respect, for type of business and focuses attention on an economic sector that experiences strong incentives to undertake acquisitions and joint ventures. The acquisitions sample consisted of 462 observation and the joint ventures ones of 214.

Variables operationalization

Dependent and independent variables. *Appropriateness of a mode of entry (dependent)*. A mode of entry is deemed as appropriate when it maximizes the cumulative abnormal returns that firms experience in the stock market as a consequence of the announcement of a given acquisition or joint venture. To calculate a firm's cumulative abnormal returns we use the method described by Brown and Warner (1985) with a window of three days. *Acquisition and joint venture partner relatedness (independent)***.** Relatedness between an acquiring and a target firm, and between two joint venture partners is measured by adopting the approach used by Merchant and Schendel (2000), and Porrini (2004). This approach consists in identifying and counting the number of SIC codes that the firms in an acquisition or a joint venture deal have in common at the four-digit SIC level and then dividing this number by the total number of four-digit SIC codes that both companies cover in total.

Moderating and control variables. *Acquisition and joint venture experience (moderating)*. These variables are calculated by counting the number of prior acquisitions or joint ventures that a firm announced during the five years prior to the announcement of the focal deal. *Control variables*. Year and industry-adjusted firm profitability were controlled for in all analyses. Because in this study acquisitions and joint ventures are analyzed separately, we employed a different set of controls in each case. Method of payment, acquisition attitude, type of target, and acquirer's leverage were controlled for in the acquisitions analysis. Joint venture ownership configuration, type of joint venture, joint venture experience between specific partners, and joint venture partner's experience were controlled for in the joint ventures analysis.

ANALYSIS AND RESULTS

Panel data analysis techniques were employed to test the previously presented hypotheses. Based on the results of the Hausman test (acquisitions' $\chi^2 = 6.2$, $p > 0.10$; joint ventures' $\chi^2 = 11.59$, $p > 0.10$), Generalized Least Squares (GLS) random effects regression analyses were used. A

Swamy-Arora adjustment, as derived in Baltagi and Chang (1994), was implemented because this study's data consist of two small and unbalanced panels.

Hypothesis 1 suggests that acquisitions are a more appropriate mode of entry at middle rather than at high or low levels of relatedness between a firm's current activities and a new entry. A regression test for this hypothesis includes acquisition relatedness linear and quadratic terms in addition to control variables. The test indicates that the acquisition relatedness linear term is positive, and the quadratic term is negative, thus indicating a significant inverted curvilinear effect of acquisition relatedness on cumulative abnormal returns. The regression model fits the data adequately ($\chi^2 = 20.87$, $p < 0.05$), and so it supports hypothesis 1.

Hypothesis 2 predicts that joint ventures are a more appropriate mode of entry at middle rather than at high or low levels of relatedness. A regression test for this hypothesis includes joint venture partner relatedness linear and quadratic terms in addition to control variables. The test indicates that the joint venture partner relatedness linear term is positive and the quadratic term is negative, thus indicating a significant inverted curvilinear effect of joint venture partner relatedness on cumulative abnormal returns. Because the regression model fits the data reasonably well ($\chi^2 = 15.36$, $p < 0.10$), it supports hypothesis 2.

Hypothesis 3 predicts that when experience in a mode of entry is low, acquisitions are a more appropriate mode to enter middle related industries than joint ventures. Two regression tests that include interaction terms in addition to linear and quadratic main relatedness effects, and a linear experience term were run to verify this hypothesis. The first test indicates that the interaction term formed by the acquisition relatedness and acquisition experience linear terms is only marginally significant ($p < 0.10$). While the inflection point may be lower for low relatedness firms, the curvilinear effect of acquisition relatedness on cumulative abnormal returns is still present (See Figure 1). Regarding joint ventures, the regression test indicates that the interaction term formed by the joint venture partner relatedness and the joint venture experience linear terms is significant ($p < 0.05$). In this case, the curvilinear effect of joint venture partner relatedness on cumulative abnormal returns goes away for those firms with low levels of joint venture experience and returns continually decrease as the level of relatedness decreases (See Figure 2). If experience does not moderate the effects of relatedness on cumulative abnormal returns for acquisitions, but it does so in the case of joint ventures, then Hypothesis 3 is supported.

FIGURE 1 - Acquisitions: The effects of relatedness on cumulative abnormal returns at different levels of experience

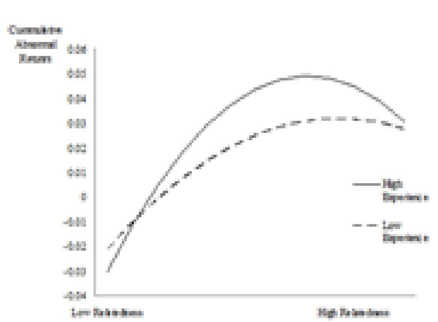
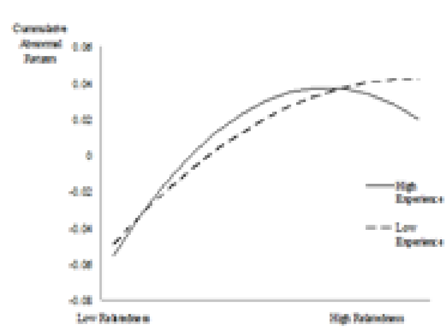


FIGURE 2 - Joint Ventures: The effects of relatedness on cumulative abnormal returns at different levels of experience



DISCUSSION

Empirical findings have not always supported the view that acquisitions and joint ventures are appropriate to enter low related industries and have raised questions regarding whether acquisition or joint venture was a more appropriate entry mode at a particular level of relatedness. The current research thus set out to provide insights into the mixed findings by exploring the possibility that both acquisitions and joint ventures would be most appropriate for entry at middle levels of relatedness. Hypotheses 1 and 2 predict these effects and both of them were supported.

Though the specific benefits and challenges of each entry mode vary, the general notion appears to be that the benefits of gaining access to the resources and capabilities of others are best captured when there is not too much but not too little relatedness. That is, when the diversification is into an area that is very related, there may not be enough gain relative to the firm developing any necessary resources or capabilities on its own to make up for the various issues inevitable in either acquiring another firm or setting up and operating a joint venture. When the diversification is into an area that is to little related, however, the firm may have difficulty in benefiting from the combined resources and capabilities and/or may not be able to identify or correctly value acquisition targets or joint venture partners. For both acquisitions and joint ventures, then, the general conclusion is that they are most appropriate for entry at a middle level of relatedness, with benefits decreasing in a curvilinear fashion for higher or lower levels of relatedness.

Further insight into this general conclusion is gained, however, when the notion of prior experience in the entry mode is included in the argument. As reflected in the support for Hypotheses 3, consideration of experience does not change the relationship between relatedness and entry for acquisitions but does change the relationship between relatedness and entry through joint venture. Thus, entry through acquisition appears to be most appropriate at middle levels of relatedness regardless of previous experience with acquisitions. In the case of joint ventures, however, the curvilinear relationship with relatedness holds only for firms with higher levels of previous experience in joint ventures. For those firms with little or no previous experience, joint ventures appear best suited for entry only at high levels of relatedness, with the benefits continually decreasing as relatedness decreases. Exactly why this is the case will require further study.

Caution, of course, should be taken before going too far in generalizing the results of any single study. While the results presented here show a consistent pattern, they do not establish causation or directly compare entry through acquisition to entry through joint venture for the same diversification action. That said, additional study of both acquisitions and joint ventures as an entry mode for diversification are warranted and encouraged.

REFERENCES

“References are available upon request from Daniel A. Cernas Ortiz, dacernaso@uaemex.mx”