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Resource-oriented acquisition strategies and the effects on the corporate value

Achim Korten
Queichheimer Hauptstr. 57
76829 Landau, Germany
Phone: +49 (0) 6341/950600
Fax: +49 (0) 6341/950602
E-mail: achim.korten@t-online.de

Abstract

The Globalization of the economy is one reason for the increasing number of Mergers & Acquisitions. This tendency can be seen on a national as well on an international level, especially between the TOP 500 companies of the United States and of Europe. Although these companies have experienced managers on a high level, company reports and studies of consulting companies show that these forms of alliance face major problems during their realization. In some cases even a revocation takes place, leading to high costs and image problems.

Taking the long-term development of the corporate value as one possible motivator for a merger or an acquisition, the question can be asked whether acquisitions accelerate the growth of the company and with this the increase of the corporate value. The influence factors for an acquisition decision as well as the analysis of its effects include a broad variety of hard and soft facts. Such a complex decision situation should be simulated and analyzed with System Dynamics. This paper will give a general overview of the perspective taken and the assumptions made in the basic model.

The invisible value of a company

Since the beginning of the 80's two basic strategic streams have developed. Porter initialized the Market-based View which puts the creation of competitive advantage based on the Five Forces in the center of strategic decisions (Porter, 1980). Wernerfelt reintroduced the approach of Penrose to academic discussion where the focus is set on a company's resources as source of sustained competitive advantage (Penrose, 1959 and Wernerfelt, 1980). Understanding strategy as "the match an organization makes between its internal resources and skills ... and the opportunities and risks created by its external environment" (Hofer and Schendel, 1978, p. 12), both perspectives on management have to be taken into account at the formulation of the corporate strategy.

As a measure of how good the company strengthens and exploits its competitive advantages and the related sources, the development of the corporate value can be taken. In this project it is defined as the sum of shareholder value, resources and competencies. To justify this approach of measurement, the following table shows some examples of different companies and its market capitalization.

Company	Market Value	Value of assets	Turnover	Intangible Value
DaimlerChrysler	78.316	70.448	149.985	7.868
Deutsche Telekom	214.650	81.983	35.470	132.667
SAP	54.985	1.524	5.110	53.461

Table 1: Examples for the intangible value of companies
as on 31st December 1999 (in million Euro)

In this table, the intangible value is defined as the difference between the market value and the value of the assets. It shows that the “invisible part” of these companies is differently valued. What might be the sources of this intangible value ? Industry and its perspectives, company-specific factors like brands, patents, image ? The answer to this question will differ from company to company. Nonetheless it illustrates that the market value exceeds the value of the assets.

In the following figure the relation between resources and strategy is illustrated. Five stages allow the identification of the gap between the resources required for the intended strategy and the existing resources (Grant, 1991).

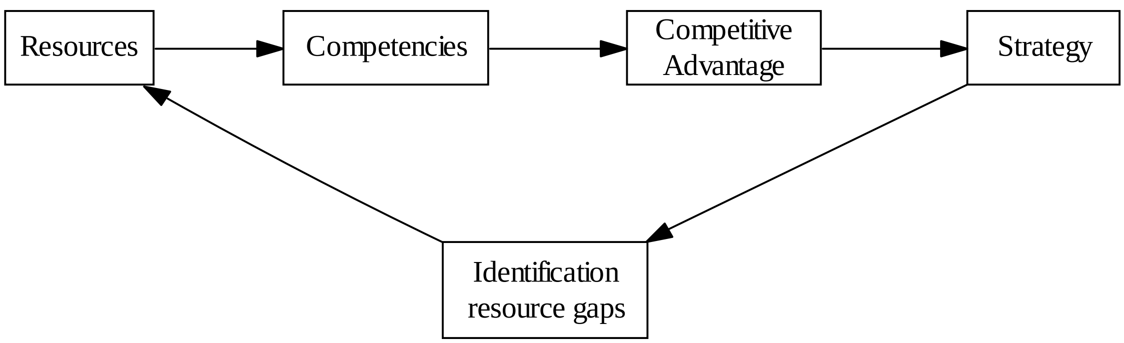

Figure 1: Resource-based strategy formulation

Resources are identified and classified. Competencies represent the capacity to deploy resources for processes, products or services (Amit and Shoemaker, 1993). Competitive advantage results from the advantages a company has regarding resources and competencies in comparison to its competitors (Porter, 1987). Strategies should be the best fit between existing resources, competencies and the competitive advantage. Resource gaps have to be identified and filled if a strategy can not be realized or does not lead to the expected results (Grant, 1991).

Closing resource gaps requires time and financial engagement. The higher the competitive advantage is, the higher the achievable rents are. Assuming that higher rents lead to higher financial resources, the closing of identified resource gaps is lightened from the monetary perspective.

Self-strengthening Structure of Resources

Based on the characteristics of returns generated by resources two different groups can be distinguished: resources like land, capital and labor follow the law of decreasing returns whereas invisible assets like knowledge and information lead to increasing returns to scale (Roos et al., 1998 and Wernerfelt, 1984). To build up and use knowledge and information about processes, products and services, at least capital and labor are required. The degree of mixture of the different resource types determine the return to scale of the resources.

Since the beginning of the 90's a theory has grown focusing on the analysis of the sources of a company's invisible value. Following the maxim "what you can measure, you can manage, and what you want to manage, you have to measure" (Roos et al., 1998) the concept of intellectual capital aims at the formulation of measurement methods for the "invisible value" of a company. Understanding the dynamics among the different types of resources as well as creating a system of their measurement gives way to an improved management of the resources. Also the resource allocation within the company can be optimized in accordance with the strategy.

Roos et al. define the intellectual capital of a company as "the sum of knowledge of its members and the practical translation of this knowledge, that is brands, trademarks and processes." (Roos et al., 1998, p. 27). A distinction is made into structural capital and human capital of a company. Structural capital is generally owned by the company and consists of the customer and organizational capital, covering the internal and the external relationships of it. Human capital results from the knowledge, the attitude and the intellectual agility of employees (Skandia, 1996).

Disposing the resources to act on a market is not sufficient to generate any flow of capital. Processes, products and services are the result of the capability to deploy the intellectual capital. As a such competencies become part of the value of a corporation. To evaluate the competence position in comparison to the competitors, a judgement of their competencies is required. One indication is how fast the competitors can react on changing or new opportunities. Sustained competitive advantage develops from being better in adopting to changing or new opportunities (Ghemawat, 1986).

Competitive advantage improves the market position as long as the advantages lead to superior products or services. The customer must perceive this in the end product in terms of e. g. price, quality or cost-benefit relation (Prahalad and Hamel, 1990). Assuming that a growing market-share leads to an increasing turnover, the generated cash-flow can be expected to increase, too. This changes the financial resources of the company and enables to further strengthen the resource settings and competencies.

Limits to exponential growth of resources

Resources can be extended in two ways: internally or externally. In the sense of accounting financial resources are distinguished in equity and liabilities. Limits on this level result on the one hand from financing rules, on the other hand from the perception (potential) investors have of the future perspective of the company. With divestments the disposable financial resources might also be increased (Porter, 1987). They represent a regrouping of capital allocation within the corporation.

Internal development of intellectual capital is intended through research and development or training. From a monetary perspective the measurement of the activities can easily be implemented. Regarding the level of existing intellectual capital within a company the measurement becomes more difficult. Explicit knowledge is generally codified in written form. Tacit knowledge which is inside the individual lacks a documentation. One solution to integrate this into the measurement might be to measure the activities motivating individuals to share their knowledge with other members of the organization by transferring it to explicit knowledge. Growing explicit knowledge creates further tacit knowledge. (Nonaka, 1991 calls it the knowledge-creating spiral.)

One approach for the external extension of knowledge might be by acquiring intellectual capital. This might be e. g. in form of a key person, patent or company possessing the required intellectual capital. Basic condition for the purchase of intellectual capital is the existence of a market for it. On strategic factor markets resources are bought and sold which are required for the implementation of a strategy (Hirshleifer, 1992).

Returns generated from a resource and the price for it depend on the expectations of the market participants about the future value of the resource (Barney, 1986). If all participants would have the same expectations, the market would be a perfect market and the price would equal the future value of the resource. Commonly the expectations are not the same. This leads to a difference between the price and the future value of the resource. A company underestimating the future value of a resource will ask a selling price inferior to its estimated future value. Companies having more accurate expectations, e. g. due to better information about or experience in exploiting this kind of resource, have the chance to obtain above normal returns with the resource as they can buy it at a price lower then its value. In the case a company overestimates the future value of a resource, the prize to be paid will be above the future value. Disposing more accurate expectations, a company will not be willing to pay more then the future value of the resource. Otherwise economic losses would be inevitable (Barney, 1986 and Porter, 1987).

Supporting strategy formulation

Supposed a continuous flow of capital in structural and human capital. Having identified a gap between the required and the existing resources, the relation between the flows of capital in structural and human capital might be modified. Also a supplemental, extraordinary flow might be appropriate to accelerate the closing of the gap between the required and the existing resource level.

Resources as a source of sustained competitive advantage determine the strategic options of a company. A gap between existing and required resources to realize a desired strategy force the management to rethink the flow of capital into the different resource types. Considering the corporate value as the sum of shareholder value, resources and competencies, the effects of resource-oriented strategy formulation become more visible.

First simulation analysis show that in the long-term the company value is mainly based on the value of the assets. If the level of Intellectual Capital is maximized, further investments in its increase cannot further increase the company value. They just support the keeping of the attained level. Further details and results of the analysis will be presented at the 2000 System Dynamics Conference in Bergen, Norway.

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