2 Fundamentals

Business combinations are a topic in different scientific disciplines. Primarily they are considered by scholars in economics, strategic management, organization theory, capital market theory and law, but also in psychology and sociology (see e.g., Jansen, 1998, 28). There is a great terminological variety and definitions are often not used in a consistent manner. This is especially true for the literature on joint ventures and alliances (Eisele, 1995, 9). In order to meaningfully compare results of empirical research it is necessary to derive a clear delimitation and classification of these terms and a clear definition of the generic term business combination.

2.1 Definition of business combination

In the market economy one of the essential features of a firm is its self-determination (Gutenberg, 1983, 457). Self-determination here means economic autonomy, that is, the right of a firm to make its decisions independently within the scope of the law.

In a market economy, individual economic entities interact by means of markets, and economic processes are coordinated by market mechanisms. Simple market contacts and market contracts are typical relationships between firms (see, e.g., Bausch, 2003, 18). The actions of firms are interdependent; they try to anticipate the actions of the other market participants when making their own decisions. In simple market contacts, e.g., spot transactions, interdependent actions are not made jointly, i.e., they are reactively and/or anticipatively made; the coordinating medium here is the market information.

When firms coordinate and combine actions and associated resources that were formerly planned and realized separately, they internalize their dependant actions in the area of their co-operation; accordingly, decisions are jointly taken in the area of co-operation. At the same time the economic autonomy of at least one of the two firms will be restricted.

The following definition is thus used in this study: A *business combination* is the conjunction of economic activities of two or more firms in defined product and/or market areas and value-adding activities. These conjunct—either coordinated or joint—activities must be based on a sustained relationship between the firms involved. This definition is broad enough to include the various types of business combinations; its constitutive features are the collective field of activity and the network of sustained relations (Bausch, 2003, 19). Intrafirm co-operative mechanisms are excluded with this definition.

The term *business combination* can be understood as a status, representing the features of the business combination; used thusly, the term relates to the content and the form of the interfirm

interaction. The term can also refer to the transaction process; in this sense the term represents the steps towards the institutionalization of the combination. A process-oriented definition would be: In a business combination, two or more firms coalesce or intensify their business associations with the result that the economic autonomy of at least one of the involved firms will be restricted or eliminated (Pausenberger, 1989, 623); this means that any business combination implies a certain restriction of decision-making autonomy.

In a business combination, companies bind themselves legally and organizationally. They become legally dependent through contracts and/or by holding interests in other firms. The organizational dependence comes from personnel and hierarchical ties, for example, directly through the interaction of employees of the firms involved, or indirectly through common institutions (Bausch, 2003, 19).

2.2 Types of business combinations

In the literature one can find various criteria for the systematization of business combinations, e.g., economic and legal autonomy, degree of institutionalization, degree of interorganizational dependence, duration, and degree of relatedness (horizontal, vertical, conglomerate), and their effect on competition. As every business combination involves a change in the economic autonomy of the firms involved, this will be used in the following as a starting point for the derivation of different types of business combinations. The classifications according to the degree of relatedness and the degree of interorganizational dependence are also relevant for the research question of this study and are presented afterwards.

Mergers and acquisitions are business combinations in which the economic autonomy of at least one of the involved firms is completely eliminated; in figure 2 they are summarized under the term “business unifications.” In an acquisition, the acquiring company takes control of the existing resources of the acquired company through an exchange of stock, payment of cash or other property, or the issue of debt instruments. The acquired company loses its economic autonomy, but may keep its legal one. An acquisition may relate to an economically independent company as a whole or to economically independent or dependant subsidiaries or parts of a firm (see Bausch, 2003, 22).

In a merger, on the other hand, at least one of the involved firms will usually lose both economic and legal autonomy. There are basically two types of mergers: in the first case, a formerly autonomous company may transfer its assets to the partner and is integrated into the partner company, whereby it looses its economic and legal autonomy; a second possibility is when the two companies form a new organizational entity to which the assets of both partners are transferred; after the transfer of assets, both companies cease to exist (e.g., Lucks and Meckl, 2002, 23). In the English-language literature, these various forms are typically

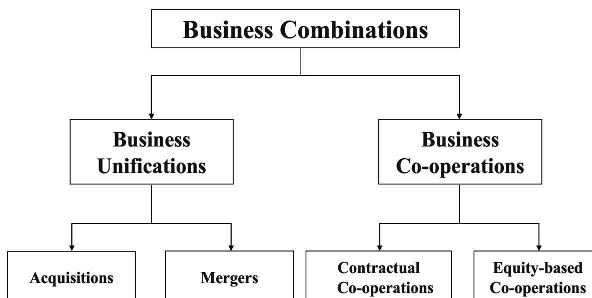
summarized under the term *mergers and acquisitions* (M&As) without any further distinction; the author will follow this approach in this work. From the viewpoint of management, the important feature of mergers and acquisitions is that they allow the influence of corporate policy; in order to substantially do so, a simple majority holding of the targets' equity with the according voting rights (> 50%) is typically seen as necessary (Bausch, 2003, 23).

Business combinations with restricted economic autonomy consist of business co-operations, sometimes also referred to as co-operative agreements, alliances, interorganizational or interfirm co-operations, collaborative arrangements, co-operative business ventures, and co-operative organizational relationships; in the following, these terms are used interchangeably. Autonomy is restricted since the parent firms have joint control over the field of co-operation; at the same time, the economic and legal autonomy of the parent firms remains intact outside the field of the co-operation. Co-operative arrangements are commonly distinguished in equity-based and non-equity-based co-operations, often also referred to as equity joint ventures and contractual or non-equity joint ventures (e.g., Harrigan, 1985; Geringer, 1991). In an equity joint venture, a separate legal entity is created in which two or more parent companies hold significant shares in order to have active management control.[3]

Contractual co-operations do not involve the creation of a separate legal entity, but are formal long-term agreements between partners to cooperate in some way (Glaister and Buckley, 1999).[4] A contractual co-operation has a "relational contract," which focuses on the characteristics of the relations between the partner firms and regulates the joint control; most of the time there is not one relational contract, but rather a variety of single contracts regulating the interactions between the partners (see, e.g., Bausch, 2003, 292ff).

Following is an overview of the different types of business combinations:

Figure 2: Types of business combinations



Source: author

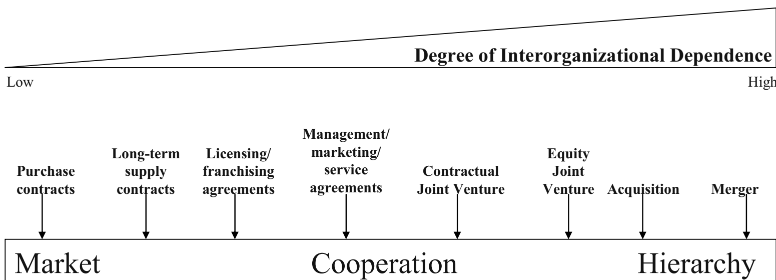
[3] Similar definitions are used by Geringer, 1988; Kabst, 2000.

[4] Many scholars do not distinguish between equity and non-equity joint ventures; some use the term joint venture only if a new corporate entity is formed (Harrigan, 1985; Hermann, 1988; Pfeffer and Nowak 1976), while others use the term as a synonym for nearly all forms of interfirm co-operations (Weder, 1989; Hall, 1984; Zentes, 1992).

Business combinations can further be classified according to their degree of relatedness: horizontal, vertical, or conglomerate. In a horizontal business combination, two or more firms in the same line of business combine their activities. A vertical business combination involves firms at different stages of production; a company may cooperate with a supplier of raw materials or, on the other end of the production stage, with a distributor. A conglomerate business combination involves companies in unrelated lines of business.

Finally, the different forms of business combination are often classified into a continuum between more market-oriented and more hierarchy-oriented mechanisms. In the following figure, selected forms of business combination are classified according to this market-hierarchy continuum:

Figure 3: Forms of business combinations along the market-hierarchy-continuum



Source: modelled after Berg et al., 1982, 10-11 and Contractor and Lorange, 1988, 6

The market is one way to organize economic activities, the central coordinating mechanism being the price; market relations are cursory and competitive. In contrast, hierarchy uses authority as a coordinating mechanism; such hierarchical relationships are principally long-term in orientation. Alliances are hybrid organizational forms and contain both market elements and hierarchical elements (see Friese, 1998, 67). A market feature of alliances is the independence of the firms and a hierarchical feature is the mutual interaction and control (see Rath, 1990, 26). Between the two extremes of spot transactions and complete merger lie several types of co-operative arrangements; these arrangements differ in the form used to compensate each partner (legal form) as well as in the strategic impact on the global operations of each partner (Contractor and Lorange, 1988, 5). The table above ranks the different forms of co-operative agreements in order of increasing interorganizational dependence — which generally, but not necessarily, correlates with strategic impact (Pfeffer and Nowak, 1976).

A co-operative agreement is thus characterized by a lower intensity of commitment and a lower degree of integration as compared to mergers and acquisitions. In alliances, partners need to coordinate and negotiate with each other. Acquisitions, as compared to alliances, are

typically characterized by a higher initial investment and a higher level of uncertainty and risk through the go-it-alone strategy.

Chapters three and four of this study consider hierarchical forms (M&As) and hybrid organizational forms (alliances), respectively, in further detail.

2.3 Business combinations from a perspective of corporate growth

Growth is a means for achieving greater value added and is essential for the survival of a firm in the long term (Canals, 2000, 2); corporate growth is thus an important topic for managers and a basic consideration in corporate strategy. It can be achieved through a variety of different and complementary forms: corporate renewal, innovation, product development, mergers and acquisitions. In general, it is not possible to say that one growth path is superior to another. Corporate growth is firm-specific and depends upon each firm's history and innovations and other variables, e.g., the industry in which a company is operating or its competitors.

There are different typologies of growth in the literature. Hax and Majluff (1991) differentiate between expansion within an existing business (three possible options: growth with the same products in the same markets, growth with the same products in new markets, and development of new products for the same markets) and diversification (two possible options: diversification to related businesses and diversification to new businesses). Gertz and Baptista (1995) focus on three levers for growth: that driven by a firm's present customers, that generated by improving a firm's economic structure, and that achieved by improving execution. Canals (2000) based his typology of growth on the source of the resources used (internal/external) and the external context (same business/different business). This combination offers four growth options: market penetration, resource deployment, market expansion, and shared diversification. The last two, in which external resources are used, can be achieved by mergers, acquisitions, and co-operative arrangements. Whereas in a market expansion, the geographical scope of the firm is increased and the business remains the same, in a shared diversification, growth in new businesses is achieved.

Bausch (2003) differentiates as well between internal and external resources, but uses control as further distinction criteria. According to his classification there are three basic growth options: internal growth, external growth and joint growth (see figure 4).

Figure 4: Growth options

Control / Source of Resources	Sole control	Split control
Own creation of resources	Internal growth	Joint growth (Merger/ Strategic co-operative arrangement)
Access to existing resources	External growth (Acquisition)	

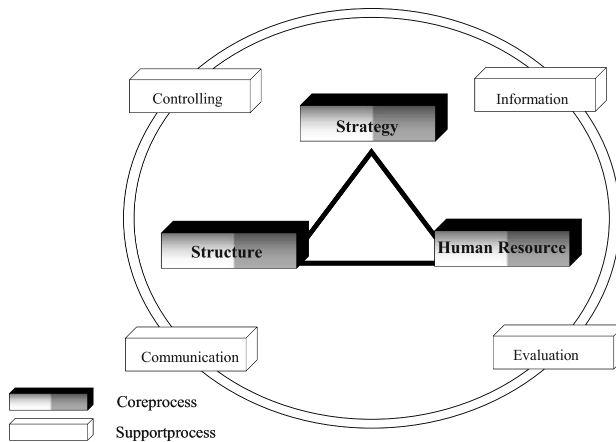
Source: modelled after Bausch, 2003, 29

Joint growth is viewed here as a combination of internal and external growth elements; it is similar to external growth because growth opportunities arise through the joining of the existing resources of the partner companies, but at the same time it is similar to internal growth because in co-operative ventures each of the partners has to continuously develop and use its own resources to achieve growth. Joint growth can be further distinguished by the control—the partner firms share in control over the use of resources; this clearly differentiates joint growth from external growth by acquisition, where only the acquiring company takes control over the resources.

2.4 Business combinations from a process perspective

The primary activities of a business combination can be summarized as strategy formation, structural design, and organization of the human resources; furthermore, information, evaluation, communication, and controlling are important secondary activities throughout the different phases of any transaction process (see figure 5).

Figure 5: Activities in the transaction process of business combinations



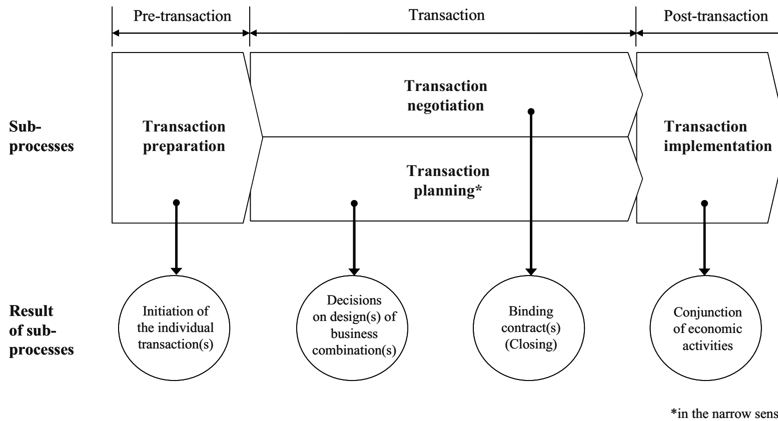
Source: modelled after Lucks and Meckl, 2002, 56

Activities belonging to the strategy domain are primarily found at the beginning of a transaction in the pre-transaction and transaction phases (see figure 6). Activities related to the structural design of a business combination occur primarily in the transaction phase and those belonging to human resources in the implementation phase.

Before describing the transaction process of a business combination it has to be noted here that no two transaction processes are the same. Further, process diagrams necessarily simplify the process that takes place in reality because process steps are depicted as occurring in a gradual, linear manner and a sequential workflow of the activities that have been assigned to specific phases is assumed. In reality, this is rarely the case; activities will occur in parallel and sometimes they may be skipped or done earlier. Thus the exact sequence of activities will depend upon the individual conditions of the transaction (see Bausch, 2003, 46).

In the following, the primary activities of a completed business combination are summarized into four sub-processes: transaction preparation, transaction planning, transaction negotiation, and transaction implementation (Bausch, 2003, 46). These sub-processes occur before, during, and after the transaction and are accordingly allocated to the following three phases: (1) the pre-transaction phase, (2) the transaction phase, and (3) the post-transaction phase (see figure 6).

Figure 6: The four sub-processes of a transaction



Source: Bausch, 2003, 47

(1) Pre-transaction phase

A precondition for a strategically intended transaction is a rationale that is directed towards the strategic needs of the relevant businesses. There are various reasons for a firm's strategic choice to grow through business combinations; these will be discussed in chapters three (for M&As) and four (for alliances). In the case of a planned transaction, a candidate screening including the search for and analysis of candidates, a preselection and prioritization of candidates, and finally, the selection of one or more candidates would follow. The pre-transaction phase ends either with the initiation of one or more projects or with the breakdown of the transaction process (Bausch, 2003, 47).

(2) Transaction phase

A transaction has to be planned and negotiated carefully; both the general project approach and the specific details of the transaction need to be carefully considered. Only the latter is counted in the literature towards the deal structuring or transaction planning (see Gomez and Weber, 1989, 71). Transaction planning contains all activities that anticipate future actions and the institutional conditions for these actions in the business combination. Transaction planning, in the narrow sense, can be divided into basic design and detailed design. This differentiation stresses the repetitive nature of the activities belonging to the design of a business combination and emphasizes that as the transaction process advances, more detailed considerations of the concrete design of a business combination can be made. Thus, in this narrow sense, the candidate screening is not part of transaction planning, but in a broader sense it can be subsumed under it (Bausch, 2003, 48).

The activities summarized under negotiation and contractual and legal designs are closely linked with the activities belonging to transaction planning. Typically they involve exploratory talks and transaction audits (due diligence) in order to reduce information asymmetries with regard to the target company or the transaction partners and in order to reach a consensus about the transaction. The contractual design of the business combinations and the legal procedure of the transaction phase (confidentiality agreement, non-disclosure agreement, and letter of intent) accompany these activities. At the end of this phase is the "closing," the execution of the planned legal activities according to the contract. In the case of an acquisition, this might include the change of ownership, transfer of assets, payment of acquisition price, etc. (see Holzapfel and Pöllath, 1994, 17ff.).

(3) Post-transaction phase

A transaction has to be implemented; this is the post-transaction-phase or integration phase. After the closing of the transaction, the coordinated or joint activities in the defined product and/or market areas and value adding activities must be realized. The specific measures that have to be taken depend on the type of business combination; the realization of a transaction may also require organizational, legal, administrative, personal, and cultural integration measures. Finally, at a certain point, the implementation of the transaction passes into the routine management of the corresponding area of the business combination.

2.5 Business combinations and success

A general definition of success is the degree of goal achievement (Bierich, 1988, 43). A goal is defined as a planned position or result to be achieved (Richards, 1978); in order to judge the success of a business combination, it must first be clear whose goals are to be followed, and second, what these goals are specifically.

From a standard microeconomics perspective, the main goal of the firm has traditionally been seen in profit maximization (Douma and Schreuder, 2002, 27). It can be shown that under the premise of profit maximization factors of production are used to produce goods and services in such a way that the difference between input and output is greatest. A profit-maximizing firm contributes to an optimal allocation of scarce resources (Teece, 1982, 40). In this form, the (owner-) entrepreneur is the goal-defining instance, and success here equates with profit.

This sole focus on profit as the main goal of the firm has often been criticized; in particular, scholars of the behavioral theory of the firm view the firm as a coalition of groups of participants, each with their own objectives (March and Simon, 1958). These participants, or stakeholders, are owners, creditors, employees, suppliers, customers, governmental bodies, local communities, and the public at a large; sometimes even competitors are considered stakeholders (Philips, 2004, 2). The stakeholder concept postulates that businesses can benefit

significantly from cooperating with stakeholder groups and states that a firm can only survive if its managers incorporate the needs of its stakeholders in the decision-making process; however, the goals of these various groups are not necessarily the same and may be contradictory; furthermore, advocates of the stakeholder theory fail to specify *how* managers should make the necessary tradeoffs among these competing interests (Jensen, 2001). An equal consideration of all stakeholder interests is hardly possible, and in the case of multiple goals, the measurement of success is also problematic. The simultaneous attainment of a satisfactory degree of goal achievement for all stakeholders is thus scarcely possible; a combination of the various goals would therefore have to be weighted, but such a weighing can only be arbitrary; an objective measurement of success is thus not possible.

Typically, studies investigating the performance or the success of a firm thus take the perspective of its shareholders.[5] The claims of all other stakeholders are defined by contracts; shareholders are seen as residual claimants of any surplus profits remaining after expenses to other participants have been paid.

In general, those with the decision-making authority should logically be the ones to receive any resulting residual payments—in directing business policy they bear the risks; if no profits are achieved, they walk away empty-handed or with a loss. Which group actually holds the decision-making authority depends on the type of the corporate governance code and further corporate rules that are based upon national law. In Western industrial nations, the decision-making authority as well as the right to residual payments rests primarily with the owners of a firm;[6] they to a large extent bear the economic risk that is connected with their investments and provide the resources for a firm's activity, and thus should be entitled to dispose over surplus profits (Franke and Hax, 1999, 3ff.).

The firm is thus primarily an instrument with which to pursue the objectives of its shareholders; one must accordingly look at what the goals of the shareholders of a firm are. Shareholders want to maximize their wealth and thus these residual payments; they expect managers and those others influencing corporate actions to make decisions that will result in the maximization of the firm's value and, hence, of the shareholders' wealth (see Prahalad and Oosterveld, 1999, 31ff.). Success from the shareholder's perspective has to be interpreted in terms of value creation or destruction for a company's shareholders; investment in a business combination should accordingly create value for its shareholders.

This perspective of a firm's primary objective and measurement of success is in line with the shareholder value approach (Rappaport, 1986), according to which, managers' primary responsibility is to maximize shareholder value. Behind this conviction is the belief that in a

[5] Shareholders are defined here as owners of one or more shares of stock in a corporation (e.g., Barron's Educational Services); a company's shareholders collectively own that company. As the focus of this thesis lies on stock-listed corporations, I will primarily use the term shareholders in the remainder of the thesis.

[6] In large German corporations employees are frequently represented in the controlling body, but in general the decision-making authority lies with the shareholders (see Franke and Hax, 1999, 4).

globalized world with liberalized financial markets only those firms that put the interests of investors at the center of their corporate policy will survive in such a competitive environment. The shareholder value approach recognizes that:

> "to continue to serve all stakeholders, companies must be competitive if they are to survive [and that] a company's long-term destiny depends on a financial relationship with each stakeholder that has an interest in the company. To satisfy these claims management must generate cash by operating its businesses efficiently." (Rappaport, 1998, 7)

Thus a firm that creates value confers benefits not only on its shareholders, but on all stakeholders. Likewise, all stakeholders are vulnerable when management fails to create shareholder value; therefore, firms must consistently focus on value-based management and strive to realize a rate of return higher than capital costs (e.g., Pape, 2000, 711; Dufey and Hommel, 1997, 185).

The shareholder value approach requires that all decision processes within a firm be directed towards the goal of increasing the value of the firm for its shareholders. The various time and risk preferences of shareholders can be operationalized through the requirement of maximizing the present value of the shareholders' income (Franke and Hax, 1999, 157ff.); for stock-listed companies, this equals today's value of all future payments that can be expected from the security.

In the case of an efficient capital market, the present value of future payments equals the market value of the shares. The claim of maximizing the market value is thus in the interest of shareholders (e.g., Steiner and Uhlir, 2001, 112ff.).

If we thus treat a business combination as an act of investment, it then has to be concluded that from an economic point of view it is only reasonable to carry out a business combination when the outcome is a higher market value for the firm than would be the case without the business combination; hence, shareholder value creation as measured by the increase of a firm's market value is the benchmark in this study against which the success of any business combination will be judged (see also Bausch, 2003, 88).

2.6 Relevant theories for business combinations

In the following section, those theories[7] that are relevant for understanding business combinations and which provide valuable connections to the research question of this study are described in their basics. The meta-analysis on value creation in alliances (chapter 4) then largely makes reference to these. Specific motive theories for mergers and acquisitions, which

[7] Here the word "theory" is used in the sense of a system of self-consistent hypotheses.

essentially tell us why M&As take place, will be illustrated separately in chapter 3.[8] The empirical investigation in chapter 5 is based on hypotheses that are derived from theories or hypotheses laid out in all prior chapters.

Market-based view

The market-based view of the firm has its origins in the industrial organization (IO) literature and the structure-conduct-performance paradigm (SCP paradigm) which was developed in the 1950s and 1960s by Mason and Bain. The SCP paradigm assumes that the industry structure determines the conduct of the market participants; the joint conduct of the firms in turn influences the collective performance of the firms in the marketplace (Bain, 1968; Mason, 1964). Bain further assumes that the conduct of the market participants only reflects the competitive situation and is therefore not central to the performance of firms. Thus we could ignore conduct and directly analyze the industry structure in order to explain performance; thereby entry barriers, number and size distribution of firms, product differentiation, and overall elasticity of demand become the primary elements of industry structure that are important to performance (Bain, 1956, 1968).

Early work in the field of strategic management has also focused on industry characteristics as the main explanation for differences in the profitability of firms (e.g., Caves and Porter, 1977; Porter, 1979). As opposed to the resource-based view (see Barney, 1986), which focuses on the resources inside the firm, this perspective looks outside the firm and focuses on the market in which it competes, and is therefore referred to as the market-based view (MBV). The MBV assumes that the success of a firm is solely determined by the competitive situation of a firm's external product markets.

The outside-in perspective on management is characteristic of the MBV; according to this perspective, every strategy occurs through the observation of the external environment of the firm. Beginning with customer needs and competitor behavior, companies develop their strategy plan. Thus the main task of management is to first correctly evaluate the firm's environment, and second, to position the firm in attractive industries. Porter writes with respect to resources that they "are not valuable in and of themselves, but because they allow firms to perform activities that create advantages in particular markets" (1991, 108); their value can be influenced by market changes. The MBV makes two basic assumptions regarding resources: they are homogeneous and they are mobile. Representatives of the MBV thus acknowledge the importance of resources for the success of a firm, but state that they should not be the starting point of a new strategy, rather their development should be based on market needs (De Wit and Meyer, 2004, 250ff.).

[8] The motive theories can be individual hypotheses and must not necessarily be self-contained theories.

According to the MBV, a firm's relative performance can be explained by its sources of market power, which are primarily the following three industry characteristics: barriers to entry, monopoly power, and bargaining power (see Grant, 1991). Porter (1980) elaborated on this by introducing a five-force framework, which includes threats of new entrants and product and service substitutes (overcoming barriers to entry), the rivalry of competition, and the bargaining power of suppliers and buyers. These forces shape what firms can charge for their products, the cost of inputs, and the investment required for the maintenance of competitive activity. With the five-forces model, Porter developed a useful analytical tool in strategic management that makes it possible to determine the level of competition in an industry and an industry's potential for profit; he assumes that the strength of the five forces is dependant on the industry and can be influenced by strategy. For Porter, the success of a firm is not only dependant upon the structure of the industry a firm is doing business in, but also on the strategic actions of the firm itself; in order to achieve a competitive advantage it is therefore also important to consider the positioning of the firm inside the industry and not only industry attractiveness (Porter, 1991, 610ff.). Both industry attractiveness and the relative competitive position of a firm have to be viewed in a dynamic context—the attractiveness of an industry can change over time and at the same time the competitive position has to be permanently defended. Porter names three generic competitive strategies for achieving competitive advantage: cost leadership, differentiation, and niche focus. When pursuing a cost leadership strategy, a firm "must find and exploit all sources of cost advantage [and] sell a standard, no-frills product" (Porter, 1985, 13); cost advantages may, for example, be realized through learning curve effects and economies of scale. Horizontal business combinations, in particular, seem suited to a strategy of cost leadership: the expansion of production capacities can lead to economies of scale and at the same time the intensity of competition can possibly be lowered through consolidation, agreements, or collusion. Differentiation by a firm from its competitors can be achieved "when [a firm] provides something unique that is valuable to buyers beyond simply offering a low price" (Porter, 1985, 13). Business combinations may provide firms an opportunity to acquire, merger, or ally with another profitable, differentiated firm and to implement a differentiation strategy (see Wirtz, 2003, 37). Porter views the cost leadership strategy and the differentiation as mutually exclusive. Focus means that a firm is not serving an entire market, but is focused on a single market segment; when following a niche strategy, a firm may use cost leadership or differentiation, but it is essential that the firm is better than its competitors in this segment in order to be successful.

Despite the focus on the external environment, Porter recognized that what goes on inside the firm matters and introduced a value chain analysis that categorizes the generic value-adding activities of an organization; he differentiates between primary activities (inbound logistics, operations, outbound logistics, sales and marketing, and service) and support activities (firm infrastructure, human resource management, technology development, and procurement)

(Porter, 1985, 36). The value chain evolved into a more complex tool, acknowledging that firms do not produce or innovate in isolation and that inter-firm linkages such as immediate suppliers and the dependency of different industries needed to be incorporated into a strategic framework (Porter, 1985, 50ff.). A value chain analysis enhances a MBV framework by expanding the range of factors a firm ought to consider when formulating a value strategy; this includes mapping of the system to capture the current and future pressure points on the firm and looking beyond firm-specific issues to encompass immediate and peripheral inter-firm networks; in order to make use of this framework effectively, firms have to draw on capabilities to collect and analyze information related to each factor.

The business combination itself, as well as the design of the business combination, is part of the strategic conduct within the framework of the SCP paradigm that is chosen in order to benefit economically from acting in attractive industries and from achieving an improved competitive position. The main explanations for business combinations with respect to the market-based view are: business combinations allow new markets to be quickly entered and can help to overcome entry barriers. Secondly, with strategically intended business combinations, firms try to bring together the fundamental drivers of competitive advantage. This convergence on the conditions for success can be seen as overcoming mobility barriers as firms try to become part of a specific strategic group or form themselves into a strategic group, allowing them to earn above-average rents. Finally, the combination of businesses can possibly set new standards that may significantly change the relative position of competing firms, i.e., firms can build market entry and mobility barriers for their own protection by means of business combinations (Bausch, 2003, 113–114).

Researchers in the field of industrial organization economics provide useful explanations for possible strategic advantages that might be achieved with business combinations with respect to drivers of competitive advantage and barriers. The discussion of economic reasons for why higher market shares lead to higher profitability has been at the center of a debate led by Bain and scholars of the Chicago School—in particular Stigler, among others, under the title "collusion versus efficiency" (see Bain, 1950, 35ff.; Stigler, 1950, 23-24). The monopoly hypothesis (or monopoly theory) and the efficiency hypothesis (or efficiency theory),[9] which provide different explanations for the formation of business combinations, are part of the context of this debate (see Conner, 1991, 125; Stigler, 1968, 39ff.); both hypotheses are described in detail in the following chapter.

[9] In the M&A literature, these hypotheses are also referred to as monopoly theory and efficiency theory although they are not necessarily individual theories (as the author of this work understands it) but rather individual hypotheses (see Trautwein, 1990, 284ff.).

Resource-based view

Contrary to the market-based view of the firm and the structure-conduct-performance paradigm, the resource-based view that emerged in the 1980s takes an internal perspective: the resources-conduct-performance paradigm. In looking at competitive advantage, the RBV focuses on a firm's specific resources and capabilities (see, e.g., Wernerfelt, 1984; Barney, 1986; Prahalad and Hamel, 1990). The theory is based on two assumptions: that the resource profiles of firms are heterogeneous and that not all resources are perfectly transferable between firms (Barney, 1991). The RBV postulates that the performance of a firm is not only dependent on industry structures, as suggested by the market-based view, but also on differences in the resource profiles of firms. The company with the resources most suitable for its strategy will succeed (Collis and Montgomery, 1995). In order to create a sustained competitive advantage, resources need to be valuable, rare, imperfectly imitable, and impossible to substitute (Dyer and Singh, 1998). Barney (1991) focuses on the achievement of sustainable competitive advantage; other authors (e.g., Eisenhardt and Martin, 2000) suggest that sustainable competitive advantage does not exist in a dynamic, rapidly changing environment; competitive advantage can only be achieved because of the ability of companies to continuously adapt to the environment; this is referred to as dynamic capability and could be defined as processes that firms use to alter their resource base.

Applied to business combinations, the RBV suggests that resources may motivate and direct external growth (Hitt et al., 1998). Firms that want to achieve above-average returns but do not possess the necessary resources can gain access to the corresponding unique resources via acquisitions and alliances. Firms with specific types of resources may use business combinations for an efficient deployment of their resources; through business combinations, firms may try to exploit excess resources and quasi-public resources in order to achieve economies of scale and scope; they may further try to transfer and commonly use complementary resources and competences and jointly build up and develop resources and combine their knowledge. Firms could also use existing competences from the target or partner firm and try to internalize them (e.g., Bausch, 2003, 121–122).

Organizational knowledge and learning

Organizational learning theory is closely linked with the resource-based view inasmuch as firms try to learn in order to create unique resources. Superior knowledge is one of the main factors for the improvement of the competitive position of a firm (Hamel, 1991; Mowery et al., 1996). Cohen and Levinthal (1990) state that a firm's need to learn is defined as "the amount of new knowledge to be acquired from a target firm in a particular strategic combination context for the purposes of building new firm capabilities, or facilitating the exploitation of existing firm capabilities." A key factor thereby is absorptive capacity, which

is defined as a firm's ability to recognize the value of new knowledge and then assimilate and apply it in a business setting (Barringer and Harrison, 2000).

Learning theory assumes that organizations form business combinations to capitalize on opportunities for organizational learning. The goal is to absorb as much knowledge as possible from the partner/target to thus increase organizational competencies and to ultimately add value to the organization. Through business combinations firms try in particular to obtain tacit organizational knowledge embedded in other firms, even though the transfer of such knowledge is difficult, as it is part of organizational routines, skills, and culture (Nelson and Winter, 1982).

Resource dependence theory

Resource dependence theory can also be seen as a major research stream within the resource-based view, as it broaches the issue of resource dependencies between inter-organizational operating companies.

Building on Emerson's (1962) formulation of power-dependence relations, as developed by Pfeffer & Salancik (1978, 2003), this framework recognizes that organizations must exchange resources to survive, but that these exchanges, if imbalanced, may give rise to power differences. Resource dependence scholars stress that managers must take steps to manage not only their structures but also their environments, reducing dependencies and seeking adequate power advantages. Firms thus will respond to demands made by external actors or organizations upon whose resources they are heavily dependent and will try to minimize that dependence when possible (Pfeffer, 1982).

From the viewpoint of the resource dependence theory, business combinations are carried out to reduce uncertainty or to assure the existence of the organization, by securing the inflow of resources that are necessary for a firm's survival in the long-term. Thus M&As and alliances provide a means to reduce the chances of future resource shortages.

Agency theory

Agency theory postulates that human behavior is self-interested, risk-averse, and subject to bounded rationality; the theory considers the relationship between a principle and an agent, who ideally looks after the principal's interests and makes decisions on its behalf. The agent, however, is frequently guided by its own self-interests and often has more specific information than the principle does about the context it is acting in; the principal, however, can reduce the information asymmetry by spending more money on information, as information is a purchasable commodity; agency theory thus tries to identify governance

mechanisms, such as controls and incentives, that prevent agents from following their self-serving behavior (Eisenhardt, 1989).

As for business combinations, three types of agency relations are relevant. First, in the case of an acquisition it can be assumed that the target has significant information advantages with respect to its own situation. In the case of mergers or alliances, mutual agency relationships exist, as each firm is better informed about its own situation than is the other party. In the case of separate management and ownership of a company, another agency relationship exists between the owners or shareholders respectively and the managers. It can be assumed that managers have information advantages as compared to shareholders due to their ongoing oversight of day-to-day business. Thus in the context of business combinations, optimization problems with respect to the contractual design of mergers, acquisition, and alliance agreements, as well as employment contracts between shareholder and managers, are particularly relevant (see Wirtz, 2003, 29).

Basically an agent can make use of three different types of asymmetric information that can lead to adverse selection and moral hazard (e.g., Baye, 2003, 444). Adverse selection (principal systematically selects bad quality in the case of information asymmetry) may arise from hidden characteristics—characteristics that are known by the agent but not by the principal. Moral hazard (agents uses action alternatives opportunistically and benefits at the expense of the principal) may occur when the agent takes hidden actions—actions that cannot be observed by the principal. Furthermore, when a principal is making a specialized investment, the agent may attempt to capitalize on the sunk nature of the investment by engaging in opportunism (the hold-up problem); the agent has an information advantage with respect to his own attitude and willingness to perform, thus how he may want to react to the investment made in advance by the principal. The service or performance the agent then performs is therefore dependent on his will formation and may be either fair or opportunistic.

Agency theory provides two solutions for the danger of adverse selection through hidden information: signaling and screening. The agent, as the better informed party, may use signaling in order to convince the principal of its qualitative characteristics; for example, managers may signal their quality by means of job references or by a willingness to agree to highly performance-related compensation. Screening can be used to reduce information asymmetry; the principle may, for example, use assessment centers to ensure the quality of managers before hiring them, or a company may reduce the information advantage of the other party by collecting external information on the partner or target from credit and rating agencies, by researching prior public releases and annual statements, and most importantly in the case of M&As, by verifying the financial situation of the target in the course of the due diligence process.

To deal with the problem of moral hazard, agency theory recommends the institution of information and control systems for monitoring the agent or else the introduction of incentive

schemes in order to align the goals of principals and agents (see e.g., Bea and Haas, 2001, 374). In the case of merger agreements, for example, there could be penalties for opportunistic actions taken after signing of the contract; managers might be disciplined by a compensation scheme that is oriented towards long-term company value or by sufficient control through bodies such as the board of directors.

To counteract the hold-up problem—something particularly relevant for alliances—it has been proposed that an interdependent relationship with the partner be established; Spremann suggests securing influence over the usage of the relevant strategic resources in the alliance (1989, 744).

Agency costs resulting from inefficiencies occur when the principal lacks complete information about its agent; agency costs are thus deadweight losses caused by information asymmetry and its resulting problems. According to Jensen and Meckling (1976), agency cost consists of costs the principal incurs for monitoring and screening activities, signaling costs from agents, and a remaining residual loss.

Agency theory explains how information asymmetries can lead to business combinations; it also points out potential problems in business combinations and proposes solutions for reducing information asymmetries between the parties involved, thus laying the foundation for a successful transaction.

Transaction cost economics

Transaction cost theory, in brief, focuses on how an organization should organize its exchange activities to minimize the sum of its production and transaction costs. The production costs of organizations vary as a result of the scale of their operations, learning and experience effects, location advantages, and proprietary influences such as patents. Transaction costs also vary and are incurred "in arranging, managing, and monitoring transactions across markets, such as the costs of negotiation, drawing up contracts, managing the necessary logistics, and monitoring the accounts receivable" (Child and Faulkner, 1998, 20). Opportunistic behavior of trading partners, bounded rationality, small-number bargaining, and information impactedness can all lead to increased transaction costs (Williamson, 1985).

Williamson (1975, 1985) identified markets and hierarchies as the two modes of organizing (in 1991, he also acknowledged the role of interorganizational forms), with market transactions generating governance costs and hierarchies bureaucratic costs (1979, 1985)—the assumption being that the most efficient alternative will be chosen. Williamson identified three relevant criteria for choosing between internal transactions and market exchanges. The first, asset specificity, refers to the extent to which "an asset cannot be redeployed to alternative uses and by alternative users without sacrifice of productive value" (1991, 281):

the higher the share of specific assets in a firm, the more likely transactions will be organized within the hierarchy. The second, frequency of transaction, says that the costs within a hierarchy will be lower than those of a market transaction with increased frequency of transaction. The third criterion, uncertainty, refers here to the likelihood of opportunistic behavior of the parties involved in a transaction: the higher the degree of behavioral uncertainty, the more likely it is that the transaction will be internalized.

Williamson ascertains the most efficient form of coordination on the basis of transaction frequency and asset specificity (at a given level of uncertainty). Asset specificity is widely seen as the dominating determinant of transaction costs (see Williamson, 1985, 52ff; Kogut, 1989, 320). Hierarchy is the most efficient coordination form when there is high asset specificity and when the costs of internalization can be amortized with a sufficient number of transactions; in the case of medium asset specificity, alliances are the most efficient form of coordination; for transactions with low asset specificity, coordination via markets is seen as most efficient.

Transaction cost theory says that business combinations are efficient if the sum of production and transaction costs is lower than in market transactions. The rationale according to transaction cost economics for entering an alliance or completely integrating an external company into the hierarchy of the firm is that this saves governance costs, reduces uncertainty, and leads to economies of scale. Hierarchy costs are assumed to be smaller than coordination costs in markets.

Summary on relevant theories

The MBV and RBV both follow the strategic management research approach, which tries to identify factors in a firm's strategies leading to steady returns and to explain the varying degrees of long-term success of companies (see Rühli, 1994, 33). Transaction cost theory and principal agent theory belong to the field of economics, particularly new institutional economics, which tries to identify the reasons why some firms earn above-average returns. In general, the RBV, the MBV, and transaction cost theory are rather decision-oriented explanatory approaches that offer clear decision-making support about when (or in which direction) to do a business combination. The subject of principal agent theory, on the other hand, is how to design business combinations. Table 1 summarizes the major rationales according to the individual theories discussed.

Table 1: Rationales for business combinations according to the major theories

Theory	Rationales for business combinations
Market-based view	❖ Business combinations allow rapid entrance to new markets and can help to overcome and to build entry and mobility barriers. ❖ Horizontal business combinations provide for economies of scale and therewith realization of the cost leadership strategy. ❖ Business combinations provide an opportunity to acquire, merge, or ally with other profitable, differentiated firms and to implement the differentiation strategy.
Resource-based view	❖ Business combinations allow access to and the transfer of necessary resources which a firm itself does not possess. ❖ Via business combinations firms may try to exploit excess and quasi-public resources in order to achieve economies of scale and scope. ❖ Via business combinations firms may try to transfer and commonly use complementary resources and expertise and try to jointly build up and develop resources and combine knowledge. ❖ Via business combinations firms can access existing expertise from the target or partner firm and try to internalize it.
Theory of organizational knowledge and learning*	❖ Business combinations can be used to obtain organizational knowledge, especially tacit organizational knowledge, embedded in other firms and to capitalize on opportunities to acquire particular new skills to thus increase organizational competencies.
Resource dependence theory*	❖ Business combinations are a means to secure the inflow of resources necessary for a firm's long-term survival.
Transaction cost economics	❖ Business combinations are efficient if the sum of production and transaction costs is lower than in market transactions.
Agency theory	❖ Business combinations may be a means to reduce information asymmetries and agency costs.

*closely linked to RBV