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ACQUISITION AS A MECHANISM OF MARKET EVOLUTION: AN EVOLUTIONARY PERSPECTIVE ON HOW ACQUISITION CREATES VALUE

Annetta Fortune

INTRODUCTION

Merger and acquisition activity generates a substantial amount of discussion within business circles among academics, analysts, and the media. Even though research and experience demonstrates that many mergers and acquisitions fall short of the intended goal of creating shareholder value, mergers and acquisitions still persist in the marketplace. The purpose of this discussion is to suggest that a potential explanation for this dilemma can be found by applying the resource-based rationale of acquisition within an evolutionary framework of business dynamics.

Business dynamics relates to the study of how business and firms change in the face of constraints. The lens of business dynamics emphasizes the role of acquisition as a vehicle of change. An evolutionary perspective highlights the impact of change over time and across levels of analysis, which suggests that we consider the cumulative impact of acquisition at multiple levels of analysis. Resource-based thinking provides a focal point for our discussion of change, firm level resources and capabilities, which illustrates the adaptive and selective impact of acquisition activity. The assumption of an evolutionary approach to acquisition from the perspective of firm level resources and capabilities establishes

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the foundation for a discussion of the adaptive and selective implications of acquisition across multiple levels of analysis. The presence of adaptive and selective implications occurring across multiple levels of analysis suggests that acquisition represents a mechanism of market evolution, which provides a potential explanation for the persistence of acquisition in light of a frequent inability to increase shareholder value at the firm level.

The contemporary state and recent history of the telecommunications industry makes this an ideal industry context to address the role of acquisition in business dynamics. Addressing the recent acquisition activity within the telecommunications industry from a resource-based perspective within an evolutionary framework highlights the adaptive use of acquisition to maintain competitiveness, as well as the capacity of acquisition to behave as a selective force that shapes the nature of the industry landscape. In particular, acquisition activity within the telecommunications industry represents a salient example of the contribution of acquisition activity to the evolution of an industry even in the absence of increased shareholder value.

BACKGROUND

The Evolutionary Perspective of Business Dynamics

Historically, the study of organizational change centers on the debate between organizational adaptation (Cyert & March, 1963; Levitt & March, 1988) and environmental selection (Hannan & Freeman, 1977, 1989). The organization adaptation perspective on change proposes that organizations are flexible and have the ability to change, or adapt, to their environments by altering routines or practices (Cyert & March, 1963; Levitt & March, 1988). Alternatively, the environmental selection perspective proposes that environmental forces drive change in the business landscape through the selection of organizations given that organizations are inert actors in the process of organizational change (Hannan & Freeman, 1977, 1989). The initial attempts at reconciling the competing camps purport that these perspectives are actually complementary (Singh, House & Tucker, 1986) and interdependent (Levinthal, 1991). However, evolutionary theory (Aldrich, 1999) advances and expands on the relationship between these two perspectives by incorporating the tenets of the adaptation and selection perspectives within a more powerful and generic theory of organizational evolution.

Evolutionary theory encompasses both the adaptation and selection perspectives by acknowledging the intentionality and the indeterminacy of change at the organizational level. Evolutionary theory purports that organizational evolution represents the aggregate effect of variation, selection, retention, struggle, and transformation, which occur across multiple levels of analysis (Aldrich, 1999). The emphasis on transformation acknowledges the presence of adaptation by recognizing the intentionality of firm action in the presence of indeterminacy. Highlighting the role of indeterminacy acknowledges the presence of selection given that this indeterminacy results from the inability of the firm to control, or foresee, the outcomes of change as a result of external forces. Furthermore, evolutionary theory emphasizes the presence of evolutionary forces across multiple levels of analysis, which integrates the firm level emphasis of adaptation with the environmental emphasis of selection into one framework. Hence, evolutionary theory provides a foundation for construing acquisition as a mechanism of market evolution based on the adaptive and selective implications of acquisition that occur across multiple levels of analysis.

The Resource-Based View of Acquisition

Taken together, the resource-based view and the capabilities perspective establish the value and importance of firm specific resources and capabilities. The resource-based view emphasizes the importance of unique, firm specific resources as contributors to competitive advantage (Barney, 1991; Penrose, 1959; Wernerfelt, 1984). The capabilities perspective (Richardson, 1972; Teece, Pisano & Shuen, 1997) extends a thread within resource-based thinking that dates back to the work of Penrose (1959) by adopting a focus on organizational processes and activities as contributors to competitive advantage. These perspectives also emphasize that path dependence and embeddedness are the key operative characteristics in the value, and resulting ability, of firm resources and capabilities to yield competitive advantage.

The resource-based rationale for acquisition follows from the value and key characteristics of firm resources and capabilities. The ability of firm specific resources and capabilities to contribute to competitive advantage makes them desirable. However, the path dependent and embedded nature of organizational resources and capabilities yields the conditions of market failure, which complicate obtaining these desired capabilities. Hence, the conditions of market failure necessitate acquisition as a vehicle to access the resources and capabilities resident in another firm.

The conditions of market failure arise due to the inability to separately identify and value a discrete asset apart from the context in which the asset resides. The path dependent and embedded nature of organizational resources and capabilities hampers the isolation and valuation of these firm specific characteristics apart from the context of the firm, which creates the conditions of market failure.

This situation is especially relevant for those resources and capabilities that are most likely to yield a competitive advantage as a result of the casual ambiguity and social complexity involved (Barney, 1991). As a result of the conditions of market failure that envelop organizational resources and capabilities, the discrete purchase of valuable organizational capabilities becomes exceedingly difficult. As a consequence of the difficulty associated with discrete purchase, the acquisition of an entire entity represents an important mode of access to obtain the value resident in the resources and capabilities of another firm.

ACQUISITION AS A MECHANISM OF MARKET EVOLUTION

Acquisition and Adaptation

An existing stream of literature within strategy empirically demonstrates the use of acquisition as a mode of access to the resources and capabilities resident within another firm (Capron, Dussauge & Mitchell, 1998; Capron & Mitchell, 1998; Granstrand & Sjolander, 1990). In particular, acquisition represents a tool for overcoming the internal inertial forces resulting from the constraints of existing routines (Capron & Mitchell, 1998; Capron, Mitchell & Swaminathan, 2001; Zollo & Singh, 2004), which contributes to the revitalization of the acquiring firm (Vermeulen & Barkema, 2001). Firms use acquisition both to build on an existing set of capabilities and to establish new sets of capabilities; however, firms tend to use acquisition to build on existing capabilities more frequently than firms use acquisition to establish new capabilities (Karim & Mitchell, 2000).

The use of acquisition as a vehicle to obtain organizational resources and capabilities possesses importance within the study of business dynamics because acquisition represents a way for businesses to change in the face of constraints. The capacity of acquisition to act as a vehicle for resource reconfiguration establishes the adaptive nature of acquisition from the standpoint of the firm and intra-firm levels of analysis given that adaptation represents a change in response to the environment (Levinthal, 1994). Acquisition is adaptive from the perspective of resources and capabilities because the acquisition of an entity preserves the context in which firm specific characteristics reside. The preservation of the firm context then in turn provides a preservation of the resources and capabilities embedded within the firm. Therefore, acquisition exemplifies a mechanism of adaptation at the intra-firm level, which maintains the existence of firm level resources and capabilities, albeit within another entity.

Acquisition also demonstrates adaptive implications at the firm level from the perspectives of both the target and the acquirer. In particular, the bilateral nature of resource reconfiguration in acquisition (Capron & Mitchell, 1998) indicates that the potential benefits of acquisition extend to the target firm in addition to the acquiring firm. Hence, the use of acquisition as an adaptive response at the resource and capability level generates adaptive results at the firm level where the unit character of the target survives and the acquirer transforms itself.

Similarly, the population or industry level of analysis also reflects the adaptive implications of acquisition. Given that the population or industry represents an aggregation of the member firms and their inherent resources and capabilities, the adaptive actions at the firm and resource level impact the composition and characteristics of the population and industry. Hence, the use of acquisition as a means of change also creates change at the population and industry level by impacting the constituencies that make up the whole. The adaptive implications of acquisition at the population or industry level would imply that the reconfiguration and recombination of resources and capabilities at lower levels of analysis would foster the continued existence and success of the industry or population as the environment changes. Hence, the use of acquisition as a means of change contributes to the discussion of acquisition as a mechanism of market evolution given the adaptive implications of acquisition across the intra-firm, firm, population, and industry levels of analysis.

Acquisition and Selection

A consideration of the impact of acquisition activity on an aggregate scale reveals that acquisition also acts as a force of environmental selection. Selection occurs as market, competitive, institutional, or other environmental forces select, or selectively eliminate, certain variations within the landscape (Aldrich, 1999). An examination of the options facing struggling firms highlights the capacity of acquisition to selectively eliminate certain resources and capabilities. Specifically, a struggling firm is a firm that lacks viability as an independent entity. Since struggling firms are no longer viable as independent entities, they generally face one of two possible outcomes: acquisition or dissolution. Acquisition acts as a force of selective elimination from a resource-based perspective given that the dissolution of an un-acquired struggling firm destroys firm specific resources and capabilities. Granted dissolution releases human and capital resources held within the firm to be used elsewhere in the business environment, but dissolution eliminates those resources and capabilities that are idiosyncratically embedded within the context of the firm, by destroying the firm as a coherent whole (Mitchell, 1994). Hence, acquisition acts as a mechanism that actually de-selects the firm specific resources and capabilities of struggling firms that are not acquired.

On the other side of the coin, acquisition acts as a force that selects certain resources and capabilities to be retained within the business landscape. Acquisition preserves some degree of the idiosyncratic firm specific characteristics following a resource-based perspective of acquisition, as well as resource-based empirical findings regarding acquisition. Given that the resources and capabilities of a target firm continue to survive in the business landscape to some extent, acquisition acts as a vehicle that fosters the maintenance of particular resources and capabilities within the business landscape. Hence, acquisition acts as a selective force through the selection of certain resources and capabilities, and the selective elimination of others.

As a result of the embeddedness of firm resources and capabilities within a firm, the selective implications of acquisition at the resource and capability level create similar results at the firm level. The embeddedness of resources and capabilities within the context of a specific firm contributes to their value by augmenting casual ambiguity, social complexity, as well as rarity (Barney, 1991). The depth of this embeddedness also transfers resource and capability level implications up to the firm level. Specifically, the selective implications of acquisitions at the resource and capability level create similar implications at the firm level because the embeddedness of resources and capabilities joins the fate of the firm to the fate of its resources and capabilities.

The selective implications of acquisition also exist at the population and industry levels of analysis. Since the existing member firms characterize the population or industry as a result of consistent selection criteria (Aldrich, 1999), the selective implications of acquisition at the population and industry levels reflect the cumulative impact of the selection via acquisition that occurs at the firm and resource level. Furthermore, the cumulative impact of this acquisition activity can also result in the selection and selectively elimination groups or populations of firms over time. Hence, at the population and industry levels of analysis acquisition represents a concerted selective force that shapes the nature of industries and populations through the cumulative impact on firms and groups of firms.

A CASE EXAMPLE: THE TELECOMMUNICATIONS INDUSTRY

The deregulation and liberalization of the telecommunications industry that began in the 1980s transformed the landscape of this industry from one of stability with few opportunities for acquisition, to one in flux with a high incidence of acquisition activity (Le Blanc & Shelanski, 2002). By the 1990s acquisitions in the telecommunications industry represented a salient feature of the industry, and garnered substantial attention in the business press. From 1990 to 1995, the telecommunications industry led all U.S. industries in acquisition activity with deals totaling approximately $110 billion (Capron & Mitchell, 1997). The acquisition fever continued through the end of the 1990s into the new millennium as more than 20 acquisitions with a total deal value exceeding $20 billion occurred from 1996–2001 (Le Blanc & Shelanski, 2002). The high incidence of acquisition activity and the escalating deal values demonstrate the relevance of acquisition as a force shaping the telecommunications industry.

The combination of deregulation, globalization, and technological advances within the telecommunications industry yielded a competitive environment that has firms racing to stake out market share. Specifically, the competitive environment within telecommunications provides strong incentives for firms to offer multi-service, worldwide solutions (Goldman, Gotts & Piaskoski, 2003; Le Blanc & Shelanski, 2002). Acquisition represents a key strategic tool in a firm's efforts to obtain the requisite resources and capabilities since acquisition provides a faster means of entry as opposed to in-house or collaborative development of resources and capabilities (Mitchell, Shaver & Yeung, 1994). Within the telecommunications industry in particular, acquisitions provide a means of expanding networks and services (Capron & Mitchell, 1997), as well as a means of capturing innovativeness, while avoiding the substantial capital investment and time required to construct and implement these resources and capabilities (Goldman et al., 2003).

The use of acquisition as a means to expand service and innovative capabilities within telecommunications reveals that the telecommunication industry represents a context where the resource-based rationale for acquisition applies. Furthermore, the use of acquisition as a means to obtain the resources and capabilities within other firms also demonstrates that acquisition represents an adaptive response for firms striving to enhance performance and survival within a changing industry environment. Given the degree of upheaval and uncertainty created by technological advances and deregulation within the telecommunications industry, the persistence in acquisition activity represents the efforts of firms to adapt and survive by scrambling to transform and augment resources and capabilities.

Prior to the deregulation of the telecommunications industry, the regulations represented the most salient environmental force affecting industry participants. In the era of deregulation, acquisition activity emerged as an important environmental force in the re-shaping of the telecommunications industry. Whereas deregulation attempted to create a competitive environment populated by many viable competitors, acquisition activity represents a consolidating environmental force that is contracting the numbers of industry participants and potential competitors (Villano, 2004). In acting as a consolidating force, acquisition shapes the nature and configuration of resources, capabilities, and firms present within the industry landscape through the selection and selective elimination of features.

The consolidation of the Regional Bell Operating Companies (RBOC's) following the Telecommunications Reform Act of 1996 exemplifies the selection of a certain resource and capability configurations through acquisition. The breakup of AT&T resulted in the creation of seven RBOC's (Ameritech, Bell Atlantic, Bell South, Nynex, Pacific Telesis, Southwestern Bell, and U.S. West). The Telecommunications Reform Act of 1996 furthered deregulation and permitted acquisition activity among the RBOC's, which yielded the current landscape of four RBOC's or Incumbent Local Exchange Carriers (ILEC's): SBC Communications, Verizon, Qwest Communications, and BellSouth. (Sheldon, 2001). Hence, acquisition served as the force that shaped the nature of the RBOC/ILEC space in the absence of the environmental force of regulatory control.

Even when considering non-traditional telecommunications firms, acquisition represents a force that selectively favors certain resource and capability configurations. These non-traditional telecommunications firms provide service solutions to niche markets created by technological advances, which diverge from the space occupied by the RBOC's/ILEC's and their intended competition, the Competitive Local Exchange Companies (CLEC's). Firms providing specialty services (such as global mobility solutions and managed IP network services) continue to prosper through an industry downturn after the acquisition of firms possessing strong yet related resources and capabilities, which enhanced and deepened the resources and capabilities of the acquirer (Johnson, 2003). Hence, among non-traditional telecommunications firms, focus and depth appear to represent the favored configuration selected and maintained by the forces of acquisition as indicated by the post-acquisition survival and continued success of these firms.

The selective elimination of resources, capabilities, and firms by acquisition is evident by the plethora of struggling, yet non-acquired, telecommunications firms including CLEC's, ISP's, cable companies, long-haul and fiber network wholesalers, and long distance providers (Goldman et al., 2003). The de-selection of the resources and capabilities embedded within these firms is particularly salient given the unabated pace of acquisition activity within the industry. The high incidence of acquisition provides numerous opportunities for the valuable resources and capabilities of target firms to be maintained within the environment. However, in the case of struggling firms, acquisition represents one of the last chances for survival. By passing over the resources and capabilities of a struggling firm, acquisition seals the fate of firms that lack viability as independent entities by leaving these firms to their demise, which removes the firm, as well as its firm specific resources and capabilities, from the landscape.

ACQUISITION AND MARKET EVOLUTION: DELINEATING ADAPTATION AND SELECTION

The discussion of acquisition as a mechanism of market evolution provides the opportunity to engage resource-based thinking within a comprehensive discussion of business dynamics. Based on evolutionary theory, a comprehensive discussion of business dynamics or organizational change incorporates multiple levels of analysis and encompasses both the adaptation and selection perspectives on organizational change. Drawing from a resource-based perspective on acquisition, a focus on organizational resources and capabilities creates a crosswalk for tracing the adaptive and selective impact of acquisition across multiple levels of analysis, which enables this discussion to address business dynamics in a comprehensive manner. Furthermore, the ripple effect of acquisition across multiple levels of analysis demonstrates that acquisition has all of the faculties of a mechanism of market evolution.

Within the telecommunications industry, acquisition represents a salient force that is actively shaping the landscape of the industry. Acquisition represents an adaptive tool that incumbents repeatedly employ as a means to reconfigure their resources and capabilities in an effort to improve performance and survival chances. Acquisition also represents an environmental force that entered the void created by deregulation, and that now shapes the nature of the industry in the absence of the regulatory regime. Hence, the context of the telecommunications industry illustrates the contemporaneous existence of acquisition as a means of both adaptation and selection.

The treatment of acquisition as a mechanism of market evolution within the telecommunications industry also provides an opportunity to advance the discussion of business dynamics by addressing two factors that delineate the role of acquisition as adaptation from the role of acquisition as selection. First, the focal level of analysis distinguishes the adaptive implications of acquisition from the selective implications. At lower levels of analysis (i.e. the firm or intra-firm levels), acquisition is an indeterminant action undertaken by firms in an effort to improve performance and survival, which represents an attempt at adaptation (Levinthal, 1994). However, at higher levels of analysis (i.e. environmental, population, or industry levels), acquisition represents a force that selects and selectively eliminations features from the landscape, which often drives the members of a population toward a certain configuration (Aldrich, 1999).

When focusing on acquisition as it relates to the lower levels of analysis within the telecommunications industry, the use of acquisition to transform and reconfigure firm level resources and capabilities demonstrates the use of acquisition as adaptation at the firm and intra-firm levels. On the other hand, when focusing on populations of telecommunication firms or the telecommunications industry as a whole, acquisition represents a predominate force driving consolidation and reshaping the nature of the industry in the era of deregulation, which illustrates the capacity of acquisition to function as an environmental level force. Acquisition became an important adaptive response at the firm level, as well as an important selective force at the environmental level, when deregulation eliminated the key environmental force shaping telecommunications and created a competitive condition for industry participants.

Second, the determination of the adaptive and selective implications of acquisition also hinges on the time horizon under consideration. Given the indeterminacy of outcomes in the evolution of the market (Aldrich, 1999), in the short term only the adaptive implications of acquisition are palpable. The outcomes of environmental forces only become palpable over the long term with the capacity to employ hindsight. For example, I mentioned in an earlier section that acquisition favored depth and focus in the resources and capabilities of non-traditional telecommunications firms; however, this selective implication of acquisition only became evident after the passage of time allowed the retrospective examination of the fate of these firms. Hence, even though acquisition represents a force of market evolution via concurrent adaptive and selective implications, the identification of these implications is temporal with adaptive implications revealed in the short term and selective implications revealed over the long term.

CONCLUSION

An evolutionary perspective highlights the role of adaptive and selective forces that operate across multiple levels of analysis in the evolution of the market. A discussion of the adaptive and selective implications of acquisitions demonstrates the capacity of acquisition to function as a mechanism of market evolution. Establishing acquisition as a mechanism of market evolution is valuable because this perspective highlights the multilevel and temporal aspects involved in evaluating the impact of acquisition activity.

The existence of multilevel and temporal implications of acquisition provides an opportunity to reconcile the continued persistence of acquisition activity given the inability of acquisitions to create shareholder value at the firm level. First, acquisition may be creating value at other levels of analysis, which may not be reflected at the firm level of analysis. Specifically, the value created by acquisition may reside at a level of analysis above that of the firm. Second, the value created by acquisition may become evident over the long term as market evolution unfolds. Hence, the critique of acquisition based on the destruction of shareholder value, as in AOL-Time Warner, Vodafone-Mannesmann, and WorldCom-MCI (Hammonds, 2002) within telecommunications, should be revisited with the perspective of acquisition as a mechanism of market evolution whose value may reside at a different level of analysis, and may become more evident over time.

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