Ally or acquire?

Chapter 5

Beatrice Orlando

Inorganic growth: the costs and benefits of equity ownership in strategic partnerships

- Inorganic growth: equity and non-equity alliances; acquisition
- Alliances are based on contracts, but such contracts are incomplete. Hence, partners need to adapt to changing circumstances and other issues not specified in contract.
- Equity means acquiring stakes in other companies: when the stake exceeds the 25% more or less – according to country rule- than a right to veto is created. If the stake exceeds the 50%, than the control over the company is gained. Aquisition entails incorporation; thus, no more contracts are needed after that.

…

- Choosing the optimal governance structure is choosing the optimal level of equity and consolidation matter basing on accounting reasons for Country:
  - Non-equity: licensing; strategic supplier; joint R&D, manifacturing or ddistribution.
  - Equity: minor equity stake; cross-equity stake; joint venture; M&A.

The benefits of increasing equity ownership in strategic relationships

- Exclusivity:
  - Rivals are unlikely to create relationships with focal partners. Thus, full exclusivity can only be reached through ownership.
- Cooperation:
  - Equity ownership aligns the interests of the two partners, especially when intense modifications are required for sinergies’ benefits

…

- Coordination:
  - It is needed to meet the aims of the partnership. Greater equity ownership gives a firm the authority to implement more elaborate coordination mechanism. It allows also to keep under control governance costs of coordination.

The costs of increasing equity ownership in strategic relationships

- Lowered motivation:
  - Managers with stock options are less motivated, because they have to give up part of their rights. Furthermore, when acquired, they can be directed from the other company.
- Uncertainty and commitment:
  - Viewing stakes as real options provides insights into determining the optimal level of equity ownership in a stategic relationship. With a minor equity option, the company has the future right of acquiring the target later. Since options gains value with uncertainty, the less the equity stake, the better; and the converse.

…

- Cost of control:
  - It depends on the alternatives available to the potential collaborator. Hence, the cost of entry increases with the increase of the equity stake.
- Sinergies independent cost of integration:
  - With aquisition, all assets are being incorporated. However, not all of them are valuable for the firm. It is needed to disentagle valuable from non valuable ones: there’s a cost of restructuring. The larger is the company, the greater the effort.

The case of vertical integration

- The choice is between defining a contract with a supplier vs. acquiring it: the two partners have to make significant modification for customization, in order to gain benefits from the deal.