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Start-ups, incumbents, and the effects of takeover competition

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ABSTRACT

Recent acquisitions involving *Tumblr* and *Instagram* have demonstrated that the takeover of an unlisted start-up company can offer enormous financial benefits to its (former) stakeholders. Considering the multimillion-dollar amounts paid for start-ups with no existing and highly uncertain future revenues, we investigate the process and outcome of negotiation dynamics in the context of takeovers. In a series of experiments, we show that even with a low level of uncertainty about a start-up's value and its financial resources, start-ups can influence bidders' behavior and consequently the start-ups' valuation. The results indicate that incumbents' bidding behavior is driven by the perceived threat level with respect to the start-up's business activities as well as by the uncertainty with respect to other incumbents' bidding behavior—drivers that are subject to activities by the start-ups' management. Interestingly, the effect even exists if incumbents clearly know that initiating a bidding process will very likely lead to losses.

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1. Introduction

Especially in times of technological advancement (e.g., the rise of the Internet), a multitude of start-up companies are founded and enter the market every year (e.g., amounting to \$48 billion in venture capital investments in 2014; National Venture Capital Association, 2015). Previous research has shown that in times of such technological discontinuities entire industries may collectively fail to adequately adapt resulting in “collective inertia” (e.g., Abrahamson & Fombrun, 1994). Collective inertia is a potential result of different behavioral patterns in the face of discontinuous business models changes initiated by a new entrant. Surviving in competitive markets forces established companies to evaluate strategies to fight off companies entering their market (Homburg, Fürst, Ehrmann, & Scheinker, 2013). To protect or recapture its market share, an incumbent's natural reaction is to take over an entrant as particularly successful players are bound to incumbent inertia (Chandy & Tellis, 2000).

Since the 1990s, there has been substantial merger and acquisition (M&A) activity despite up- and downturns in the economic cycle. In the U.S. alone, for example, in 2013, there were nearly 10,000 M&As, with a total value of over \$950 billion (FactSet Research, 2014). In addition to M&As between large established firms, acquisitions of

Internet start-ups have also involved tremendous sums. Facebook's \$1 billion deal to take over *Instagram* and Yahoo's \$1.1 billion investment in *Tumblr* shows that firms are willing to pay extremely high prices for start-ups that are losing money and which face a high uncertainty with respect to their future revenues and profits.

In the existing literature, the dynamics of competition in corporate takeovers have received special attention. Despite the existing literature on M&As involving competing bidders (Betton, Eckbo, & Thorburn, 2008; Boone & Mulherin, 2007), alternative takeover strategies (e.g. Berkovitch & Khanna, 1991; Boone & Mulherin, 2009; Giammarino & Heinkel, 1986), and the outcomes of competitive bids (e.g. Aktas, de Bodt, & Roll, 2010; Giliberto & Varaiya, 1989), little is known about why and how negotiation dynamics influence takeover outcomes, particularly because merger negotiations always carry the risk that multiple incumbents enter an auction process for the target company (Aktas et al., 2010; Betton et al., 2008; Eckbo, 2009). Thus, it is unclear what effects “overshadowing” auctions' behavioral and market dynamics have on the evaluation of the target company, the competitive situation, the actual bidding behavior, and, ultimately, on the target company's price.

More recently, the determinants of takeover prices and the distribution of synergy gains between targets and bidders have been analyzed mostly based on available data of listed companies. It is often observed in the M&A market that targets with internal growth potential initiate acquisitions to address their financial constraints (Masulis & Simsir, 2013). Targets also prefer to set up an auction to maximize their premium through greater competition, however the gains distribution

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between targets and bidders depends on target size (Schlingemann & Wu, 2014). This result may depend on the entry decision of invited bidders.

With high uncertainty, targets should prefer auctions compared to negotiations (Gentry & Stroup, 2014). Even different bidder types, e.g., strategic or financial bidders (Gorbenko & Malenko, 2014) or private equity (Roosenboom, Fidrmuc, & Teunissen, 2009) lead to different valuations of targets. Summing up, auctions offered by targets with (severe) financial constraints are common among listed companies and may be even more common among unlisted start-ups due to a high valuation uncertainty. Unfortunately, this empirical data is not available because there are no disclosure requirements of unsuccessful bidders.

Considering that *Facebook*, *Google*, and *Yahoo* have all tried to acquire *Tumblr* in 2013, our study focuses on how unprofitable, unlisted start-ups can benefit from competition among incumbents. We address the question whether start-ups can implement a business model which deliberately forgoes sustainable profits in order to threaten incumbents' revenues by providing a disruptive service for free (or at very low cost).¹ The ultimate goal of this "born-to-be-sold strategy" is that the incumbent acquires the disruptive start-up.² We focus on the sustainability of this strategy and address two research questions: (i) How likely is it that a bidding process is initiated by one or more incumbents even though it is clearly irrational to bid for the start-up? (ii) If a bidding process for the start-up is initiated, we ask how bids evolve in the bidding process, if the number of actual bidders and the level of their bids are unknown?

Our research questions are embedded in a conceptual framework that is based on a two-stage takeover model that captures the process and the outcomes of negotiation dynamics in takeovers (Betton, Eckbo, & Thorburn, 2009). In order to rule out rational economic or strategic explanations for a corporate takeover, we designed a series of experiments with managers and MBA students that focus solely on the incumbents' competitive behavior. The results indicate that even in case start-ups (or their venture capitalists) do not interfere, uncertainty with respect to other incumbents' bidding behavior leads to suboptimal actions by bidders, resulting in higher prices.

Our findings contribute to the management and entrepreneurship literature because actual or assumed takeover competition has important ramifications. We show how market dynamics and assumptions about competitors' reactions influence incumbents' behavior in favor of corporate takeovers and provide an argument as to why even those companies that appear to lack a business model are being taken over. Considering that the mere competition between incumbents sufficient explains takeovers indicates the potential for investors to manipulate

¹ While the ultimate goal of viable start-ups is to generate profits, sales growth or more generally a growing customer base have seemed to be more desirable for many start-ups over the last ten years. In the end, however, the subsequent repeated losses will affect the valuation of a company. For example, the stock price of *Rocket Internet* declined by about 50% in 2015 due to "skepticism about the ability of its many subsidiaries to turn sales growth into profit" (McCrum, Jackson, & Vasagar, 2015).

² An anecdotal example of a start-up following a born-to-be-sold strategy is *Napster*. In 1999, music majors were hit hard by *Napster*, a small US-based company that enabled its users to globally exchange music files. *Napster* did not charge a fee for the service, or provide any advertising space. Thus, they operated without any obvious business model. Within weeks, millions of users adopted the free service and up- and downloaded hundreds of millions of (copyrighted) music files (RIAA 2000). The major music labels (including the *Bertelsmann Music Group*, *BMG*) identified the massive illegal file swapping as one of the main reasons for the sharp decline in music sales (Bhattacharjee et al., 2007) and, consequently, sued *Napster* in 2000. At the same time, *BMG's* mother company *Bertelsmann* displayed a vivid interest in acquiring *Napster*, the company that had produced only losses so far and had no viable business model. In interviews with managers of *Napster* and *Bertelsmann* (who wish to remain anonymous) about the business model, we were told that *Napster* and its investors never had the goal to establish a profitable business—they knew about the potential disruptive strategic relevance of the service (and its user base) to the music industry and expected the labels to buy the company off the market to protect their traditional business. Thus, *Napster's* investors followed a born-to-be-sold strategy.

the M&A process. In case a start-up additionally fuels the diffusion of noisy signals about its value, it mostly increases the likelihood of bidding as well as the levels of bids as other firms are lured into the auction. This herding behavior may lead to even greater competition and therefore increases the perceived threat level of the disruptive start-up. Hence, start-ups are likely to successfully execute their born-to-be-sold strategy.

2. Conceptual framework

Similar to the approach of Betton et al. (2009), we base our conceptual framework on a two-stage takeover model in which the first stage involves private negotiations of incumbents with a start-up, which might lead to an auction during the second stage. The conceptual framework outlines incumbent companies' options for reacting to the market entry of a disruptive start-up. The framework provides a guideline for our experimental design, as described in the next section.

Our primary assumptions are (i) a start-up with limited resources enters a market that has multiple incumbents; (ii) the start-up increases its customer base due to a superior value proposition (for example, a free service such as the one offered by *Instagram*); and (iii) it therefore attracts the attention of incumbents as they lose market share.

Such a simplified scenario captures the main features of many markets, particularly online markets. Given the effective and cost-efficient way for companies to innovate is to participate from user innovations (von Hippel, 1976), the optimal strategy for an entrant would be to take an intermediate position in the value chain between supply and demand, and to internalize network externalities which, in the digital business, are attached to small marginal costs. A perfect environment for such user-generated value is provided in the *Napster* example, where the start-up used peer-to-peer communities of interest: Those community-based innovations can be found "off-line" (Franke & Shah, 2003), but especially online (Lerner & Tirole, 2002; von Hippel & von Krogh, 2003). Hence, creating strong (online) communities does not only lead to ever new and inexpensive products, but also to cohesive in-group identification and a clear demarcation to other products brands (Armstrong & Hagel, 1996; Muniz & O'Guinn, 2001). Consequently, offering attractive user-generated content that is provided within a community of peers for free ultimately induces a self-accelerating growth process, often leading to oligopolistic or 'winner takes all' market structures (due to positive externalities, e.g., Katz & Shapiro, 1986; Farrell & Saloner, 1986; Westland, 1992). In this case, the entrant reaches strategic relevance as the incumbents lose market share and revenues.

When faced with this scenario, an incumbent has two options: first, it can attempt to take over the start-up's business and add the start-up's users to its own customer base (analog to Homburg et al., 2013). An incumbent would benefit by increasing its customer base but would still cannibalize its core business. In fact, changing the business model (e.g., by charging user fees; Pauwels & Weiss, 2008) might reduce losses but also carries the risk of shrinking the customer base. Second, an incumbent can ignore the start-up and thus lose business, at least in the short run. However, due to limited resources and a lack of substantial revenues, the start-up cannot survive in the long run without an investor, and the *status quo ante* will be restored. Even if it is obvious that the start-up will eventually go bankrupt as a stand-alone company without additional funds, it requires cooperative behavior by all incumbents to "bleed out" the start-up, which is at best difficult to coordinate and at worst illegal.

Because their decisions are interdependent, all incumbents would be better off by ignoring the start-up and eventually restoring the *status quo* instead of taking over the start-up's business (resembling a *N*-person dilemma game situation; see Dawes, 1980). Ignoring a start-up also reduces the incentive for others to imitate it; once a start-up has been sold, many imitators will try to repeat the success (Economist, 2011). Thus, universal cooperation among traditional

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