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Market reactions to asset sales: Effects of the Joint Venture Prerequisite

Richard J. Arend [a,*], Tomas Mantecon [b,1]

[a] *University of Nevada, Las Vegas College of Business, 4505 Maryland Pkwy, Box 456009, Las Vegas, NV 89154-6009 United States*
[b] *University of Nevada, Las Vegas College of Business, 4505 Maryland Pkwy, Box 456008, Las Vegas, NV 89154-6008 United States*

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Summary We analyze the strategic issue of inter-firm resource transfer – i.e., the methods firms use to buy and sell assets. We introduce a typology of asset sale mechanisms delineated by levels of information uncertainty. We analyze this typology, by exploring how firms choose among the mechanisms and by exploring how they are rewarded by the financial markets for their choices. We find that factors involving the level of information asymmetry, the firm's bargaining power, the firm's current opportunities and pressures, and the firm's ability to engage in the various mechanisms, all correlate with both choices and rewards.
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Introduction

One of the most important kinds of strategic decisions a firm makes is how to transfer business assets. A firm *purchases* an asset when it is not as beneficial for the firm to build that asset or to lease it or even to forgo it. A firm *sells* an asset when that asset's value to the firm is less than its value to other firms. In an ideal environment – i.e., with rational parties and no market failures – voluntary asset transfers are beneficial to all of the parties involved; an assumption that forms the basis of present market economies. However, market failures may arise when uncertainties exist, for example, regarding the value of the assets involved. Alternative mechanisms to simple transfers, such as joint ventures (JVs), can address informational market failures regarding issues like the asset's true market value. To better understand strategic decisions regarding asset transfers, we offer a typology of transfer mechanisms based on two main uncertainties (i.e., the value of the assets being transferred and, the roles of the firms in the transfer), and then we analyze not only on what basis firms choose among the mechanisms but also how the financial markets reward their choices. We do so building on micro-economic theory (i.e., relevant to bargaining power, information asymmetry treatments, and auctions).

Asset transfers and joint ventures are two significant activities in our economy. We consider asset transfers as

* Corresponding author. Tel.: +1 702 895 1622; fax: +1 702 895 4370.
E-mail addresses: Richard.Arend@unlv.edu (R.J. Arend), Tomas.Mantecon@unlv.edu (T. Mantecon).
[1] Tel.: +1 702 895 2526; fax: +1 702 895 4650.

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voluntary sales of parts (e.g., property, plant, equipment, divisions, etc., but not the full firm) of involved parties. We consider a joint venture (JV) to be *a special mechanism for pooling complementary assets owned by separate firms* (Balakrishnan & Koza, 1993: p99). Up to 3% of all large manufacturing plants are transferred in partial-firm asset transactions in any given year (Maksimovic & Phillips, 2001) in the US. And, joint venture activity comprises the major portion of the more than 10,000 inter-firm partnerships created in the US annually (Schifrin, 2001), with recent growth rates at 25% per annum (Duysters & Hagedoorn, 2000), where joint venture termination, which is a common occurrence, most often involves a beneficial transfer of assets between parents (Reuer, 2001).

While the economic impact of asset transfers, whether through straightforward sales or through joint ventures, is significant, asset transfer issues remain under-analyzed. Maksimovic and Phillips (2001) note that the literature on non-merger asset sales remains small. And, despite a sizable literature on joint venturing, there is a current gap in the management literature on *how* joint ventures are used in different ways as asset transfer mechanisms, rather than as one homogenous mechanism (e.g., an option on partner assets — see Chi, 2000)[2]. Our desire to explore the asset transfer issue in its many forms, including through the use of JVs, follows Reuer's (2001) call for more research into the topic of governance changes. We contribute to the management literature with a comparative analysis of these distinctive forms of asset transfers.

We introduce a typology of asset sale mechanisms and then analyze its applicability to firm behaviour and its insight into explaining firm performance variation. Our typology includes three types of asset sale mechanisms, each of which is represented in the empirical analysis by, respectively: simple transactions; short-term joint ventures that terminate with a sale; and, long-term joint ventures that terminate with a sale. We apply an event study methodology to both asset sale announcements and to JV termination announcements to assess the performance impact of the asset transfer. For the JVs, we restrict the sample to two-firm JVs between 1985 and 2003 where one parent bought the JV. We find that firms' choices among the three asset sale mechanisms correlate with factors measuring asymmetric information, a firm's bargaining power, its related opportunities, and its capability. We also find that the financial markets reward firms that choose their asset sale mechanism wisely, and vary the reward level with certain factors (e.g., higher rewards for higher bargaining power).

The paper continues as follows: We generate the typology and the related hypotheses regarding the choice of asset sale mechanism and the bases for that choice. We describe the data (i.e., the JV and the asset sales samples), the empirical methodologies (i.e., the event study technique and self-selection), and the results. We then discuss the results prior to considering the limitations and to generating the conclusions.

Hypotheses

The Typology of Asset Sale Mechanisms

The assumption that under ideal conditions voluntary exchange of resources results in benefits is a cornerstone of economics (e.g., Demsetz, 1966). Rational firms only buy or sell assets when they expect a benefit from doing so. Complications arise under non-ideal conditions — i.e., market failures — that undermine the efficiency of this process. While there are many market failures that could occur, only one type — informational market failures — is of interest in this paper[3]. The informational market failure of interest here is the *value of the asset* for the parties involved, and further, its future value in an uncertain environment, especially when the asset is combined with a partner's assets. Asset valuation under a condition of asymmetric information is often labelled the lemon's problem (Akerlof, 1970), a classic market failure that has several solutions. Asset valuation under uncertainties about asset synergies is a more recent problem, one often addressed through the use of solutions that act as options (e.g., Chi, 2000), where the downside risk of future costs is mitigated.

The set of possible solutions to the informational market failures generates our asset sale mechanism typology. The problem of one-sided information asymmetry can be resolved through an information transfer mechanism, such as a joint venture (e.g., Balakrishnan & Koza, 1993; Johnson & Houston, 2000; Reuer, 2001; Reuer & Koza, 2000). The problem of future synergy uncertainty can be resolved through an experiential, long-term, value-creating, knowledge-sharing arrangement between partners such as a joint venture (e.g., Chi, 2000; Kogut, 1988). Alternative mechanisms to the straightforward sale and the sale-through-JV are included in the typology, but are *not* tested in this paper. We label straightforward sales *Asset Sales*, and include various modes of these sales like two-party transactions and multi-party auctions (*n.b.*, where the auction mechanism might address a different information asymmetry — i.e., helping the seller determine how valuable the asset is to a specific potential buyer — McAfee & McMillan, 1987). We label the sales that use a mechanism to reveal the value of the seller's focal asset to a buyer as *Asset Valuation Mechanisms*, and include various modes of these mechanisms like short-term JVs, warrantees, third party inspections, and reputation-based behavior (i.e., where a firm that would misrepresent an asset's value would be punished by peers in its industry at a sufficient level to deter such an act). We label the sales that use a mechanism to reveal the *ex ante* unknowable future value of combined assets to partners as *Synergy Valuation Mechanisms*, and include various

[2] The sizable literatures on JVs in particular and alliances in general explain several issues — e.g., alliance costs and benefits, alliance hazards, and alliance functions. As well, some of the literature considers JVs, as one homogeneous mechanism, as an option on partner assets, or as a due diligence method. None of the literature considers explicitly the *various* ways that the JV mode can affect asset transfer (i.e., that a JV can play more than one role, and do so regarding only part of the partner's full set of assets).

[3] Market failures involving market power, public goods, and externalities that are related to asset transfers are not considered here, as these are assumed to be relatively unusual cases compared to the cases involving informational problems. We consider adverse selection, moral hazard, hold-up, and unintentional knowledge transfer as specific cases of informational market failures.

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