Resource dependency & transaction costs: investigating recent mergers in the US rental-car industry

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ABSTRACT

Resource dependency theory and transaction cost theory are combined to explain the Enterprise Rent a Car company acquiring Vanguard's National and Alamo brands. Emphasis is placed on the novel application of resource dependency onto the customer groups associated with each respective brand.

INTRODUCTION

There are many theories in the academic world that attempt to lend understanding to the topic of acquisitions. Why might a company choose to purchase a competitor, or ally with a complimentary company? Academics have long been focused questions like this, and while no one single theory is always right, there are enough theories already presented in literature that upon data collection regarding a certain organization and a certain maneuver by said organization, the selection of an appropriate theory or two is a relatively simple act. This paper will attempt to utilize Resource Dependency Theory and Transaction Cost Economics Theory to demonstrate why the Enterprise Rent-A-Car company made a major acquisition of a competitor.

RESOURCE DEPENDENCY THEORY

Resource Dependency Theory (RDT) can be defined as an explanation of how the external resources of an organization affect the behavior of said organization. RDT argues that in order to survive, an organization must acquire resources (Pfeffer and Salancik, 1978). In a traditional manufacturing company, resources would be things like money, a skilled labor force, technology, and raw materials with which to manufacture. In a service industry oriented organization, resources are still required and are similar: money, labor, and resources required to provide specialized service. In a car rental example, resources include the vehicles to be rented themselves in addition to generally required resources (Enterprise purchases 7% of the vehicles sold in the Unites States).

RDT offers an externally focused perspective of why a firm might acquire or merge with another organization (Haleblian et al, 2009). If an organization can join forces with another similar or complementary organization, there are that many more resources available to the new entity. This reduction in competition is the main reason for mergers or acquisitions. There are two other potential explanations for why an organization might want to engage in a merger: "to manage interdependence with either sources of input or purchasers of output by absorbing them, and to diversify operations and thereby lessen dependence on the present organizations with which it exchanges" (Pfeffer, 1976).

Donaldson (1995) stated, "organizations were no longer seen as needing to adapt to their environments as they could adapt their environments to themselves". There is obvious advantage to an organization if it can adapt not only itself to an environment, but manipulate the conditions of the environment itself. As Levinthal and Warglien (1997) put it, "Good landscape designers do not direct the flow of traffic...they induce behavior by laying out attractive pathways." If an environment can be molded to benefit an organization, without sacrificing the organizations ability to adapt, then access to resources and the associated benefits of said resources are limitless. It is important to note that an organizations affecting of an environment is only that; other organizations are also out there in any environment, adapting themselves and affecting the shared conditions as well. As put by Donaldson (1995), "The environment exists independently of whether or not the organization perceives it. Thus the organization does not create its environment, nor does the organization enact the environment in the sense that the environment exists because the organization acts it our or makes a representation of the environment." The careful creation of market conditions regarding resource allocation can be easily disrupted by another force upon the resources in an environment.

In a competitive environment in which resources are scarce, "Resource Dependence Theory produces an image of organizations as survival seekers desperate maneuvering in political fashion control or be controlled, whereas in reality those organization which are firms are seeking to maximize profit-to-risk and adjust their strategy according to the dictates of the law of supply and demand" (Donaldson, 1995). In terms of a merger or acquisition, the result is growth. This is inherent in addition. Stability obtained through organizational growth should be seen not just as survival seeking but rather as profit maximizing based in the economic concept of profit-to-risk (Donaldson, 1995). RDT allows for profit maximization by rewarding growth with profits; as an organization has more resources, so too it has more power.

Resource Dependency Theory comprises certain conditions. In addition to the requirement that an organization needs resources, it is acknowledged that the resources come from the organizations environment. However, since any environment is almost certain to contain other organizations, it stands to reason that resources may be occupied by these competitors. Using the traditional RDT one would think that competitors in the US would be competing over liquid capital, skilled workers, vehicles to lease, prime real estate, and other resources with which to do business. The customer, however, is the ultimately most desirable resource. Access to customers yields the revenue stream, and although all resources are important in this scenario the profits (which are the goal of these organizations) are generated by the customer. Any other resource is in support of this resource based grail.

RDT views an acquisition as the gaining of the assets and capabilities of the purchased organization. It also removes the consumer of resources from the shared environment. This double effective gaining of positives and removal of negatives demonstrates that when conditions are right regarding two organizations and their resources, an acquisition by one of the organizations can be a very effective strategy.

TRANSACTION COST THEORY

Why do companies exist? This is the fundamental question in Transaction Cost Theory (Williamson, 1995). Transaction Cost Theory (TCT) can be defined as an explanation of how the costs of engaging in an action by an organization affects the behavior of said organization. TCT contains two behavioral assumptions: bounded rationality, and opportunism (Williamson, 1985). Bounded rationality is the concept that in the decision making process, you are restricted by the amount of data you possess, your ability to reason, and the timeframe involved. Opportunism is the concept of taking advantage of circumstances, regardless of consequences for others. A transaction cost (also called an institutional cost) can be defined as a cost incurred by an institution participating in a market (Cheung, 1987). In a traditional manufacturing company, transaction costs could include any incremental cost required by engaging in any behavior that supports bringing a good to market, such as purchasing resources like raw materials or hiring costs associated with a worker, to determining how much to charge for a finished product. In a service industry, these transaction costs would include any costs incurred in providing services to a customer. In a car rental example, costs could include the methods required to bring customers into the companies awareness (including marketing to insurance companies, corporations, and third party search vendors).

Every organization will expand as long as the organizations activities can be performed cheaper within the company than by outsourcing the activities to external providers in the market

(Corse, 1937). A company exists in the traditional sense to provide a good or service to a customer base for profit. This is not an exhaustive explanation, but does define certain concrete aspects of a company.

TCT views an acquisition from its "make-or-buy" perspective. Should an organization, based on its costs, choose to develop internally what it needs to compete, or purchase such needs externally? Firms often cannot acquire a capability on the same time scale as they are making make-or-buy decisions for particular transactions, and that as a result, capabilities considerations alone can drive governance choices (Langlois, 1992). Viewing the decision to make or buy based on costs makes the process of an acquisition straightforward.

DISCUSSION OF THEORY

While RDT and TCT both offer some understanding of the management decision regarding an acquisition, neither theory perfectly explains the decision. From a resource based point of view, by simply acquiring more customers, through aggressive marketing to the corporate world or by building relationships with price conscious third party search vendors in an industry, could result in the proverbial ultimate resource, the customer variable, increasing greatly. Simply taking these customers out of the environment through traditional means would remove them from the grasp of any competition. Similarly, from a transaction cost point of view, simply reducing the costs associated with a process through a streamlining or internet technology based procedure could allow for increased profits. The simple mathematics of the division of total customers by total price could yield a satisfactory result in the TCT paradigm through aggressive marketing. RDT adds assets to a firm after acquisition while removing the competitions occupation of resources. TCT states that if it's cheaper to obtain a resource by buying it, you do so instead of making it internally.

APPLICATION OF THEORY

Founded by Jack Taylor in 1957 as the Executive Leasing Company, Enterprise Rent-A-Car (ERAC) was rechristened in 1989. Still privately held by the Taylor family, by 2006 ERAC had annual revenues approaching $ 10 Billion, nearly 900,000 total vehicles in the rental fleet, and well over 60,000 employees, making it the largest, most profitable automotive leasing organization in the United States. As ERAC celebrated its 50th anniversary, the Taylor family chose to acquire the Vanguard Automotive Group, the parent company of the National and Alamo brands, culminating in the new Enterprise Holdings Corporation in 2009. To explain why such a large, successful company would choose to acquire new additional brands, and retain them as such and operate them semi-independently from their already powerful Enterprise image, requires more understanding from a theoretical perspective.

Enterprise Rent-a-Car has traditionally operated their rental operations with a focus on "insurance replacement" markets, as opposed to "corporate accounts" or "recreational travels". This means that the majority of revenues for ERAC came from a third party source; an insurance company pays for a rental vehicle if an insured customer's car is in for a validated claim oriented policy-covered repair. By law in the USA, the victim of an auto accident has their car repaired or replaced by the liable party, so for the purposes of this paper "insurance replacement" means any rental for which an insurance company is responsible for payment, regardless of liability. Payment is through a direct-billing agreement with the insurance companies, and this type of

rental makes up more than 70% of all ERAC transactions. By contrast, National Rent-a-Car (NRAC) operates mainly at airports and the majority of their transactions come from travelers, most specifically "corporate accounts" travel. This means that the individual renting a vehicle is having their company pay for the transaction through a corporate direct-billing agreement. This makes up more than 80% of their total transactions. The final variable in this scenario is the pay-as-you-go customer, or "recreational traveler". Alamo Rent-a-Car (ARAC) is primarily operated with the National Rent-A-Car operations, saving on costly airport real estate, and focused mostly on transactions for customers who have booked reservations through price-conscious online retailers like Travelocity or Expedia. These types of transactions are more than 70% of their total. The difference between these classes of customers reveal that each class of customer has an associated pattern of payment which could be classified as a resource.

While any of the brands operated by the new Enterprise Holdings Corporation has theoretical access to any type of customer, the specific customer-centric focus each separate brand traditionally operated with prevented a dilution of customer-service with each branding attempting to provide a maximum of customer satisfaction by type, and a maximization of profitability for each brand. ERAC was by far the largest company, but the insurance replacement customers daily rates were lower than corporate account rates or recreational rates. NRAC had the highest rates but the smallest fleet-size footprint and larger operating cost, and ARAC tailored a no-frills approach that enabled them to offer a competitive rate but with a lower associated support cost. Each customer class was a resource theoretically available to each rental fleet, but for practicable availability, the statistics demonstrate that each brand operates best with its core customer focus.

If Enterprise Holdings is able to gain more data from its customers and mold their customer base into a more malleable form, and in turn filter customers by type into one of the 3 customer-centric brands to maximize customer satisfaction and overall profit, managing customers as a manipulate-able resource yields multiple benefits. In addition to this, increasing the overall size of the rental fleet increases the demand Enterprise Holdings can apply to General Motors or the like; a contract requesting more vehicles may yield a cheaper cost per unit, another benefit.

Enterprise Holdings exists to lease vehicles to customers for profit. ERAC was able to first succeed in this endeavor by focusing on the insurance replacement market, but was unable to penetrate with impact the corporate account or recreational rental markets. The decision to acquire Vanguard and its National and Alamo brands was made in part because it was cheaper to purchase outright the brands, and most particularly their associated corporate account list (NRAC) and relationship with third party search vendors (ARAC). Trying to expand under the Enterprise label would have been too time consuming, and too costly. By absorbing the competition specific to the customer classes ERAC was most interested in attaining, ERAC was able to minimize transaction costs by taking advantage of the opportunity presented by the acquisition.

Enterprise Holdings now possesses a much larger footprint in the insurance replacement, corporate accounts, and recreational rental markets. This enables them to strategically market a carefully allotted cost designed to maximize profitability. With the increased fleet size, Enterprise Holdings can revisit contracts with the various providers of their vehicles, potentially decreasing per unit costs. By focusing each brand on their existing customer class, brand

dilution is avoided. From a customer service perspective, each customer class can enjoy the level of service desired by their preexisting expectations.

From a Resource Dependency Theory point of view, Enterprise took the National and Alamo brands, with all of their associated corporate contracts and relationships with online partners, out of the environment thereby freeing up the primary resource (the customer base) and adding to their already impressive rental fleet. From a Transaction Cost Theory, it was cheaper for Enterprise to buy National's corporate reputation (and corporate contract lists) and Alamo's recreational price conscious reputation (and partnerships with online travel search engines) than it would have been to grow their own reputations along those customer centric lines.

CONCLUSIONS

A recent review of literature in transactions cost economics concluded that the majority of empirical make-or-buy studies testing TCT hypotheses can be “reinterpreted as … consistent with a competence or resource-based perspective" (Carter & Hodgson 2006). These theories are complementary. The Resource Dependency Theory explains much of what Enterprise Rent-A-Car was engaging in during their purchase of National Rent-A-Car and Alamo-Rent-A-Car in 2007. By demonstrating that the back end resources were not affected negatively (hiring, purchasing of vehicles, marketing, etc) and by demonstrating that front end resources were greatly affected (more customers seeking provided services) this joining was of benefit to ERAC. Transaction Cost Theory explains much of what was occurring as well, taking advantage of the opportunity to purchase strategic competitors to further the firm's reason for existing. When analyzed retroactively through the lens of RDT and TCT the decision to acquire Vanguard by Enterprise was a valid one.

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