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Mergers and Acquisitions: Overcoming Pitfalls, Building Synergy, and Creating Value

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1. Mergers and acquisitions: A closer look

Mergers and acquisitions (M&A) represent a popular strategy used by firms for many years, but the success of this strategy has been limited. In fact, several reviews have shown that, on average, firms create little or no value by making acquisitions (Hitt, Harrison, & Ireland, 2001). While there has been a significant amount of research on mergers and acquisitions, there appears to be little consensus as to the reasons for outcomes achieved from them (King, Dalton, Daily, & Covin, 2004). Herein, we begin by reviewing some of the extant research on mergers and acquisitions, identifying the key variables on which the studies have focused. Thereafter, we summarize some of the major work on a primary reason for failure—paying too high a premium—and discuss why executives often delay too long the divestiture of poorly performing businesses that were acquired. Additionally, we examine research suggesting the importance of an acquisition capability based on organizational learning from the acquisitions and complementary science and technology for strategic renewal. Finally, we end with a discussion of the research on cross-border mergers and acquisitions which have become prominent in recent years.

2. Research on mergers and acquisitions

A representative review of the extant research on mergers and acquisitions over the last 25 years (89 articles) produced a list—available from the authors—of the most common variables studied. The top three research variables include:

1. The extent to which the acquisition increased the diversification of the acquiring firm/the relatedness of the acquiring firm (58% of the studies);
2. Firm size or the relative size of the acquired to the acquiring firm (52% of the studies); and
3. The acquisition experience of the acquiring firm (28% of the studies).

The method of payment for target firms appeared in 18% of the studies, with more emphasis in research after 2004.

While there are logical arguments to suggest that target firms with greater relatedness to an acquiring firm should produce higher performance, existing research provides mixed evidence. The recent research by Palich, Cardinal, and Miller (2000) suggests a curvilinear relationship between relatedness and performance. Mixed results from prior research can be explained by the fact that few of the studies examined nonlinear relationships.

The impact of firm size on acquisition performance likely results from the effectiveness of the integration process, with integration being more difficult for larger acquisitions. Yet, the acquired firm must be large enough to have an impact on the acquiring firm's performance (King, Slotegraaf, & Kesner, 2008). While a complex relationship, research findings for firm size are more consistent than for many of the other variables.

Acquisition experience has been the subject of study for a number of years because of its assumed importance. Yet, the more critical issue is likely to be the amount learned from making an acquisition. Obviously, a firm with some experience should be able to learn from additional acquisitions, but having more experience does not ensure that greater learning occurs. Early experiences can produce more learning than later experiences but without adequate absorptive capacity, early lessons may be generalized to subsequent acquisitions to which they are not applicable. Thus, the relationship between experience and learning is likely to be curvilinear but also even more complex (Haleblian & Finkelstein, 1999). While prior research and its conclusions are useful, increased utilization of a common set of variables in M&A research could minimize model under-specification and facilitate achieving greater consensus on the drivers of acquisition performance. This being the case, we still need to learn more about the requirements for making successful acquisitions; toward that end, we examine next some factors that contribute to acquisition failure and success.

3. Acquisition premiums

While the acquisition premium has been identified as a significant variable (Krishnan, Hitt, & Park, 2007; Sirower, 1997), it has been examined in only a minority of M&A studies. An *acquisition premium* is the price paid for a target firm that exceeds its pre-acquisition market value. Over the past 20 years, the average premium paid has been 40%-50% (Laamanen, 2007). The justification for a premium is the potential synergy that can be created in the merger of the two firms. A premium is paid to entice the target firm shareholders to sell to the acquiring firm.

However, the premium paid should not and cannot be greater than the potential synergy if the acquisition is to produce positive returns. Of course, it is difficult to predict the value that can be created by synergy, and it is often difficult to realize the potential synergy because of the challenges of achieving integration (Sirower, 1997).

There are other reasons that acquiring firms pay large premiums. One such reason stems from agency factors when top executives engage in opportunistic behavior that provides them personal gains (Trautwein, 1990). Because acquisitions increase the size of a firm, they often have a positive effect on a top executive's compensation and enhance his/her power. Furthermore, if the acquisition diversifies the firm, it may also reduce that top executive's employment risk. Because these are personal gains that rarely produce positive returns for the acquiring firm, acquisitions made for these purposes are unlikely to be successful.

Another reason for high premiums is executive hubris (Roll, 1986). In this context, *hubris* is executives' overconfidence that they can achieve the synergy projected when the firm is acquired and integrated. Yet, firms acquired where hubris is a major factor are unlikely to achieve the needed synergy. As a result, firms may pay too high a premium and are unable to earn adequate returns to compensate for the premium and also produce a positive return (Hayward & Hambrick, 1997). When hubris is instrumental in the acquisition, it is not uncommon for the CEO to do a less than adequate job of due diligence or to ignore negative information provided by the due diligence process (Hitt et al., 2001).

However, Sirower (1997) downplays hubris as a primary factor in paying too high a premium for a target. Rather, he suggests three alternative causes for overpayment: (1) unfamiliarity with critical elements of the acquisition strategy, (2) lack of adequate knowledge of the target, and (3) unexpected problems that occur in the integration process. Overpayment may also result from decision biases; for example, Baker, Pan, and Wurgler (2009) found that the majority of acquisition announcements use a target firm's 52-week trading high to determine acquisition premiums. Still, while an unsuccessful acquisition may be due to a lack of capabilities or experience on the part of the executive, an assumption on the part of managers that they can make a deal work (hubris) likely plays a role in premium overpayments.

Other factors can also influence premiums paid. For example, relationships between individuals in the two firms may lead to higher premiums, especially if those relationships are board interlocks (Haunschild, 1994). Of course, multiple bidders for a particular target also drive up the premiums paid for an acquisition. These cases have been termed the *winner's curse*, whereby the acquirer with the winning bid often overestimates a target firm's value (Coff, 2002).

Most of the research suggests that paying high premiums is likely to result in negative performance of the firm, due to an inability to earn adequate returns beyond the premiums paid (Datta, Narayanan, & Pinches, 1992). A large premium places a major burden on managers of the acquiring firm to recoup those costs and extract sufficient synergies from the merged firm. Research suggests that about 70% of acquiring firms fail to deliver the necessary results to recoup the premium payment (Sirower, 1997). Because managers in the acquiring firm face tremendous pressure, they are likely to take additional actions in attempt to garner positive returns. For example, they frequently engage in restructuring processes to consolidate assets and sell off others that are considered redundant (Cascio, Young, & Morris, 1997). This restructuring action basically results in operational synergy, but it is often inadequate to recoup the high costs of the acquisition because of large premiums. Under such conditions, managers then often engage in more risky actions designed to reduce costs and increase cash flows from the acquisition. For example, a common action is large-scale workforce reductions (Krishnan et al., 2007). Unfortunately, employee turnover erodes the human capital in firms, reduces the performance of the acquiring firm (Cording, Christman, & King, 2008), and harms the long-term value of the acquired firm's assets.

4. Divestiture of acquired businesses

When acquisitions are unsuccessful, it may be wise to divest a business rather than continue to suffer losses from that acquired business. For example, after several years of experiencing losses, Daimler-Chrysler divested the Chrysler assets, even though it had to do so at a significant loss from what it originally paid to acquire Chrysler. Some argue that DaimlerChrysler should have sold Chrysler much sooner to avoid suffering those losses, as it may have been able to obtain a higher price for the Chrysler assets. In fact, Time Warner also suffered criticism for several years suggesting the need to divest AOL, even if it had to do so at a loss. Recently, the company announced that the AOL assets would be spun off from the parent firm.

While important, there has been a dearth of research on divestitures of acquired businesses (Brauer, 2006). A decision to divest an acquired business is essentially reversing a major strategic decision made earlier, often by the same executive. Therefore, the divestiture decision is influenced by various psychological and organizational factors (Shimizu & Hitt, 2004). Yet, because of the high rate of failure associated with acquisitions, eventual divestiture of acquired businesses is not uncommon. For example, Kaplan and Weisbach (1992) found that 44%

of the acquisitions they studied were eventually divested. Acquired firms are likely to be divested when the acquired unit is performing poorly, but also when organizational inertia to maintain the acquisition is low, when the business unit is smaller, and when the acquired firm is young and small. Also, when parent firms have divestiture experience, they are more likely to divest acquired businesses (Shimizu & Hitt, 2005).

Oftentimes, executives escalate their commitment to the prior decisions and try to avoid divesting the business (Shimizu, 2007). However, when the acquiring firm's overall performance is strong and it has higher slack, executives are often more willing to divest poorly performing acquired businesses (Hayward & Shimizu, 2006). Certainly, acquired businesses that are performing poorly are more likely to be divested when there is a change in the CEO and when more independent directors are added to the board. Thus, there are a number of non-business factors that contribute to making decisions to divest businesses that have not produced the synergy and positive returns predicted when they were acquired.

5. Acquisition capability development

There are at least two important types of learning in acquisitions. Drawing from success or failure experiences, firms can learn to (1) select better future targets, and (2) improve their integration processes for future acquisitions. We referred to this type of learning earlier. In this section, we also examine learning from the target firm, especially after it is acquired.

While relatedness between the target and acquiring firms is important, research has shown that synergy is created largely by complementary capabilities. *Complementary capabilities* are different abilities which fit or work well together. Although the integration of complementary capabilities is an important criterion for success in acquisitions, much of the knowledge underlying these capabilities is tacit. Furthermore, the true value to an acquiring firm can only be captured if the valuable capabilities in the acquired firm are fully integrated into and absorbed by the acquiring firm. This requires that the acquiring firm learn the new and valuable knowledge stocks held by the acquired firm. If the acquiring firm is able to learn and absorb the knowledge, thereby integrating it with its own knowledge stocks, it can create new and possibly even more valuable capabilities. Thus, the learning that occurs in the acquisition process and the integration thereafter is crucial to its success (Hitt et al., 2001). In fact, some firms have had significant success in making acquisitions, and this success can be at least partially attributed to their ability to learn from the acquired firms and to absorb and integrate the new knowledge in order to build new capabilities. Two examples of such companies are Cisco Systems and

General Electric.

While at a coarse-grained level, a positive linear relationship has been argued to exist between acquisition experience and performance (Barkema, Bell, & Pennings, 1996; Barkema & Schijven, 2008a, 2008b). At the same time, others have noted that the relationship is likely curvilinear (Haleblian & Finkelstein, 1999; Zollo & Reuer, in press). The differences in results of studies examining the relationships suggest that other factors are likely involved. While experience suggests learning, it is a coarse-grained proxy for it. And, there are many factors that likely affect the firm's ability to learn as it gains experience.

Organizational learning in acquisitions is highly complex. First, there is the opportunity to transfer experience into situations where it does not apply. For example, transferring acquisition routines from one industry to another may not be effective. Essentially, the firm must learn to adapt the knowledge gained to the context in which it is applied (Finkelstein & Haleblian, 2002). Certainly, when the organizations are too homogeneous, very little learning can occur. Thus, heterogeneity or differences between the firms is necessary for firms to acquire new knowledge (Hayward, 2002). Alternatively, the firm must have adequate absorptive capacity in order to learn the knowledge, so there must be some homogeneous elements that allow it to learn and integrate the new knowledge.

Firms can institute processes by which they deliberately learn. For example, Haleblian, Kim, and Rajagopalan (2006) argue that learning can be enhanced through an active process of evaluating performance feedback from recent acquisitions. Of course, managers must then analyze the acquisitions to understand the factors leading to the performance, regardless of whether it is positive or negative. If the performance is strong, the routines used seemingly work; if the performance is poor, however, they must be reevaluated and perhaps changed.

A third mechanism for learning is that of observing, and learning from, others. This is often referred to as *vicarious learning* (Miner & Haunschild, 1995). Such learning tends to be more exploratory than the mere exploitation of their current knowledge stocks gained from prior experience. It also often occurs through board interlocks and the acquisition experience of the firms on which their board members serve (Haunschild & Beckman, 1998). The bottom line is that firms can learn from acquisitions, and probably must do so in order to gain the greatest value from them.

6. Technological learning in acquisitions

Innovation has become an increasingly important source of value creation in many

industries. The importance of innovation has been heightened by rapid technological change and growing knowledge intensity in industries. Because of these factors, innovation must come faster and there is a higher need for novel solutions, especially in high-technology industries. Thus, firms have turned to mergers and acquisitions as an alternative strategy for obtaining the knowledge necessary to create innovations with the speed needed and the novelty necessary to either maintain a competitive advantage or to build a new one (King et al., 2008; Makri, Hitt, & Lane, in press; Uhlenbruck, Hitt, & Semadeni, 2006). While some research suggests that acquisitions may produce a reduction in innovation output over time (Hitt, Hoskisson, Johnson, & Moesel, 1996), if a target with complementary capabilities is selected, acquisitions have the opportunity to develop novel knowledge and to enhance the innovative output of an acquiring firm.

A key element in the positive effect of acquisitions on innovation is the knowledge relatedness between the acquiring and acquired firms and, of course, the ability to integrate the knowledge into the acquiring firm (Cloodt, Hagedoorn, & Van Kranenburg, 2006). Makri et al. (in press) examined the knowledge relatedness between acquiring and acquired firms in high-technology industries. Their study emphasizes the importance of knowledge complementarities between targets and acquirers, and suggests that firms in high-technology industries have a higher likelihood of achieving novel inventions if they can identify and acquire businesses that have scientific and technological knowledge that is complementary to their own. The study found that the effects of knowledge complementarities are strongest when both science and technology complementarities are combined; the integration of the two enhances innovation quality and novelty.

The synergistic relationship between science and technology is based partly on the role of science knowledge in the innovation process. Science knowledge provides the base for the technological knowledge which is normally more focused on providing solutions to problems (application). Thus, science enables a better understanding of a problem at hand whereas technology helps to resolve those problems. Oftentimes, combining science knowledge from two firms can help to produce more novel innovations, while combining technological knowledge often leads to more incremental innovations. However, the combination of scientific and technological complementarities in acquisitions is quite complex and challenging. In general, if the acquiring and acquired firms possess similar knowledge stocks, the resulting innovations are likely to be incremental. Certainly, it is helpful to have some similar knowledge stocks in order for the acquiring firm to absorb other complementary knowledge stocks. Thus, managers of firms

must manage effectively the breadth and depth of their own scientific and technological knowledge, but also find ways to incorporate new knowledge in order to survive over the long term. There are biases toward incremental innovations, partly because they provide short-term returns and are less risky (Hoskisson, Hitt, Johnson, & Grossman, 2002). Yet, firms must seek the more novel and complementary knowledge stocks in order to create unique knowledge that leads to novel products and services over time. Another possible form of complementarity is combining different geographic operations (Kim & Finkelstein, 2009); as such, we discuss cross-border M&A next.

7. Cross-border mergers and acquisitions

In waves of mergers and acquisitions during the late 1990s and early 2000s, the number of cross-border acquisitions has increased greatly (Shimizu, Hitt, Vaidyanath, & Pisano, 2004). These acquisitions are often made for similar reasons as domestic acquisitions, but they also broaden the reach of firms and allow them to effectively enter and/or enrich their competitive position within international markets (Brakman, Garita, Garretsen, & Marrewijk, 2008). Much of the prior research has examined cross-border acquisitions as a means of entering foreign markets, compared to using joint ventures or Greenfield ventures (Isobe, Makino, & Montgomery, 2000). Some have argued that cross-border acquisitions actually reduce the transaction costs involved in entering new markets (Brouthers & Brouthers, 2000).

While cross-border acquisitions may reduce certain types of costs, they still must overcome the costs associated with the liability of foreignness in the host country; this includes knowledge about the different culture, area regulations, and the pervasive business norms of the location. Acquisitions help to overcome this liability because the acquired firm should have the local knowledge needed, assuming that the acquiring firm can capture this knowledge in making the acquisition (Eden & Miller, 2004).

More recently, scholars have used institutional theory to help understand how country institutions affect firms' choice of market entry and the performance outcomes of different modes of entry (Brouthers, 2002; Xu & Shenkar, 2002). Research by Zhu, Hitt, Eden, and Tihanyi (2009) found that acquiring firms are likely to create more value when the firms acquired are based in countries with lower risks. In particular, firms are better able to achieve synergy when the institutions of the host country are more similar to the institutions in the acquiring firm's home country. Clearly, however, firms based in developed countries that acquire firms in emerging market countries commonly transfer knowledge stocks to the firms in the host country. This is

likely to benefit more the firm in the host country than the acquiring firm, unless the newly acquired firm can be effectively integrated into the acquiring firm (Kostova & Zaheer, 1999). The acquiring firm is more willing to transfer these knowledge stocks because they have acquired the firm's assets and thus control the use of this knowledge, whereas the firm is less likely to do so in international joint ventures where they have lower control over how that knowledge is used and where it is applied. Obviously, integration is a critical element and is more complex and challenging when the institutions differ greatly between the home and host countries (Chakrabarti, Jayaraman, & Mukherjee, 2009).

8. Conclusions

Mergers and acquisitions have long been a popular strategy, and are increasingly common in many industries. This strategy has been employed by both large and small firms, and by established and newer firms. While at one time M&A was largely a strategy used by U.S. and Western European firms, it has become much more common in other regions of the world, and especially in acquisitions that cross country borders. While popular with many executives, it is a highly complex strategy and one that is fraught with risk. In fact, even though the strategy has been employed for several years and studied by countless scholars, a large number of acquisitions fail to produce the results promised.

Herein, we have explored some of the reasons why acquisitions fail and have suggested ways for firms to increase the probability of acquisition success. Certainly, firms must make careful selections of their acquisition targets and try not to pay too high a premium; if they select the wrong firm or the premium paid is too large, the likelihood of failure is high. Yet, if firms search for and identify targets that have complementary capabilities and put in place mechanisms that enrich their learning from the acquired firm, they are more likely to build new capabilities and enhance their own competitive position in the market. In sum, mergers and acquisitions can sometimes be a highly effective and successful strategy, but this strategy must be very carefully designed and implemented.

Notes

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