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Motivation and ability in the decision to acquire

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ABSTRACT

This study considers the decision to undertake an acquisition using a framework built around the concepts of motivation and ability to acquire. The paper develops an integrative model to examine how firm characteristics contribute to motivation and ability in predicting the likelihood of an acquisition and draws on two streams of literature to motivate the model: behavioral theory of the firm to explain a firm's motivation to acquire, and absorptive capacity to explain a firm's ability to acquire. Results from a publicly traded sample show that firms failing to meet aspirations (i.e., those with motivation) are more likely to acquire, as are firms that have a high absorptive capacity (i.e., those with ability). Most interestingly, absorptive capacity moderates the influence of performance shortfalls in the decision to acquire and is most important when the motivation to acquire is low.

1. Introduction

The rationale for acquisition activity has primarily been that firms seek higher performance (Bergh, 1997; Hoskisson & Hitt, 1990) and create value from economies of scale and scope, market power, and learning (Hitt, Ireland, & Harrison, 2001). The extant literature pays considerable attention to the post-acquisition performance of acquisitions (Ahuja & Katila, 2001; King, Dalton, Daily, & Covin, 2004). However, comparatively less is known about the antecedents of these acquisitions, particularly as it relates to their timing (Iyer & Miller, 2008). The decision to acquire may be driven by a firm seeking efficiency (Bailey & Friedlaender, 1982) trying to gain quick access to a target firm's market, resources, and capabilities, overcoming entry barriers (Chang & Rosenzweig, 2001), potential synergies (Porter, 1980, 1985), agency problems (Jensen, 1988), lowering the cost and risks associated with product development, or developing new capabilities. Firms face the need to continually innovate (Nelson, 1995; Rosenkopf & Nerkar, 2001; Teece, Pisano, & Shuen, 1997) and failing such innovation, newer, more innovative products tend to overtake older, less innovative ones in the marketplace. Given the challenge to innovate, many firms face erosion of their competitive advantage when they are unable to meet their need for innovation through in-house development (Rigby & Zook, 2002). Beyond relying on internal processes such as research and development (R&D) activities to create innovations, firms may turn to the acquisition of other companies as a means of gaining access to innovations (e.g., Ahuja & Katila, 2001; Rigby & Zook, 2002).

This paper introduces an integrative model of the decision to acquire, arguing that the decision to acquire is affected not only by the *motivation*, but also by the *ability*, to undertake an acquisition. The first required element, motivation, can range from managerial opportunism and self-interested behavior (Jensen, 1988), to seeking the best outcomes for shareholders. Iyer and Miller (2008) study firm level factors in acquisition timing, as opposed to economy- or industry-wide influences, and consider behavioral motivations as an antecedent to acquisitions. The behavioral theory of the firm (Cyert & March, 1963) holds that firms engage in search in response to performance feedback (Cyert & March, 1963; Levinthal & March, 1981) and Iyer and Miller (2008) suggest that this search may lead to acquisitions.

While motivation is a necessary antecedent to acquisitions, firms must also have the *ability* to identify and successfully integrate targets. The extant literature has considered the ability to acquire to depend on the availability of slack resources (Jensen, 1993; Penrose, 1959) or the potential synergy between acquirer and target firms (Chatterjee & Wernerfelt, 1991; Porter, 1980, 1985; Silverman, 1999) that may result in more market power through increased scale and scope. While Iyer and Miller (2008) consider performance feedback as a primary motivation for acquisition timing, they also consider slack and distress to be other factors to which the firm responds. Although financial slack is normally a required element, it seems evident that it takes more than monetary resources for a firm to successfully acquire. Financial slack can be available to multiple firms and hence distinguishing which ones are likely to engage in

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an acquisition requires a deeper understanding of ability. One such ability is that some firms are better equipped to identify targets and – perhaps more importantly – to make use of the knowledge they possess. Cohen and Levinthal (1990) refer to this capability as absorptive capacity, defining it as the ability of a firm to acquire, assimilate, transform, and exploit knowledge (Cohen & Levinthal, 1990; Zahra & George, 2002). Given the high cost of acquisitions, the identification of the right target among a large number of firms is essential. Thus, firms with higher levels of absorptive capacity are better able to evaluate potential targets and separate the wheat from the chaff, and thus should be more likely to make an acquisition than counterparts with less absorptive capacity. So, while motivation is necessary, the ability to acquire also plays an important role in the decision to acquire. Further, while motivation and ability each influence acquisition activity, this framework argues that the combined effect is also an important consideration.

Prior applications of behavioral theory focus primarily on the influence of performance feedback on business-level strategy and search behaviors. For example, behavioral theory has been used to explain business level decisions such as search through increased R&D spending (Hundley, Jacobson, & Park, 1996), new ways of doing R&D (Bolton, 1993), and innovation and organizational learning (Greve, 2003a, 2003b). Although a firm may engage in different types of search, this paper focuses on one of the possible outcomes of these search activities: the likelihood of acquiring another firm. Underperformance, as understood in behavioral theory, might serve to motivate executives to consider making an acquisition aimed at restoring performance to expected levels. Adding to that nascent stream of research is one of this study's primary contributions. The focus of this paper is to extend the behavioral theory literature by demonstrating that failure to meet aspirations in innovative output influences corporate strategy. Specifically, the authors expect that a discrepancy between performance and aspirations in innovation will lead firms to search for solutions in order to close the performance–aspiration gap. Other studies of performance feedback to which firms respond typically focus on financial and accounting measures such as return on assets (e.g., Iyer & Miller, 2008), free cash flow, and net income. The authors extend theory here by introducing the notion that firms adjust their corporate strategy in response to underperformance in non-financial areas, specifically in innovative output. The authors also expand the understanding of acquisition behavior further by suggesting that both motivation and ability are necessary, and that the presence of both will have a reinforcing effect on the likelihood of acquisition.

2. Theory and hypotheses

Prior research indicates that firm performance hinges in part upon its ability to innovate (e.g., Bowen, Rostami, & Steel, 2010), and hence poor performance in innovation may increase the motivation of managers to act in order to close the performance gap. One potential response to underperformance in innovation would be to obtain innovations outside the organization by acquiring another firm. The behavioral theory of the firm suggests that a change in performance, specifically recent performance (Cyert & March, 1963; Levinthal & March, 1981), is a critical factor in motivating managerial action. More specifically, behavioral theory speaks not to absolute performance, but rather to performance relative to expectations. Iyer and Miller (2008) make the extension of search in response to underperformance to corporate level decisions—namely acquisitions. They find that acquisition activity increases as financial performance approaches aspirations below firm aspiration levels. Instead of using financial performance as a motivating factor, this paper expands the domain of behavioral theory by considering firm performance in terms of innovation.

For innovative firms that rely on innovation to establish competitive advantage, falling short of their expected level of innovation is likely to motivate managers to find ways of restoring innovative output. One option available to them would be to invest more heavily in research and development in order to jump-start innovation internally. However such spending increases may not always be the best option. First, given the uncertain nature of innovation, increased spending does not necessarily translate to improved output. Researchers show that the efficiency with which R&D expenditures become valuable innovations depends on the degree to which a company is able to integrate technologies across domains and functions (Amir-Aslani & Negassi, 2006), the firm's decision to cooperate within a group of firms (Cefis, Rosenkranz, & Weitzel, 2009), corporate diversification decisions (Desyllas & Hughes, 2010), and economies of scale and scope related to the size of the firm's R&D operation (Henderson & Cockburn, 1996). Spending more money is no guarantee of more innovation. Second, internal development can be a slow process, causing innovative output to be below expectations for longer than managers would prefer. Finally, managers who observe the innovative outputs of their firm fall short of expectations may also feel that increased spending on internal development efforts would be ineffective. In these situations, acquiring an existing stock of innovations may be seen as a more immediate, less risky course of action. Supporting this notion, King, Slotegraaf, and Kesner (2008) find that some acquisitions act as a substitute for internal knowledge development through R&D. When internal R&D fails to produce the expected level of innovative output, managers are likely to look elsewhere. Hence failure to meet aspirations for innovation may motivate firms to pursue an acquisition. Therefore, the authors predict a positive relationship between failure to meet innovative aspirations and the decision to acquire:

Hypothesis 1. Performance below aspirations with respect to innovations increases the likelihood of acquisition.

However, the motivation to acquire is likely to be insufficient. Firms must also have the ability to identify suitable targets, and be confident in their ability to successfully integrate the knowledge and capabilities of the target firm post-acquisition. The construct of absorptive capacity (Cohen & Levinthal, 1989, 1990) is a useful perspective from which to view this process. Cohen and Levinthal (1989) define the construct as the ability to "identify, assimilate, and exploit knowledge from the environment." (Pg. 569) Thus the construct represents how skillfully a firm can find, understand, internalize, and use knowledge outside the firm to their advantage. This carries two implications for the decision to acquire. First, while there is little doubt that a firm must have slack resources in terms of cash, debt capacity, and managerial time in order to make an acquisition, the problems associated with identifying suitable targets, collecting and absorbing information about the targets necessary to identify the most promising one, and applying that information to their internal decision-making process must also be addressed. All else being equal, firms that are high in absorptive capacity will have an advantage in being able to understand who the potential targets are, what each of them has to offer in terms of knowledge stocks and innovative capabilities, and to assess which potential targets would best fit the firm's needs. Firms that are lower in absorptive capacity will be less capable of finding suitable acquisition targets and thus less likely to acquire.

The second implication concerns the firm's potential to benefit from an acquisition. A firm that is high in absorptive capacity will be better able to internalize the knowledge resident in an acquisition target and will thus have more opportunities for recombining knowledge (Fleming, 2001). This should ultimately lead to increased innovative output (Henderson & Cockburn, 1996; Wu & Shanley, 2009). Knowledge is "sticky", and simply eliminating the firm boundaries

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