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Economic Crisis, Acquisitions and Firm Performance

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This paper examines the effects of the recent economic crisis, relative to the pre-crisis period, on firm acquisition behavior and how such behavior impacts short-term firm performance. We develop hypotheses on how firms adjust their geographic and product market scope in response to the economic crisis. Using data on acquisitions in Italy during the period 2007–2010, we analyze whether firms use acquisitions to enter and/or expand the firm's presence in different product markets and different geographic markets before and during the economic crisis. Results suggest that the crisis negatively affects the likelihood of both diversifying and crossborder acquisitions, which is consistent with the behavioral theory of the firm. As a response to economic downturns, firms tend to focus on their core business as well as their home market, suggesting they are more reluctant to explore new industrial and geographical markets. We then rely on the diversification literature to link acquisitions to firm performance. We find that diversifying acquisitions have a negative effect on short-term accounting performance in crisis times. Crossborder acquisitions have a positive impact on short-term accounting performance in crisis times, although this impact tends to become weaker (though not significantly) than during non-crisis times. We lastly discuss the implications of these findings for managers and scholars.

Introduction

The global financial crisis of 2008 has placed renewed emphasis on understanding how firms manage their strategy in response to dramatic shifts in the environment. An economic crisis can cause unpredictable, significant downward shifts in the level of demand (Lee and Makhija, 2009) and dramatically alter the level of environmental munificence (Wan and Yiu, 2009); i.e., the level of resources available. Existing firm strategies may therefore be rendered ineffective (Meyer et al., 1990). Management scholars are increasingly interested in understanding the implications of an economic downturn on firms' strategy and performance (Lim et al., 2009; Muurlink et al., 2012; Parnell et al., 2012; Varum and Rocha, 2011; Zona, 2012).

Extant research on decision making, mostly based on the behavioral theory of the firm and prospect theory, acknowledges that, when confronted with an economic crisis, firms are faced with a dilemma: whether to avoid risk and pursue conservative strategies, or to take risks to extend their competitive advantages (Zona, 2012). Proponents of the risk-avoidance perspective suggest that firms tend to reduce risk during an economic downturn. For example, it has been argued that firms are likely to perceive high levels of environmental uncertainty — as with crisis times — as threatening. In such conditions, they tend to be conservative (Chen and Miller, 2007) and hesitate to modify their strategy (Amburgey and Miner, 1992; Pablo et al., 1996; Wan and Yiu, 2009). High uncertainty and large potential losses therefore may push executives away from risky projects (Zona, 2012).

Proponents of the risk-taking perspective emphasize, instead, that firms may actually respond to economic adversity by undertaking greater, not lower, risk. For example, it has been shown that greater levels of organizational slack can foster innovation during times of low performance (Greve, 2003) or economic downturns (Zona, 2012). Furthermore, firms with greater external orientation may be more likely to exploit market opportunities (Cheng and Kessner, 1997).

We contend that the distinction between risk-avoidance and risk-taking behaviors is not dichotomous, but rather more nuanced to capture the reality of corporate behavior. Scholars may be better off focusing on the "amount of risk" firms are willing to undertake under conditions of economic adversity. Building on the behavioral theory of the firm, we suggest that, when confronted with an economic crisis, firms that take risky actions tend to focus their search locally, and avoid excessive risk-taking behaviors that may impair firm survival or that may engender excessive uncertainty. We apply these arguments to the context of changes to the scope of the firm; i.e., how firms adjust their geographic and product market scope in

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response to the recent economic crisis. In particular, we focus on acquisitions, one of the key elements of executing strategy, especially strategic change. Our first objective is to understand how the crisis affected acquisition behavior. We examine the use of acquisitions to enter and/or expand the firm's presence in different product markets and different geographic markets before and during the economic crisis.[1]

Our second objective is to understand the impact of these acquisition behaviors on the firm's performance during the crisis, relative to before the crisis. We argue that an economic downturn likely alters the performance effects of acquisitions, since crisis times are associated with conditions of economic adversity and increased risk. Furthermore, diversifying and crossborder acquisitions involve varying levels of risk. Thus, we examine whether and how the impact of the acquisitions on firm performance varies before and during the crisis.

The empirical analysis is carried out on a sample of 385 acquisitions in Italy during the period 2007–2010. As one of the largest European economies, Italy represents an important context for investigating the impact of the crisis on firms' strategies. We find that the crisis negatively affects the likelihood of both diversifying and crossborder acquisitions. In addition, we find that the positive impact of crossborder acquisitions on accounting short-term performance tends to become weaker (though not significantly) during the crisis, while diversifying acquisitions reduce short-term performance during the crisis.

This paper provides several contributions to the literature on environmental jolts, behavioral theory and acquisitions. First, this research extends our understanding of how environmental jolts can impact the scope of the firm. Existing research examines divestiture activity (e.g., Shimizu, 2007) and diversification patterns (Hill and Hansen, 1991). We extend these arguments by incorporating changes in acquisition behavior across both industry and geographic markets. Second, we extend the boundary conditions of the behavioral theory of the firm to incorporate the impact of an economic crisis on corporate scope decisions, extending the work of Zona (2012) and Iyer and Miller (2008). Focusing on an under-represented context, this research demonstrates that behavioral theory can help to explain firm acquisition behavior in response to an economic crisis of incredible magnitude. Finally, our findings provide insights into the impact of an economic crisis on acquisition short-term performance relative to prior to the crisis.

The paper is organized as follows. In the next section, we develop our hypotheses related to acquisition behavior and the effects on performance from existing research. In the third section, we describe the research design, and, in the fourth, we present the results of the empirical analysis. Then we discuss the main findings and implications of the study for theory and practice. Finally, limitations and future research directions are outlined.

Theoretical background and hypotheses development

Economic crisis and firm acquisition behavior

The recent economic crisis resulted in dramatic changes in the external environment of firms. The problems in the financial market led to a reduction in capital available to firms, making it difficult to obtain sufficient resources for working capital and debt service obligations. In addition, the crisis had huge effects on incomes, government finances, and labor markets (European Social Watch Report, 2010). As a result, consumer demand fell, eventually trickling down to reduced business-to-business demand for products and services, spurring greater unemployment, which further exacerbated these effects. The reduction in demand for goods and services would likely result in lower than anticipated revenues, and likely higher costs for firms that could not rapidly reduce labor and other costs. These factors presented managers with the high likelihood of declines in performance and potential losses (Zona, 2012). In addition, forecasting in such an environment is unreliable, creating additional uncertainty.

We utilize the lens of behavioral theory (e.g., Cyert and March, 1963) to examine how such effects would impact firm acquisition behavior. The decline in consumer and industrial spending that occurs during economic downturns, and that we witnessed in the most recent economic crisis, will result in declining revenues and declining profits for firms. Under such economic conditions, firms are likely to experience performance below aspiration levels, particularly early in the crisis as the magnitude of the crisis is not immediately evident. Even during later stages of the crisis, firms may overestimate performance aspirations since such targets are often tied to prior performance levels, i.e., performance prior to the crisis (Cyert and March, 1963). While firm aspirations are typically based on peer firm (i.e., social) and historical performance comparisons (Bromiley and Harris, 2014; Greve, 2003), such comparisons may be less relevant in an economic crisis, particularly historical performance levels. Instead the economic crisis may invoke varying reference points, including both the "standard" historical and social aspirations noted above, as well as a survival level. Managerial attention will shift between

[1] It is worth noting that we are not suggesting firms will increase their acquisition activity during an economic crisis. The business press has documented how the number of acquisitions declines during an economic downturn overall. But, for firms that do pursue acquisitions during an economic crisis, we argue that such acquisitions represent problemistic search activity, and firms are more likely to make such acquisitions in local areas (in the neighborhood of current operations), and are less likely to make diversifying or crossborder acquisitions.

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