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How does acquisition experience create value? Evidence from a regulatory change affecting the information environment

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ABSTRACT

We argue that acquisition experience translates more readily into learning to select than into learning to restructure. The acquisition selection stage is less causally ambiguous than the subsequent restructuring stage—because its web of activities is less complex and its outcome less delayed—and causal ambiguity undermines learning from experience. Therefore, we hypothesize that more-experienced acquirers will perform particularly well when the information environment is less transparent and thus the ability to select targets (versus to restructure them) is more important. Relying on a unique database of 1388 acquisitions realized by private equity firms in the United States between 1975 and 2005, and exploiting a regulatory change affecting the information environment faced by acquirers when selecting their targets, we find results largely consistent with our theory.

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1. Introduction

The goal of understanding how accumulated acquisition experience affects future acquisition performance has taken center stage in the discourse between organizational and strategy scholars. A considerable literature has pointed out that learning from acquisition experience is quite difficult; acquisitions are complex strategic decisions prone to causal ambiguity—which undermines learning from experience, because it obscures the causal link between how a certain acquisition was conducted and its final outcome (Heimeriks, Duysters, & Vanhaverbeke, 2007; March & Olsen, 1975; Mosakowski, 1997; Zollo, 2009).

However, past research has generally neglected that acquisitions are decisions composed of multiple stages and that these stages might differ in their level of causal ambiguity, such that past acquisition experience might translate into learning to perform some stages more than others. In particular, based on extant literature, we may separate the acquisition process into at least two distinct stages (Barkema & Schijven, 2008b; Puranam, Powell, & Singh, 2006), each of which contributes to final financial performance. The first is the selection stage, during which an acquiring

firm strives to reduce information asymmetry between itself and a potential target so that it can more accurately assess the target firm's value (Capron & Shen, 2007; Puranam et al., 2006). The second is the restructuring stage, during which an acquiring firm endeavors to build up an acquisition's actual value using corporate restructuring (Barkema & Schijven, 2008b; Heimeriks, Schijven, & Gates, 2012).

We argue that acquisition experience mainly teaches firms to select targets rather than to restructure them, since causal ambiguity will be higher during the restructuring stage than during the selection stage. This will be true for at least two reasons. First, the restructuring stage will be relatively more complex because it includes more activities and those activities are more interrelated (King, 2007). Second, after the restructuring stage ends, feedback about its outcome will be more delayed (King, 2007) than feedback from the selection stage. Experiential learning suffers when causal ambiguity increases (March & Olsen, 1975; Mulotte, Dussauge, & Mitchell, 2013). Thus, we can expect that firms engaging in acquisitions are likely to learn more about how to properly execute the selection stage (where causal ambiguity is lower) than about how to properly implement the restructuring stage (where causal ambiguity is higher). If this is true, we should observe that firms with a longer history of acquisitions perform particularly well in cases where the external environment in which the target is evaluated is “opaque” and thus the ability to select (versus the ability to restructure) becomes more crucial.

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We apply our conceptual arguments to a context that is well suited to testing our theory: acquisitions—also called buyouts—performed by private equity (PE) firms (Castellaneta & Zollo, 2015). Different from acquisitions realized by strategic acquirers—whose performance is typically difficult to assess because acquired firms are not left (and resold) as separate entities—acquisitions realized by PE firms offer a relatively clean measure of overall performance using the internal rate of return (IRR). Drawing on a private database of 1388 buyouts realized in the United States between 1975 and 2005, and exploiting an arguably exogenous regulatory shock influencing the transparency of the information environment, we find results largely consistent with the notion that acquisition experience enhances performance when an acquirer's capacity to select target companies is more relevant.

2. Theory background and hypotheses

2.1. *Experiential learning to select versus add value*

Previous studies have consistently theorized and shown that performance increases as organizations gain production experience in operational settings, a phenomenon known as the “experience curve effect” (Andress, 1954; Hirschmann, 1964; Wright, 1936). This relationship has been documented in production settings for aircraft (Benkard, 2000), ships (Rapping, 1965), trucks (Argote & Epple, 1990), and semiconductors (Hatch & Mowery, 1998), among others. However, findings about learning from experience in strategic contexts have been decidedly less consistent (see Barkema & Schijven, 2008a). In particular, studies about acquisitions found positive relationships between experience and performance (Barkema, Bell, & Pennings, 1996; Bruton, Oviatt, & White, 1994; Fowler & Schmidt, 1989), while others reported finding the relationship to be non-significant (Hayward, 2002; Wright, Kroll, Lado, & Van Ness, 2002; Zollo & Singh, 2004) or U-shaped (Haleblian & Finkelstein, 1999; Porrini, 2004).

To explain why experience might have a different impact on performance in operational and strategic contexts, previous research has pointed to differences in causal ambiguity. Causal ambiguity refers to the difficulty of determining the exact causal relationship between a certain task (or decision) and its outcome (Mosakowski, 1997). Quite simply, if a task is causally ambiguous—and so it is difficult to understand the link between how the task is executed and its outcome—it is less likely that the repetition of a task over time leads to some learning and therefore to improved performance. As the previous literature shows, where decision makers' bounded rationality (Simon, 1947) is assumed, causal ambiguity depends mainly on two characteristics of the decision at hand: its complexity and its temporal distance from the outcome (i.e., the time span between the execution of a decision execution and the observation of its associated outcome).

A decision's complexity is relevant because complexity can obscure the cause–effect linkages between a decision and its outcomes. Complexity is determined by the number of activities involved in a decision and the degree of their interdependence (Zollo & Winter 2002)—which in turn is highest when activities are reciprocal, such that the input of one activity constitutes the output of the other activity, and vice versa (Puranam & Goetting, 2011; Thompson, 1967). These two factors are in fact the key parameters of complexity as defined in the NK models (Gavetti & Levinthal, 2000).

Further, the time span between the execution of a decision and the observation of the associated outcome might influence causal ambiguity. As King (2007, p. 170) explained, “a long time interval between a competency execution and its outcome limits

opportunities for performance assessment. In addition, longer time gaps may raise decision makers' propensity to engage in self-serving attributions that can distort more-accurate assessments of competency–performance relationships.”

We suggest that the degree of causal ambiguity likely differs not only across decisions (i.e., operational vs. strategic) but also across different stages of the same decision. As noted above, acquisitions entail two different stages: selection and restructuring (Barkema & Schijven, 2008b; Puranam et al., 2006). The selection stage consists mainly of engaging in a systematic search for and collection of information about a range of potential targets, elaborating on that information in order to decide which target to pursue, and bidding a convenient offer (Makadok & Barney, 2001; Puranam et al., 2006). Extracting value during an acquisition's selection stage is therefore derived from the acquiring firm's superior (i.e., more precise) assessment of the target company's current value relative to the assessments made by other potential acquirers (Capron & Shen, 2007; Reuer & Ragozzino, 2008). In contrast, extracting value during an acquisition's restructuring stage is accomplished through careful reorganization of a target firm after it is acquired. An acquiring firm can create value in this stage by creating synergies (when the target firm is integrated) and/or by improving the acquisition's stand-alone value (when it is not integrated)—for example, by redefining some key strategic variable, such as which market or markets the target firm serves (Quah & Young, 2005; Wright, Hoskisson, & Busenitz, 2001; Wright, Hoskisson, Busenitz, & Dial, 2001).

We can expect the restructuring stage of a strategic decision to be more causally ambiguous than the selection stage. First, a restructuring stage is typically more complex than a selection stage (Bruton et al., 1994). Indeed, it is usually composed of a high number of activities that are also quite interdependent. “from the conversion of the information system, to the integration of supply and distribution chain, from the selection, retention and motivation of human resources to the restructuring and reorganization of the new product development” (Zollo, 2000, p. 206). The resulting confusion and lack of clarity can make it quite difficult for a newly combined entity to isolate the performance effect of any single activity (Cording, Christmann, & King, 2008). Previous research has shown that, due to the complexity of the restructuring phase, past acquisition experience per se does not enhance the performance of the restructuring phase, which instead increases only if that experience is articulated in codified knowledge (Zollo & Singh, 2004). By contrast, the selection phase consists of a relatively limited and well-defined set of activities (mainly target search, evaluation, and bidding), which makes the overall process not only easier to execute than the restructuring stage (Barkema and Schijven, 2008b) but also simpler to evaluate ex post—which implies that the tacit accumulation of past acquisition experience might be a valid guide for selecting new targets.

Second, usually—even if certainly not always—the span of time that passes between the end of a selection stage and the observation of its associated outcome is also quite short, since reliable feedback on the value that a selection generates is relatively immediate. Once a target firm has been acquired, for instance, almost any information missing at the selection stage can be obtained by the acquiring firm, allowing the acquirer to evaluate whether its ex ante assessment of the target's value was accurate and whether the price paid reflects the firm's value (Puranam et al., 2006). By contrast, after the restructuring is terminated, it usually takes at least three years to recognize the actual economic impact of changes implemented in the target company's business (Cording et al., 2008). Any short-term indicator of performance during the restructuring phase might be a poor (or even bad) predictor of the real value that a restructuring creates. For example, a post-

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