

The Effect of Top Management Team Retention on the Post-acquisition Performance

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Abstract: The acquisition strategy is one of the most popular corporate strategies for growth. However, little is known about the effect of retaining the TMT of the acquired firm on the post-acquisition performance. Based on the market for the corporate control perspective and the resource-based view of the firm perspective, the present paper propose that there is a divergent effect of TMT retention on the post-acquisition performance according to the pre-acquisition performance of the target firm. Furthermore, it is proposed that (1) when TMT of the acquired firm represents knowledge-based resources and (2) when the acquisition occurs between successful and unrelated firms, the benefit of retaining the TMT of the acquired firm will increase. However, (1) when TMT of the acquired firm represents property-based resources and (2) when the acquisition occurs between unsuccessful and related firms, the benefit of replacing the TMT of the acquired firm will increase. Finally, theoretical and managerial implications are discussed, and future research directions are suggested.

Key words: acquisition; post-acquisition integration; top management team

JEL codes: M10, M12, M51

1. Introduction

Acquisition strategy is one of the most popular approaches for corporate growth (Seth, Song, & Pettit, 2000). However, past research has suggested that acquisition does not create shareholder value (Datta & Puia, 1995). Nevertheless, acquisition strategy has been considered as a way to acquire a new technology and restructure an old system, so to maximize the organizational value (Haspeslagh & Jemison, 1991).

One of the most important issues in post-acquisition activities may be whether to retain the top management team member of the acquired firm or not, since every organization is a reflection of its top management team (TMT) (Hambrick & Mason, 1984). Much of the research suggests that TMT failure of the target firm is the most crucial antecedent of the acquisition (Herman & Lowenstein, 1988), and this literature suggests that getting rid of the previous management should improve the performance of the acquired firm. In contrast, TMT of the acquired firm may be valuable, needs to be retained after acquisition, and positively affects post-acquisition integration, since (1) it develops and controls strategic assets of the firm, and (2) these assets or resources, when applied appropriately, should generate above average returns and can create a sustainable competitive advantage (Barney, 1986; Peteraf, 1993). This perspective is useful especially when firms make acquisitions of successful firms.

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However, some recent research shows different findings on the effect of TMT retention and post-acquisition performance. For example, Cannella and Hambrick (1993) found a positive relationship between TMT retention and post-acquisition performance, while Martin and McConnell (1991) found a negative association between them. Furthermore, some researchers suggest that there may be no association between acquired firm TMT stewardship and acquisition performance (e.g., Walsh & Elwood, 1991; Walsh & Koznick, 1993).

This inconsistency may result from overlooking complex contexts and situations where acquisitions occur. For example, which target to acquire? Is the target a successful firm or an unsuccessful firm? This paper will propose that the pre-acquisition performance of the target firm will be an antecedent of TMT retention.

In addition, this paper will deal with another fundamental issue: Is there a relationship between the retention of the TMT of the target firm after the acquisition and post-acquisition performance of the acquired firm? This paper will address potential factors that can intervene in this relationship based on the type of resource and acquisition (Cartwright & Cooper, 1992; Das & Teng, 2000; Haspeslagh & Jemison, 1991): Under which condition, retaining TMT of the target firm is the most beneficial to post-acquisition performance?

Regarding these issues, this study will develop a theory on the relationship between the pre-acquisition performance of the target firm, TMT retention, and post-acquisition performance from the perspective of acquiring firm.

2. Theory and Propositions

2.1 When Acquiring Unsuccessful Target Firm: The Market for Corporate Control Perspective on Acquisitions

Research has suggested that one reason firms pursue the acquisition strategy is due to the change in the marketplace where speed becomes of the essence and the need for rapid renewal plays a significant role in driving organizations to acquire competencies rather than to build them internally (Hayward, 2002; Vermelulen & Barkema, 2001). The finance and economics literature conceptualizes acquisition as natural forces in a market for corporate control where alternative management teams compete for the right to control the assets of undervalued corporations (Jensen & Ruback, 1983). The market for corporate control is defined as the transferring of managerial control to new capital providers (e.g., through acquisition) (Hitt, Hoskisson, Johnson, & Moesel, 1996).

Although there are many reasons for acquisitions (e.g., creating synergies, ensuring financial and tax advantages, establishing market power), much of the research from the market for the control perspective suggests that TMT failure and improvement in efficiency using resources of the firm are two of the key motivators for acquisition (Herman & Lowenstein, 1988; Walsh & Koznick, 1993). When the top managers engage in self-interested behavior, their company's performance is likely to diverge increasingly from its maximum potential (Berle & Means, 1932; Fama & Jensen, 1983). Due to this underperformance, other management teams are likely to offer themselves as alternatives to the incumbent management. As a consequence, the right to manage resources of the underperforming firm is taken over to the new management team. Indeed, Lowenstein (1983, p. 272) pointed out that the acquiring company's expected gain resides "almost entirely in the expectation that it will be able to root out deadwood inefficiencies and put a target's assets to better use."

Also, acquisitions are viewed as a solution to the agency problems arising between managers and stockholders, since the threat of acquisition focuses managers on the goal of shareholder wealth maximization

(Philippatos & Baird, 1996). Empirical findings have also suggested that successful, better performing firms make acquisition of poorly-performing companies and subsequently create greater value (Servaes, 1991). Poor performance predicts executive turnover (Dalton & Kesner, 1985) and a board will dismiss its top managers if its firm is performing poorly compared to other firms in the industry (Morck et al., 1988). Therefore, the replacement of management is considered to be a natural consequence, as well as a useful mechanism to enhance the acquired firm's performance (Agrawal & Walkling, 1994; Martin & McConnell, 1991).

Given that the top managers of the poorly-performing firms have failed to maximize resources and have lost the trust from the board, the acquiring company may consider them as a liability to build synergy after the acquisition. Therefore, getting rid of the previous management could improve the performance of the acquired firm, when the prior performance of the acquired firm is low.

Proposition 1: When the pre-acquisition performance of the target firm is poor, the less TMT will be retained after the acquisition. In turn, the less TMT of the poor-performing target firm are retained, the higher post-acquisition performance will be.

2.2 When Acquiring Successful Target Firm: Resource-based View of the Firm on Acquisitions

The resource-based view (Penrose, 1972; Wernerfelt, 1984) suggests that organizations are collections of valuable resources that can be used to achieve their goals, and the success or failure of an organization is determined by its usable resources. Briefly, the resource-based view of the firm theorizes that the accumulation of resources, that are valuable, rare, imperfectly imitable, and for which there are not strategically equivalent substitutes create resource position barriers to deter competition, and competitive advantage resulting in above-normal returns (Barney, 1991; Petraf, 1993; Wernerfelt, 1984). From this viewpoint, every strategy is for acquiring valuable resources, and acquisition, too, is a mechanism that organization can maximize value by gaining access to the idiosyncratic and valuable resources of other organization (Madhok, 1997; Ramanathan et. al., 1997).

Since the resource-based view holds that an organization is viewed as a bundle of specialized resources that are deployed to create a privileged market position, how these resources are organized, employed, and subsequently integrated by the top managers is of interest (Barney, 1986; 1988; Dietrich, Cool, & Barney, 1989; Rumelt, 1982; Wernerfelt, 1984). It is especially relevant to the acquisition situation, since the post-acquisition activity, which is integrating and organizing different resources from different organizations, is one of the most important factors to determine success or failure of acquisitions.

According to Hambrick and Mason (1984), firms are also a reflection of their top management teams and organizational outcomes can be predicted through an examination of these individuals. Therefore, the TMT of firms can represent their unique and competitive resources. In fact, the TMT is responsible for their firm's success or failure due to their resources such as strategic decisions, corporate culture, human resource selection and enhancement, knowledge that is internal to the firm as well as their external knowledge of the industry, market, and competitors (Cyert & March, 1963; Hambrick & Mason, 1984; Ireland & Hitt, 1999; Salancik & Pfeffer, 1977).

Given these resource-based view point of view and upper-echelon perspective, it seems natural that retaining the TMT of the target firm whose prior performance is high is beneficial for the post-acquisition performance. Indeed, Cannella and Hambrick (1993) reported that the loss of the TMT from the acquired firms negatively affected the post-acquisition performance of the acquired firm. In addition, TMT departure after acquisition may heighten the level of disruption and uncertainty in the firm following acquisition (Cannella & Hambrick, 1993;

Hambrick & Cannella, 1993; Krishnan et al., 1997). Therefore, when acquiring successful target firm, which is mainly motivated by the intention to enjoy the resource of the target firm, retaining TMT of the target firm will be beneficial for the post-acquisition performance.

A knowledge-based argument (Kogut & Zander, 1992; Barney, 1991) is another ground for arguing the importance of retaining the TMT of the acquired firm. Knowledge is information laden with experience, truth, judgment, intuition, and values; a unique combination that allows individuals and organizations to assess new situations and manage change (Huseman & Goodman, 1999). Often, the TMT knowledge is tacit, and its value is due to its inimitability. Also, the TMT generates a culture of knowledge creation and dissemination within the organization through culture development. Therefore, from a knowledge-based perspective, the TMT can be a source of competitive advantage. In particular, as the marketplace continues to become even more dynamic, and decision processes become more unstructured with few rules, and knowledge and experiences of the TMT come to be more important for organizational outcomes (Cohen et al., 1972; Cyert & March, 1963; Mitzberg et al., 1976).

In addition, the TMT of the acquired firm plays a role of transporting knowledge within the newly combined firm, which is crucial to knowledge production and development (Argote & Ingram, 2002). Also, the TMT may provide the acquiring firm with access to knowledge that is novel or different (Gruenfeld et al., 2000) and can act as conduits for the transfer of fine-grained information (Kraatz & Moore, 2002).

In sum, the TMT of the successful target firm is a source of value for the acquiring firm. When top managers depart, valuable resources and expertise may be lost which hinders post-acquisition integration (Cannella & Hambrick, 1993; Hambrick & Cannella, 1993). Dismissal of the TMT during the acquisition period also will affect the communication within the firm and will aggravate the high levels of uncertainty (Tombaugh & White, 1990), which results in lowering post-acquisition performance. Therefore, the acquiring firm can employ and enjoy the resources from the acquired firm when the TMT of the acquired firm remains, which may be the key of the acquisition success. In other words, when acquiring a successful firm, the more the TMT of the acquired firm is retained, the higher the performance after the acquisition.

Given the rationale from the market for the corporate control perspective on the acquisition of an unsuccessful firm and resource-based view on acquisition of a successful firm, the following proposition can be developed.

Proposition 2: When the pre-acquisition performance of the target firm is high, the more TMT will be retained after the acquisition. In turn, the more TMT of the high-performing target firm are retained, the higher post-acquisition performance will be.

2.3 The Effect of the Type or Resources

Sometimes, it may be impossible to retain every TMT members after the acquisition, since it may lead to an increase of TMT size, which is associated with high cost of team coordination. In addition, in some cases, the acquired firm does not need a high degree of autonomy and strategic interdependence, which, in turn, lowers the benefit of retainment of TMT (Haspeslagh & Jemison, 1991).

Then, what can determine the value of the TMT of the acquired firm for post-acquisition performance? One of the answers may be the characteristics of resources that the TMT has access. Since firm resources are of various types, it is no surprise that scholars have proposed a number of different typologies. The simplest approach differentiates between tangible and intangible resources (Grant, 1991). Barney (1991) classifies firm resources into physical capital resources, human capital resources, and organizational capital resources. Das and Teng (1998) categorized firm resources into financial, technological, physical, and managerial resources. Miller and Shamsie

(1996) suggest that, based on the notion of barriers to imitability, all resources may be classified into two broad categories: property-based resources and knowledge-based resources.

Property-based resources are legal properties owned by firms, including financial capital, physical resources, human resources, etc. They are protected through property rights in such forms as patents, contracts, and deeds of ownership (Miller & Shamsie, 1996). Owners enjoy clear property rights to these resources, or rights to use the resources so that others cannot take them away without the owners' consent. Thus, acquiring organizations could be an heir of these resources legally, and they could have full access to them. Therefore, when the resource to which the acquired TMT has access is this type of resource, the benefit of retaining the TMT shrinks. In other words, the higher the proportion of property-based resource in the acquired firm is, the lesser the benefit of retaining the TMT will be.

However, the benefit of retaining the TMT of the acquired firm will increase, when the TMT holds knowledge-based resources, which refer to a firm's intangible know-how and skills (Miller & Shamsie, 1996). In contrast to property-based resources, knowledge-based resources are not easily imitable owing to knowledge and information barriers. Others cannot easily copy or imitate knowledge-based resources because they are vague and ambiguous. Thus, tacit know-how, skills, and technical and managerial systems not protected by patents, all fall in this category (Hall, 1992). Imitating technological and managerial resources may be inherently uncertain, because knowledge creation inevitably involves "irreducible ex-ante uncertainty" (Lippman & Rumelt, 1982).

Besides imperfect imitability, technological and managerial resources are also imperfectly substitutable. Satisfactory substitutes and alternatives to superior technologies and managerial talents are often not available. Furthermore, organizational resources, such as culture and learning capacity, are deeply embedded in a firm, and are almost impossible to be moved (Das & Teng, 2000). Therefore, when the resource to which the acquired TMT has access is this type of resource, the benefit of retaining the TMT increase. In other words, the higher the proportion of knowledge-based resource in the acquired firm is, the higher the benefit of retaining the TMT will be.

Proposition 3: The effect of retaining TMT of the target firm on post-acquisition performance will be moderated by the type of resources the TMT has access to.

Connecting this proposition to former propositions on the effect of the pre-acquisition performance of the target firm, following propositions can be developed.

Proposition 3a: In the acquisition of unsuccessful target firm, when the TMT of the target firm has access to the knowledge-based resources, the negative relationship between TMT retention and post-acquisition performance will be weaker. In contrast, if the TMT of the target firm has access to the property-based resources, the negative relationship between TMT retention and post-acquisition will be higher.

Proposition 3b: In the acquisition of successful target firm, when the TMT of the target firm has access to the knowledge-based resources, the positive relationship between TMT retention and post-acquisition performance will be stronger. In contrast, if the TMT of the target firm has access to the property-based resources, the positive relationship between TMT retention and post-acquisition will be weaker.

2.4 The Effect of the Type of Acquisition

Acquisitions have been classified according to the following four types: Vertical, horizontal, conglomerate, and concentric (Cartwright & Cooper, 1992). In a vertical acquisition, one organization is acquiring another within their supply chains. Transaction cost analysis would suggest that this type of acquisition occurs to internalize or lower the costs of production or of doing business in the open market. In a horizontal acquisition, two

organizations in the same industry (competitors) combine operations. This type of acquisition occurs for economies of scale, market power, or the acquisition of competencies from the competitors. A conglomerate acquisition is the acquisition of an unrelated organization. The objectives are usually to reduce systematic risk between industries and to develop a large internal capital market. Concentric acquisition refers to a combination between organizations offering complimentary products or services. An example of such would be a wireless service organization being acquired by an organization with core competencies in local and long distance services. Potential economies of scale, use of similar distribution channels, and sales capabilities could overlap.

Although the four types are differentiated, often the classification for a given acquisition is not so straightforward, so the present paper will focus on whether the acquisition is between related firms or unrelated firms.

Relatedness has been defined as the extent to which acquired and acquiring firms serve similar customers, or utilize similar production processes (Rumelt, 1982; Porter, 1987). Research suggests that the type of acquisition affects the value of the TMT, as it is suggested that management retention should be more important in unrelated acquisition than in related ones, since the target firms' TMT are likely to be more familiar with their operation than the acquiring firm (Cannella & Mambrick, 1993; Walsh, 1988). In other words, in a related type of acquisition, it may be possible that the acquiring firm has already access to the resources of the acquired, or at least, the resources of the acquiring firm can be easily applied to the acquired firm. Also, since unrelated firms are more likely to be organized as decentralized conglomerates with less contact between TMT after the acquisition, there will be little process losses in the new composed TMT (Gupta & Govindarajan, 1986). In addition, utilizing resources of the acquired firm and transferring skills from the acquiring firm to acquired firm can be easily done in some degree without the high cost of restructuring. Therefore, the value of retaining the TMT of the acquired firm will decrease when the acquisition occurs within the related firms. In contrast, in the unrelated acquisition, resources of two organizations may be different and not applicable to the other. Therefore, resources of the acquired firm will be considered as very precious and critical ones for post-acquisition performance, and the TMT of the acquired firm will be taken as valuable by acquiring firm.

However, this viewpoint may be too simplistic one, when considering the effect of TMT retention may be divergent according to the pre-acquisition performance of the target firm. In other words, the effect of the relatedness is the same to acquiring either successful target or unsuccessful target? For example, when the target firm is successful and related, the value of TMT of the target firm may be high to the acquiring firm, too, since they may have useful and valuable capabilities and skills to employ the resources of the target firm as well as they may have good knowledge on the industry. Also, these capabilities, skills, and knowledge can be easily integrated into the acquiring firm, since the TMT of acquiring firm and acquired firm may have many commons (e.g., functional background, network position and status). Therefore, they may well be retained in the TMT of the acquiring firm.

Also, when the target firm is unsuccessful and unrelated, the TMT of the target firm may well be replaced, too. Since the motivation of acquiring unrelated target firm may be more to expand its business scope, to enter a new business industry, or to earn financial benefit from re-selling the target firm rather than just to obtain resources of the target firm (Chang, 2004), the acquiring firms may change TMT to synchronize with themselves or to attract potential buyers.

Therefore, there may be the same amount of needs for the acquiring firm to retain and replace TMT of the target firm when acquiring successful and related target firm, or acquiring unsuccessful and unrelated target firm.

The proposition that past research has suggested, which is that the value of retaining the TMT of the target firm will decrease in related acquisition and the value of it will increase in unrelated acquisition, may be only relevant when acquiring successful and unrelated target firms, and acquiring unsuccessful and related target firms. Therefore, following propositions are developed:

Proposition 4: The effect of retaining TMT of the target firm on post-acquisition performance will be moderated by the type of acquisition.

Proposition 4a: In acquisition of unsuccessful target firm, when the target firm is related to acquiring firm, the negative relationship between TMT retention and post-acquisition performance will be stronger. However, if the target firm is unrelated to acquiring firm, the relationship will not be changed.

Proposition 4b: In acquisition of successful target firm, when the target firm is unrelated to acquiring firm, the positive relationship between TMT retention and post-acquisition performance will be stronger. However, if the target firm is unrelated to acquiring firm, the relationship will not change.

3. Discussion

Although the TMT is the most important group in an organization (Ireland & Hitt, 1999), what we know about the effects of the TMT of the target firm on acquisition is very little (Jemison & Sitkin, 1986; Walsh, 1988). Mostly, based on the financial and economic perspective, it has been considered almost natural to replace the TMT after acquisition without thinking over its disadvantages. However, as resource-based view of the firm suggests, firms acquire others to obtain the resources inherent in the top management team and that retention of that group aids post-acquisition performance. This paper attempts to incorporate these two perspectives, and propose that the effect of TMT retention on post-acquisition performance is divergent according to whether the pre-acquisition performance of the target firm is high or low. It implies that the market for the corporate control perspective may explain well on acquiring unsuccessful target firm, while resource-based view may explain well on acquiring successful target firm.

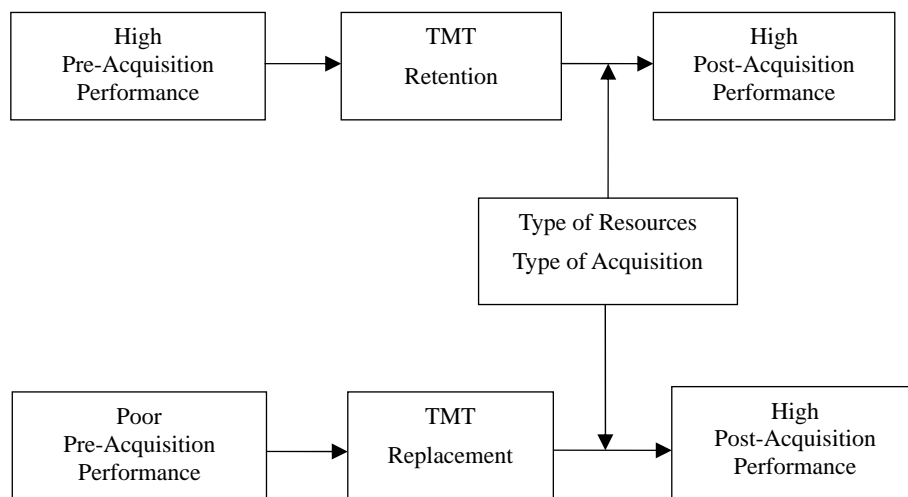


Figure 1 The Effect on TMT Retention on Post-Acquisition Performance

Furthermore, the present paper attempts to identify the specific condition under when the retention of the TMT becomes more important and less important. Based on the type of firm resources, the present paper proposes

that the positive relationship between retaining TMT of the successful firm and post-acquisition performance will be stronger when the TMT has access mainly to knowledge-based resources rather than property-based resources, and the negative relationship between retaining TMT of the unsuccessful firm and post-acquisition performance will be stronger when the TMT has access mainly to property-based resources rather than knowledge-based resources.

In addition, the moderating role of acquisition type in the relationship between TMT retention and post-acquisition performance is suggested. Different from the past suggestions on the effect of acquisition type on the TMT retention, this paper pointed out that the type of acquisition has its effect only in specific condition — acquisition of successful and unrelated target firm, or acquisition of unsuccessful and related target firm: When acquiring successful and unrelated target firm, retention of TMT of the target firm will be beneficial to post-acquisition performance, while acquiring unsuccessful and related target firm, replacement of TMT of the target firm will be beneficial to post-acquisition performance.

However, retaining or replacing the TMT of the acquired firm has different issues to be solved. Since most acquisitions are expected to create synergy from combining different firms, coordination and collaboration of these firms, and different TMTs from different firms may be the most important issue for the success of acquisition (Singh & Montgomery, 1987; Souder & Chakrabarti, 1984). But coordination and collaboration of different TMTs may require more time and effort than just relying on existing TMT of the acquiring firm. Perhaps, recent research on team composition (e.g., Bunderson & Sutcliffe, 2002; Harrison et al., 2002; Jehn et al., 1999) can shed light on this problem. To summarize, these scholars suggest that while deep-level diversity (e.g., identity-based attributes) may be dysfunctional in the short-term and surface-level diversity (e.g., demographics) may be easily overcome, in the long-term, the benefit of surface-level diversity diminishes, and the value of deep-level diversity increases. Therefore, since the TMT composition after acquisition includes deep-level diversity issues as well as surface-level diversity issues, whether to retain or replace the TMT of the acquired firm may be also determined by the objective of the acquisition — whether it is for achieving a fast and immediate outcome or not. This issue may be an interesting and important future research topic.

Another important issue is the size of the TMT includes “Does the size of the TMT change after acquisition according to the resource type and acquisition type?” Every acquisition requires integration and synchronization between two firms, which imply that acquiring firms need to assign new manager, who have worked for the acquiring firm, to the acquired firm. However, especially, when the TMT of the acquired firm has access to knowledge-based resources and when the acquisition occurs between related firms, retaining the TMT of the acquired firm is beneficial for the post-acquisition performance. As a result, to maximize resource obtainment and integration, the new TMT will be composed of the TMT of the acquired firm and TMT of the acquiring firm, which results in the large TMT size. However, large team needs high cost to be well-coordinated (Campion et al., 1993, 1996). Therefore, it can be said that large TMT can be beneficial, and at the same time, large TMT is expensive. Then, how can we compromise the profits and losses? Which factors will be related to this paradox? Future research may well attempt to solve this problem.

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