RETENTION EFFECTS IN POST-ACQUISITION STRATEGIC AND SOCIAL CONTEXTS: A CLOSER LOOK AT HOW RETAINED TARGET FIRM EXECUTIVES AFFECT ACQUISITION PERFORMANCE

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Abstract - This study examines how post-acquisition firm performance is affected by the decision of retaining executives who used to work at the target in the combined new firm. We focused on three dimensions of the retention decision: (1) whether or not one or more target firm executives are retained in the combined firm; (2) average tenure of the retained executives with the target firm before they join the combined firm; and (3) the new job positions of the retained executives in the combined firm. We also examined the strategic and social contexts where retained executives' knowledge is more likely to complement knowledge possessed by acquiring firms' executives and when retained executives are more motivated to apply their knowledge. Using a sample of large acquisitions by U.S. manufacturing companies, we provide empirical evidence that the positive effects of executive retention on post-acquisition performance are stronger when the acquiring and the acquired firms are from unrelated industries and when the target firms are relatively small. Theoretical and managerial implications of these findings are discussed.

Keywords - Acquisition performance, executive retention, top management teams, the resource-based view,contingency perspective

I. INTRODUCTION

Global mergers and acquisitions (M&As) activities reached US$ 3.6 trillion in 2017, the fourth consecutive year tosurpass $3 trillion(Thomson Reuters, 2017). Companies have been spending huge amounts of money in M&A deals, however, it has been documented that 40% to 80% of M&As failed to meet their claimed objectives (Dunbar, 2014).Numerous studies have examined the factors that influence post-acquisition performance of the "combined firms" (Cartwright & Schoenberg, 2006; Haleblian, Devers, McNamara, Carpenter, & Davison, 2009; King, Dalton, Daily, &Covin, 2004). Whether or not the combined firm retains executives who previously worked at the target firm, among others, has been identified as a key acquisition success factor (Jemison &Sitkin, 1986), because they have tacit and nontransferable knowledge about the acquired business, which is crucial in post-acquisition integration between the acquiring and the target firms.

However, previous studies on the "retention effects" are not without their limitations. First, the retention decision is not a simple "yes or no" option. It has several layers, which requires a closer look at the various retention choices the acquiring firm makes. Starting from deciding whether or not to keep target firm executives in the newly formed combined firm, the acquiring firm must also decide whom to retain and what roles the retained executives should play in the post-acquisition top management team (TMT). The layers of the retention decision and their performance implications, however, have yet to be systematically examined. Second, by retaining target executives, the combined firm establishes only "potential access" to the target-specific knowledge owned by the executives. It remains a question whether or not the executives will use their knowledge in the firm's post-acquisition operations. An in-depth understanding of the retention effects would require examining how post-acquisition contexts may facilitate or hinder the use of retained executives' knowledge. This contingency approach has received only limited attention so far.

This study aims to address the above-mentioned limitations. We ask one question: How do retention choices influence performances of the combined firms in different post-acquisition strategic and social contexts? We examined the retention decision along three dimensions: (1) whether or not one or more target firm executives are retained in the combined firm ("retention"); (2) average tenure of the retained executives with the target firm before they join the combined firm; and (3) the new job positions of the retained executives in the combined firm. We argue that the presence of target firm knowledge and the status of retained executives potentially have a positive impact on post-acquisition firm performance. But this potential can only be realized if retained executives work with other TMT members in facilitating strategic and social contexts. Specifically, in terms of strategic context, we suggest that positive retention effects on post-acquisition performance will be stronger if retained executives' knowledge complements the acquiring firm's executives' knowledge (knowledge complementarity). In terms of social context, we emphasize incentive compatibility between acquiring firm executives and retained target executives. Retained executives are more likely to use

their knowledge if they find themselves in a social context in which they have incentives to prove their abilities.

This study contributes to the retention and acquisition research in several aspects. Theoretically, we propose a contingency approach to understanding the performance effects of executive retention, which extends the RBV analysis to include critical contextual factors. Practically, the findings will help companies evaluated possible costs and benefits associated with retention and appointment of acquired firm top executives based on different organizational conditions, which, in turn, may increase the probability of acquisition success.

II. THEORY AND HYPOTHESES

A. Executive Retention Choices and the Presence of Acquired Firm Knowledge

The retention of target top executives' human capital and social capital is considered one of the key determinants of post-acquisition success for several reasons (Cannella & Hambrick, 1993). First, the RBV suggests that knowledge possessed by the target firm executives is an intrinsic component of the target firm's resource base (Cannella & Hambrick, 1993; Castanias&Helfat, 1991). One of the most valuable resources obtained from the acquisition is the human and social capital embedded in the target firm's employees, particularly in its top management team (Zollo& Singh, 2004). Their knowledge of the target firm's markets, long-term relationships with suppliers and buyers, traditions and history, intangible capabilities and routines, and underlying political structure would be beneficial for effective implementation of the acquisition (Bergh, 2001). The tacit knowledge of the acquired organization will not be easily observed or replaced from outside the target firm. These arguments suggest that the combined firm will benefit from retaining target firm executives. This may particularly be true when the retained executives had spent longer tenures at the target firm or when they are granted with higher-ranking jobs in the new firm. However, we argue that retention, firm tenure, and job positionsare only indicators of the "presence" of target firm knowledge. The following paragraphs explain how strategic and social contextsinfluence the retention effect on acquisition performance.

B. TMT Knowledge Complementarity in Post-Acquisition Strategic Context

One condition that may affect how retained executives' knowledge will be used involves the relative strategic importance of their knowledge. Simply put, retained executives have more chances to apply their knowledge if their contributions are seen as unique and complementing other TMT members' cognitive resources. Conversely, retained knowledge loses its value if there is significant overlap between the knowledge structures of acquiring and target executives. TMT knowledge complementarity refers to different or dissimilar skill sets and backgrounds that offset one another (Barney, 2001). In research on strategic alliance formation, partner complementarity has been regarded as a key matching (Mitsuhashi and Greve, 2009). In the context of acquisition, whether the retained target executives and other TMT members complement one another's knowledge is critical to organizational fit, a key determinant of acquisition success (Haspeslagh& Jemison, 1991; Wiersema &Bantel, 1992). Two parties are defined as "complementary" if their different capabilities can be combined to create greater value. TMT complementarity contributes to strategic fit through "valuable" differences in knowledge and skills.

In this study, we examine TMT knowledge complementarity in terms of industry relatedness between the acquiring and the target firm. Industry relatedness is defined as the extent to which the acquiring and target firms serve similar customers, operate in similar markets or utilize similar production processes (Rumelt, 1974; Porter, 1987). It is likely that top executives from the two firms share similar experience and background and possess similar knowledge and skills when the acquisition is highly related. As a result, expertise and capabilities of the retained acquired top executives are likely to become redundant and easily replaceable in related acquisition. Such industry familiarity can eliminate or significantly diminish the need for acquiring firm managers to "learn" the business of the acquired firm (Hitt, Harrison, & Ireland, 2001). They are more likely to effectively employ their "dominant logic" or common conceptualization of the success requirements in an acquired business (Prahalad & Bettis, 1986). By contrast, in unrelated acquisitions, the acquiring firm may be greatly dependent upon the retained top executives (Krishnan et al., 1997). These arguments lead to our first hypothesis:

Hypothesis 1: The relationship between retention of acquired top executives and post-acquisition financial performance will be stronger when the acquisition is unrelated.

Another determinant of the strategic importance of retained knowledge has to do with the executives' firm tenure. The RBV suggests that the retention of long-tenured executives would lead to better acquisition outcomes (Bergh, 2001). Firm tenure, or the number of years one has been employed by a firm, has been indicative of firm-specific knowledge (Pennings et al., 1998). Long firm tenure is often associated with rich firm- and industry-specific experience, long-standing relationship with key customers, suppliers and other stakeholders so as to be representative of valuable, inimitable, rare and non-substitutable firm-specific knowledge. Such unique and non-transferable knowledge accumulated from years of working with the acquired firm enabled those acquired top executives to provide helpful

insights into key factors in the acquisition implementation process and improve the effectiveness of the implementation, which could lead to more successful acquisition outcomes (Bergh, 2001; Cannella & Hambrick, 1993; Haspeslagh& Jemison, 1991). However, again, the value of knowledge brought by retained acquired top executives to the acquiring firm may be contingent upon the acquirer-target relatedness. For an unrelated acquisition, the acquiring and target firms serve different customers and utilize different production processes, which makes it difficult to replace the target firm executives (Cannella & Hambrick, 1993). By contrast, for a related acquisition, the acquiring firm's top executives may have expertise and skills relevant to managing the acquired business. As a result, acquired top executives can be replaced by acquiring top executives without detrimental influence on post-acquisition performance since they possess overlapping knowledge base. Even acquired top executives with long firm tenure become less valuable and influential in post-acquisition outcomes. Therefore, we hypothesize:

Hypothesis 2: The relationship between the average firm tenure of retained acquired top executives working in the acquired firm and post-acquisition financial performance will be stronger when the acquisition is unrelated.

C. TMT Incentive Compatibility in Post-Acquisition Social Context

Relative size of an acquisition was defined as relative size of the acquired firm to the acquiring firm (i.e., the ratio of firm size of the two firms) (Haleblian& Finkelstein, 1999). It is closely related to the compatibility between the acquiring firm's and acquired firm's top executives in terms of motivation and goal. While TMT complementarity considering relatedness mainly focuses on the heterogeneity of knowledge and skills, TMT compatibility considering relative size emphasizes the homogeneity of goals and motivation. Comparable-size acquisitions may cause motivation and coordination problems during the post-acquisition integration (Finkelstein, 1992; Hambrick, 2007).

First of all, relative size of the acquired firm to the acquiring firm affect power disparity among subgroups splitting by their origins in the joint TMT (Carpenter et al., 2004; Finkelstein & Hambrick,1996). Relative size can influence relative subgroup power and the likelihood of subgroup members voicing their opinions and enacting their suggestions (Lau &Murnighan, 1998). Powerful executives have the ability to influence strategic decision such as resource allocation. In acquisition contexts, retention creates two subgroups splitting along their original firms. Relative size of the acquired firm to the acquiring firm implies their relative subgroup power. When the acquired firm is relatively large compared with the acquiring firm, the retained executives tend to possess more social power and receive more internal support which may enable them to influence strategic decisions such as how many resources will be transferred from or to the acquired firm and make them less willing to share their knowledge and skills and cooperate with other TMT members from the acquiring firm. It may lead to negative reactions from the retained executives such as resisting any strategic changes of post-acquisition integration and being committed to the strategic status quo (Hambrick, Geletkanycz& Fredrickson, 1993).

Second, retained top executives are likely to leverage their relatively favorable negotiating position to require exchanges of resources in the pursuit of their self-interest when the acquired firm is relatively large. The retained acquired firm top executives usually experience a process of organizational socialization, or so-called "getting on board", which refers to the process by which newcomers make the transition from being organizational outsiders to being insiders (Ashforth, Sluss, & Saks, 2007; Bauer, Bodner, Erdogan, Truxillo, & Tucker, 2007). As suggested by organizational socialization literature, newcomers will use a variety of adjustment strategies to manage this transition, including proving, giving, exchanging and negotiating (Cooper-Thomas, Anderson, & Cash, 2012). Newcomers are more likely to use proving and giving strategies when they need for achievement and affiliation, whereas use exchanging and negotiating strategies when their need for autonomy and dominance.

After an acquisition was made, during the organizational socialization process, when the acquired firm is relatively large, the retained top executives' desire for autonomy and dominance may be salient and thus they tend to use strategies of exchanging and negotiating. They may be unwilling to share their knowledge, skills, expertise, information and network unless the oldtimers, i.e., TMT members from the acquiring firm offer them with valuable resources and favorable treatment (e.g., pay rise and privilege), even at the expense of the new organization. By contrast, when the acquired firm is relatively small, the retained top executives will be strongly eager to fit into the new organization and earn their legitimacy. Therefore, they are more likely to have a strong propensity to share their knowledge, expertise and information with other TMT members and contribute to the post-acquisition implementation in order to demonstrate their abilities and gain acceptance.We therefore predict:

Hypothesis 3: The positive relationship between retention of acquired firm top executives and post-acquisition performance is stronger when the acquired firm is relatively small to the acquiring firm.

There remains one question concerning the deployment of acquired firm top executives: what position should the retained executives be appointed to? Cannella and Hambrick (1993) addressed this

question by suggesting that retained acquired firm top executives should be provided with high-ranking positions and included in the post-acquisition firm's dominant coalition. Such "status bestowal" (officership and/or directorship) could decrease the turnover rate of the acquired firm top executives resulting from a sense of status decline following the acquisition and thus improve post-acquisition performance.

In addition, much of research on turnover of acquired top management teams used the theory of relative standing (Frank, 1985) to examine why acquired firm top executives depart (Lubatkin, Schweiger, & Weber, 1999). Relative standing is usually presented in access to the center of power, titles, inclusion, etc. It predicts that acquired firm top executives are more likely to stay and cooperate after an acquisition when they are given a greater sense of status and importance in the newly combined firm. Appointing acquired firm top executives to high-ranking positions in the top management team may help provide them with such a positive sense of their status and worth in the new organization (Ranft& Lord, 2000).

The change in relative standing resulting from granting status would be more manifested when the acquired firm is substantially smaller than the acquiring firm. These executives bestowed with status may find that their career has received a large boost, afford to make informed decisions about how to manage post-acquisition adjustments, have a high degree of morale and willingness of cooperation, all of which could facilitate the process of post-acquisition implementation.

Therefore, (in)compatibility in motivation and goal resulting from variation in relative firm size influence the potential benefits from high-ranking position appointments. We thus hypothesize:

Hypothesis 4: The positive relationship between appointing one or more members of the acquired firm's executives to high-ranking positions in the top management team of the new firm and post-acquisition performance is stronger when the acquired firm is relatively small to the acquiring firm.

III. RESEARCH METHODOLOGY

A. Sample Selection and Data Sources

We draw our sample from Mergers & Acquisitions transactions database provided by the Thomson Reuters's Securities Data Corporation (SDC) Platinum for the years 2000-2012. For an acquisition to be included in the sample, the following criteria were employed: (1) acquisitions had to be completed; (2) acquisitions with transaction value of greater than 100 million US dollars (Haleblian& Finkelstein, 1999); (3) only those acquisitions in which the acquiring firm's CEO of the announcement year held CEO position of the new firm the year following the focal acquisitions were kept to eliminate as many confounding events as possible, e.g., CEO succession. We collected background information on executives from annual reports in EDGAR system and BoardEx database and financial information from COMPUSTAT. The final sample consists of 162 acquisitions made by 123 acquiring firms involving 127 CEOs .

B. Dependent Variable

Post-acquisition performance. Post-acquisition performance was measured by return on assets (ROA) for the combined firm two years after the announcement year because the research purpose is to examine the actual outcomes of those acquisitions, or whether or not the expected synergistic potential would be realized in the post-acquisition phase, and firm performance would be improved in the long run. Data were obtained from COMPUSTAT.

C. Independent Variables

Retention. We created a dummy variable to identify whether or not there were any TMT members in the combined firm who were top executives retained from the acquired firm one year after the acquisition, which was coded 1 if there were any top executives who were retained and 0 otherwise. Data was obtained from annual reports of EDGAR.

Relatedness. Based on Morck, Shleifer, and Vishny (1990) and Haleblian and Finkelstein (1999), we examined 4-digit NAIC codes from the six main lines of business (by sales) in which an acquiring firm and acquired firm operated. If a firm operated in fewer than six 4-digit industries, all industries were taken into considered. An acquirer and target were classified as "related" if they had at least one 4-digit NAIC code in common among the top six in which they operated at the time of the acquisition. Otherwise, they were classified as "unrelated". We created a dummy variable which was coded 1 if the acquirer and target were classified as "related" and 0 otherwise. Data was obtained from SDC Platinum.

Relative size. Adopted from Asquith, Bruner, and Mullins (1983) and Haleblian and Finkelstein (1999), we first calculated the ratio of target's total assets to acquirer's total assets. The relative size of an acquisition was classified as "large" when the ratio of target's total assets to acquirer's total assets was overthe 50thpercentile. Otherwise, they were classified as "small". An acquisition with "large" relative size was then coded as 1 and 0 otherwise. Data was obtained from SDC Platinum and EDGAR system.

Average firm tenure of retained top executives. First, we identified each of the acquired firm's top executives and key employees who were presented in the top management team (i.e., at and above the level of vice president) of the joint organization one year after the acquisition. Consistent with Bergh (2001), firm tenure of acquired firm top executives was computed as the mean number of years each of these

retained top executives and key employees had been employed by the acquired firm at the time of the acquisition, and then log transformed to normality.

High-ranking position appointment. The retained top executives presented in the top management team of the new organization could be appointed to either high-ranking positions such as COO, president, director or relative low-ranking positions such as VP or group president. Adopted from Cannella and Hambrick (1993) and Bergh (2001), we created two dummies, "high rank" and "low rank" to identify the appointment. High rank was coded 1 if at least one of the retained top executives held any of the following six titles: CEO, chairman, vice-chairman, president, COO and director, otherwise equals to 0. Low rank was coded 1 if none of the new job titles of the retained top executives was included in above-mentioned six titles, i.e., CEO, chairman, vice-chairman, president, COO and director, otherwise equals to 0. If high rank and low rank both equal to 0, it indicates that none of the top executives was retained.

Control Variables

We included a number of control variables, which have been related to acquisition performance in prior empirical studies.CEO age was measured as the logarithm of CEO's age in the year of the acquisition announcement. It can be seen as a proxy for a CEO's experience and influence (Cannella & Shen, 2001). CEO's firm tenure was measured as the logarithm of the total number of years since the CEO joined the focal firm. Besides, we also controlled for variables concerning CEO's social ties. Payment method was measured using two dummy variables: (1) cash payment equals to 1 for cash only; (2) stock payment equals to 1 for stock only. If cash payment and stock payment both equal to 0, it will represent a combination of cash and stock. Data was obtained from SDC Platinum.We also controlled for previous acquisitions to identify those firms that acquired other firms in recent years using a dummy variable. Information required to construct this variable was collected from SDC Platinum.Pre-acquisition performance was measured as industry-adjusted performance by subtracting the median six-digit NAICS industry return on assets (ROA) from firm-level ROA one year before the acquisition (Haleblian& Finkelstein, 1999). Consistent with Sanders and Carpenter (1998), TMT size was measured as the total number of persons comprising the new firm's top management team and then log transformed to normality. Data were collected from EDGAR system.Industry growth was measured as the 5-year sales growth in the 4-digit NAICS code industry (Owen & Yawson, 2010).Adapted from Haunschild (1993) and Haleblian and Finkelstein (1999), we also controlled for the potential effects of macroeconomic environment on acquisition activity by entering certain years as a set of dummy variables.

D. Data Analysis

The data were structured as a pooled cross section and time series. They were unbalanced because the number of observations varies among firms. Therefore we used the generalized least squares (GLS) regression method to analyze this pooled cross-sectional time-series data (xtgls, Stata 13) to address the issue of heteroscedasticity as well as autocorrelation (Zhang & Rajagopalan, 2009).

IV. RESULTS

Hypothesis 1 predicted that in unrelated acquisitions, the positive relationship between retention of acquired firm top executives and post-acquisition performance would be stronger. Results indicated the effect of retention is positive and marginally significant ($\beta = .08$, $p < .10$), the interaction effect of retention and acquisition relatedness is negative and marginally significant ($\beta = -.08$, $p < .10$). Hypothesis 1 is, therefore, supported.

Hypothesis 2 predicted that in unrelated acquisitions, the positive relationship between the average firm tenure of retained top executives and post-acquisition performance would be stronger. Results indicated the effect of average firm tenure is positive and marginally significant ($\beta = .04$, $p < .10$), the interaction effect of average firm tenure and acquisition relatedness is negative and marginally significant ($\beta = -.04$, $p < .10$). Hypothesis 2 is supported.

Hypothesis 3 predicted that when the acquired firm is relatively small to the acquiring firm, the positive relationship between retention and performance would be stronger. Results indicated the effect of retention is positive and significant ($\beta = .10$, $p < .05$), the interaction effect of retention and relative size is negative and significant ($\beta = -.11$, $p < .05$). Thus, we found empirical evidence that supports Hypothesis 3.

Hypothesis 4 predicted that when the acquired firm is relatively small to the acquiring firm, the positive relationship between high-ranking position appointment and post-acquisition performance would be stronger. Results indicated the effect of high-ranking position appointment is positive and significant ($\beta = .16$, $p < .01$), the interaction effect of high-ranking position appointment and relative size is negative and significant ($\beta = -.20$, $p < .01$). Hypothesis 4 is, therefore, supported.

DISCUSSION AND CONCLUSIONS

The present study adds to this research stream by investigating three related and successive questions on the deployment strategy concerning acquired firm top executives: "Whether to retain acquired firm top executives or not?" "Which ones should be retained, long-tenured or short-tenured top executives of acquired firms?" and "What positions should retained top executives be appointed to?" and extending the

inquiry into two organizational conditions, acquisition relatedness and relative size that may moderate retention effects on post-acquisition performance. The results show that the effect of retaining acquired firm top executives was more positive in unrelated acquisitions and when acquiring firms were substantially larger than acquired firms. The effect of retaining acquired firm top executives with longer firm tenure was more positive in unrelated acquisitions and the effect of appointing retained acquired firm's top executives to high-ranking positions in the new organization's TMT was more positive when acquiring firms were substantially larger than acquired firms. As a matter of fact, the moderating effect of relatedness and relative size may be so strong that it changes not only the magnitude but also the direction of retention effects on post-acquisition performance.

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