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Top management team diversity affects acquisition success

By ***Anna Nadolska***

The lack of diversity on a listed company's executive board can have a beneficial impact on that company's growth by mergers and acquisitions (M&A). That benefit, though, comes with an associated cost that is not immediately obvious.

"We found that organisations do indeed learn and do so through the members of their Top Management Teams."

Although homogenous boards can be shown to reach agreement on corporate strategy and tactics quickly, enabling them to grow rapidly through the medium of M&A, they extract added value less quickly from their new acquisitions than do those buying companies whose boards are more diverse.

These arresting, almost counter-intuitive, findings derive from the research that I carried out in the preparation of my paper *Good Learners: How Top Management Teams Affect The Success and Frequency of Acquisitions,* co-authored with Prof. Harry Barkema of the London School of Economics and Rotterdam School of Management.

In this paper, we set out to develop new theory and hypotheses on how a firm's top management team learns from acquisition experience; why, in consequence, the composition of the team is crucial, and how this affects acquisition frequency and success.

We focus on the diversity of the top team and argue that heterogeneous teams, as compared to homogenous ones, acquire less but benefit more from their acquisition experience and are more successful with their acquisitions because they avoid mis-transferring their experiences.

We tested our hypotheses on acquisition frequency and success using longitudinal data on more than 2,000 acquisitions by 25 Dutch companies over four decades (1966 to 2006). These companies were active in a wide variety of industries, including paper and packaging, office equipment, pharmaceutical and chemical products, food products, brewing, retailing, trading and tank storage, and printing and publishing.

The sample companies made 2,036 acquisitions, of which 406 were divested over the 40-year period. We found that organisations do indeed learn and do so through the members of their Top Management Teams (TMTs). However, the extent of an organisation's learning depends on TMT composition.

I believe that there are lessons to be learnt that go beyond the merely academic and can be translated into day-to-day corporate activity, rendering

Top management team diversity affects acquisition success *(continued)*

By ***Anna Nadolska***

future mergers and acquisitions more successful than they have traditionally been. The starting point was a desire to try and answer some long-standing questions. Do organisations learn from their acquisition experiences? Who learns from acquisition experience? What conditions stimulate learning?

Research is confusing on this point. Anecdotal evidence from M&A observers (rather than from advisers or corporate practitioner) suggests that only around 35-40 per cent of all M&A activity can be considered successful in delivering value to the buyer and its stakeholders; the other 60-65 per cent fail.

This helps explain the old adage which advises that when a new bid is announced it is more profitable to sell shares in the bidder and buy shares in the target. The £1.7 billion offer for TSB announced on 12 March by Spanish bank Sabadell provides up to date evidence of the soundness of the adage. TSB's share price quickly rose by more than 25 per cent while the Sabadell price fell by 8.2 per cent.

Some companies, we found, actually performed worse the more they acquired. It is probably safe to say that some companies do learn while others do not. There are a number of clear questions that companies should always ask before they launch an acquisition. What are we really buying? Customers? Competition? Cost economics? Capabilities?

What is the target's stand-alone value? The would-be buyer should assess the value of the target company without taking into account synergies and assess the following elements for fit. Where are the synergies - and the skeletons? The buyer should assess the type of synergies to be expected – cost-reducing or value enhancing – and determine how much costs are associated with achieving them. The buyer needs to take into account negative synergies and, arguably most importantly, to set a walk-away price. That is, determine a maximum price to be paid and stick to it.

Corporate history is, however, littered with evidence demonstrating that after hubris almost inevitably comes nemesis. For a recent example, we need look no further than the spectacular fall from grace of The Royal Bank of Scotland under the leadership of a man who clearly thought he had discovered the philosopher's stone for the banking industry. RBS had the option of walking away from its proposed purchase of ABN AMRO when markets started to sour in 2007 but didn't. Other notable disasters featuring in top 10 bad deal lists include AOL/Time Warner and HSBC/Household.

Why, then, is it so difficult to learn from acquisitions and how can learning be made easier? In short, what makes an acquisition successful? An examination of the decision makers throws up interesting results, which suggest that the acquisition models pursued by high-profile chief executive officers believing in the cult of their own personality is not the optimum path for a company to pursue.

Collective decision-making based on the input of the entire TMT is more likely to deliver a balanced outcome than a decision based on the absolute certainty of a single individual's self-belief. This can apply even if the size of the TMT is relatively small; even in cases where an acquisition does not deliver the expected benefits, the decision to proceed with the purchase will have been a more considered one for which responsibility will be shared by a team rather than shouldered by one person whose judgment might have been clouded.

> *"...the acquisition models pursued by high-profile chief executive officers believing in the cult of their own personality is not the optimum path for a company to pursue."*

The value of diversity

Of greater importance than size is the extent of the diversity of the management team. We focused on two measures of diversity. One, diversity of tenure: the length of service of each board member at the company will affect strategic and tactical thinking. Two, diversity of education, which could otherwise be described as taking into account the nature of the educational background rather than its duration.

Diversity in educational background and training implies different skills, views, and ways of approaching and evaluating investments. For instance, an engineer may focus on the manufacturing aspects of an acquisition, a lawyer on the legal aspects, and a manager with an MBA on organisational and financial ones. We believe these issues are proven to matter to teams attempting to solve the problems presented by tasks confronting them. Diversity affects task conflict.

In the paper, we argue that diverse teams are more likely to share their experience with acquisitions. They are more likely to have comprehensive debates about past acquisitions. They are more likely to source more information from outside the team in order to resolve debates.

They will, therefore, spend more time in deciding which insights, skills, and routines are worth transferring from one acquisition to the next and on developing acquisition processes and capabilities. Homogenous teams, by contrast, tend to learn less from their experience. If they fail to appreciate and understand the nuances of each new acquisition, they will fail to extract value from the companies they buy.

Hence, we predict that heterogeneous teams will take longer to decide on acquisition processes and, as a consequence, will make fewer of them per year than homogenous teams. On the other hand, since their discussions will be more comprehensive and capability formation relatively slower, more diverse teams are also relatively less likely to mistakenly generalise and mis-transfer lessons from previous acquisition experience. This tendency towards a heightened emphasis on care and reflection will help to deliver a relatively higher acquisition success rate than that achieved by more homogenous teams.

In sum, our theory implies that diverse TMTs will acquire less frequently, but at the same time will acquire more successfully than homogenous teams. In practical terms, if a company decides that it wants to grow fast, it will be better placed to do so if it has a homogenous Top Management Team driving that strategy in similar countries. By contrast, a business strategy that is dependent upon slower acquisition-led growth would be better executed by a heterogeneous team.

When a team can call on diverse memory and experience and is inclined to discuss differences, it will make better use of the richness of the experience that resides within it. ■

Good Learners: How Top Management Teams Affect The Success and Frequency of Acquisitions, **written by Anna Nadolska and Prof. Harry Barkema appears in the *Strategic Management Journal,* Vol. 35, Issue 10, p1483-1507. DOI: http://dx.doi.org/10.1002/smj.2172**

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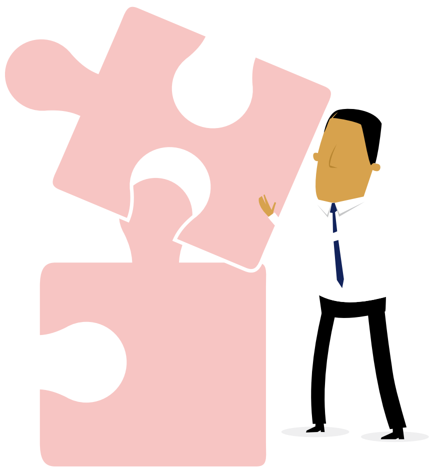

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