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▶ Can brain responses to movie trailers predict success?

By Maarten A.S. Boksem

▶ Pride and fear during major organisational change

By Cees van Riel and Guido Berens

▶ A psychological lens on the acquisition process

By Taco Reus

▶ Why are so many Dutch companies relocating abroad?

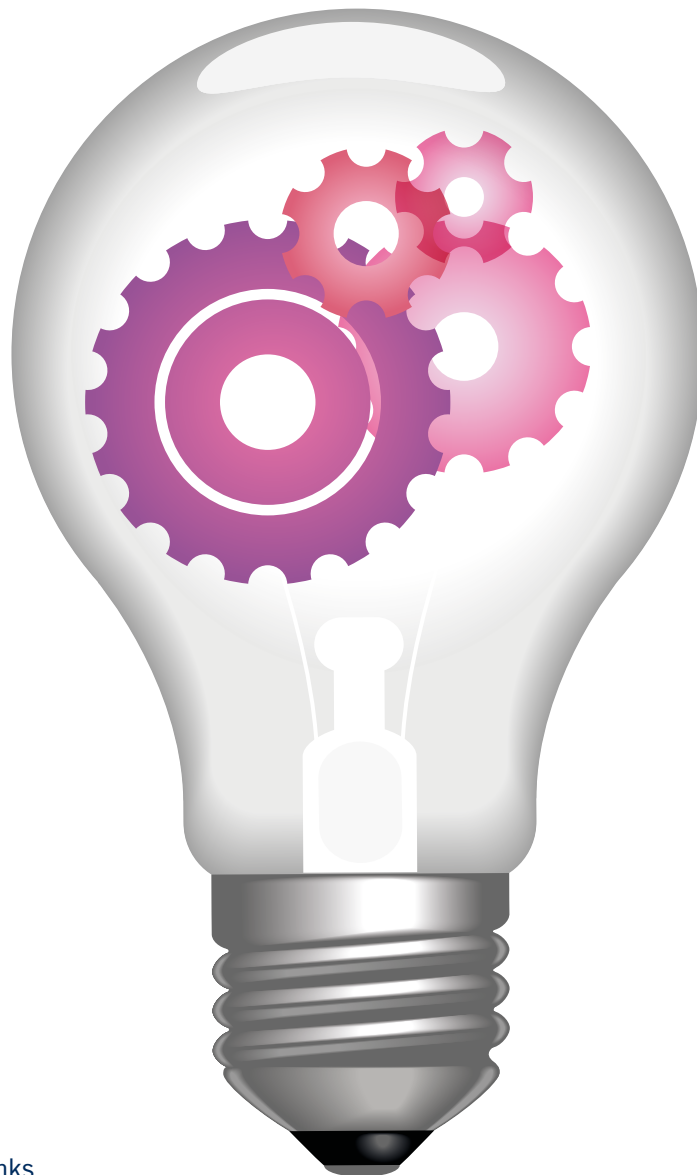
By Marc G. Baaij

▶ The value of big data to big ports

By Rob Zuidwijk

▶ Cloud computing: pushing the right managerial buttons

By Saeed Khanagha

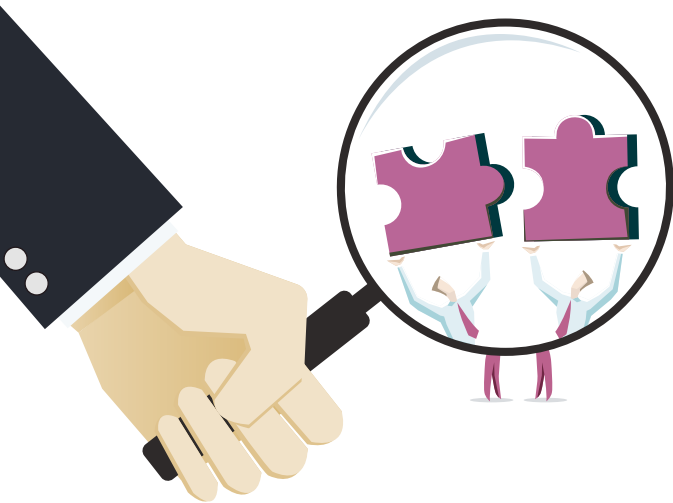


The business school that thinks and lives in the future

A psychological lens on the acquisition process

By **Taco Reus**

The application of psychological theories to understand the world of business can be a fascinating exercise. Some might argue that an artificial legal entity and its administrative processes cannot be examined in the same way as humans and their behaviour can be. However, empirical observations through the lenses of psychological theory suggest findings can be revelatory and provide rich insights for smart strategic thinking.



Despite the advances being claimed for artificial intelligence, the days when companies might be able to run themselves look a long way off. Rather, as long as companies are populated and managed by men and women, corporate thinking and corporate processes closely mimic those of the humans involved. Psychological theories dating back as far as the early 1900s help us to understand how “firms” behave, their strategic direction, and ultimately what determines their successes and failures in competition.

A case in point is the use of psychological theory to understand mergers and acquisitions, and the diverse challenges firms face in the acquisition process. The process is like a journey that takes would-be acquirers from the very secretive pre-deal phase of back-room planning, due diligence, and tense negotiations, to the very public post-deal phase when the announcement brings the deal into the spotlight of staff, competitors, consumers and regulators, and subsequent post-merger integration.

Psychological lens

A psychological lens sheds light upon various key events in the process, and provides insight into how firms can optimise the chances of acquisition success, and the uncomfortable fact that so many fail to deliver the promises made for them in the heat of battle.

In the pre-deal phase, the strategic decision-making on whether to proceed with an acquisition and what to pay for a deal is generally made by a small team of executives, acting as

part of a broader confidential strategic corporate development plan. In all likelihood, they will be drawing on information provided by employed in-house analysts or highly paid external advisers.

This pre-deal information search and sense making is an analytical process based on much data collection on the target and industry in search of potential for synergies. Yet, while the analysts are deriving conclusions based on much information, the executives in charge of the strategic and tactical decision-making process itself are often left with summaries and distilled conclusions. For those executives the process therefore essentially remains highly uncertain even when they can turn to a large number of advisers.

Anchoring theory

Psychological theory, stirred by the seminal research of Tversky and Kahneman, suggests that under such conditions of heightened uncertainty, decision-makers are plagued by biases – they are bound to use unconscious simplification techniques to make the decision controllable. In our research we found that in the process of deciding what premium to pay for a deal, acquirers seem to be overly drawn to the premium that was paid for the preceding deal in the market. The preceding deal’s premium forms such a hard and simple fact that it is anchored in executives’ minds.

Anchoring theory in psychology explains that executives can’t help but give more weight to information that agrees with the anchor (ie, the pre- ▶

A psychological lens on the acquisition process *(continued)*

By **Taco Reus**

ceding deal's premium), and give less weight to information that disagrees with it, even though it may be more relevant to the focal decision (ie, what premium to pay for the focal deal). Our research supports this premise, particularly when preceding acquisitions happened more recently and were similar in size, when focal deals were executed in a foreign market, and when acquirers lacked acquisition experience in the target market or had a higher acquisition rate.

Given the constraints upon collecting information on putative targets, anchoring might enable managers to make rapid decisions and persuade shareholders that their proposed premia represent acceptable standards in the industry. However, by overly relying on preceding acquisition premia, managers may ignore important information specific to the focal deal. Decision-makers, as well as their advisers, therefore would be wise to consider the influence that such anchoring has on their decision-making, possibly by incorporating hard checks to make the influence of anchoring more explicit, and reduce exposure to its risks.

Psychological theory also helps to make sense of contradictory findings about the organisational processes in-

involved in such strategic events. For example, researchers found that experience in doing acquisitions is positively, negatively, and insignificantly related to acquisition performance.

Organisational experience

A psychological theory of learning – known as transfer theory – helps to explain these contradictory findings. It argues that people apply but also mis-apply their experiences in subsequent tasks depending on whether the focal task is structurally rather than superficially similar to the prior experiences. Cognitive psychologists therefore have studied when people make positive transfers (when prior experience applies well to a new task), and negative transfers (when prior experience does not apply well to a new task).

Because organisational routines can be as rigid as individual routines, this transfer theory also helps to understand the role of organisational experience. We found that firms that make large deals are served well by their experience if they have made large deals in the past. However, many firms making large deals predominantly have experience in making small deals.

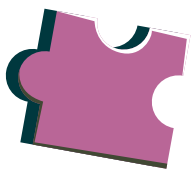
We found that such small-deal experience hurt more than it helps in doing large deals. Mega-deal perfor-

mance tends to suffer because the routines developed through small-deal experiences that tend to affect only a small part of the acquiring firm do not apply in the large-deal context that affects a large part of the acquiring firm.

Fortunately, the rich psychological research on transfer theory also provides recommendations on how to avoid these negative effects. For example, when the firm is able to retain key employees of the acquired firm, negative transfers are less likely because they are not rooted in the same organisational routines and allow what psychologists have termed intentional mindful abstraction: the process of actively considering whether established routines would benefit a new task or need considerable adaptation.

Knowledge transfer

Psychology theory can shed new light on processes that have been considered extensively from other angles before. For example, many researchers and consultants strongly assume that knowledge transfer benefits performance and this assumption is so widespread that for many it seems too obvious to examine empirically. Yet, the behavioural theory of the firm – arguably the most psychological among or-



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organisational theories – sheds a different light on the relationship. It reveals that knowledge transfer can actually hurt performance.

While M&A research has stressed the disruptive nature of post-merger integration on the acquired firm and its knowledge base, the findings from one of our recent studies on international acquisitions suggest that, at least in part, knowledge transferred from the acquirer to the acquired firm may itself be the root of disruption.

We found that so-called non-location-specific knowledge, such as managerial or operational knowledge, of the acquirer can disrupt the power dynamics and routines of the acquired firm because it forms a threat to pre-existing knowledge of the foreign acquired firm. Non-location-specific knowledge transfer might destabilise power structures, to the detriment of the performance of foreign acquired firms, particularly for acquirers with strong pre-deal success who might be overly confident in their own knowledge.

Moreover, also in the context of international acquisitions, psychological theory helps in understanding cultural influences when attempting to win the hearts and minds of staff in the acquired organisation. Psychological theory suggests that paying heed to the emotions of others is constrained by cultural differences because of an ethnic bias (ie, people are attracted more toward people from the same cultural background) or because of a lack of familiarity (ie, people generally have less insight into the life of people from more distant cultures).

Indeed, we found acquirers generally had more difficulty to attend to emotions when they made their deals in culturally more distant countries. Yet, we also found that acquirers tend to attend more to emotions when they made their deals in countries with a humane orientation – that is 'societies [that] encourage and reward individuals for being fair, altruistic, friendly, generous, caring, and kind to others' (House et al, 2004).

When it comes to implementing an acquisition effectively, we also found that psychological insights about justice are crucial. Justice research has argued and demonstrated that fairness of processes and procedures affect the attitudes and behaviours of those impacted by such practices.

The central conclusion of this work is that people tend to accept decisions more if they consider the process of making this decision to be fair. People will then think more positively about the decision, even if it negatively affects them. In the context of acquisitions we found that providing clear justifications for the decision is important for short-term performance directly following a deal, but not for longer-term performance. In contrast, providing a voice to those affected by the deal (acquired employees) has no impact directly following the deal but does positively impact upon longer-term performance.

To close, a psychological lens can provide interesting and novel insights into consequential strategic decisions, and the acquisition process in particular. This has real, practical implications

therefore executives are advised to be aware of the psychology behind the acquisition process; if left unchecked, the consequences are bound to be costly. ■

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This article draws its inspiration from several recent papers including *Anchoring on the acquisition premium decisions of others* written by Shavin Malhotra, Pencheng Zhu and Taco H. Reus. The paper was published online in the *Strategic Management Journal*, 4 Sept 2014. DOI: <http://dx.doi.org/10.1002/smj.2314>

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