Growth at Any Price?

When firms are desperate to grow and to please shareholders who demand growth, they take desperate measures such as overpaying for acquisitions and put themselves on the road to long-term hardship.

When Quaker Oats bought drinks company Snapple in 1994 it was basing its big bet on the successful management of Gatorade, which it bought in 1983. Some analysts estimated that the US$1.7 billion it paid was about US$1 billion too much. Problems with merging corporate cultures and challenges in the new age drinks market led to Quaker selling Snapple just 27 months later for only US$300 million.

Such examples illustrate what tends to happen when companies and the managers who run them get desperate for growth or lean on acquisitions to achieve it, according to a new INSEAD research paper, When Firms Are Desperate to Grow via Acquisition: The Effect of Growth Patterns and Acquisition Experience on Acquisition Premiums.

Jay Kim, Associate Professor of Entrepreneurship and Family Enterprise at INSEAD, who co-authored the paper with Jerayr Haleblian of the University of Georgia and Sydney Finkelstein of Dartmouth College, found that firms pay significantly more for their targets when they get caught up in either growth challenges or when they become addicted to growth by acquisition.

High price for growth

But such desperate, knee-jerk efforts to find new growth avenues don't usually pay off because desperation leads managers to make mistakes and judgment errors.

In his research, examining over 878 acquisitions by U.S. commercial banks over a 12-year period, Kim found that companies that are hungry for growth pay a 31 percent higher acquisition premium compared to companies with healthy growth.

"Managers who are desperate for growth may become more willing to take a higher risk or they may become more prone to making judgmental errors and sub-optimal decisions," said Kim.

Experience cuts price

But experience can reduce such risks. "In the study, we found that experienced acquirers tended to pay lower acquisition premiums than the inexperienced acquirers who were equally desperate. This is because acquisition experience helps companies develop the capabilities to evaluate targets in a more accurate manner," says Kim.

"Experienced firefighters are able to stay calm in an emergency situation. Similarly, experienced acquirers may be able to stay calm when they are desperate for growth and avoid fatal mistakes, such as overpaying."

But what if a firm lacks this strategic acquisition experience?

A little help from friends

The study found that companies engaging external advisers were able to reduce their acquisition premiums, thanks to the rich and diverse experience of consultants.

"Investment and acquisition advisers tend to have more experience than any single acquirer so acquirers may be able to benefit from their adviser's experience and knowledge so that's probably one way to mitigate the danger of or lack of your own experience," said Kim.

"When you don't know what to do, it is almost always a good idea to seek for the help of an experienced friend."

Kim also found that even for companies with experience, using external advisers was more effective at reducing the price the firm might be willing to pay in that emergency situation, than the firms' own experienced management, as desperation can cloud the judgment of even the most experienced managers.

While many would argue that consulting fees are tied to the price of the deal and might make advisers favour a higher premium, Kim argues that this may not affect the quality of their advice as much as we are concerned about. "We have this image of greedy investment bankers, but we should realise that they also have an incentive to maintain their reputation, so in a way, the danger of using an acquisition adviser is probably largely offset by their need to maintain a good reputation," he said. Kim adds that the use of multiple advisers can also bring down the potential dangers of biases among consultants.

Don't get addicted

While experience can help a company's continued growth by acquisition, there is also a danger of becoming too reliant on acquisitions over other forms of growth. For managers who are striving to meet their quarterly growth targets, the lure of another acquisition that could give them immediate growth is a temptation that is hard to resist.

"When managers have been relying heavily on acquisitions for growth, they will become increasingly dependent on acquisitions for growth. They will become desperate when they cannot find a viable takeover target because they cannot grow on their own, and will become willing to pay significantly higher acquisition premiums when they come across a seemingly attractive target," Kim said.

Keeping the market at bay

Kim's advice for business leaders is to remember that the sense of desperation can negatively affect the quality of their decision making. "This is easier said than done," said Kim. "But it is absolutely important for business leaders to be aware that any acquisition comes with a price and it is important to ask whether it is worth paying it."

"The managers' main job is to satisfy the shareholders, the investors, and the stock market. But, again, it is very important to be aware that inaction is also an action. When there is pressure and when you give into the pressure and make rushed decisions, then that could result in an outcome that could harm your company in the long run and destroy shareholders' value. So a critical leadership skill that a manager should develop is the guts to resist some of the unnecessary pressure," Kim added.

But he adds that this danger is most prevalent today.

"My prediction is that an increasing number of companies will engage in an acquisition in a desperate attempt to achieve growth and as this trend continues, we will see many managers give in to the pressure and overpay for their acquisitions."


Jay Kim is Associate Professor of Entrepreneurship and Family Enterprise at INSEAD.

Follow us on twitter @INSEADKnowledge or Facebook https://www.facebook.com/Knowledge.insead.

Find article at
https://knowledge.insead.edu/leadership-management/strategy/growth-at-any-price-2588