Buying companies for new competencies: Is it worth it?

In fast-moving industries, large companies are increasingly using acquisitions as a strategy to obtain new competencies from smaller firms. The key aspect of the acquisition is to gain access to the knowledge assets of the target firm. This knowledge- which often resides in the employees- is critical for the acquisition to create value for the acquiring firm. However, the difficulty of evaluating and monitoring employees in a large firm and the reduction in employees’ incentives, due to less control over their efforts and lower profit-sharing, can lead to a persistent decline in their productivity after the acquisition.

When Rahul Kapoor, a PhD candidate in strategy at INSEAD, became interested in acquisitions, he noticed that although many promising hi-tech start-ups were being acquired, the technology’s progress seemed to stall after the acquisition. Evaluating candidates for technology acquisitions is not so simple, as there’s greater uncertainty about what is being acquired and how that will create value. Kapoor’s paper, The Impact of Acquisitions on the Innovation Productivity of Inventors at Semiconductor Firms: A Synthesis of Knowledge-based and Incentive-based perspectives, with co-author

Kwanghui Lim of Melbourne Business School, explains the mechanisms through which these transactions end up not creating value for the acquiring firms. Kapoor says that “people are of the upmost importance for knowledge-based acquisitions – such as the engineers who develop new technologies. Larger firms need to buy smaller innovative firms to keep pace with the changing technologies so as to remain competitive.”

Kapoor and Lim collected data from 54 domestic acquisitions made by US semiconductor firms between the years 1991 and 1998. They matched the employees of the acquired firms to two groups of employees. The first group comprised employees from similar firms that did not get acquired. The second group comprised employees from the acquiring firms. They found that compared to employees from non-acquired firms, the productivity of employees from acquired firms was persistently lower for five years after the acquisition. However, when compared to employees from the acquiring firm, the acquired employees were less productive for the first two years and their productivity converged with that of employees from the acquiring firm from the third year onwards.

Explaining this result, Kapoor says acquiring firms may be at a disadvantage for at least two reasons. The first is the change in incentives. Large acquirers find it very difficult to match incentives that employees enjoy at smaller firms. The second is the temporary disruption that employees of acquired firms face after the acquisition, due to the need for integration and reorganisation of activities. While both the employees from acquired and acquiring firms may face disruption, the disruption is often worse for employees of the acquired firm. Hence, acquirers may be better off valuing acquisitions after taking into consideration that the productivity of acquired employees is likely to suffer after the acquisition and may never rise to pre-acquisition levels.

Kapoor and Lim also provide some solutions to assist acquirers in improving the productivity of employees in the firms they acquire. First, acquiring target firms that have similar organisation structures and routines to coordinate tasks can reduce the degree of disruption after the acquisition. Second, targets that have a moderate overlap in employee skills will help to create a common language between the target and the acquiring employees. However, high overlap will create redundancies and often lower productivity. Finally, acquiring targets that are not too small may minimise the reduction in incentives and is likely provide greater employee productivity.

The Impact of Acquisitions on the Innovation Performance of Inventors at Semiconductor Companies by Kwanghui Lim and Rahul Kapoor can be found in Academy of Management Journal, Vol 50, No 5 (Oct): 1133-1155.

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