International Marketing Trends Conference 2015

Paris, JANUARY 23-24 2015

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The influence of the cultural distance on cross-border acquisitions of Italian firms

Keywords: *cross border acquisitions, target firms'performance, national cultural distance, mid-sized firms.*

1. Introduction and objectives

The paper aims at analyzing the influence of cultural distance on the acquisitions from foreign investors of the Italian mid-sized firms in terms of economic performance of target firms.

Two are the main topics of the research.

The first, relative to cross border acquisitions, is quite voluminous, even if it is mainly focused on the acquirer perspective within the research stream on the foreign market entry mode choices. The studies assuming the perspective of the target firm have highlighted that the performance indicators used in the evaluation of acquisitive operations are overall employment growth, profitability and productivity of acquired firms (McGuckin e Nguyen, 2001; Conyon et al., 2002; Bernard e Sjolhom, 2003; Gugler e Yurtoglu, 2003; Oberhofer, 2013).

The second on cultural distance is especially relevant in studies on firms'internationalization strategies. Among them, numerous works have focused on cultural distance as explicative variable of the results of operation of cross-border acquisitions (Morosini, 1995; Morosini et al., 1998; Larsson e Risberg, 1997; Barbopoulos et al., 2011).

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Methodologically, the preliminary analysis was the identification within the MBRS database of the data sample involving the Italian mid-sized firms acquired from a foreign investor between 1999 and 2009. Over the sample period, the MBRS database includes 143 completed acquisitions between a foreign acquirer and an Italian mid-sized target firm. The focus of the analysis in the paper is on the subsample of 80 surviving firms as autonomous companies with a foreign ownership that are evaluated through ratios analysis and other accounting measures in the post acquisition period, in order to understand if these measures improve or not.

Using a multidimensional measure of cultural distance (Hofstede, 1980, Hofstede and Bond, 1988, Hofstede and Minkov, 2010; Kogut and Singh 1988) we want to test the relationship between the cultural distance and the target firm's performance in cross border acquisitions through a regression analysis.

The findings support our hypothesis suggesting that cultural distance had a positive effect on post-acquisition performance. The article is structured in the following manner: we first describe the relevant literature on the effects of national cultural distance on cross-border post acquisition performance. Second, we describe the methodology and empirical model designed to test theoretical explanation, and then we present the results. Finally, some managerial implications and concluding comments are discussed.

Key words: cross border acquisitions, target firms' performance, cultural and psychic distance, mid-sized firms.

2. Literature review

In line with the increasing importance of cross border acquisitions in the international process of firms, the literature on the topic is quite various, even if it seems to prefer mainly the perspective of acquirer firms.

Focusing the analysis on the acquisitions in the perspective of target firms a relevant stream of research develops empirical studies aimed at measuring the post-acquisition performance of the target firm, sometimes with contrasting results.

McGuckin and Nguyen (2001) use plant-level data for the entire US manufacturing sector for the period 1977–87 to examine the effects of ownership changes on employment, wages and plant closing.

Other studies (Karpaty, 2004; Piscitello and Rabbiosi, 2005) analyzes the difference between foreign and domestic ownership of firms with respect to labor productivity. Using French manufacturing firm-level data, Bertrand and Zitouna (2008) found that M&As don’t increase the profit of French target firms, even on the long run, but they clearly raise the productivity of target firms.

Chari, Chen, Dominguez (2012) undertake a systematic analysis of the performance of U.S. firms that are acquired by firms located in emerging markets, using transaction-specific information and firm-level accounting data over the period 1980-2006. Following the acquisition, the performance of target firms tends to improve. In particular, the ROA in target firms increases by 7% in the five years following the acquisition. The evidence also suggests that U.S. target firms undergo significant restructuring after acquisition by an emerging-market firm. In particular, employment and capital decrease, suggesting that divisions may be sold off or closed down. This conjecture is also supported by the fact that sales decline after acquisition.

The culture is indubitably a relevant variable in cross border acquisitions specially when there is a significant national cultural distance between the acquirers’ and targets’ countries of origin.

Hofstede (1980, 25) defines culture as “the collective programming of the mind which distinguishes the members of one human group from another”. According to GLOBE Project, culture is the set of “shared motives, values, beliefs, identities, and interpretations or meanings of significant events that result from common experiences of members of collectives and are transmitted across age generations” (House et al., 2002).

The study of Hofstede (1980), based on the values and beliefs that characterize the cultures of different countries of the world, identifies four different cultural dimensions: power distance, uncertainty avoidance, individualism-collectivism and masculinity-femininity. Subsequently, two additional measures were added later to further studies: long-term orientation (Hofstede and Bond, 1988) and indulgence versus restraint

(Hofstede, Hofstede and Minkov, 2010). With this approach, the cultural distance is intended as a measure of the differences or similarities between national cultures.

The cultural dimensions of Hofstede's model (1980, 1988, 2010) were largely used in the international literature to describe the phenomenon of the internationalization of companies through the index proposed by Kogut and Singh (1988).

The literature on cross-border M&A rarely investigates the relationship between national cultural distance and performance of the target firm after the acquisition.

Extant studies report ambiguous, inconclusive and sometimes contradictory findings. In fact, there is no unequivocal evidence that national cultural distance influences absolutely positively or negatively the target firm’s post-acquisition performance.

Recently, an empirical study has shown that the impact of the degree of internationalization on the acquiring MNE performance is indeed not the same for all multinationals: it is positive for MNEs that operate in culturally similar countries and negative for multinationals that operate in culturally diverse countries (de Jong and van Houten, 2014).

Socio-cultural proximity is also highly influential upon the target company’s performance, as Piscitello and Rabbiosi (2005) demonstrate for the Italian case. In fact, they discover that the beneficial effects from inward FDI through acquisition in the Italian economy are higher when the acquirer is a European-based multinational. However, when it is a US or a UK company, the effects seem to be positive as well, although weaker.

Some scholars suggest that the effect of cultural distance on cross-border acquisition performance of the acquirer depends on the level of acquisition experience of the acquirer itself and that experience may mitigate the negative effects of cultural distance. In fact, more internationally experienced acquirers are more likely to be aware of cross-border acquisition pitfalls and are more skilled at resolving acquisition related conflicts, thus they have better performances (Dikova, 2009; Dikova and Rao Sahib, 2013). In addition, experience may make MNEs aware of inter-country differences and therefore proactively take measures to mitigate potential negative effects of cultural distance on performance. Cultural distance may impede learning and disturb the decision making process (Hutzschenreuter et al., 2014).

Subsequently the acquisition, post-acquisition integration is crucial for the success of M&A operations and its performance, even more in the case of cross-border M&A. Yet, there is a peculiar relation between national cultural distance and post-acquisition integration: large differences in national culture reduce foreign acquisition performance if the acquired unit is tightly integrated into the acquirer, but they enhance acquisition performance if post-acquisition integration is limited (Slangen 2006). Moreover, Stahl and Voigt (2008) found that in cross-border M&As that require lower levels of integration, national cultural differences were positively associated with integration benefits.

Other studies also suggest that some of the problems associated with sociocultural integration may be reduced in cross-border acquisitions. For example, Evans et al. (2002), and then Goulet and Schweiger (2006), found that managers involved in cross-border M&As are predisposed to pay greater attention to the less tangible but critical cultural issues that are often overlooked in domestic M&As and to working toward developing shared understandings involving national cultural differences.

To summarize, national cultural distance influences performance in diverse ways, sometimes positively, sometimes negatively, depending on various factors.

Thus, existing theoretical arguments about the cultural diversity-performance relationship can be divided into a negative view and a positive view.

The negative view states that cultural diversity can be a cause of increased intra-firm complexity at several levels, for at least two main reasons. First, when a firm operates in multiple, culturally diverse markets, this requires it to tailor itself to numerous foreign national cultures, creating complexities in dealing with different beliefs, behaviours and perceptions (Barkema, H.G. & Vermeulen, F. 1998).

Second, complexities are further expected to arise through differing firm-level characteristics, such as conflict management, decision-making, and leadership styles (de Jong and van Houten, 2014).

Although culturally diverse operations can lead to improved insights and learning opportunities (Morosini et al., 1998), increasing levels of cultural diversity will lead to increased coordination, agency and transaction costs, all negatively related to firm performance (Tihanyi et al., 2005).

In contrast, as the recent Positive Organizational Scholarship perspective also highlights (Cameron et al., 2003), the positive view argues that multinational firms benefit from culturally diverse operations through increased access to the routines and repertoires of other cultures, using two main arguments. First, there are learning opportunities and creativity benefits arising from exposure to the diverse routines embedded in culture (Morosini et al., 1998; Olie and Verwaal, 2004).

As firms interact with firms/business units from different cultures, they learn from each other at various operational levels, effectively pooling their individual routines. Cultural differences may be complementary and hence have a positive effect on performance (Shenkar, 2001).

Second, as some national cultures and country-specific routines lend themselves better to certain tasks, intra-firm specialization can occur, enabling business units to focus more on what they are relatively or absolutely better at (Morosini et al., 1998).

In line with the studies supporting the positive relationship between national cultural distance and post-acquisition performance, in this paper we hypothesize that the beneficial impact on the target company's performance is higher when the national cultural distance between the acquirer and the acquired firm is higher.

3. Method

The sample

M&As covered in this study took place in Italy from 1999 to 2009. The original data come from Mediobanca.

We started from a database of 111.204 Italian mid-sized firms, but only 143 had the requirements to be used in this study, for a total of 1.287 annual reports.

On the side of the acquiring firms, the majority of those is located in the European Union (63.6% of the total), while the 21.7% is located in the USA and the 14.7% in other countries.

The 94.4% of the foreign acquirers here considered comes from advanced economies, and only the 5.6% comes from developing countries and emerging economies.

Most of the acquiring firms is located in the USA (21.7%), followed by the UK (12.6%) and France (11.2%).

On the acquired-firms side, the 49.6% belongs to the mechanic industry, and the 18.2% belongs to the chemical and pharmaceutical industry. Together, they represent about the 68% of the sample. The other target firms belong to the industry of personal and household goods (14.7%), to the food industry (9.8%), to the printing and paper industry (3.5%) and to the metallurgic industry (3.5%). The 0.7% of the sample belongs to other manufacturing industries.

The 47.5% of the 143 acquired firms of the sample comes from the north-east of Italy, while the 42% comes from the north-west. Thus, the 89.5% of the acquired Italian firms is located in the North of Italy. Probably, in northern Italy there is a major number of firms, or they are more attractive for the foreign acquirers.

Out of the 143 acquired firms, only 82 companies were suitable for this study because, among the others:

- 15 firms failed, were put in liquidation or went out of business in the post-acquisition period;
- 25 were incorporated;
- 11 were acquired again by Italian companies;
- 2 were real estate companies;
- 1 was a holding;
- 6 societies were created after the considered period;
- 1 have not deposited the annual report.

Then, two other firms were excluded from the analysis for the lack of data about their cultural distance.

Thus, the final sample is composed of 80 companies. Table 1 shows the country frequencies for these 80 acquisitions.

The USA have the highest number of transactions, 16, corresponding to the 20% of the total. The only other non-European country in the top ten is Japan, with 3 acquisitions, corresponding to the 4% of the sample.

With regard to Europe, UK has completed 14 acquisitions, which represent the 17% of the sample, followed by France, with 9 acquisitions (11%); Germany, with 7 operations (9%); the Netherlands, with 6 acquisitions (7%) and Switzerland, with 4 acquisitions (5%). Among the other European countries, Sweden, Austria, Spain and Belgium have all completed 3 transactions respectively, for an amount of the 4% of the sample; Portugal 2 (2%); Ireland, Denmark, Luxembourg and Finland have concluded only one acquisition respectively. The same is for Singapore, China and India.

European countries completed 58 acquisitions out of 80 analyzed, that is the 72.5% of the sample.

In the period considered, the largest number of acquisitions in the sample was recorded between 2006 and 2008, with a peak of 16 in 2008, as the table 2 shows. Immediately after there was a drastic decline, probably due to the global economic crisis that suggested more caution in international investments.

Table 1 – Number of acquisitions by the acquirer's country of origin

Acquirer's Country of Origin	Number of Acquisitions	% of the total
USA	16	20
UK	14	17
France	9	11
Germany	7	9
The Netherlands	6	7
Switzerland	4	5
Sweden	3	4
Austria	3	4
Japan	3	4
Spain	3	4
Belgium	3	4
Portugal	2	2
Luxembourg	1	1
Singapore	1	1
China	1	1
Ireland	1	1
Finland	1	1
India	1	1
Denmark	1	1

Total	80	100

Table 2 – Number of acquisitions per year

Year	**Number of Acquisitions**
1999	4
2000	6
2001	7
2002	5
2003	5
2004	4
2005	8
2006	12
2007	10
2008	16
2009	3
Total	80

The acquired firms belong to diverse industries. In detail: 46 out of 80 belong to the mechanic industry (57.5%); 7 to the food industry (8.75%); 8 to the industry of personal and household goods (10%); 3 to the printing and paper industry (3.75%); 10 to the chemical and pharmaceutical industry (12.5%); 6 to other industries (7.5%).

The variables

Dependent variables: performance is measured in two ways: as labor productivity and as profitability of the acquired firms. In fact, other studies have used those measures to assess the target firms' performance after an acquisition (Bertrand, 2009; Chari, et al., 2012; Damijan et al., 2012; Heyman et al., 2007; Karpaty, 2004).

Following Karpaty (2004) and Damijan et al. (2012), *labor productivity* is measured as value added per employee, while *profitability* is measured as EBITDA *(Earnings Before Interest, Taxes, Depreciation and Amortisation*). This indicator gives information on the company's operating profits before nonoperating expenses (such as interest) and noncash charges (depreciation and amortization). Thus, it constitutes a good way of assessing profits since it eliminates the influence of financing and accounting decisions (Bertrand and Zitouna, 2009).

Independent variable: the key independent variable in this study is the national cultural distance. It is measured following Kogut and Singh (1988) index, based on Hofstede's (1980) national cultural scores. Thus, using the Kogut and Singh's (1988) formula, it was created a multidimensional measure that estimated the cultural distance between Italy and the other 19 countries considered along Hofstede's power distance, uncertainty avoidance, masculinity/femininity, individualism, long term orientation and indulgence versus restraint scores, updated to 2010:

$$DC_J = \sum_{i=1}^{6} \frac{\left\{ \frac{(I_{ij} - I_{iu})^2}{V_i} \right\}}{6}$$

Control variables

In this study some control variables are used. *Size* is measured as natural logarithm of sales, following Chari et al. (2012).

Year, *industry* and *geographical origin* are included to control for their effect on the target firm's performance. The variable *year* takes values from 1999 to 2009, namely the years in which acquisitions were completed. The variable *industry* is a dummy assuming the corresponding ATECO 2007 code for each industry.

Finally, it was controlled for the *uncertainty avoidance*, because in literature it is shown that it may influence the post-acquisition performance of the target firms (Morosini et al, 1998). In order to control for uncertainty avoidance in this analysis, the Hofstede (2010) national culture scores for the uncertainty avoidance of the acquiring firm's country of origin is used.

The model

The hypothesis is tested on the sample of acquisitions using the multiple linear regression.

At the theoretical level, the multiple linear regression equation takes the following form:

$$Y = \beta_0 + \beta_1 X_1 + \ldots + \beta_m X_m + \varepsilon$$

where β_0 is the intercept, and β_1, β_2, … β_m are the regression coefficient; ε indicates the error of the model.

4. Results

Labor productivity

The coefficient associated with the cultural distance is 0.016, which means that there is a weak but positive influence of cultural distance on the labor productivity of target firms after the acquisition. This result confirms our hypothesis made in line with Morosini et al. (1998) findings.

The other variables included in the analysis, namely the year, the industry, the geographical origin of the acquired company and uncertainty avoidance are not significant in relation to labor productivity.

Probably, the acquired firms have benefited from the routines and organizational practices with which they come into contact after the acquisition. In fact, in the literature it was highlighted that when the acquired firms interact with acquiring companies from different cultures they learn from each other at the various operational levels, pooling their individual practices (Morosini et al., 1998).

In addition, the specificity of national culture have an impact on the way of imaging and organizing production. Generally, after an acquisition the new owners reorganize the production structure of the acquired firms, just in the way they believe it is better because of their past experiences and their cultural features. They may introduce some innovations that have positive impacts on performance, such as practices and more efficient production processes, or they may make investments in research and development and in most technologically advanced machines.

It is also possible that, after the acquisition, the acquirer has undertaken a reorganization of its global operations, looking for economies of scale and scope, and this has helped the target companies to focus on what they can do better.

Another cause of the improvement in post-acquisition labor productivity may be the corporate restructuring that often begins after an acquisition, for reasons of efficiency. In fact, reducing the number of employee, you can have an illusory improvement in labor productivity if the output is the same than before.

Finally, it may be possible that the acquirer have stimulated a more active employees' participation in the production processes organization and management, and that has had a positive impact on productivity. This kind of employee participation is typical of some cultures, such as that of Germany.

Profitability

The coefficient associated with the cultural distance is -0.044, which means that there is a slight but negative influence of national cultural distance on the profitability of target firms after the acquisition.

The other variables included in the analysis, namely the year, the industry, the geographical origin of the acquired company and uncertainty avoidance are not significant in relation to profitability.

Thus, in contrast to the labor productivity, the profitability of the acquired firms of the sample did not benefit from the cultural distance of the acquirer.

National cultural distance not only brings positive aspects, but rather it could increase the management complexity. When different cultural value systems meet, they may conflict. In addition, the management practices of the acquirer may be unsuitable to achieve the best post-acquisition performance in a different cultural context. Conflicts may arise between the management of the acquired and the acquirer in the decision-making process and in the styles of leadership.

All those negative aspects may affect the company's profitability by increasing the costs of inter-firms coordination.

Indeed, both due to the cultural distance and to the geographical distance, it may have difficulty in the transmission of information or misunderstandings between the acquired company and the headquarter. The decision-making process may be longer due to cultural differences or hierarchical or inter-personal conflicts. When a multinational acquires a firm that belongs to a cultural context with opposite characteristics, the resulting culture clash can paralyze the activity, negatively affecting the profitability of the acquired company, but also the profitability of the buyer.

The profitability of the acquired company is also influenced by the strategy of the acquirer. Sometimes acquisitions are made just to have easier access to a foreign market, or to obtain benefits within a larger group, or to obtain skills and knowledge that would be difficult to obtain otherwise. In all these cases, the buyer may sacrifice the subsidiary's profitability to reach other benefits sought.

Finally, it may be that the benefits in terms of profitability need more time to occur, and so the four-years time span used in this analysis may be inadequate in this regard.

5. Discussion and conclusion

Following the route of Morosini et al. (1998) we investigate the impact of cultural factors on cross border acquisition performance. The results partially support the hypothesis of a positive relationship between national cultural distance and cross border post-acquisition performance. In fact, we find that cross border acquisitions increase the productivity of Italian firms in case of higher national cultural distance. On the contrary, they do not raise their profit.

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