

6-13-2015

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Recommended Citation

Asgari, Elham and Hunt, Richard A. (2015) "THE CURIOUS CASE OF CORPORATE SPIN-INS: GENERATING PROFITS OR PROBLEMS?," *Frontiers of Entrepreneurship Research*: Vol. 35 : Iss. 13 , Article 2.
Available at: <http://digitalknowledge.babson.edu/fer/vol35/iss13/2>

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THE CURIOUS CASE OF CORPORATE SPIN-INS: GENERATING PROFITS OR PROBLEMS?



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ABSTRACT

Corporate spin-ins are acquisitions in which the acquired companies were founded by former employees of the acquiring firm. Since a large majority of acquisitions fail to achieve the synergies necessary to justify acquisition premiums, spin-ins may offer an opportunity for acquirers to reduce costly information asymmetries and generate superior outcomes by leveraging prior employment ties. However, the return of ex-employees who successfully cashed in on their innovations is not without complications. This paper situates spin-ins theoretically within the corporate entrepreneurship and M&A literatures, and empirically examines a proposed framework through a pair-wise comparison of acquisitions, both with and without prior employment ties.

INTRODUCTION

One of the central preoccupations of corporate entrepreneurship (CE) is innovation (Ireland, Covin & Kuratko 2009; Van de Ven & Engleman 2006). Since existing business models exert a strong influence over R&D investment decisions (Benner & Tushman 2002), large firms often filter information through the lens of what has worked in the past (Chesbrough 2003; Christensen 1997). This can make the internal discovery and development of “the next big thing” a serious challenge. Moreover, most innovation-related outcomes are attributable to a relatively small group of elite performers (O’Boyle & Aguinis 2012), who often constitute the firm’s creative engine. The loss of key employees can deal a severe blow to the firm’s explorative capacity (Jaaskelainen 2011). Conversely, it can be difficult for innovative employees to remain optimally deployed in large, administratively complex organizations (Garvin 1983; Prahalad & Hamel 1990), especially when their respective innovations involve disruptive technologies (Christensen 1997) that may challenge highly profitable existing business lines and potentially lead to strategic disagreements (Klepper & Thompson 2010).

Under these conditions, it is not unusual for intra-industry entrepreneurial spinouts to occur, with former employees forming their own companies to develop competing technologies (Klepper & Sleeper 2005). In fact, more than 300 new ventures have been founded by former employees of just four firms: Cisco, Apple, Google and Microsoft. Often, the innovations of these ex-employees are permanently lost to the parent-firms, but in some cases the new ventures are acquired and the employees are re-integrated into the parent-firm. Some companies, most notably Cisco, have even funded departing employees with the intention of eventually acquiring the new ventures. Acquiring innovation in this fashion is known as a *spin-in*. Though thinly researched to-date, the phenomenon is becoming increasingly important in sectors characterized by rapid technological change and low barriers to entrance by new ventures. In addition to situating spin-ins theoretically, we ask: Under what conditions do spin-ins yield favorable outcomes? Is it wise or unwise to re-integrate innovative former employees through the use of a spin-in?

First and foremost, spin-ins are corporate acquisitions, subject to the potential benefits and challenges that accompany efforts to foster corporate entrepreneurship through a strategy to “buy” rather than “make” resources, capabilities, markets or technologies. Existing research on M&A overwhelmingly suggests that acquisitions destroy shareholder value (Agrawal & Jaffe 2000; King 2004). The principal reason for this lies in the tendency of acquiring firms to pay acquisition premiums that are not ultimately justified by the revenue-side and expense-side synergies that are ultimately realized (Sirower 1997). Ostensibly, spin-ins should be a partial cure to the value-destroying facets of acquisitions. The prior ties that characterize spin-ins should, in theory, make the costly information asymmetries associated with due diligence less onerous than that of acquisitions involving no prior ties. However, the re-integration of former employees who have been materially enriched through a spin-in may give rise to post-merger complications that impact acquisition outcomes. In the following section we explore the conceptual basis of these concerns.

HYPOTHESES DEVELOPMENT

The M&A Paradox

The scorecard on corporate acquisition outcomes is generally bleak. As King et al. (2004:196), concluded: “After decades of research the overwhelming conclusion must be that M&A activity, on average, does not positively contribute to an acquiring firm’s performance.” Moreover, the returns to acquiring firms have steadily deteriorated over the past fifty years, (Moeller et al. 2005). Even the best explanatory models for the heterogeneity of acquirer returns exhibit an unexplained variance (Cartwright & Schoenberg 2006), exceeding 70% (Stahl & Voight 2005). This persistence forms the basis of what has been dubbed the “M&A Paradox” (e.g. Agrawal & Jaffe 2001). Simply put, the “M&A Paradox” holds that despite virtually all extant research demonstrating that corporate acquisitions, on average, fail to create shareholder value (Datta et al. 1992; King et al. 2004), tens of thousands of deals and more than \$2 trillion are annually transacted (Thomson Reuters 2014). With rare exception, acquiring firms pay a significant premium above the prevailing market price for a target firm (Cartwright & Schoenberg 2006). The classic justification for these premiums focuses on “synergies,” representing the acquirer’s beliefs that integrating the acquirer’s and target’s business operations will generate incremental value (Sirower 1999). The inability to explain why firms routinely fail to achieve synergies is a notable gap in existing acquisition frameworks (Capron et al. 1998; Hitt et al. 1998).

Since acquisitions typically involve a “take-out premium” (Sirower 1999), new sources of value must be created by the acquiring firm to justify the $1 + 1 = 3$ arithmetic that characterizes acquisition premiums. If the principal rationale of acquiring firms in paying hefty acquisition premiums is based on revenue growth or cost control greater than that which can be achieved independently, then explanatory models for the returns to acquiring firms must take into account the acquirer’s ability to justify those premiums through value-enhancing synergies (Capron et al. 1998; Hitt et al., 1998). Extant research has identified three primary culprits of this “synergy trap” (Sirower 1997): (i) executive hubris (e.g. Hayward & Hambrick 1997) which drives excessive acquisition premiums; (ii) information asymmetries (e.g. Seth et al. 2000), which impair the *ex ante* ability to accurately assess synergies; and, (iii) integration difficulties (e.g. Puranam et al. 2009), which limits the *ex post* capacity to achieve synergies.

Addressing Synergy Traps through Spin-ins

Despite the pervasive inability of acquiring firms to extract value from M&A activity, novel approaches to the three impediments comprising the synergy trap have been in short supply. In essence, acquirers appear to repeat the same mistakes over and over (Agrawal & Jaffe 2001). The use of corporate spin-ins may be a notable exception. In theory, prior employment ties should be instrumental in deriving incremental value through a realization of relational exchange elements (Dyer & Singh 1997; Poppo & Zenger 2002) that cannot be replicated by individuals and entities that do not share existing conditions for mutually beneficial exchange (Blau 1964; Emerson 1976). Two specific ways in which we would expect to see benefits from the familiarity that is fostered through prior employment ties pertain to information asymmetries and executive hubris.

Spin-ins and Information Asymmetries

Even under the best circumstances, acquisition-related due diligence is performed under a multitude of constraints, primarily stemming from incomplete information (Officer et al. 2009). Even when financial and operational performance disclosures are exemplary, the tacit knowledge and underlying capabilities of an organization are rarely available for unbiased review (Singh & Zollo 1998). As a consequence, intentional and unintentional information asymmetries arise that may have a marked impact on the valuation of a target entity. This may, in turn, lead to a miscalculation of the opportunities to achieve revenue and cost-control synergies. To the extent that the quantity and quality of information can be improved during the due diligence process, acquirers may avoid paying excessive acquisition premiums. Spin-ins should, therefore, have an advantage over deals that involve no prior ties. By virtue of the ability to leverage existing relationships, acquirers of a spin-in should be in a position to better ascertain the financial and operational prospects of the target firm. We would expect these improved optics to result in comparatively better acquisition outcomes. Accordingly, we predict that:

H1: On average, spin-ins will generate higher returns for the acquiring firms than acquisitions in which there are no prior ties with founders of the acquired firm.

Spin-ins and Executive Hubris

As noted above, even the best M&A models account for only one-third of the heterogeneity in acquisition outcomes; and yet, durable predictors have been identified, one of which is the role of the CEO in setting and implementing an acquisitive strategy. Even after controlling for known effects associated with prior acquisition experience, conglomeration and method of payment, research has consistently demonstrated that executive over-confidence accounts for a significant portion of the excess premiums paid in value-destroying acquisitions (Ferris, Jayaraman & Sabherwal, 2013; Hayward & Hambrick, 1997). Malmendier and Tate (2005) showed that CEOs meeting the definition of arrogant were 2.54 times more likely to consummate a value-destroying acquisition. In the context of spin-ins, however, many of the elements that drive judgment errors stemming from over-confidence are no longer relevant. Often, firms such as Cisco will actually sponsor departing employees by taking an equity stake in the spinoff. Even when employees leave without parent-firm sponsorship, the acquiring firm is “spinning in” technological innovations that previously “walked out the door” (Klepper & Thompson 2010). If anything, spin-ins are tantamount to an acknowledgement that a departing employee has surpassed the innovative prowess of the parent-firm. For this reason, we would expect that in addition to reducing information asymmetries, spin-ins also reduce the adverse effects of executive hubris:

H2: Acquisition premiums related to CEO hubris will be smaller for spin-in acquisitions than for acquisitions in which there are no prior ties with founders of the acquired firm.

Spin-ins and Post-Acquisition Integration

While our theory predicts that spin-ins will generate benefits to acquirers with respect to information asymmetries and CEO over-confidence, acquisition integration – the third component of the “synergy trap” articulated by Sirower (1997) – is less clear. Improvements in the quality and quantity of information should reduce the risk that an acquirer will perform inadequate due diligence. However, the organizational and cultural impacts of spin-ins are complicated by their tendency to create massive compensation disparities (Alles & Alles 2002). At a minimum, spin-ins create serious issues regarding the opportunity costs faced by innovative employees who choose to remain with the parent-firm. Spin-ins may thus unintentionally spawn perverse incentives whereby innovative employees are motivated to suppress technological breakthroughs until they can capitalize independently on the opportunity. Therefore, while the logic of using spin-ins as one facet of a corporate entrepreneurship strategy seems promising based on information asymmetries and executive hubris, there may be countervailing forces that limit the suitability of spin-ins as a consequence of organizational climate issues arising from the re-integration of former employees. If the integration process fails to generate synergies sufficient to justify the acquisition cost, then asset impairments will occur, requiring the parent-firm to recognize the loss of shareholder equity, usually through the write-down of goodwill and other intangible assets. Therefore, even while we expect that spin-in outcomes will be comparatively better than acquisitions that involve no prior ties, we predict that integration complications will render the typical spin-in value destroying:

H3: The majority of spin-ins will result in intangible asset write-offs by the acquiring firms.

METHOD

Since there is no central repository of data on spin-ins, a major undertaking of our study involved the compilation of spin-in transactions. In order to insure an ample population of deals both with and without prior employment ties, we focused on sectors with high M&A volume: software, cloud services and electronic gaming. Using SDC Platinum, we assembled a pool of 200 acquisitions of firms founded by ex-employees of 112 parent-firms, 1995-2009. For the purpose of constructing a matched set comparison, we also identified 200 acquisitions consummated by 103 firms that had no prior ties to the acquired firms’ founders. Biographical information was compiled from disclosure statements issued by the acquiring firms.

Dependent Variables

Testing the predicted relationships required the use of two dependent variables: Cumulative Abnormal Returns (CAR) and Acquirer Asset Impairment (AAI). CAR, which has been used extensively in acquisition research (Sirower 1999), is a continuous variable representing the sum of the differences between the expected return on a stock and the actual return. AAI is a categorical indicator for the occurrence of asset impairments (identified through SEC disclosures). Asset write-downs are required when the cash flows generated from acquired assets fail to achieve the levels used to justify the purchase price. Consistent with efforts to examine the long-term impact of acquisitions (Agrawal et al. 1992), our measures were set at 3 years post-acquisition.

Predictors and Controls

The focal predictors of our analysis are Acquisition Type (AT), which is a discrete dichotomous variable, coded as “1” to indicate that an acquisition was classified as a spin-in; CEOHubris (CEO), which is scaled measure of CEO over-confidence, drawn from Hayward and Hambrick (1997); and, a product term for AT*CEO. To insure our results were not simply an artifact of known M&A effects, the models included covariates pertaining to the target company, as well as conglomeration effects, relatedness criteria, method of payment and prior acquisition experience related to the acquiring firm. Controls were also employed for year-specific conditions related to macroeconomics, capital market movements and industry-level performance.

Analytical Strategy

As noted above, our research design involved a matched pair-wise analysis of 200 transactions drawn from spin-ins and non-spin-ins. Pair-wise matching insured equivalent means and variance for each focal covariate, so that the paired transactions resembled one another in all respects other than prior employment ties. The purpose of employing pair-wise analysis with data drawn from matched sets is to remove bias in the comparison of groups by ensuring equality of distributions of the matching covariates we employed (Wang & Liu 2013). The matched set comparisons of 200 paired transactions were constructed while controlling for 9 separate dimensions, to account for the acquired firm's size, age, founder experience, and financial performance, as well as acquirer's size, age, prior M&A experience, profitability, and distance from the target's industry classification. With pair-wise matching, the null hypothesis is that there are no significant differences between the paired subjects, tested using z-statistics and applying McNemar's test (McNemar 1947). T-test scores for each of the nine dimensions across the two matched set pools ranged between 0.13 and 0.87, confirming that the pools were statistically indistinguishable aside from the existence of prior ties for the spin-in pool.

RESULTS

The results of our empirical analysis provide support for all three of predicted relationships, confirming our sense that while spin-ins fare markedly better than acquisitions for which there are no prior ties, they are, on average, a losing proposition.

Consistent with Hypothesis 1 (Table 1), the variable AT (coded as spin-in = 1), is positive and significant, meaning that, on average, spin-ins generate higher cumulative abnormal returns, over and above the predictive power of known covariates, such as prior M&A experience, conglomeration and diversification effects, and payment method (King et al. 2004). As indicated in Table 2, spin-ins displayed higher CAR in 64% of the pair-wise matches. The adjusted R² for a model containing only the controls was 0.31. Including the discrete dichotomous indicator for Acquisition Type, the R² was 0.36 yielding a DR² of 0.05, which constitutes a 16% improvement in the model's explanatory power. Hypothesis 2 also finds significant support, with product term AT*CEO indicating that spin-ins reduce the adverse effects of executive over-confidence in the context of a complete analytical model.

Finally, concerning Hypothesis 3, it is apparent from Tables 1 and 2 that although spin-in performance is, on average, superior to that of non-spin-ins, the majority of spin-ins do not ultimately create shareholder value for the acquiring firm. In fact, 52% of spin-ins in our study resulted in asset impairments that required a transaction-specific write-down by the acquiring firm. This confirms our prediction that spin-ins will significantly resolve two sources of the

“synergy trap” (Sirower 1999) – information asymmetries and executive hubris – but will not overcome key confounds associated with the third driver of acquisition value destruction: the integration of processes, technologies and humans.

DISCUSSION AND IMPLICATIONS

A persistent challenge facing large-scale incumbents involves balancing continuity and change: how, on the one hand, to harvest attractive margins through the replication of existing technologies and efficient returns to scale, and on the other hand, to maintain a flow of innovative breakthroughs. Widely supported research on the essentiality of ambidexterity has noted the difficulties firms face in striking this balance internally (e.g. Raisch et al. 2009). Frequently then, firms turn to corporate acquisitions as a means to pursue corporate entrepreneurship (Markides 2006). However, acquisitions have their own set of difficulties and have been shown, on average, to be a source of shareholder value destruction (King 2004; Sirower 1997). Therefore, we posed the question: If both “make” and “buy” are unattractive options, what is the most promising course of action? To this conundrum, we sought to examine an under-explored CE hybrid: spin-ins.

In this paper, we have proposed a framework wherein spin-ins constitute an attempt to deal simultaneously with the problems of disruptive internal development and the problems of value-destroying acquisitions. In this regard, spin-ins appear to be an interesting partial solution. Synergy traps caused by information asymmetries and executive over-confidence are substantively mitigated, but the vast majority of acquiring firms ultimately fail to generate value from spin-ins due to faulty or incomplete integration of the spun-in company. While spin-ins result in significantly better acquisition-related outcomes than transactions without prior employment ties, their efficacy as a component of any firm’s corporate entrepreneurship strategy may be bounded by the acquirer’s ability to handle organizational and cultural disruptions that stem from reuniting with innovative former employees.

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Table 1 – Predicted Relationships and Significant Regressed Values

Hypothesis	Focal Variable	Coeff.	p-value	Model F-Test
H1: <i>On average, spin-ins will generate higher returns for acquiring firms than acquisitions with no prior ties with founders of the acquired firm.</i>	Acquisition Type (AT)	0.47	< 0.001	58.6
H2: <i>Acquisition premiums related to CEO hubris will be less for spin-ins than for acquisitions with no prior ties with founders of the acquired firm.</i>	AT*CEO	0.14	< 0.01	49.1

Table 2 – Abnormal Returns and Asset Write-Offs at 5 Years Post-Acquisition

Acquisition Type	Firms in Cohort (#)	CAR at Years Post-Acquisition	% of Acquisitions with Asset Write-Offs	Percentage of pairs with higher CAR 3 Yrs Post-Acquis
Spin-In	200	-3%	52%	64%
Non-Spin-In	200	-11%	69%	36%