Great expectations force risky business acquisitions

May 16 2017, by Matt Weeks

A good reputation can be bad for business, according to new research from the University of Georgia.

For highly regarded companies, public esteem comes with benefits such as hiring better talent and charging higher prices. But it also brings expectations that are nearly impossible to meet, says Mike Pfarrer, associate professor of management at UGA's Terry College of Business.

"As much as people like to say that the stock market is blind to prejudicial behavior, because it's run by humans there are a lot of human biases baked into it—and we exposed one," Pfarrer said. "Reputation is inherently a psychological construct. So, if you do a lot of good over a period of time, people start to expect more from you. If you keep delivering the same old thing, even if it's a great product, the market may not reward you for it."

Pfarrer and colleagues looked into how expectations affect firms with good reputations. Specifically, they studied how companies on Fortune's "Most Admired Companies" list differed from others in their merger and acquisition behaviors.

The research, published in *Strategic Management Journal*, found that, in contrast to other businesses, high-reputation companies make about twice as many acquisitions—and those purchases tend to be less related to the company's expertise. And, despite their prestige, the market penalizes them for it through lowered stock value.

"We looked at about 1,400 firms over nearly 20 years and found that high-reputation firms take bigger risks in order to meet or exceed the expectations that investors put on them," Pfarrer said. "Think of a company like Google. We've seen it grow up in our lifetimes and start acquiring other firms like YouTube. At first, organic growth is good enough for investors. But, eventually, to satisfy the ever-upward growth that the market demands, they have to start buying other companies because they can't meet expectations organically anymore."

Acquisitions are risky endeavors, especially when the business is outside a company's expertise, Pfarrer said. So, even though businesses feel forced to make acquisitions in order to keep their reputations, investors react to these moves with trepidation.

"When Microsoft bought Skype, the market reacted by asking, 'What are you doing?' But the reality is that Microsoft probably had a lot of good reasons for doing it," Pfarrer said. "It's easy to pick on these companies, but we have to assume that firms that have been around a long time with billion-dollar market caps are not inherently dumb."

Even when investors take this knowledge into account, their behavior is unlikely to change, Pfarrer said.

"We all have these behaviors and emotions hard-wired into us. It's just how we are," Pfarrer said. "We used to think that they made us irrational, but now we know that it's not really irrational. It's human nature. The lesson for managers may be to think twice about making risky acquisitions to meet expectations because the market is going to penalize you for it anyway."

More information: Jerayr J. Haleblian et al. High-Reputation Firms and Their Differential Acquisition Behaviors, *Strategic Management Journal* (2017). DOI: 10.1002/smj.2645

Provided by University of Georgia