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The Curvilinear Effect of Acquisition Premiums on Firm Performance, and the Moderating Role of Top Management Team Faultlines: Propositions and Model

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Abstract:

Merger and acquisition (M&A) premiums play a significant role in firm performance, but existing literature shows inconsistent findings regarding their specific impact. Based on a systematic review of prior researches, this study analyzes the nonlinear inverted U-shaped effect of acquisition premiums on firm performance, as well as the moderating role of top management team (TMT) faultlines (including task-related faultlines and bio-demographic faultlines). Several propositions of important theoretical and practical value are proposed, and a theoretical model is constructed to illustrate the relationship among acquisition premiums, firm performance, and TMT faultlines.

Keywords: *Acquisition premiums, Firm performance, TMT task-related faultlines, TMT bio-demographic faultlines, Moderating effect.*

1. INTRODUCTION

Acquisition has become increasingly important for firms looking to achieve rapid growth and expand their operations. It is also seen as a significant way to upgrade and transform industries, thereby enhancing market competitiveness (Narayan et al., 2021). As the number and value of acquisition transactions continue to rise, so does the occurrence of acquisition premiums, particularly high-value premiums. Acquisition premiums refer to the amount that a buyer pays above the prevailing market value of a firm. According to incomplete statistics, out of approximately 4,000 acquisition premium cases since 2018, around 50% of cases have a premium rate that exceeds twice the market value. Additionally, 2.5% of cases have a premium rate between 20-50 times the market value, and 2.5% of cases have a premium rate exceeding 50 times the market value (Cen et al., 2020). However, existing studies have provided conflicting findings regarding the impact of acquisition premiums on firm performance.

Some scholars argue that high acquisition premiums indicate expected synergies and improve post-acquisition performance (Varaiya, 1987). On the other hand, other scholars suggest that high premiums negatively affect firm value creation (Nnadi and Aghanya, 2018). However, there is a lack of clear explanations for these opposing views. Building on upper echelon theory, which emphasizes the role of the top management team (TMT) in acquisition decisions (Boateng et al., 2017), Alhanhanah et al. (2019) propose that the characteristics of TMT members are closely related to the level of acquisition premiums. Nevertheless, there is limited research on how the attributes of TMT members influence the relationship between acquisition premiums and firm performance.

From a conceptual perspective, resource dependence theory (Yin et al., 2008) suggests that the composition of top managers is crucial for firms to navigate environmental uncertainty. In recent years, the concept of top management team (TMT) faultlines, which reflects the internal composition characteristics of TMT, has gained significant attention in research on evaluating the heterogeneity of TMT composition (Bezrukova et al., 2009). TMT faultlines refer to a hypothetical division line that separates TMT into different sub-groups based on one or more characteristic attributes of its members. This division significantly impacts the effectiveness of knowledge and information sharing between

sub-groups within the TMT, thereby influencing the strategic formulation of firms, such as acquisitions. Therefore, our study primarily focuses on two aspects, one of which is analyzing whether there is an inverted U-shaped relationship between acquisition premiums and firm performance, the other of which is exploring how TMT faultlines affect the relationship between acquisition premiums and firm performance.

This research contributes to the literature related to the relationship between acquisition premiums and firm performance, and the boundary conditions of this effect from the perspective of TMT faultlines. Our study begins with a review of the literature on the relationship between acquisition premiums and firm performance. Based on literature review, we propose three research propositions. Subsequently, we conduct model construction and variables definition which are important foundations for further empirical research. Finally, we give the future research prospects.

2. Literature Review and Research Propositions

2.1. Acquisition premiums and firm performance

Drawing on the fundamental principles of resource dependence theory, the firms may seek to acquire resources they lack through acquisitions during their growth process, due to environmental uncertainty and insufficient resources. However, this process may result in the emergence of acquisition premiums, as firms may pay higher prices to improve the success possibility of their acquisition decisions and achieve goals such as management synergy, economies of scale, and cost reduction. Despite this, there are currently inconsistent empirical researches on the impact of acquisition premiums on firm performance (Cho et al., 2016). Researches based on synergy theory suggest that a reasonable premium paid by acquirers can bring diversified resources to firms, improve the efficiency of resource allocation, promote the play of multiple synergy effects, and improve firm profitability, ultimately leading to improving post-acquisition firm performance. However, the researches based on information asymmetry theory suggest that the higher the acquisition premiums paid by the acquirer, the greater the risk level (Mescall et al., 2018), the greater the financing constraints (Merkoulova and Zivanovic, 2022), the greater the risk of stock price collapse, and the worse the future operating performance, which is not conducive to the improvement of post-acquisition firm performance.

The existing literature on the TMGT effect suggests that as the independent variable increases, previous positive impacts may turn into negative impacts after exceeding a certain “critical point” (Chen et al., 2017). Therefore, we posit that an inverted U-shaped relationship exists between acquisition premiums and firm performance. Specifically, when acquisition premiums increase from low to medium level, premium acquisition can enhance firm performance. Firstly, the synergistic effect of sharing technology, sophisticated equipment, and advanced production knowledge between the two companies can improve production efficiency, allocate resources among firms with different technical efficiency levels, significantly reduce the occurrence of resource mismatches, and improve the R&D and innovation capabilities of firms (Zollo and Meier, 2008). Additionally, the business scope of the firm becomes more diversified and the product technology becomes more specialized, which can accelerate product upgrading and contribute to the improvement of firm performance. Secondly, the sharing of human, relational, and information resources brought by the acquisition plan can broaden market entry channels and customer resources, enhance the brand effect, and continuously expand the market sales of the acquisition firms, reducing inventory rates. This can convert more product output into cash flow, which is beneficial to the improvement of firm performance. Finally, the payment of an acquisition premium indicates management affirmation of the firm’s current economic strength and confidence in its future operating and management, sending a positive signal to the market, enhancing investor confidence and positively contributing to the improvement of firm performance.

With the continued escalation of acquisition premiums, premiums that exceed the medium level will amplify the operational risk and performance pressure of post-acquisition firms, thereby hindering the improvement of firm performance. Firstly, in high premium acquisition activities, the acquirer is at a disadvantage in terms of information, as the evaluation of the financial status and market value of the acquired firm often differs significantly from the actual situation, leading to inefficient resource allocation in the post-acquisition company and a failure to generate positive economic synergies, which negatively impacts corporate performance. Secondly, high premium acquisition activities result in the formation of substantial goodwill (Sun et al., 2021), an increase in fixed operating costs, a limitation on

the growth of operational leverage, an increase in the risk of stock price collapse, and an increase in operational risk, thereby rendering the long-term earnings of post-acquisition firms unsustainable and impeding the improvement of firm performance. Finally, high premium acquisition activities are often accompanied by high performance commitments. If a company fails to fulfill its performance commitments as agreed after acquisition, its profits will be reduced to a certain extent (Kumar et al., 2021), which will directly or indirectly negatively affect firm performance in many aspects. Based on these findings, we propose the following proposition:

P1: Acquisition premiums have a significant inverted U-shaped impact on firm performance.

2.2. The moderating effect of TMT faultlines

As previously mentioned, resource dependence theory emphasizes that the characteristics of top managers are crucial when making decisions about integrating resources from external environment in a firm. The characteristics of TMT are crucial for the firms to identify, acquire, and effectively utilize limited resources in order to maintain survival and gain competitive advantages. According to team faultlines theory, team faultlines are key concept for evaluating the characteristics of TMT (Chen et al., 2017). To further explore the effect of TMT faultlines on the firm outcome, existing literature often categorizes them into two types, including TMT task-related faultlines and bio-demographic faultlines (Bezrukova et al., 2009). Therefore, our study mainly explores the moderating effects of TMT task-related faultlines and TMT bio-demographic faultlines on the relationship between acquisition premiums and firm performance.

2.2.1. The moderating effect of TMT task-related faultlines

TMT task-related faultlines are generated by differences in task-related characteristic attributes among TMT members, such as educational background, tenure, and professional background (Bezrukova et al., 2009). When high-level TMT task-related faultlines exist, they can increase cognitive differences among sub-groups, enrich the knowledge resource reserve of TMT (Ou et al., 2017), and facilitate information and knowledge exchange between sub-groups, as well as the acceptance of differentiated information and knowledge.

The inverted U-shaped relationship between acquisition premiums and firm performance becomes more apparent when the level of TMT task-related faultlines is high. In other words, as acquisition premiums move from low to medium level, high-level TMT task-related faultlines can maximize the synergy of multiple resources brought about by acquisition premiums, allowing firms to obtain additional benefits. Specifically, the presence of high-level TMT task-related faultlines highlights the importance and value of diverse knowledge, enhances the recognition and respect of TMT members for the professional knowledge and contributions of other sub-groups, and provides a more rational scientific decision-making foundation for various sub-groups within TMT to determine the “moderate” range of acquisition premiums. Moreover, when faced with highly uncertain tasks, high-level TMT task-related faultlines facilitate the sharing of information, knowledge, and resources among different sub-groups, enabling the TMT to effectively utilize the various knowledge, abilities, and resources possessed by its members. This ultimately improves a firm’s innovation capabilities and market competitiveness, increases the advantages and success probability of acquisition, and thus enhances the positive effect of acquisition premiums.

As the level of acquisition premiums increases from medium to excessive, a portion of the excess premiums may be attributed to decision-makers’ overvaluation of the acquired firm due to insufficient information or unscientific decision-making behaviors. The presence of high levels of TMT task-related faultlines further exacerbates the negative impact of excessive acquisition premiums on firm performance. This is because high levels of TMT task-related faultlines lead to greater knowledge, information, and resource reserves within TMT, which can increase their confidence in resisting external risks and cause them to underestimate the level of risk and overestimate returns. Additionally, the formation of “recipes” from heterogeneous knowledge, information, and resource combinations among different sub-groups within TMT can increase their dependence on making decisions on complex issues (Sun and Chu, 2021). This can lead to a reduction in the time spent on detailed investigation, analysis, and judgment, which increases the probability of the acquirer promising a high acquisition price. Therefore, we propose that excessive acquisition premiums have a negative impact

on firm performance, and this impact is further strengthened by the presence of high-level TMT task-related faultlines. Based on these, we propose the following proposition:

P2: TMT task-related faultlines positively moderate the inverted U-shaped relationship between acquisition premiums and firm performance.

2.2.2. The moderating effect of TMT bio-demographic faultlines

TMT bio-demographic faultlines refer to differences in top managers' bio-demographic characteristics, such as age and gender, among TMT members (Bezrukova et al., 2009). High levels of TMT bio-demographic faultlines can lead to TMT members identifying more strongly with those who share similar relational characteristics, while generating bias against other members, which can result in interpersonal conflict (Hutzschenreuter and Horstkotte, 2013). Additionally, members of the same sub-groups who share similar social experiences and values tend to communicate more actively with each other, but may have limited communication with members outside the sub-groups, which can reduce trust between different subgroups and create communication barriers.

The inverted U-shaped relationship between acquisition premiums and firm performance becomes flatter when the level of TMT bio-demographic faultlines is high. Specifically, as previously discussed, when acquisition premiums increase from low to medium level, the achievement of acquisition with premiums can enable firms to share multiple information resources and expand their business scope through the synergistic effect. However, when the bio-demographic faultlines are at high level, it can cause significant differences in the cognition and values of TMT members, leading to group bias and stereotypes among TMT members. Due to mutual exclusion and obvious communication barriers among different relational subgroups within TMT, this can hinder the process of information exchange and sharing resources among different relational subgroups within TMT (Pearsall et al., 2008). Furthermore, group bias and stereotypes formulated in the different relational group may require extra time to relieve TMT members' conflicts and integrate internal dispersed resources (Hutzschenreuter and Horstkotte, 2013), which results in reducing the agility of firms to respond to external dynamic changes and the timeliness of strategic decisions such as acquisitions. This can ultimately reduce the success probability of firms in implementing acquisition decisions.

As the level of acquisition premiums increases, transitioning from medium level to high level, premiums exceeding the medium level will result in the recognition of enormous goodwill by the firms (Haleblian et al., 2017), increasing the risk of stock price collapse and financial integration risk (Mescall et al., 2018), and causing the firms to be unable to maintain long-term earnings. When TMT bio-demographic faultlines are at high level, on the one hand, the reduction in information and resource exchange and transmission between sub-groups will inhibit TMT's over-confidence level, making decision-making more rigorous and conservative, and thereby reducing the cost and operational risks of the firms after acquisition. On the other hand, high levels of TMT bio-demographic faultlines will create a significant gap between different sub-groups, and the members may have feelings of distrust or even hostility towards other sub-groups' members (Thatcher et al., 2003). Due to the decreasing willingness of sharing knowledge and information among different sub-teams, TMT may avoid information and knowledge overload in dealing with complex strategic issues, such as acquisitions. The decrease in the degree of social interaction willingness and the limitation of sharing excessive redundant knowledge and information can enable TMT to better analyze and process existing information and resources, to a certain extent, reducing the negative effects of high-level acquisition premiums on firm performance. Based on these, we propose the following proposition:

P3: TMT bio-demographic faultlines negatively moderate the inverted U-shaped relationship between acquisition premiums and firm performance.

3. THEORETICAL MODEL

3.1. Definition of Management

Through a systematic review and theoretical analysis of relevant literature, as well as the three propositions mentioned above, this study constructs a theoretical model illustrating the intrinsic relationship among acquisition premiums, firm performance, and top management team faultlines, as shown in Figure 1.

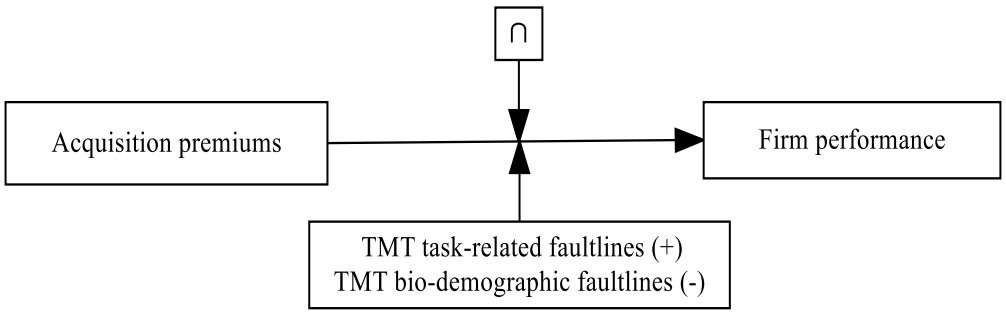

Figure 1. *The theoretical model*

3.2. Research Method

In oder to examine the inverted U-shaped relationship between acquisition premiums and firm performance, we may estimate the parameters of the models (1)-(3) as below:

$$ROA = \alpha_0 + \alpha_1 Control + \varepsilon_0 \quad (1)$$

$$ROA = \beta_0 + \beta_1 Premiums + \beta_2 Control + \varepsilon_1 \quad (2)$$

$$ROA = \delta_0 + \delta_1 Premiums^2 + \delta_2 Control + \varepsilon_2 \quad (3)$$

In order to analyze the moderating effects of TMT task-related and bio-demographic faultlines on the inverted U-shaped relationship between acquisition premiums and firm performance, we may construct the parameters of the models (4)-(6) as below:

$$ROA = \varphi_0 + \varphi_1 Premiums + \varphi_2 Premiums^2 + \varphi_3 Taskfau + \varphi_4 Taskfau \times Premiums + \varphi_5 Taskfau \times Premiums^2 + \varphi_6 Control + \varepsilon_3 \quad (4)$$

$$ROA = \omega_0 + \omega_1 Premiums + \omega_2 Premiums^2 + \omega_3 Biofau + \omega_4 Biofau \times Premiums + \omega_5 Biofau \times Premiums^2 + \omega_6 Control + \varepsilon_4 \quad (5)$$

$$ROA = \lambda_0 + \lambda_1 Premiums + \lambda_2 Premiums^2 + \lambda_3 Taskfau + \lambda_4 Taskfau \times Premiums + \lambda_5 Taskfau \times Premiums^2 + \lambda_6 Biofau + \lambda_7 Biofau \times Premiums + \lambda_8 Biofau \times Premiums^2 + \lambda_9 Control + \varepsilon_5 \quad (6)$$

3.3. Measures

In order to estimate the parameters of the above models, this study provides measurement methods for each variable based on relevant literature.

3.3.1. Dependent variable: Firm performance (ROA)

Building upon prior research (Li et al., 2019), the utilization of return on assets (ROA) as a measure of firm performance is deemed more effective in capturing the input-output and asset utilization levels of firms, and has gained widespread acceptance in the research related to evaluation on firm financial performance.

3.3.2. Independent variable: Acquisition premiums

This study adopts the measurement proposed by Yang et al. (2022), the acquisition premiums are measured by the portion of the transaction price that exceeds the net asset book value, which is as follows:

$$acquisition\ premiums = \frac{total\ transaction\ price - net\ asset\ book\ value \times acquisition\ ratio}{net\ asset\ book\ value} \times acquisition\ ratio \quad (7)$$

where net asset book value is the target firm's net asset book value.

3.3.3. Moderating variables: TMT task-related faultlines and bio-demographic faultlines

TMT task-related faultlines and bio-demographic faultlines. This study utilizes the measurement method proposed by Cooper et al. (2013) to assess TMT task-related faultlines, selecting educational level, tenure, and functional background as the main indicators. Additionally, TMT bio-demographic faultlines are measured using age and gender as the main indicators. To accurately gauge the level of TMT faultlines, it is important to consider both the strength and distance of these faultlines, as noted by Thatcher et al. (2003). The strength of TMT faultlines is measured by assessing the degree of aggregation within the team's sub-teams, while the distance of TMT faultlines is measured by evaluating the degree of differences between different sub-teams within the team. We follow prior empirical research and adopt the calculation method for TMT faultlines strength and distance proposed by Thatcher et al. (2003) and Bezrukova et al. (2009), respectively. The formula for calculating the TMT faultlines strength and distance are as follows:

$$Fau_g = \frac{\sum_{j=1}^{q}\sum_{k=1}^{2} n_k^g \left(\bar{x}_{\bullet jk} - \bar{x}_{\bullet j\bullet}\right)}{\sum_{j=1}^{q}\sum_{k=1}^{2}\sum_{i=1}^{n_k^g}\left(x_{ijk} - \bar{x}_{\bullet j\bullet}\right)},\ g = 1, 2, \ldots\ldots, S \quad \textbf{(8)}$$

$$Fau = Max(Fau_g) \quad \textbf{(9)}$$

$$D_g = \sqrt{\sum_{j=1}^{q}\left(\bar{x}_{1j\bullet} - \bar{x}_{2j\bullet}\right)^2} \quad \textbf{(10)}$$

$$D = Max(D_g) \quad \textbf{(11)}$$

In equation (9), Faug represents the strength value of faultlines in the gth category. n represents the total number of members in TMT of the firms. q represents the total number of characteristic attributes of TMT members of the firms. g represents the classification method, and there are a total of g categories for TMT of the firms with n members. K represents the number of TMT in the sub-team under the gth binary pattern. $\bar{x}_{\bullet jk}$ represents the average value of TMT in the sub-team K on jth characteristic. $\bar{x}_{\bullet j\bullet}$ represents the overall average value of TMT members on jth characteristic. x_{ijk} represents the value of the ith top manager in the sub-team K on jth characteristic. A larger value of Faug indicates a stronger faultlines strength in the gth category.

In equation (11), Dg represents the distance value of faultlines in the gth classification; $\bar{x}_{1j\bullet}$ represents the average value of TMT members of the first sub-team in jth characteristic under the gth binary pattern; $\bar{x}_{2j\bullet}$ represents the average value of TMT members of the other sub-team in jth characteristic under the gth binary pattern. Finally, we measure TMT faultlines level by multiplying the standardized values of TMT faultlines strength and distance.

3.3.4. Control variables

In order to ensure the robustness of our findings, we adopt several control variables in the regression models based on previous researches in this field. Specifically, firm size is represented by the logarithm of total assets (Demerjian and McVay, 2012), firm age is measured by the number of years since its establishment (Austio et al., 2000), TMT size is measured by the number of TMT members (Xie et al., 2022), firm growth is measured by the growth rate of total operating revenue (Levy and Tasoff, 2017), asset liability ratio is measured as the ratio of total liabilities to total assets (Lara et al., 2016), dual is measured by a dummy variable (CEO concurrently serving as the Chairman is assigned a value of 1, while the opposite is assigned a value of 0) (Pham et al., 2015), and total asset turnover is measured as the ratio of sales revenue to total assets (Li et al., 2018). Additionally, industry and year dummy variables should be included in the above econometric models to control for industry and year effects. The main variables and their definitions are shown in Table 1.

Table 1. *Variables Definition*

Variable Type	Variable	Description
Dependent Variable	Firm performance	The ratio of net profit to average total assets
Independent Variable	Acquisition premiums	It is shown in equation (7)
Moderating Variables	Top management team task-related faultlines	Based on the tenure, education level, and functional background of TMT members, the calculation formulas are shown in equations (8)-(11)
	Top management team bio-demographic faultlines	Based on gender and ages of TMT members, the calculation formulas are shown in equations (8)-(11)
Control Variables	Firm size	Natural logarithm of total assets of the firms
	Firm age	The number of years since its establishment
	Top management team size	The number of TMT members
	Firm growth	Growth rate of total operating revenue
	Leverage	The ratio of total liabilities to total assets
	Dual	CEO concurrently serving as the Chairman is assigned a value of 1, while the opposite is assigned a value of 0
	Total assets turnover ratio	The ratio of sales revenue to total assets

4. Conclusion

Existing researches have not yet integrated acquisition premiums, firm performance, and top TMT faultlines into a unified framework for in-depth analysis. In light of this, this study systematically reviews and analyzes the intrinsic relationship among these three elements. Based on this analysis, three important theoretical propositions are proposed. Finally, a theoretical model is constructed to illustrate the relationship among them, accompanied by an econometric model and the measurement methods for each variable within the model. This provides a foundation for conducting empirical research on the relationship among acquisition premiums, firm performance, and TMT faultlines.

Due to limitations of space and time, this paper only conducts a literature review and theoretical analysis of the intrinsic relationship among acquisition premiums, firm performance, and TMT faultlines. The validity of the theoretical propositions and the established model proposed in this study still requires empirical testing. Further exploration and empirical analysis of the relationship among acquisition premiums, firm performance, and TMT faultlines remain worthwhile endeavors for future research, which will also be the focus of our forthcoming studies.

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