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EMPOWERING ENTREPRENEURS THROUGH DECENTRALIZED MANAGEMENT

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Being acquired by a private equity (PE) firm offers a substantial potential value-add to an existing business. But acquiring and managing multiple businesses is hard, and research suggests that far from all acquisitions lead to a superior outcome[1]. More specifically, according to research collated by Harvard Business School professor Clayton Christensen and colleagues, between 70-90% of all mergers and acquisition deals fall short of expectations[2].

In this article, we discuss the literature on acquisition strategies, centering on two key aspects - the way organizations can be managed and the need for strategic interdependence - that can help explain why so many acquisitions do not meet the expectations, and why some acquisitions meet (and even exceed) the expectations. We undertake this task in relation to entrepreneurship simply due to entrepreneurs are the cornerstone of abnormal returns[3]. We finish this paper by linking the discussion to our strategy at Esmaeilzadeh Holding, thereby giving the reader a better understanding of how we strive to deliver superior returns while minimizing risks.

The traditional way of organizing

This way of organizing is notable. In this organizational structure, the decision-making authority resides with the top-level management, that is, the executives. They create the strategy for the whole organization and decide the objectives and key results (OKRs) for all functional departments. The head of the different functional departments is responsible for reaching the key results set by the top-level management. The heads' key results become their subordinates' objectives, and so on down to the lowest level. This structure, which is referred to as the centralized structure, enhances efficient production as well as creates a sense of control throughout the organization.

A well-known example of an organization that has employed this type of structure historically is the Japanese automaker Toyota, where all decisions were made by the top-level management and information traveled only one way. Worth mentioning, however, is that Toyota had other valuable traits such as encouraging their front-line workers to suggest improvements and help make them, which is generally not a trait associated with a centralized structure.

Why the knowledge economy demands a new way of organizing

In the knowledge economy, which is characterized by an accelerated pace of technical and scientific advances[4], the disadvantages of the traditional way of organizing are many[5]:

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[1] Haleblian, J., Devers, C. E., McNamara, G., Carpenter, M. A., & Davison, R. B. (2009). Taking stock of what we know about mergers and acquisitions: A review and research agenda. Journal of management, 35(3), 469-502.
[2] Christensen, C. M., Alton, R., Rising, C., & Waldeck, A. (2011). The new M&A playbook. Harvard business review (March 2011).
[3] Schumpeter, J. A. (1934/1983). The theory of economic development: An inquiry into profits, capital, credit, interest, and the business cycle. Transaction Publishers.
[4] Powell, W. W., & Snellman, K. (2004). The knowledge economy. Annu. Rev. Sociol., 30, 199-220.
[5] Castells, M. (1996). The information age: Economy, society and culture (3 volumes). Blackwell.
Porter, M. E. (1980/1998). Competitive strategy: Techniques for Analyzing Industries and Competitors. The free press.

- A lack of optimality: Because the decisions are solely made by the executives, rather than those knowledgeable employees who best understand the changing market, there is a higher risk for suboptimal decisions
- A lack of horizontal linkages: Because the decisions are solely made by the executives and those decisions cascade down to the different functional departments, rather than being taken through conversations between the functional departments, linkages across departments is generally low
- A loss of contribution: Because the decisions are solely made by the executives, rather than letting all knowledgeable employees have a say, the full potential of the employees is not fulfilled
- A loss of agility: Because the decisions are solely made by the executives, rather than by knowledgeable employees closer to the actual changes, new directives will take longer time to implement
- A loss of flexibility: Because the decisions are solely made by the executives, rather than throughout the organization, the executives are reluctant to revise the OKRs mid-season even though it might be fruitful

Evidently, the traditional way of organizing has its flaws. This begs the question of whether the opposite type of organizational structure, namely the decentralized organization, is more advantageous?

In the optimal case, the decision-making authority resides throughout the organization, especially among the most knowledgeable employees in conjunction with the executives. Emphasize is on collaborative strategy, empowered employees, horizontal collaborations, widespread information sharing, agility, and flexibility. A well-known example of an organization adopting this type of organizational design is Alphabet (formerly known as Google), where employees are given lots of authority and autonomy.

> *"We encourage our employees, in addition to their regular projects, to spend 20% of their time working on what they think will most benefit Google"*
> 2004 Founders' IPO Letter

The most significant strength of this organizational structure is enhanced effectiveness, that is, doing the rights things more frequently. This capacity to rapidly respond to unexpected changes constitutes an important source of competitive advantage [6]. This is achieved through an increased level of collaboration between employees who in the traditional organization would otherwise be disconnected as they belong to different departments and different hierarchical levels. Moreover, a very important long-term benefit of this structure is also that the quality of life for the employees, and their motivation, may be improved because of empowerment and giving them more autonomy over their work.

Doerr, J. (2018). Measure what matters: OKRs – The Simple Idea That Drives 10x Growth. Penguin Business.

[6] Teece, D. J., Pisano, G., & Shuen, A. (1997). Dynamic capabilities and strategic management. Strategic management journal, 18(7), 509-533.

On the negative side, however, the two most prominent issues in this type of organization are the coordination problem, which is a by-product of distributing authority throughout the organization, and the lack of fit between what the organization wants and what is available, an issue referred to as "articulation errors" [7]. These two issues are more prominent in extreme forms of decentralization and can thus be kept at bay by keeping a certain level of structured connectedness. Table 1 below summarizes the key differences between the two ways of organizing.

Table 1: Two ways of organizing

	CENTRALIZATION	DECENTRALIZATION
DECISION-MAKERS	Few	Many
HIERARCHY	High	Low
CONTROL	Top-down	Bottom-up (and Top-down)
COLLABORATION	Vertical	Horizontal (and Vertical)
AUTONOMY	Low	High
KEY STRENGTHS	Control & Efficiency	Adaptability & Effectiveness
KEY WEAKNESSES	Untapped potential & Inflexibility	Articulation error & Coordination problem

The critical issue here is to sort out whether the new way of organizing truly facilitates long-term entrepreneurial behavior, which, as stated above, is a necessity for abnormal returns. Research suggests that it does. For example, as Lumpkin and Dess claimed in their classic and highly cited 1996 paper[8]: "it is the freedom granted to individuals and teams who can exercise their creativity and champion promising ideas that are needed for entrepreneurship to occur…. entrepreneurial managers are important to the growth of firms because they provide the vision and imagination necessary to engage in opportunistic expansion". Put differently, what Lumpkin and Dess believed was that empowering employees through decision power and autonomy was one of the main ingredients of having an entrepreneurial-oriented organization.

Can PE firms augment entrepreneurship?

Ever since Jensen's influential 1989 paper[9], a central hypothesis has been that PE firms have the power to improve the performance of the organizations they invest in. By supporting the acquired organizations through a variety of activities, such as board work, improving equity incentives, improving demand factors, and redefining the current strategy[10], PE firms can improve operational effectiveness and efficiency in the organizations they acquire[11].

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[7] Benveniste, G. (1994). Twenty-first Century Organization: Analyzing Current Trends. Imagining the Future. Jossey-Bass.

[8] Lumpkin, G. T., & Dess, G. G. (1996). Clarifying the entrepreneurial orientation construct and linking it to performance. Academy of management Review, 21(1), 135-172.

[9] Jensen, M. C. (1997). Eclipse of the public corporation. Harvard Business Review (Sept.-Oct. 1989).

[10] Gompers, P., Kaplan, S. N., & Mukharlyamov, V. (2016). What do private equity firms say they do?. Journal of Financial Economics, 121(3), 449-476.

[11] Bloom, N., Sadun, R., & Van Reenen, J. (2015). Do private equity owned firms have better management practices?. American Economic Review, 105(5), 442-46.

It is furthermore theorized that these support activities, in addition to the extra growth capital that is associated with being acquired by a PE firm[12], also positively influence entrepreneurial behaviors because enhanced access to capital, in conjunction with additional human capital and more aligned incentives, facilitates the recombination of resources, which is a key ingredient in innovation[13].

Does this mean that organizations acquired by PE firms are more entrepreneurial, as compared to similar firms not acquired? The short answer is that they can be more innovative, but not necessarily. The long answer requires us to distinguish different types of acquisitions strategies, both regarding the organizational design and the need for interdependence post-acquisition.

To start with, Kortum and Lerner analyzed the relationship between early-stage private equity investments (venture capital) and innovation using a sample of 530 manufacturing firms[14]. Their findings show that even though this type of PE accounted for ca. 3% of corporate research and development (R&D), it is responsible for ca. 8% of all industrial innovations. In other words, this research suggests that organizations backed by PE were close to three times as innovative as similar organizations without PE backing.

In another study, Lerner and other research scholars analyzed the patenting behavior of 472 firms, belonging to a variety of industries, before and after they received PE backing[15]. With regards to the number of innovations (quantity), the key finding was that little had changed before or after receiving PE backing. However, with regards to the characteristics of the innovations (quality), their findings suggest that after the transaction, the PE-backed organization experienced a beneficial refocusing of its innovative activities. Specifically, the analysis suggested that those organizations who received PE backing increased their inventions' economic importance by ca. 25%.

These two studies, however, omitted to take into consideration the level of autonomy of the acquired organization post-acquisition, and as we argued above, the way organizations are managed can influence the level of entrepreneurship. Several studies have been conducted that do take that into account, a few of those are explicitly discussed here.

Two studies analyzed how the level of integration affected subsequent short-term innovation output, one of the studies relied on a dataset of 217 technology acquisitions[16], and the other relied on a dataset of 62 pharmaceutical acquisitions[17]. Their fundamental hypothesis, which was empirically supported, was that structural integration, which refers to the combination of formerly distinct

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[12] Klein, P. G., Chapman, J. L., & Mondelli, M. P. (2013). Private equity and entrepreneurial governance: Time for a balanced view. Academy of Management Perspectives, 27(1), 39-51.
[13] Penrose, E. T. (1959). The theory of the growth of the firm. Oxford, England: Oxford University Press.
[14] Kortum, S. & Lerner, J. (2000). Assessing the contribution of venture capital. The RAND Journal of Economics, 31(4), 674-692.
[15] Lerner, J., Sorensen, M., & Strömberg, P. (2011). Private equity and long-run investment: The case of innovation. The Journal of Finance, 66(2), 445-477.
[16] Puranam, P., Singh, H., & Zollo, M. (2006). Organizing for innovation: Managing the coordination-autonomy dilemma in technology acquisitions. Academy of Management journal, 49(2), 263-280.
[17] Paruchuri, S., Nerkar, A., & Hambrick, D. C. (2006). Acquisition integration and productivity losses in the technical core: Disruption of inventors in acquired companies. Organization science, 17(5), 545-562.

organizations into one larger organization, disrupt the target's innovative capabilities because it ends their autonomous existence and causes disruption of their routines.

The loss of autonomy and disruption of routines associated with integration has moreover been found to decrease employee retention[18]. And the retention of employees, especially those key employees who constitute the core of the organization's competitive advantage, is central to preserving the acquired organization's capabilities that are based on tacit knowledge[19]. If the acquiring organization loses those employees post-transaction, their innovative capabilities risk not only being disrupted, but they can also be lost.

On the other hand, in a follow-up study on the same technology-related sample mentioned above, Puranam and co-authors argued and found evidence that this disruption may, however, be worthwhile if there is a high strategic interdependence between the acquiring-acquired organization[20]. The integration is arguably worthwhile because research suggests it to be the single most important factor in explaining synergy realizations[21]. What it comes down to, it seems, is whether the benefits of integration, that is, reduced redundancies and economies of scale[22], outweighs the increased costs of undertaking the integration[23], and the benefits of autonomy[24].

Acquisition strategies

The reason why so many acquisitions fall short of the expectations is that acquirers incorrectly match the strategic purpose of the transaction and the specific needs of the acquired organization post-transaction. Based on the above discussion. and inspired by prior literature [25], we propose the following framework for distinguishing different acquiring (and managing) strategies (see Figure 1).

This framework, which considers the need for the acquired firm's level of decentralization post-acquisition (x-axis) and the need for strategic

[18] Angwin, D. N., & Meadows, M. (2009). The choice of insider or outsider top executives in acquired companies. Long Range Planning, 42(3), 359-389.
[19] Ranft, A. L., & Lord, M. D. (2002). Acquiring new technologies and capabilities: A grounded model of acquisition implementation. Organization science, 13(4), 420-441.
Ranft, A. L. (2006). Knowledge preservation and transfer during post-acquisition integration. In Advances in mergers and acquisitions. Emerald Group Publishing Limited.
[20] Puranam, P., Singh, H., & Chaudhuri, S. (2009). Integrating acquired capabilities: When structural integration is (un) necessary. Organization Science, 20(2), 313-328.
[21] Larsson, R., & Finkelstein, S. (1999). Integrating strategic, organizational, and human resource perspectives on mergers and acquisitions: A case survey of synergy realization. Organization science, 10(1), 1-26.
[22] Bauer, F., & Matzler, K. (2014). Antecedents of M&A success: The role of strategic complementarity, cultural fit, and degree and speed of integration. Strategic management journal, 35(2), 269-291.
[23] Slangen, A. H., & Hennart, J. F. (2008). Do foreign greenfields outperform foreign acquisitions or vice versa? An institutional perspective. Journal of Management Studies, 45, pp. 1301-1328.
[24] Datta, D. K., & Grant, J. H. (1990). Relationships between type of acquisition, the autonomy given to the acquired firm, and acquisition success: An empirical analysis. Journal of Management, 16(1), 29-44.
[25] Angwin, D. N., & Meadows, M. (2009). The choice of insider or outsider top executives in acquired companies. Long Range Planning, 42(3), 359-389.
Angwin, D. N., & Meadows, M. (2015). New integration strategies for post-acquisition management. Long Range Planning, 48(4), 235-251.
Cunningham, C., Ederer, F., & Ma, S. (2021). Killer acquisitions. Journal of Political Economy, 129(3), 649-702.
Haspeslagh, P. C., & Jemison, D. B. (1991). Managing acquisitions. Free Press.
Nahavandi, A., & Malekzadeh, A. R. (1988). Acculturation in mergers and acquisitions. Academy of management review, 13(1), 79-90.
Siehl, C., & Smith, D. (1990). Avoiding the loss of a gain: Retaining top managers in an acquisition. Human Resource Management, 29(2), 167-185.

interdependence between the acquiring-acquired organizations post-acquisition (y-axis), has the potential to significantly increase the success rate of acquisitions. We will now go through the proposed framework, which comprises five broad-ranging strategies.

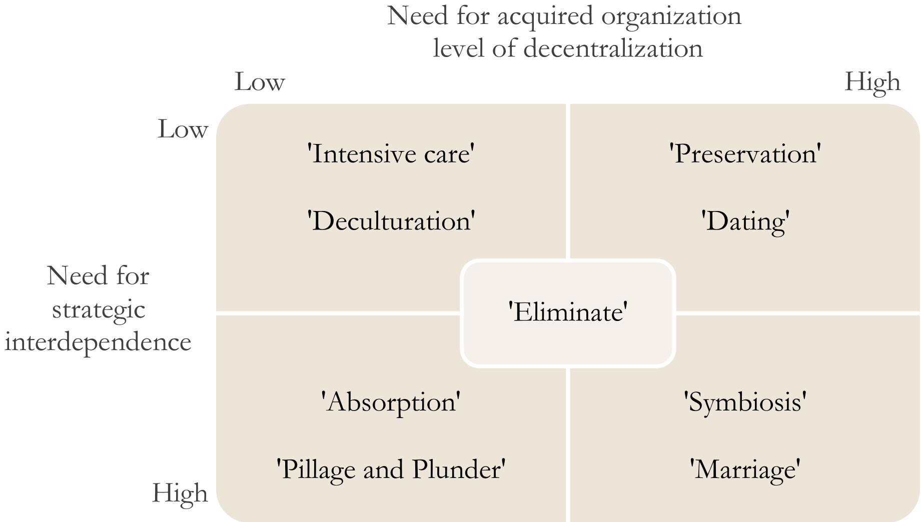

Figure 1: 5 different acquisition strategies

Intensive care & Deculturation

Both Intensive care and Deculturation is characterized by the low need for autonomy and low strategic interdependence. Intensive care is the fiercest, although both require substantial remodeling. Prior to the acquisition, acquirers believe that the targeted firm is operated suboptimal and that they have the capacity to improve that in a noticeable way.

Both strategies, therefore, create value mainly by changing the governance and/or the financial structure of the acquired organization in such a way that creates superior processes, including new and improved routines. Consequently, these strategies are only suitable when the acquired organization is operated insufficiently, when personnel is easily replaced, and when the disruption of existing routines and culture is regarded as positive, or at least not as negative. Although the transfer of personnel is common in these types of transactions, research suggests that the acquiring firm tends to have an internal CEO post-acquisition[26].

The fundamental strengths of these strategies are that they are very quantifiable and the required timescale to turn the acquired organization into a relatively well-functioning entity can be short, suggesting that buying and selling the acquired organization can occur within a relatively short period. Disadvantages include that the overall targeted firm's strategy is by default quite imitable as its firm-specific assets is not based on tacit knowledge (if they were, replacing employees and taking authoritative control would be a poor idea), and that the long-term value potential per transaction is rather limited.

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[26] Angwin, D. N., & Meadows, M. (2009). The choice of insider or outsider top executives in acquired companies. Long Range Planning, 42(3), 359-389.

Preservation & Dating

Both Preservation and Dating is characterized by a high need for autonomy and low strategic interdependence. Preservation can be seen as the least extreme one, where the acquired organization's operations can be precisely labeled as "business as usual". Prior to the acquisition, acquirers believe that the targeted firm is operated at a high capacity.

These strategies create value mainly through supporting the acquired organization when realizing its long-term objectives and key results, for example through board representation. Because the principal objective of the acquiring organization is to support the acquired organization, these strategies are suited for acquired firms that have superior processes, routines, and performance. Post-acquisition, research suggests that the acquired firm is more likely to have an internal CEO, and the turnover of personnel is low[27].

This implies the two strategies' key strength, namely to maximize the long-term value potential, as a result of the acquired organization is inimitable as what they do is based on tacit knowledge and path-dependency (if it weren't, the acquired firm wouldn't have superior performance pre-transaction). Knowledge transfer between the parent and the portfolio organizations can moreover result in serendipitous value creation, implying that the acquirer's competencies are also important to unlock this type of value creation[28]. The disadvantages of these two strategies are that the returns per deal require a relatively long time to blossom, simply since the strategy is based on realizing expected results, and that the long-term success of the acquisition may be dependent on keeping key personnel in the organization.

Absorption & Pillage and Plunder

Both Absorption and Pillage and Plunder is characterized by the low need for autonomy and high strategic interdependence. One can regard the Pillage and Plunder strategy as the harsher option, where it literally entails taking what one wants and eliminating the rest. Prior to the acquisition, acquirers believe that the targeted firm has something valuable, such as a unique product offering, and/or a superior R&D department, which integrated into the acquired firm would unlock greater long-term value than the two entities would separate and/or unlock greater value at a faster rate than the cost of acquiring those competencies/build those product offerings internally. They also believe that the targeted firm has something less valuable, which they either can improve by taking control over the acquired organization or getting rid of through divestiture or abandonment.

These strategies, therefore, create value primarily by taking control over suboptimal managed organizations, taking advantage of economies of scale, and/or seizing ownership of vital products/services. Furthermore, research suggests these strategies entail many personnel changes post-acquisition for the acquired organization, commonly including replacing top executives, although

[27] Angwin, D. N., & Meadows, M. (2009). The choice of insider or outsider top executives in acquired companies. Long Range Planning, 42(3), 359-389.
[28] Graebner, M. E. (2004). Momentum and serendipity: How acquired leaders create value in the integration of technology firms. Strategic management journal, 25(8-9), 751-777.

retaining key operating managers for the parts of the business the acquirer deem valuable[29].

The central strengths of these strategies are economies of scale and the expanded product/service offering which over time can result in beneficial customer lock-in effects. Disadvantages include that the strategy has limited quantifiability, as a consequence of the strategy entails integrating similar organizations, and that the associated layoff of personnel post-acquisition can harm future performance more than anticipated.

Symbiosis & Marriage

Both Symbiosis and Marriage are characterized by a high need for autonomy and high strategic interdependence. Marriage, which symbolizes a formal union and legal contract that unites two previously distinct entities into one, making their future actions an intrinsic part of the other's, is the most intense. Like the Pillage and Plunder, and the Absorption strategies, acquirers utilizing these strategies see a value in linking together the targeted firm with their operations, products, and/or services. However, in this case, they believe that taking authoritative control over the acquired organization is harmful, which can, for example, be a result of the acquired organization's operations being based on tacit knowledge. Even so, this is the most difficult strategy to pursue as a consequence of the requisite major changes and significant resources involved justified to reach the desired outcome. Prior to the acquisition, acquirers believe that the targeted firm is operating in a sound way. They also believe that they have the capacity to increase the overall value of the two companies in a noticeable way by keeping them under the same roof.

Thus, these strategies create value chiefly through creating customer lock-in effects by having a broader product/service offering as well as facilitating knowledge transfer between the organizations. Even though these strategies involve high levels of autonomy, research suggests the acquired organization is somewhat more probable to appoint a new, external CEO post-acquisition, although not as likely as the Pillage and Plunder, and the Absorption strategies[30].

The most notable strength of these two strategies comprises synergies between the portfolio companies in conjunction with allowing them to keep their identity and feeling of independence, increasing the chances for long-term expected as well as serendipitous positive synergy effects[31]. Disadvantages include that this is the most challenging strategy to pursue, as well as limited quantifiability.

Eliminate

This strategy is purposefully located in the middle of the figure as it is not bounded by the two factors. This strategy is most similar to the Pillage and Plunder strategy,

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[29] Angwin, D. N., & Meadows, M. (2009). The choice of insider or outsider top executives in acquired companies. Long Range Planning, 42(3), 359-389.
[30] Angwin, D. N., & Meadows, M. (2009). The choice of insider or outsider top executives in acquired companies. Long Range Planning, 42(3), 359-389.
[31] Graebner, M. E. (2004). Momentum and serendipity: How acquired leaders create value in the integration of technology firms. Strategic management journal, 25(8-9), 751-777.

although this strategy does not involve any transfer of assets of any sort. The aim is simply to eliminate the threat, and by that, pre-empt future competition.
Since this strategy is more than a mere theoretical possibility, that is, some organizations actually employ this strategy, we wanted to include it in the framework. However, as this strategy is very different from the rest, and so far off from what we do at Esmaeilzadeh Holding, we will not focus more on it in this paper. For the avid reader, we recommend the following papers[32].

Esmaeilzadeh holding's investment strategy

Because our portfolio companies concentrate on acquiring and consolidating profitable, stable, niched businesses with superior margins, we truly invest in the founding entrepreneurs and their team of knowledgeable employees. For that reason, we are not interested in taking operational control over the acquired organizations nor making too many changes post-transaction, such as cutting personnel. By now, the long-term disadvantages of doing that to knowledge-intensive organizations based on tacit knowledge are evident.

> *"It doesn't make sense to hire smart people and then tell them what to do; We hire smart people so they can tell us what to do"*
> Steve Jobs

Instead, our objective is to *let the entrepreneurs be entrepreneurs* and support them along their journey. Typically, we contribute to the future success of the acquired organizations through board work, participating in investment committees, creating superior incentive plans, and by adding them to our growing ecosystem of successful and dedicated entrepreneurs. Accordingly, this excludes three of the acquiring and consolidating strategies outlined above, namely both strategies that take away the autonomy of the acquired organization post-acquisition (Pillage and Plunder & Absorption, Intensive care & Deculturation) and the strategy that kills the acquired organization (Elimination).

Given our investment objectives – to maximize shareholder value while minimizing the risks – we shy away from making acquisitions whose ultimate success depends on the strategic interdependence of the acquired organizations and the rest of the portfolio companies. Those entail too many changes post-transaction and are thus not in line with what we stand for. This excludes one of the strategies, namely the Symbiosis & Marriage strategy.

Although we shy away from high need of strategic interdependence acquisitions, we strongly believe that synergies between our portfolio companies are valuable, and we have a set of in-house strategies in place aiming to unlock those. Thus, to conclude, our strategy at Esmaeilzadeh Holding can, at large, be describes as following the Preservation & Dating strategy. If taking details into consideration, it is more in line with Preservation.

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[32] Cunningham, C., Ederer, F., & Ma, S. (2021). Killer acquisitions. Journal of Political Economy, 129(3), 649-702.
Kamepalli, S. K., Rajan, R., & Zingales, L. (2020). Kill zone. Working paper, March 2020.
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