Business Turnaround Processes Following Acquisitions: Reconsidering the Role of Retrenchment

Gary J. Castrogiovanni  
UNIVERSITY OF TULSA  
Garry D. Bruton  
TEXAS CHRISTIAN UNIVERSITY

For almost two decades, a prevailing view has been that business turnaround processes should match the strategic or operating nature of the underlying problems. Based on their study of textile firms (Robbins and Pearce, 1992), Pearce and Robbins (1993) questioned this view, offering a model that suggests that retrenchment is a desirable initial response, regardless of the types of problems faced. This article describes a test of the Pearce/Robbins view that examined the value of retrenchment following the acquisition of 46 distressed firms. The present study, thus, extended the Pearce/Robbins findings and conclusions beyond the independent business focus of their own work to the postacquisition context. An empirical study of 46 distressed and recently acquired firms revealed no retrenchment effects on performance ($p = 0.7027$), although two other types of actions: (i) capital infusion, and (ii) integration, did influence performance ($p = 0.0198$ and $p = 0.0860$, respectively). A negative interaction of degree of decline and capital infusion on performance was found also ($p = 0.0564$). The implications of these findings are discussed. Because no significant retrenchment effect was found, this raises questions about the generalizability of the Pearce/Robbins conclusions. Specifically, this study showed that retrenchment may not be a universally desirable stage in the business turnaround process because retrenchment did not seem beneficial following the acquisition of distressed firms. Therefore, this study identified a potential bound to the generalizability of the conclusions resulting from the Robbins and Pearce (1992) study. Although their conclusions may be valid for independent businesses, they may not apply to businesses recently acquired by other firms. A primary implication, therefore, is that the desirability of particular turnaround actions or processes may vary from one context to another. Furthermore, the present study found that, in the post-acquisition context, efforts by corporate parents to facilitate turnaround by infusing capital into the distressed firms actually resulted in worse performance. In contrast, efforts to integrate distressed firm assets into other businesses within the parents’ corporate portfolios proved to be beneficial.

Address correspondence to: Dr. G. J. Castrogiovanni, College of Business Administration, University of Tulsa, 600 South College Avenue, Tulsa, OK 74104-3189.
ment stage during the recovery stage. To the extent that problems arose from poor strategic health, businesses would concentrate on entrepreneurial moves during the recovery stage.

Pearce and Robbins cited several normative works in the practitioner-oriented literature (Bibeault, 1982; Goodman, 1982; Slatter, 1984), suggesting that successful turnarounds result from multistage processes, and providing some indication that retrenchment might be an initial stage. They then noted that the multistage view had been supported empirically by Grinyer and his colleagues (Grinyer, Mayes, and McKiernan, 1988; 1990; Grinyer and McKiernan, 1990), but Pearce and Robbins observed that this research did not indicate the role of retrenchment during these stages. The only empirical support of a retrenchment stage was their own study (Robbins and Pearce, 1992) of 32 textile manufacturers. Given the small sample and single industry focus of that study, it is clear that much more research is needed before the notion that there is a universal need for a retrenchment stage can be accepted.

This article reports a study of retrenchment benefits among recently acquired businesses. This postacquisition turnaround context was chosen to test rigorously the Pearce/Robbins’ claim that retrenchment is an essential first stage in the turnaround process. Pearce and Robbins (1993) speculated that a need to generate or preserve slack resources might be the reason why retrenchment is essential. Because acquired businesses often can access slack available from their parent firms, then retrenchment may not be needed in postacquisition business turnarounds. Thus, this study of postacquisition turnarounds either would add considerable support to the claim that retrenchment is an essential turnaround stage, or it would identify a limit to the generalizability of that claim.

In this article, possible benefits of retrenchment are detailed. Aside from the well-recognized efficiency benefits and the slack benefits speculated by Pearce and Robbins, a possible momentum creation benefit is also considered. Next, the issue of whether retrenchment is always necessary is addressed. Then, this study’s postacquisition context and research hypotheses are described, its research methods are explained, and the results are presented and discussed.

Benefits of Retrenchment

As noted, prior views were that retrenchment is desirable for overcoming efficiency and cash flow problems (Hofer, 1980). Additionally, Pearce and Robbins (1993) speculated that slack may be a crucial concern because retrenchment might serve to generate the slack resources needed to implement entrepreneurial moves. Furthermore, retrenchment might be useful for creating positive change momentum. These three potential benefits of retrenchment: (1) efficiency restoration, (2) slack generation, and (3) momentum creation, are examined in turn below.

Efficiency Restoration

Because, according to the Pearce/Robbins definition (see above), retrenchment consists of actions intended to increase efficiency, the potential efficiency restoration benefit of retrenchment is self-evident, if not somewhat tautological. Efficiency may be restored in various ways. For example, Hambrick and Schecter (1983) found three successful turnaround “gestalts,” all of which fit the Pearce/Robbins’ definition of retrenchment. Asset/cost surgery was described as a combination of asset reduction and cost cutting. Selective product/market pruning was interpreted as a focus on the business’s most profitable products and market segments, combined with an abandonment of the least profitable ones. Piecemeal productivity was somewhat unclear, although it did result in greater capacity utilization and employee productivity.

SLACK GENERATION Following the original formulations by Barnard (1938) and March and Simon (1958), Cyert and March (1983, p. 36) described slack as “payments to members of the [organizational] coalition in excess of what is required to maintain the organization.” For example, a business might overpay suppliers by failing to negotiate the best prices and terms possible; or it might provide executives with lavish offices, high salaries, and other “perks” in excess of what they could get from another employer. In this sense, slack is very similar to the inefficiencies that retrenchment might seek to reduce to yield an efficiency restoration benefit.

More recently, however, Bourgeois (1981) and Singh (1986) have noted that slack has other connotations. Absorbed slack refers to excess organizational costs; whereas, unabsorbed slack refers to “uncommitted, liquid resources in organizations” (Singh, 1986, p. 567). Because strategic change is not cost free (Castrogiovanni, Baliga, and Kidwell, 1992; Smart and Verrinsky, 1984), businesses must have uncommitted resources available for use in strategic turnaround efforts. In a study of bankrupt firms matched with survivors, Hambrick and D’Aveni (1988) noted that the eventual bankrupt firms had less unabsorbed slack as far back as 10 years before bankruptcy occurred, and that unabsorbed slack continued to diminish among the bankrupt firms until their eventual failure.

Thus, poorly performing businesses may not have access to the capital and other resources needed to implement entrepreneurial moves in a strategic turnaround. To generate these resources, retrenchment may be a necessary stage, although it does not directly address strategic health concerns. That is, businesses must cut costs or sell assets to free resources for the strategic turnaround effort (cf. Pearce and Robbins, 1993).

Momentum Creation

Khandwalla (1983–84) suggested that the various stakeholders of a business organization experiencing performance problems often need to see some quick improvements as evidence that the problems can be overcome. Various authors (e.g., see Castrogiovanni, Baliga, and Kidwell, 1992) have suggested that performance decline causes management to lose credibility in the eyes of key stakeholders. Quick improvements can help restore this credibility (or, following management changes,
establish it for the new management team). These improvements serve to strengthen stakeholder beliefs that there will be a successful turnaround, and consequently they become more motivated to do their part to make it occur. In Khandwalla's (1983–84, pp. 24, 25) words:

A demoralized organization needs success to keep the momentum of mobilization going; otherwise, disillusionment can set in fast. The success need not be spectacular either, for, following a history of failures and disasters, even small successes build confidence and restore morale. This means that the change agent must identify tasks in which, with proper planning and concentrated effort, quick success is highly probable.

There is general agreement that retrenchment moves tend to generate quicker payoffs than entrepreneurial moves (Hambrick and Schecter, 1983; Hofer, 1980). Thus, even when problems are strategic and, consequently, require entrepreneurial moves, retrenchment may be a necessary first stage. Through retrenchment, a business can create the momentum for change needed to implement the entrepreneurial moves of a strategic turnaround effort.

Is Retrenchment Essential?

To summarize, traditional views on turnaround have maintained that the response should match the problem. Thus, when the problems arise primarily from inefficiency, retrenchment is warranted. However, when problems are strategic, the turnaround effort should focus on entrepreneurial moves to reposition the business. Pearce and Robbins (1993), however, argued that retrenchment may be a universal aspect of successful turnaround. A retrenchment stage may be desirable, even when efficiency problems do not exist because of its slack generation or momentum creation benefits. However, this does not mean that, as Pearce and Robbins suggested, retrenchment is universally necessary or desirable.

Various authors (e.g., Miller, 1990; Mintzberg, 1989; Starbuck, Greve, and Hedberg, 1978) have noted that an obsession with efficiency can ultimately lead to business performance decline or even failure. A classic example of this was Henry Ford's obsession with efficiency, which led to his singular focus on the Model T, although the market was becoming segmented. It seems unlikely that cost cutting or asset reduction (i.e., retrenchment) activities would be desirable in such a case (cf. Barker and Mone, 1994).

In the study by Schendel, Patton, and Riggs (1976), 54 manufacturers that had experienced successful turnaround were examined. Of these, 39 were classified as having efficiency problems. Of those 39, 29 were classified as having emphasized efficiency improvement (i.e., retrenchment moves) in their turnarounds. The other 10, along with the 15 of 54 that had experienced strategic problems, emphasized entrepreneurial moves. These findings, therefore, indicate that retrenchment is not essential, because 25 of the 54 successful turnarounds examined did not engage in it. In fact, Schendel, Patton and Riggs (1976, p. 11) noted:

Efficiency problems predominated as causes of downturn, but it is interesting to note that the upturn phase was brought about by proportionately more effort placed on changes in corporate strategy.

Because their own study (Robbins and Pearce, 1992) offered the only empirical evidence cited by Pearce and Robbins (1993) to support their claim that retrenchment is an essential initial stage, and because Schendel, Patton, and Riggs (1976) offered contradictory evidence, then that claim must be questioned. Although both studies had relatively small samples, the one examined by Schendel and co-workers was broader. Whereas the Robbins/Pearce sample consisted of 32 textile firms, Schendel and colleagues examined 54 firms from various industries. Perhaps some factor unique to the textile industry context necessitated retrenchment as a first stage in the turnaround process. Alternatively, it is possible that the Robbins/Pearce findings were influenced by the relatively short time frame used to assess turnaround success. In their study, Schendel and colleagues noted that performance improvement took place over an average of 7.7 years, with a range from 4 to 16 years. In the Robbins/Pearce study, turnaround success was defined and measured as 2 years of profit improvement. If retrenchment moves indeed generate quicker payoffs than entrepreneurial moves (Hambrick and Schecter, 1983; Hofer, 1980), then the Robbins/Pearce measure of turnaround success may have been biased toward businesses that engaged in retrenchment.

Postacquisition Turnarounds

The preceding discussion suggests that the need for a retrenchment stage may be context-specific. Although retrenchment seemed essential in the textile industry context examined by Robbins and Pearce (1992), it did not seem essential in the broader context studied by Schendel, Patton, and Riggs (1976). Therefore, to clarify when, where, and why retrenchment is essential, research must focus on various turnaround contexts. One such context pertains to postacquisition turnarounds.

Porter (1991) described a restructuring approach to corporate strategy whereby firms acquire businesses having problems, turn those businesses around, and then sell them at a profit. Alternatively, a parent might acquire a distressed business with the hope of first turning it around and then gaining various synergies between that business and others in its portfolio. Examination of such postacquisition turnarounds would clarify whether retrenchment is associated with success, regardless of whether the firm has efficiency or strategic problems.

Following the Pearce/Robbins arguments, therefore, the first hypothesis to be tested is whether retrenchment is essential for business turnarounds even in the postacquisition context:
H1: There is a positive relationship between retrenchment and turnaround performance, so that performance will be greater when retrenchment occurs, than when it does not.

If a need for slack resources is, indeed, a reason that retrenchment may be desirable, then the infusion of slack by a parent firm should likewise be desirable. In his discussion of business turnarounds, Hofer (1980) noted that retrenchment (i.e., operating turnarounds, in Hofer’s terms) is necessary to improve the cash position of a business near bankruptcy, regardless of the efficiency or strategic nature of the problems. Curiously, Hofer did not mention the possibility of direct infusion of capital into a business in the absence of retrenchment. This omission could be because Hofer’s discussion seemed to assume that the businesses being turned around did not have a wealthy parent to offer assistance. Indeed, an independent business would find it difficult to increase its capital base by taking on more debt or selling new equity shares because risk-averse lenders or investors would likely steer clear of a business already experiencing major problems.

Following acquisition, however, a parent might infuse capital into a newly acquired business. Indeed, arguments on moving funds among businesses within a corporate portfolio are well-entrenched within the literature on corporate strategy. In Boston Consulting Group terms, for example, a corporation might acquire a “problem child” business and then infuse capital into it in an effort to turn that business into a “star” (Abell and Hammond, 1979). Thus, H2 examines whether such capital infusion efforts are likely to pay off.

H2: There is a positive relationship between capital infusion and turnaround performance, so that performance will be greater when capital infusion occurs, than when it does not.

Aside from the possibility of capital infusion, post-acquisition turnarounds also differ from independent business turnarounds in terms of the benefits received by the owners. In cases of independent businesses, benefits are relatively straightforward; that is, increases in shareholder wealth correlate positively with increases in business profit or stock price. When a business is acquired by a corporate parent, however, benefits to the parent may result from synergies or other positive influences on existing operations, rather than from improvement in the profitability or stock market value of the distressed business thus acquired (e.g., Porter, 1991). Therefore, instead of seeking to enhance the profitability or market value of the acquired business in a traditional turnaround effort, the parent may attempt to integrate the newly acquired business into its existing operations. H3 examines whether such efforts, indeed, tend to be beneficial.

H3: There is a positive relationship between acquired business integration with existing units in the portfolio and turnaround performance, so that performance will be greater when integration occurs, than when it does not.

Research Methodology

Sample Selection

This study utilized a sample of distressed firm acquisitions previously generated by Bruton, Oviatt, and White (1994). To develop that sample, Bruton and co-workers scanned the 1988 COMPSTAT research file to identify 817 firms that had been acquired between 1979 and 1987. Of those firms, 93 were defined as being financially distressed (before their acquisitions) because they had experienced 2 consecutive years of decline in both net income and return on investment. Then, 32 firms were eliminated because of data problems (i.e., missing or ambiguous data), because they had not been acquired by another business firm (i.e., acquisitions by individuals, managers, or employee stock ownership plans), or because the acquiring firm had an ownership interest before the acquisition.

For the remaining acquire firms, Bruton, Oviatt, and White (1994) then examined published sources, obtaining 133 articles to validate the sample. Five firms were found to be recovering from financial distress before acquisition. Five others were in declining industries, and, although they had experienced performance declines, their performance was equal to or better than their industries’. Of the 51 firms remaining, five could not be examined in this study, because data on the types of turnaround actions taken could not be obtained. Further details on the sample selection process are available in Bruton, Oviatt, and White (1994). Additional details on the sample (as well as descriptions of the measures used, descriptive statistics, and findings of supplemental analyses) are available from the authors.

Variables and Measures

In this study, the dependent variable was acquisition performance, independent variables were retrenchment, capital infusion, and integration; and degree of decline was a statistical control variable.

PERFORMANCE. Because a primary business goal is the maximization of owner wealth, performance was defined as benefits accruing to the acquiring parent firm in this study of postacquisition turnarounds. It was possible to use performance data obtained from Bruton, Oviatt, and White (1994), because: (1) they also sought to explain benefits accruing to acquiring firms; and (2) this study utilized their sample. Furthermore, this was desirable to minimize potential problems of common method bias because the dependent and independent variables were assessed using panels of raters (see below). That is, because this study’s rater panel, which assessed the independent variables, differed from that employed by Bruton and co-workers to assess the dependent variable (performance), rater beliefs about likely variable relationships would not affect hypothesis tests.

Bruton, Oviatt, and White (1994, pp. 978–979) described the performance measure in the following manner.
The focus of this study was the performance of the acquisition of distressed assets. Strict reliance on accounting measures of performance was inappropriate because they would have reflected the performance of whole firms, not just the acquisitions of interest. . . . Also, the small sizes of the study groups precluded the use of market measures in an event study methodology, and neither accounting nor market measures were available on the acquiring firms that were privately held. Therefore, we constructed a subjective measure of each acquisition’s performance using a panel of academic evaluators. . . . The panel’s evaluations were based on excerpts from all the published accounts of the results of the acquisitions by industry experts, stock analysts, and business writers that were available to us. . . . We assumed that, since people pay for the outputs of this competitive group of writers and sometimes invest on the basis of their advice, the risk to the writers of ruining their reputations by sloppy reporting and analysis would ensure that the articles provided the most accurate publicly available information about the acquisition results. All the excerpts referred specifically to the acquisitions that were the subjects of this research and not just to the overall performance of the firms.

The performance measure thus employed by the panel was a seven-point scale with values ranging from (1 =) “very unsuccessful,” where the acquiring parent firm did not benefit significantly, to (7 =) “very successful,” where significant benefits did accrue to the parent. Bruton, Oviatt, and White (1994) reported high interrater reliability (0.94), and performance was estimated as the mean value of the panel’s ratings, along this seven-point scale.

**INDEPENDENT VARIABLES.** As noted, the three independent variables were retrenchment, capital infusion, and integration. To measure these variables, a second panel of three academic raters was assembled. The raters were doctoral students in strategic management at a major university. All had finished their doctoral coursework and were in the process of completing their dissertations. Each rater was well versed in the strategic management and turnaround literatures, but was not informed of the specific purposes of this study or the hypothesized relationships to be tested.

Following Pearce and Robbins’ (1993) definition and their contention that retrenchment is an essential first stage in turnaround efforts, retrenchment was defined as the initial set of reactions by a firm, designed to increase efficiency by reducing costs and assets relative to the profits generated. Capital infusion was defined as an increase in the capitalization of a distressed firm that can result from such actions as: (1) direct investment by its acquiring parent; (2) loans from the parent; or (3) guarantees of payment by the parent to distressed firm suppliers. Integration was defined as the combining of distressed firm resources with those of the acquiring parent, so that the operations of the previously separate firms are no longer distinct.

The measures themselves were dichotomous scales coded as 0 ( = “no”) or 1 ( = “yes”). Raters were provided with the same published accounts previously examined by the Bruton, Oviatt, and White (1994) panel, along with definitions of each independent variable. Each published account had appeared in press after the corresponding acquisition announcement, with the latest one being published 7.6 years following the acquisition. On average, however, the latest account for each acquisition was published 3.2 years following the corresponding acquisition. Raters were instructed to read the accounts pertaining to a particular acquisition, rate whether the accounts suggested that retrenchment, capital infusion, and/or integration (i.e., the independent variables) had occurred, and then repeat this process for each of the remaining distressed firm acquisitions under consideration. The variable was assigned a value of 1 ( = “yes”) if at least two of the three raters concluded that the particular type of actions (e.g., retrenchment) took place, and it was otherwise assigned a value of 0. Using methods detailed by Ferreault and Leigh (1989), interrater reliability was calculated at 89.6% in this process for assessing the independent variables.

**CONTROL VARIABLE.** To account for possible autoregressive effects on the dependent variable (performance), degree of decline was analyzed as a statistical control variable. It is conceivable that, on the one hand, distressed firms that had the greatest decline might subsequently tend to experience the greatest turnaround, simply because there was more room for improvement in the first place. On the other hand, decline of those same firms might have advanced to the point where they were experiencing a “downward spiral” in performance (Hambrick and D’Aveni, 1988) and improvement was, thus, very unlikely (cf. Weitzel and Jonsson, 1989). Degree of decline was, therefore, measured as the percentage change in net income of the distressed firm over the 2-year period ending a year prior to that firm’s acquisition.

**Data Analysis**

Multiple regression analysis was employed using 0–1 “dummy” variables to indicate retrenchment, capital infusion, and integration. Because the dependent variable (performance) was estimated on an ordinal (seven-point) scale, and the control variable (degree of decline) was continuous, while the independent variables (retrenchment, capital infusion, and integration) were dichotomous, this form of regression analysis was an appropriate analytic method.

Three interactions were examined in the regression. The interaction between degree of decline and retrenchment is consistent with Hofer’s (1980) claim that such actions as cost cutting and asset reduction are essential when a distressed firm is nearly bankrupt, although they may not be essential when problems are less severe. Hofer’s claim was based on
Table 1. Regression Results Showing Effects on Performance: Hypothesis Tests

<table>
<thead>
<tr>
<th>Variable</th>
<th>t-value</th>
<th>p-value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Intercept</td>
<td>5.724</td>
<td>0.0001</td>
</tr>
<tr>
<td>Degree of decline</td>
<td>-1.148</td>
<td>0.2583</td>
</tr>
<tr>
<td>Retrenchment</td>
<td>0.385</td>
<td>0.7027</td>
</tr>
<tr>
<td>Capital infusion</td>
<td>-2.434</td>
<td>0.0198</td>
</tr>
<tr>
<td>Integration</td>
<td>1.763</td>
<td>0.0860</td>
</tr>
<tr>
<td>Retrenchment and degree of decline interaction</td>
<td>-0.475</td>
<td>0.6378</td>
</tr>
<tr>
<td>Capital infusion and degree of decline interaction</td>
<td>-1.968</td>
<td>0.0564</td>
</tr>
<tr>
<td>Integration and degree of decline interaction</td>
<td>1.356</td>
<td>0.1832</td>
</tr>
</tbody>
</table>

R-square = 0.2427 (F = 1.740, p = 0.1288); adjusted R-square = 0.1032; n = 46.

the logic that such actions tend to generate the quick payoffs needed to restore cash flow and avert the immediate threat of bankruptcy.

In the postacquisition context, however, cash flow of the distressed firm also could be quickly restored by the infusion of capital from the acquiring parent firm. Thus, using the same logic as Hofer (1980), capital infusion might be desirable when decline has been severe, but unnecessary when decline has been relatively slight. Consequently, the interaction between degree of decline and capital infusion was examined in this study.

At the most severe extreme, Weitzel and Jonsson (1989) argued that decline progresses to a “dissolution stage” where a firm can no longer operate as a distinct entity. In the postacquisition context, the acquiring parent could still benefit by integrating the distressed firm’s resources into its own operations. If, as Weitzel and Jonsson suggested, the distressed firm truly cannot survive on its own, then integration might be the most beneficial option (and perhaps the only viable one) available. Thus, the interaction of degree of decline and capital infusion was included in the analysis.

Hypotheses were tested in a single regression examining the influences of the control variable, the three independent variables, and the three interactions on performance. Then, both to corroborate the findings and to identify a more parsimonious model, step-wise regression was employed. Such corroborations was desirable, because of possible multicollinearity concerns, given that interaction terms are, by definition, correlated with their component variables. (For example, because the decline—retrenchment interaction was measured as the product of both degree of decline and retrenchment, correlation with those two variables was an unavoidable artifact of the measurement process.) Because, as with hierarchical regression, the stepwise process is iterative, it was possible to check for changes in relationship direction or substantial changes in relationship magnitude that could occur with multicollinearity and, thus, obscure a “true” relationship.

Results

Results of the multiple regression are presented in Table 1. At the 0.05 level of statistical significance, only capital infusion accounted some of the variance in performance. Two other regression model terms: (1) integration; and (2) the interaction of capital infusion with degree of decline, approached the 5% level of statistical significance. Given the relatively small sample size, these relationships are worth noting.

H1 was that retrenchment is positively related to performance. Clearly, no retrenchment—performance linkage was observed in this study. In fact, as both t- and p values in Table 1 show, retrenchment had less explanatory power than any other term in the regression model. Thus, H1 was not supported.

Regarding capital infusion, H2 also was not supported, although the analysis provides significant and interesting results. Whereas a positive relationship between capital infusion and performance was hypothesized, a statistically significant negative relationship was found to exist. Furthermore, the negative interaction with degree of decline is consistent with this finding. Thus, it seems that acquiring firms waste money if they use their own capital to turn around a recently acquired, distressed firm—and the extent of this problem depends somewhat upon the degree to which the distressed firm has already experienced performance decline.

At a 10% significance level, there did seem to be a positive relationship between integration and performance. H3, therefore, received some support. Thus, it seems that a parent can benefit from the acquisition of a distressed firm by integrating the resources of that firm into its own. Although this would not be a true turnaround, because the distressed firm would not survive intact, it does show how some aspects of a distressed firm’s operations may be salvaged.

In Table 2, the stepwise regression results are presented. Using the stepwise procedure, only capital infusion and its interaction with degree of decline were included in the resulting model. Because those variables had the strongest effects
Table 2. Stepwise Regression Results Showing Effects on Performance

<table>
<thead>
<tr>
<th>Variable</th>
<th>Parameter Estimate</th>
<th>F-value</th>
<th>p-value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Intercept</td>
<td>5.0182</td>
<td>203.16</td>
<td>0.0001</td>
</tr>
<tr>
<td>Capital infusion</td>
<td>-2.8049</td>
<td>6.07</td>
<td>0.0178</td>
</tr>
<tr>
<td>Capital infusion and degree of decline interaction</td>
<td>-0.0170</td>
<td>3.14</td>
<td>0.0834</td>
</tr>
</tbody>
</table>

R-square = 0.1258 (F = 3.09, p = 0.0555; n = 46.

observed in the hypothesis test results (i.e., Table 1), the stepwise results are consistent. Furthermore, the relationship directions and significance levels are comparable with those obtained in the hypothesis tests. Thus, it does not seem that the results were confounded by multicollinearity.

To ensure that these results were not caused by unintended artifacts of the sample selection process, supplemental analyses were conducted. Because our sample included both manufacturing and nonmanufacturing firms whereas Pearce and Robbins sampled textile manufacturers, we created a dichotomous variable indicating whether the sample member was a manufacturer. We then tested for a “manufacturer-retrenchment” interaction and obtained insignificant results. Then, we repeated the above-described regression analysis using only the manufacturer subsample, and we obtained results similar to those shown in Table 1. Our results, therefore, seem to generalize throughout the postacquisition context, regardless of whether an acquired firm was a manufacturer. Additional regression runs were performed on subsamples excluding firms that were outliers (in our over-all research sample) on the dependent and control variables. Again, the results were consistent with those shown in Table 1. Thus, we can rule out “sample member outliers” as an explanation of our findings. The results of these supplemental analyses are available from the authors.

Discussion

In summary, retrenchment was not found to have a significant effect on performance; capital infusion (along with its interaction with degree of decline) was found to have a negative effect; and integration was found to have a slight positive effect. These results have significant implications regarding: (1) the benefits of retrenchment; (2) turnaround theory; and (3) corporate strategy.

A Retrenchment Stage?

In a recent critique of the Pearce/Robbins view, Barker and Mone (1994) re-examined the sample used in the study by Robbins and Pearce (1992) that led to the claim that retrenchment is an essential turnaround stage. Barker and Mone found that retrenching firms tended to be those experiencing the greatest decline. Furthermore, although retrenching firms did experience the largest improvements in performance, the absolute levels of performance thus attained did not tend to exceed the absolute performance levels attained by firms that had not engaged in retrenchment. As a result, Barker and Mone concluded that retrenchment may be a consequence of decline rather than an essential facilitator of turnaround. That is, severe decline first forced some firms to retrench in order to survive, and then severe decline may have accounted for the relatively high performance improvements because of autoregressive effects whereby those firms improved more, simply because there was more room for improvement. In rebuttal, Pearce and Robbins (1994) focused on the slight methodological differences between their study and the Barker/Mone replication. This seemed to be a weak defense, however, because a true relationship should be robust rather than method bound, and, thus, should be observable under alternative methodologies.

Findings of the present study seem to support the view presented by Barker and Mone (1994). In this study, 43% of the distressed firms were judged by the raters to have engaged in retrenchment. In 75% of those retrenching cases, the raters judged performance to be successful (i.e., performance scores greater than the middle value of four on the seven-point scale employed). Of the firms that did not engage in retrenchment, performance was successful in only 62 percent. On the surface, arguments favoring retrenchment seem to be supported because proportionately more retrenching firms experienced successful performance, but the fact that the majority of nonretrenching firms also experienced successful performance suggests that retrenchment may not be an essential turnaround stage.

Such superficial observations, however, fail to account for the possibility of spurious correlations attributable to possible autoregressive effects. As Table 1 shows, there was no significant retrenchment influence on performance when potential autoregressive effects were partialled out (by using degree of decline as a control variable), and actual ratings along the seven-point performance scale were examined. In fact, with a t-value of 0.39 and a p-value of 0.70, retrenchment actually had the weakest impact on performance of all the terms included in the regression. Thus, this study yielded no evidence that retrenchment had any impact on performance whatsoever.

Furthermore, there seems to be no theoretical basis as to
why retrenchment may be an essential turnaround stage. Pearce and Robbins (1993) speculated that a need for slack might be the reason, but when the present study examined the generation of unabsorbed slack within distressed firms through capital infusion, the impact on performance was actually negative. With no significant retrenchment effect and a negative capital infusion effect, the Pearce/Robbins claim seems questionable. As Barker and Mone (1994) concluded, retrenchment, along with its perceived benefits, may be more a consequence of decline than a facilitator of turnaround.

Implications for Turnaround Theory

“Turnaround” has been used rather loosely in reference to a variety of situations in which efforts are made to improve performance. Hofer (1980), for example, noted that turnaround efforts might focus on any of a number of performance criteria, such as sales or profits. Because such criteria are imperfectly correlated, this has impeded development of a unified view of how to turn distressed firms around. In a sales-oriented turnaround, for example, increases in advertising and promotional expenses, and other costs such as those of extending distribution channels, could lead to sales improvement (and net income gains), while causing profitability (e.g., return on investment) to decline somewhat. In contrast, consider cases where firms have “spread themselves too thin” by expanding too quickly across geographic markets. By reducing geographic scope, profitability might be increased, while sales would likely decrease.

In an effort to clarify thinking on turnarounds, Pearce and Robbins (1993) attempted to synthesize the literature into an integrated view of turnaround situations and processes, including a glossary with definitions of key terms. Although their work is laudable, its biggest contributions may stem more from the issues raised that the conclusions drawn. They raised the issues, for example, that researchers should consider the possibility that turnaround may be a multistaged process, and that careful attention be paid to delineation of the turnaround situation or context. They concluded, however, that turnaround is a multistaged process with retrenchment as the appropriate initial stage in every situation or context.

Perhaps Pearce and Robbins went too far by advocating a single prescriptive model. Under Pearce and Robbins’ (1993) criteria, the distressed firms examined in this study, indeed, were facing turnaround situations. However, retrenchment, as an initial turnaround stage, did not seem to have an impact on performance. However, there were two key differences between the sample examined here and that examined in the study of Robbins and Pearce (1992), which laid the foundations for the Pearce/Robbins model. First, the present sample of distressed firms operated in a variety of industries, whereas, the Robbins/Pearce sample had a single industry focus. Second, the present sample consisted of recently acquired firms.

The multi-versus single-industry difference between the two samples cannot explain why the Pearce/Robbins view was not supported. Industry conditions were considered during sample selection, so that some sample candidates were ruled out when it was found that their performance, although declining, was still better than that of their industries, on average. If retrenchment is, indeed, an essential turnaround stage in all industries, as Pearce and Robbins suggested, then this sample “purification” step should have been sufficient for addressing industry differences, and a significant, positive relationship between retrenchment and performance should have been observed. On the other hand, if industry conditions during the turnaround efforts accounted for performance differences among sample members, regardless of whether retrenchment occurred, then such an environmental determinist perspective suggests that turnaround efforts are inherently useless (see Aldrich, 1979). If so, then the Pearce/Robbins model has very limited value, at best.

In contrast, the postacquisition nature of the sample examined in this study could explain why the Pearce/Robbins model was not supported, even if that model is valid in other contexts. First, the array of business-level turnaround options may differ between independent businesses and those owned by a corporate parent. It was noted, for example, that although independent businesses may not have access to outside capital when they are already financially distressed, capital infusion may, indeed, be an option available to distressed businesses within a corporate portfolio.

Second, and perhaps more importantly, the meaning (and measurement) of “business turnaround” may differ between independent businesses and those with corporate parents. Whereas retrenchment may be a necessary turnaround stage for independent businesses, it may be unnecessary for distressed firms with corporate parents. Consequently, the Pearce/Robbins model may not be universally applicable. By failing to find a retrenchment effect, this study, therefore, provides evidence of a “postacquisition” bound to the applicability of that model.

Implications for Corporate Strategy

Overall, the raters used in this study seemed to consider these distressed firm acquisitions to be somewhat successful from the acquiring parent’s perspective, because the performance variable mean, at 4.78, was slightly above the middle value (four) on the seven-point scale employed. However, because retrenchment was insignificant, and capital infusion was negatively related to performance, the success of these acquisitions seems to have resulted more from the attainment of potential synergies than from turnaround efforts aimed at making the businesses more profitable on their own. Although acquiring firm intentions were unknown, these findings cast doubt on the viability of Porter’s (1991) “restructuring” approach to corporate strategy whereby a parent: (1) acquires distressed firms with the intention of turning them around; (2) turns those firms around; and then (3) sells them at a profit.

In the Bruton, Oviatt, and White (1994) study, the key
finding was that acquiring parents tended to benefit more from related acquisitions than from unrelated ones. This implies that efforts to capitalize on synergies between the distressed firms and those of other units within their acquiring parents’ portfolios tend to be beneficial. In the present study, the positive effect of integration is consistent with that finding, because a distressed firm’s business must be very closely related to that of a unit within the parent—if not the exact same business—for integration to take place.

The negative effect of capital infusion on performance, observed in this study, raises questions about the desirability of providing cash to distressed businesses in corporate-level attempts to assist those businesses in their turnaround efforts. Some (e.g., Williamson, 1975, 1985) have argued that diversification sometimes may give portfolio members an edge over their independent business competitors, because their corporate parents often can provide them with capital more quickly and efficiently than traditional capital markets. The Boston Consulting Group (Abell and Hammond, 1979) has claimed that corporate parents should provide capital to some of their distressed businesses (i.e., some “problem children” businesses) to help them overcome their problems. In this study’s sample, such capital infusion efforts were unsuccessful; that is, they actually hurt the parents. This finding, therefore, calls into question the logic of providing capital to distressed businesses in a corporate portfolio. Either the logic itself is unsound, or the acquiring firms in this study did not implement that logic properly, and thus could benefit from further guidance on when, where, and to what extent capital should be provided to a distressed business.

Escalating commitment might explain why firms may have implemented unsound capital infusion logic or why they may have implemented sound logic improperly. It is possible, for example, that escalating commitment caused managers to pump more money into an acquisition after other turnaround efforts failed, in attempts to turn bad acquisitions into good ones. Because our methodology could not distinguish between capital infusion that was planned upfront (i.e., when the acquisition decision was made) and that which was decided on later (i.e., after upfront plans had failed), we could not determine whether escalating commitment might account for the negative capital infusion effect. Future research can examine this possibility.

Conclusion

Using the same sample as Bruton, Oviatt, and White (1994), this study, therefore, extends the previous findings. Whereas Bruton and colleagues showed that acquisition of distressed firms is more likely to benefit a parent when the businesses are related, this study showed that integration is a way that such benefits may be gained. Furthermore, this study provides evidence that neither retrenchment nor capital infusion efforts tend to benefit the parents following distressed firm acquisitions.

The findings have strong implications for business turnaround theory, in general, and the value of a retrenchment stage, in particular. Specifically this study showed that retrenchment may not be a universally desirable stage in the business turnaround process, as Pearce and Robbins (1993) have contended, because retrenchment did not seem beneficial in the postacquisition context examined here. Because most turnaround theory and research has focused on independent firms, this finding suggests that other conclusions about business-level turnarounds (e.g., the value of management change, the strategic-operating dichotomy) should be examined in the postacquisition context (or, more broadly, in corporate portfolio contexts) to assess generalizability.

Thanks are extended to Ben Oviatt and Margaret White for their assistance in developing the research sample and their feedback during various stages of this research.

References

Hambriick, D., and Schecter, S.: Turnaround Strategies for Mature


