LBOs' effects on innovation: evidence from France

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Aim of the paper

Leveraged Buy-Outs (LBOs) are a common exit strategy for owners looking to sell their businesses. These deals facilitate business transfers, in particular when business owners are seeking retirement and want to gain capital from their businesses. Critics of LBOs argue that the high leverage characteristic of these deals prevents investment and increases the risk of future bankruptcy whereas private equity supporters point out that investors create value by improving management incentives and by contributing with financial and operational expertise to their portfolio companies. These concerns give rise to the need to assess the impact of LBOs on innovation. France is an interesting setting to investigate the impact of LBOs on innovation because the French private equity market (comprising both venture capital and buyouts) is the second largest in Europe after the United Kingdom (UK), with about 6 billion Euros of funds invested in 2012 (AFIC, 2013). Buyouts constituted the majority of PE funds, reaching 58% of investments.

Although the change in governance resulting from LBOs is generally found to exert a positive impact on firm's economic and financial performance (see e.g. Cumming et al., 2007), a common view in the media is that these transactions are associated with cost-cutting activities and short-termism, to the detriment of innovation and Research and Development (R&D) investments.

The aim of the paper is to provide an empirical analysis of the innovative efforts of a sample of manufacturing firms that underwent an LBO.

Contribution to literature

We contribute to the literature on real effects of buyouts in two ways. First, we contribute by using Community Innovation Surveys (CIS) that have never been used to analyze buyouts. Existing studies have focused on expenditures on R&D and patenting activity as measures of innovative activity. However, not all research expenditures are well spent and the literature acknowledges that the use of patents is not a perfect measure of innovative activity. Thanks to broader definition and measures of innovation, CIS data substantially enhance our ability to measure and study the impact of LBOs on innovation. Second, nearly all studies on LBOs and innovation have concentrated on the US and the UK[1]. By shifting the focus to France and following Boucly et al. (2011), this study investigates the possibility that some LBOs aim to seize innovation opportunities and expand the scale and scope of the target's activities. France provides an interesting context to study LBOs and innovation because in this country LBOs

[1] The only exception we are aware of is the study of Western Europe by Ughetto (2010). More generally, there are hardly LBO studies from continental Europe (see Gilligan and Wright (2010) for an overview).

often involve private family-managed and family-owned firms[2] that tend to be, on average, smaller than non-family firms and for which access to external finance may be more difficult than in the US or the UK.

Data and results

To analyze the impact of LBOs on innovation at the company level, we use a new database built from four different databases: Capital IQ (to isolate transactions), CIS 2006 and CIS 2004 (for innovation data) and DIANE (for financial statements). To our knowledge, this is the first study to use CIS surveys (Community Innovation Survey) in relation with LBOs. Community Innovation Surveys are conducted at regular intervals in Europe. Questions are based on the Oslo Manual guidelines, which distinguishes four types of innovations: product innovations, process innovations, organizational innovations and marketing innovations.

Our empirical study provides no evidence that ex-post innovation expenditure is lower for LBO targets than for comparable firms in France. In addition, we find no evidence that, as for contribution to innovation, LBOs alleviate financial constraints or facilitate business relations. In contrast, we find a positive effect of LBOs on product and service innovation but this effect is not related to radical or disruptive innovation as LBOs have a positive impact on product innovation that is new only to the firm.

Discussion and practical implications

Results suggest that, following an LBO, management is not only focused on "cost cutting" activities that aim to increase value creation. Private equity firms also encourage managers of LBO targets to build new strategies to find and exploit value creation potentials. Further,

[2] In France, the proportion of family firms is higher than in the UK. As stated by Mandl (2008) using data from FBN International (2008), family firms account for 83 percent of all businesses in France versus 65 percent in the UK.

these results emphasize the resources and capabilities that buyout specialists bring in terms of contribution to innovation to their portfolio companies as they suggest that LBOs do not lead to the acquisition of skills or resources that enable the introduction of disruptive innovation.

Hence, results suggest that buyouts have a positive effect on incremental innovation and that private equity firms help to make innovation spending more effective (i.e. by providing guidance and advice) and even more efficient. It could be that private equity firms help the company to focus on its core innovative capabilities and bring innovative products to the market without increasing innovation spending.

Contrary to Boucly et al (2011), results also suggest that LBOs do not alleviate financial constraints as we find a positive effect of LBOs on the lack of financial resources as a factor hampering innovation. This result is in line with Bertoni et al. (2013). Moreover, as we find no effect of LBOs on innovations new to the market, it seems that LBOs do not help to achieve “radical” innovation. This result could be a clue that LBOs lead to the strengthening of financial and human resources constraints that hamper radical innovation. But another interpretation is also possible. It could be that, as better innovators, LBO targets feel more acutely the financial and human resources gap that has to be filled to achieve radical innovations. Further research is needed to disentangle these possible explanations.

These conclusions have important managerial implications. LBOs are now common in manufacturing industries to facilitate business transfers and both business owners and buyers-managers have to realize that cost saving in innovation is not the main goal of private equity firms. On the contrary, LBOs can be a source of innovative renewal as private equity firms will encourage managers to enhance the competitive position of their products for instance by complementing their offer with services that add value to their products and satisfy more complex customer demands.

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