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Managerial innovation incentives, management buyouts, and shareholders' intolerance of failure

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ABSTRACT

This study demonstrates that, apart from managerial agency problem, shareholders' intolerance of failure also deteriorates managerial innovation incentives in public firms. Furthermore, management buyouts improve the innovation intensity, even if managers gain no excess value from the buyouts in collaboration with private equity firms. The study provides insights into the interrelation between firms' innovation, corporate governance, and dividend policy. It presents a rationale behind empirical evidence of a positive relationship between management buyouts and innovation intensity. It provides empirical implications on firms' characteristics that facilitate management buyouts and the return and risk structure of private equity firms.

1. Introduction

Management buyouts (MBOs) of public firms have thrived as a method of corporate restructuring. The corporate finance theory demonstrates that MBOs can increase firm value by realigning managers' interests with those of shareholders, improving operating efficiency, increasing tax shields, and prompting close monitoring by large outside shareholders.[1] Existing studies on leveraged buyouts have accumulated empirical evidence that supports these theoretical predictions.[2] Furthermore, several studies on corporate finance and management present empirical evidence that post-MBO firms increase investments in innovation, such as new product developments, technological inventions, patenting activity, R&D size and capabilities, and new business creation.[3]

[1] Shleifer and Vishny (1987) discuss the potential factors of MBOs that create excess value. Bayar (2011) provides a comprehensive survey of theoretical and empirical studies on MBOs.

[2] Nikoskelainen and Wright (2007), Renneboog et al. (2007), and Wilson et al. (2012) examine the impact of going-private transactions on firms' equity returns and operating performance using data of UK public firms. Renneboog et al. (2007) also summarize previous studies by presenting empirical evidence on the US and UK firms' equity returns.

[3] See Wright et al. (1996), Zahra (1995) and Lerner et al. (2011).

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This study provides a rationale behind the empirical evidence of a positive relationship between MBOs and innovation intensity by examining managerial innovation incentives in public firms and the impact of MBOs in collaboration with private equity firms on managerial innovation incentives. A theoretical model is developed based on the studies of Fluck (1998) and Myers (2000).[4] In the model, a self-interested manager of a public firm can decide whether to stay public or go private before he chooses a level of innovation intensity. The expected values of a project and the probability of innovation failure increase with innovation intensity.

When the firm stays public, managerial choice of the innovation intensity is subject to shareholders' intolerance of innovation failure, which arises from the fact that two types of investors, sophisticated and unsophisticated investors, display their different perceptions of firm value when an innovation realizes its outcome. Their intolerance of failure poses excessive dismissal risk to the manager in the event of innovation failure. It dissuades him to reduce a dividend and share the loss of the failure with shareholders, particularly when the manager can gain large value of future appropriation from strong managerial entrenchment. The model demonstrates that the shareholders' intolerance of failure exhibits harmful effects when unsophisticated investors coexist with sophisticated investors and this causes further deterioration of managerial innovation incentives in public firms, apart from the agency problem between shareholders and managers. It also demonstrates that managerial choice of innovation intensity is interrelated with corporate governance stringency against managerial entrenchment and the dividend policy in the event of innovation failure.

When the firm goes private, the manager can choose the innovation intensity without being subject to the dismissal risk posed by the shareholders' intolerance of failure. The model demonstrates that MBOs improve the innovation intensity, even if the manager gains no excess value from the buyout in collaboration with a private equity firm. However, the manager fails to attain the optimal innovation intensity that maximizes the firm's expected present value, net of the managerial efforts, because the agency problem remains in the private firm.

This study contributes to four topics of corporate finance studies: managerial innovation incentives, corporate governance, dividend policy, and public-to-private ownership restructuring. A strand of the study examines the impact of corporate governance on innovation incentives in public firms and suggests that public firms' innovation incentives can be improved by nurturing managerial entrenchment that mitigates the investors' intolerance of failure.[5] This study presents a consistent result that as corporate governance becomes stringent, managerial innovation intensity diminishes for a given dividend policy, which is also supported by empirical evidence.[6] It also demonstrates the condition under which shareholders' intolerance of innovation failure poses potential risk to hinder managerial innovation incentives and how it poses this risk.

This study shows that a firm exhibits identical innovation intensity under corporate governance with different stringency against managerial entrenchment because it chooses a different dividend policy. This result provides an empirical implication on the interrelation between corporate governance stringency and the sensitivity of dividends to cash flow changes in the event of innovation failure.

Managerial motivation for undertaking MBOs of public firms and its impact on managerial innovation incentives to enhance firm value have not been explored. To the best of the author's knowledge, two outstanding studies have been conducted to examine the issues.[7] The present study extends this literature by highlighting different managerial motivations for going private to those emphasized in the previous studies. It suggests that the manager who has an opportunity to innovate a project is induced to undertake MBOs by circumventing excessive dismissal risk that arises from shareholders' intolerance of failure. It also provides empirical implications regarding firms' characteristics that facilitate MBOs of public firms and the return and risk structure of private equity firms.

This paper proceeds as follows. Section 2 describes the model and assumptions. Section 3 derives the managerial appropriation of operating cash flows in a public firm. It also examines managerial innovation intensity and the dividend policy. Section 4 considers a going-private transaction in collaboration with a private equity firm and examines managerial innovation intensity in a post-MBO firm. Section 5 concludes the paper.

[4] These studies examine the feasibility of equity financing by self-interested managers and dividend policy under the condition that the firm's cash flows are unverifiable.

[5] Holmstrom (1989) and Manso (2011) show that fostering managerial innovation incentives requires that managerial compensation contracts display substantial tolerance of innovation failure in their principal-agent models. Aghion et al. (2013) demonstrate that when a competent manager is exposed to the risk of being dismissed because of poor performance caused by a random shock, large shareholders' monitoring can insulate him from unfortunate dismissal and this improves his innovation incentives. Ferreira et al. (2014) examine managerial incentives to search for innovative projects under public and private ownership and show that public firms' intolerance of failure diminishes the innovation incentive. Sapra et al. (2014) demonstrate a U-shape relationship between managerial innovation intensity and takeover costs by examining a self-interested manager's investment decisions on innovation in the presence of a takeover threat.

[6] See Danielson and Karpoff (2006), Stráska and Waller (2010), and Becker-Blease (2011).

[7] Elitzur et al. (1998) demonstrate that managers with substantial equity shares are motivated to undertake an MBO by simultaneously diversifying unsystematic risk of the manager's shares and retaining ownership control. Boot et al. (2008) demonstrate that the manager is motivated to go private by the uncertainty on shareholders' interference in the managerial investment decision, which arises from the market liquidity of public firms. These studies also derive the conditions under which MBOs improve the managerial incentives to increase operating cash flows and to search for innovative projects.