The role of firms’ innovation strategies in private equity investments

It is more and more recognized that innovation capabilities are the main drivers of firm performance (Brown, Fazzari et al. 2009, Ahlstrom 2010, Hall and Lerner 2010). While investors seem to take into account innovation capabilities in their investment decision, very few is known however on the significance of innovation criteria in investor’s rationale and on related assessment methodologies.

From a theoretical perspective, no precise relationship between identified quantifiable innovation indicators (such as R&D investment, patents or number of past innovations) and either firm performance (Cameron 1998, Demirel and Mazzucato 2009) or investment (Jaruzelski and Dehoff 2005) has been established. This results remains regardless of the selected performance criteria (turnover, margin, employment, survival…). There is therefore a growing research question about the variables that could help investors steering firms’ innovation capabilities.

From an empirical perspective, some investors like venture capitalists are specialized in financing innovative firms. But their rationale on innovation capabilities remains mostly tacit. Innovation assessment appear implicitly through the set of criteria used to select investment proposals (Macmillan, Siegel et al. 1985, Kaplan and Strömberg 2000). Nevertheless, those criteria characterize results of innovative activities more than capabilities.

The objective of this research is therefore to investigate private equity investors’ rationale to characterize the role of firms’ innovation strategy in their decision making process and then shape investment steering tools accordingly.

Research setting

This paper is based on a multiple case study (Eisenhardt and Graebner 2007) carried out thanks to a collaboration with a French private equity fund. We study more specifically three French middle market companies recently financed by the fund. In-between SMEs and large firms, middle market companies’ category gathers long lasting firms, with entrenched innovation capabilities and a large diversity of innovation patterns. Investment rationales are still to be consolidated, especially as literature mainly refers to new ventures and early stages venture capitalists. Data have been gathered through multiple interviews with investors as well as firms’ managers (founder, CEO, R&D or innovation deputy officer, research partners) in order to have different viewpoints on firm’s performance and innovation pattern.

Main findings and contributions

Our empirical analysis shows that investors’ initial valuation methods are usually based on foreseen financial returns assuming no radical change in the firm. Nevertheless, although they are not quantified, firm’s historical innovation capabilities are considered as an asset by investors. It confirms the hypothesis that innovation capabilities would be part of investors’ decision making process even if it still needs to be formalized. As investors’ assessment of firm’s innovation capabilities depends on their knowledge on related innovation strategies, the innovation management literature can be used in order to define a set of indicators and tailor them to middle market companies.
More specifically, the in-depth analysis of three investment cases revealed rationales which go beyond a selection process based on financial tools. Paired with the assessment of firms’ capabilities, investor’s designed new performance indicators (such as increased employment rate or preservation of a family governance). Under certain conditions, they would also take into account externalities at the industry or eco-systemic level. The investment selection process turns into a valuation process where investors actively support tailored innovation strategies to reach specific targeted performances. The investment can be modelled not as a single decision based on existing firms’ assets but as an agreement to follow a defined strategy to secure and develop some innovation potentials. Therefore, the deal structuring is an essential stage as it secure the terms and conditions associated with the investment decision and the related post-investment activities that will support firms’ development.

References


