Preserving Innovation Flair

Budding start-ups often aim at the big prize of either going public or getting acquired, but both avenues can hurt innovation. What's the best path to growth while maintaining your firm's creative flair?

Facebook's bumpy first year as a public company recently sparked debate about the creative benefits of private ownership. The social giant drew heavy criticism for what some felt was an awkward adaptation to the increasing importance of mobile, as well as for a series of copyright and privacy controversies. Only in recent weeks did Facebook's share price top its IPO price.

Before its inevitable listing, the company is said to have worried about the effects of public scrutiny on its innovative potential. Now it wrestles with the beast that is the public marketplace and is grilled on new projects and tweaks to its model at every turn.

Meanwhile, Dell's innovation slump and its founder's buyout proposal are due to the pressures the company has felt at the hands of a demanding public market.

When entrepreneurs ask themselves whether they should take their startups public or sell to the highest bidder, they are in fact putting their firm's innovative potential in question, according to a new paper by INSEAD professor Vikas A. Aggarwal and Wharton professor David H. Hsu.

In Entrepreneurial Exits and Innovation, the first paper to address how entrepreneurs should evaluate the alternative liquidity paths available to them, Aggarwal and Hsu find that going public or being acquired does in fact influence a firm's innovation output.

By measuring the number of patents filed by venture-backed biotechnology firms that were founded between 1980 and 2000, along with the associated citations to these patents, the authors found three different innovation consequences for firms transitioning from being start-ups to being public or acquired firms.

The IPO effect

According to the study going public caused innovation quality to suffer the most.

Aggarwal and Hsu's research determines that this is mostly due to information disclosure. As public companies must disclose their inventions as well as their results, managers may opt to back safer projects in order to produce results in the short term.

"What happens in the case of private companies is that you're able to operate under the radar screen, and that allows you select projects that may have a higher risk of failure. That then allows you to make investments where you're not under the constant scrutiny of larger owners or the public market," said Aggarwal in an interview with INSEAD Knowledge.

"The competitive aspect of disclosure can be quite important, particularly when you have to disclose what's in your pipeline and who are you partnering with; this influences the types of projects you will select" he added.

This mechanism of information disclosure is accelerated under analyst scrutiny, as more information is uncovered and divulged to investors hungry to know about pipelines and future share prices.

"Analyst scrutiny and the number of products a firm has in its early stage pipeline are both metrics for which there is greater oversight and risk. When analysts are scrutinising a company that has a lot of early stage projects in the pipeline, those are the conditions under which we would expect the disclosure mechanism to be most salient" Aggarwal said.

Getting acquired

In a merger, the effects are also negative when the company in question is bought out by a publicly listed one. While acquired firms saw an increase in the quantity of their innovations, they experienced a decline in overall innovation quality. This has to do with managers of the acquiring firm pushing for short-term and observable outcomes. Such a focus however may be detrimental to the long-term innovation potential of the organisation, according to Aggarwal.

It's not all bad news for firms that get acquired though. In the study Aggarwal and Hsu found that companies being bought by a private entity rather than a public one see an increase in innovation quality. This is because private acquirers maintain more information confidentiality relative to their public counterparts. Lower technology overlap between the two firms also helps insulate the acquired firm, protecting its ability to innovate.

The Silver (Lake) Lining

"This has important implications for private equity ownership," says Aggarwal. "In particular, it says a lot about the value that private equity firms can create. Dell is a great example: One of the reasons they've been less innovative over the past decade or so is because they've been under constant public scrutiny. Part of the motivation behind the buyout is to spur innovation at all levels of the company."

Of course, Aggarwal readily admits that it's possible to go public without losing the capacity to innovate (think Amazon). "I think the question is: Would Amazon have been more innovative under a private ownership regime? We know that Facebook held off on its IPO for as long as possible, in part because it feared the consequences of being in the public eye and the possible innovation implications that would have; while we of course never know the counterfactual, what our research tells us is that private relative to public ownership for a given company is likely to spur innovation."


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