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# LBOs Slash R&D: So What?

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# LBOs slash R&D: So what?

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Research Translation

Much has been written recently about the negative impact of leveraged buyouts, or LBOs, on research and development (R&D) expenditures. Corporate R&D spending has been identified as a key determinant of market share in many global industries. However, evidence to test the assumption as to whether LBOs really lead to reductions in R&D is mixed. Furthermore, researchers who study LBOs have not attended to the question of whether such supposed reductions in R&D, if they exist, are damaging to firms and/or the economy.

William Long from the Center for Economic Studies and David Ravenscraft from the University of North Carolina set out to answer these questions concerning the impact of LBOs on R&D expenditures and performance. They argued that the high levels of debt associated with LBOs should be associated with reductions in R&D spending for several reasons:

1. Managers cannot reveal all of the pertinent information concerning promising R&D projects to their debt providers for competitiveness reasons. Consequently, the debt holders, whose power increases in an LBO, are less likely to agree to new projects.
2. Debt providers are also hesitant to fund risky R&D projects because they recognize the downside risk but fail to attend to the potential gains.
3. R&D expenditures result in the creation of assets that are not easily sold in the event of financial problems.
4. Financial controls, which are assumed to be associated with high debt levels in LBOs, discourage long-term investments such as R&D because of their short-term impact on profitability.
5. The added stress and time commitment associated with an LBO can distract managers away from important issues such as innovation.
6. Debt payments associated with LBOs often reduce tax burdens, making the tax benefits from R&D less attractive.
7. Debt places restrictions on how much cash flow managers can allocate to other areas such as R&D.

Long and Ravenscraft also set out to determine whether reductions in R&D, if they exist, are important. First, they explored the idea that R&D is less important in firms that typically engage in LBOs. Second, they investigated the effects of R&D reductions on short and longer term performance.

To examine these ideas, they studied 72 LBOs that occurred between 1981 and 1987, representing a composite of LBOs identified exclusively for their study combined with LBOs identified in six other studies. They also created a comparison group that consisted of 3,329 companies that had not engaged in LBOs. Much of the information about LBOs and comparison firms came from confidential files maintained by the Bureau of the Census, and made available to the authors.

To investigate the notion that LBOs are associated with reductions in R&D, three years of pre-LBO R&D expenditures, divided by sales, were compared with three years after the buyout. Strong support was found for the idea that LBOs hurt R&D. The size of the decline was dramatic, with R&D/sales ratios dropping by almost 40 percent.

However, other findings seemed to indicate that the R&D reductions, although significant, might not have been as important as they appeared on the surface. Long and Ravenscraft linked R&D directly to performance and discovered that the reductions had no significant impact on operating margins, either in the short or longer term—up to five years after the LBO.

Furthermore, they found that most, but not all, of the firms engaged in LBOs were "low tech." The average R&D/sales in these companies was less than one half of the R&D/sales of the manufacturing companies in their comparison group. Consequently, LBOs tended to occur in firms in which R&D was not as important as it was in other firms. The researchers explained that executives and financiers who orchestrate LBOs may seek low R&D firms to avoid the negative consequences associated with R&D cutbacks that are typically a part of LBO restructuring.

This study provides perhaps the strongest evidence to date that LBOs are associated with declines in R&D. However, the policy implications are also important. If LBOs occur primarily in firms in which R&D is not important and if R&D reductions do not significantly damage performance, then they do not pose a business or public policy problem, at least from an R&D perspective. Much of the R&D that gets cut must be marginal, low-productivity R&D. So if LBOs kill R&D, so what?

Source: "LBOs, Debt and R&D Intensity," by William F. Long and David J. Ravenscraft, *Strategic Management Journal, 12* (Special Issue), 1993, 119-135.