Study: If you give companies R&D credits, they are more likely to acquire startups

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Firms that receive research and development (R&D) credits are much more likely to acquire venture capital (VC) backed startups, alongside investing in their own R&D efforts, according to new research by ESMT Berlin.

These findings

, available as a working paper, emerge from research by Merih Sevilir, professor of finance at ESMT Berlin and head of the department laws, regulations, and factor markets at the Halle Institute for Economic Research (IWH), alongside her IWH colleague William McShane.

The researchers wanted to understand how established firms contribute to the startup ecosystem and identify how the R&D credits play a role in this market.

To do so, they used data from over 3,500 U.S.-headquartered firms that received tax credits related to R&D, over a 25-year period. Using mergers and acquisitions (M&A) platforms, such as Thomson Reuters M&A data, Sevilir and McShane then reviewed the acquisitions made by these firms who received tax credits, to understand how they were utilizing this tax break.

They found that investment by these firms in M&A expenditure is similar in volume to that of R&D expenditure in the sample, with a mean of 104.5 million USD per year and 115.18 million USD per year, respectively.

While the researchers also found that one standard deviation change in the tax-based cost of R&D capital is associated with approximately a 10.6% lower expected count of

acquisitions of VC-backed firms. This clearly shows that if R&D taxation increases, firms are less likely to acquire startups.

Interestingly, larger organizations were only interested in using these tax credits to invest in startups who were VC-backed, ignoring firms that were not VC-backed.

"For firms that receive R&D credits, much of the spending will go on human capital i.e. wages and expenses for inventors," says Prof. Sevilir. "However, there is no guarantee here that this R&D investment will prove to be cost effective or even create any new developments. For larger firms, it can make more sense to acquire a startup who is already creating an innovative product or service, and help to fund their journey, as opposed to starting from scratch on their own."

For startups, the researchers say that this acquisition by a larger firm can be a huge positive to their organization. Startups typically lack the taxable income necessary to benefit from tax credits, therefore being acquired allows them to boost their growth and innovation capabilities through a greater cash injection.

While for firms, acquiring these high-performing startups allows them to diversify their R&D efforts, and likely improve their future potential innovations by using an outsourced team to invent, as well as their own.

The researchers say that this reallocation effect of R&D tax credit-induced M&A activity by established firms plays a significant role in supporting startups, which have a high need for capital but limited access to it.

More information: R&D tax credits and the acquisition of startups. www.econstor.eu/bitstream/1041 … 323/1/1851821171.pdf

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