IPO firms can shatter 'growth ceilings' by investing in people, knowledge

18 July 2012, By Steve Smith

(Phys.org) -- When a company goes public, it's a sign that the firm has hit its stride. By choosing to be publicly traded, it's signaling that it's at the forefront of innovation, that it will use its IPO proceeds to make the next big leap forward, continue growing and make its new shareholders money.

Right?

Actually, according to new research, many young companies hit what researchers have identified as an "entrepreneurial growth ceiling" shortly before they go public. The ceiling is the point when a growing firm has collected any number of growth-related problems and issues and needs cash from an IPO to continue moving forward. Smashing against that growth ceiling is often a big reason the companies decide to go public in the first place, the study says.

The newly published research, which analyzed more than 360 new venture firms over time, found that the cash resulting from a company's IPO can help it break through an "entrepreneurial growth ceiling," but only if those resources are used in certain, specific ways that can tackle many issues at once, said lead author Theresa Welbourne, University of Nebraska-Lincoln professor of management and director of the Center for Entrepreneurship in UNL's College of Business Administration.

Breaking through within a year of going public is critical for a firm's long-term success, the authors wrote.

"Young firms are resource-starved, and an influx of large amounts of cash, as in the case of an IPO, can be a dream turned nightmare for many new ventures because there is little strategic direction of how to spend the cash," Welbourne and her co-authors wrote. "Without a short-term strategic direction for allocating resources immediately following an IPO, can a long-term competitive advantage ever be achieved?"

Welbourne and her co-authors analyzed the prospectuses of the companies, examined at how each one's IPO proceeds were to be spent and then factored in the companies' post-IPO performance data.

Their findings: Firms that assigned their IPO proceeds to human resources and innovation -- specifically, research and development - broke through their "entrepreneurial growth ceilings" much faster than those that chose to invest in other areas, such as sales and marketing or physical plants and equipment. Those firms' stocks also performed better over the longer term than other new ventures who invested IPO proceeds elsewhere, the study showed.

Why? The authors said the most strategic and valuable resources that can be gained from IPO proceeds are those that can be used to solve multiple problems at once, problems that become more critical as a company continues to grow.

Issues related to human resources involve managerial shortcomings, employee-related issues and the need to recruit and hire more employees to handle company expansion, according to the study.

By pushing IPO proceeds toward human resources, a company can address problems relating to management capacity, training and development, organization structure, knowledge capacities, compensation and motivation, the authors wrote.

Meanwhile, investing quickly in research and development can support the firm's need to expand its product line, develop next generation products and improve production processes -- which ultimately affect sales, marketing production and retention.

Conventional wisdom and actual practice seem to suggest the opposite of the researchers' findings, the study says, as layoffs and staff reductions along with decreases in R&D spending made headlines over the last several years.

"In efforts to increase productivity and produce positive earnings to shine for investors and the stock market, perhaps, management is overlooking the new fundamentals of business -- building people and knowledge," the authors wrote.

The study appears in the journal *Management Decision*. In addition to UNL's Welbourne, it was authored by Heidi Neck of Babson College and G. Dale Meyer of the University of Colorado Boulder.

Provided by University of Nebraska-Lincoln
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