

## Chapter 30

# Entrepreneurial Finance and the Creation of Value: Agency Costs vs. Cognitive Value

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### ABSTRACT

*The O.M. Scott case study published in 1989 has come to be a classic in modern corporate finance. High leverage traditionally appears as a strong incentive to refrain from sub-optimal investment behavior by self-interested managers. Thus reducing managerial agency cost has been considered as an essential driver of enhanced value in much of financial modeling. The present chapter attempts a somewhat different, albeit complementary, mainly resource based interpretation of the very rich empirical material contained in Baker and Wruck's description of the Scott-LBO. In fact, a close reading of the case suggests that the observed significant increase in operating performance post-LBO is to a great extent the consequence of yet unexplored cognitive changes induced by the private equity firm leading the operation. One may hypothesize that concepts of cognitive value and cognitive cost are relevant to entrepreneurial finance, especially in the case of funding highly innovative young ventures.*

### INTRODUCTION

In a well documented case study published in 1989 in the *Journal of Financial Economics*, Baker and Wruck described the case of the leveraged buyout of the O.M. Scott and Sons Company and the resulting substantial increase in operating performance. The analytic focus of their article may be described as an effort to apply the conceptual tool box of traditional positive agency theory (Jensen

& Meckling, 1976; Jensen, 1986) to establish a plausible link between the incentive structure resulting from an increase in leverage and enhanced firm value. In an attempt to fully understand the nature and behavioral influence of incentives, Baker and Wruck achieved an in-depth analysis of the underlying (contractual) mechanisms. In doing so, the authors not only confirmed some of PAT's (positive agency theory's) most fundamental reasoning, but also helped to put some

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flesh on the bones of the theoretical structure of one of the most prominent approaches modern corporate finance has to propose to come to grips with the classical capital structure puzzle raised by Modigliani and Miller (1958).

While we basically agree with the major conclusions concerning the positive impact of the LBO's incentive structure on long-term value creation by imposing constraints on entrepreneurs limiting the possibilities of sub-optimal myopic behavior, we contend that there is more to it than merely financial discipline. Especially, a close reading of the O.M. Scott case raises the central question of where the superior value creation capability of the entrepreneurs actually came from in the first place, rather than of how to simply reduce managerial agency costs of conflicting interests in the traditional sense (Berle & Means, 1932). In fact, one of the shortcomings of traditional agency theory's financial modeling, when considered in its most rudimentary form, lies in its assuming opportunities for value creation to be given with objectively communicable performance parameters<sup>1</sup> (Jensen, 1986)<sup>2</sup>. In doing so, the financial models gain analytical sharpness. Narrowly focusing on problems of agency costs allows for parsimonious explanations of efficient capital structure changes in situations where improper alignment of incentives and failure in systems of control actually exist. However, reducing agency costs is but one possible, albeit potentially relevant, dimension along which to proceed in an effort to enhance value, and it is largely insufficient to explain the specific requirements of entrepreneurial finance in highly uncertain innovative environments. In fact, by definition, innovation is the very process through which new investment opportunities are brought into existence.

With a longstanding tradition in strategy research, the resource based approach of the firm as pioneered by Penrose (1959) takes on a different perspective. In doing so, it allows for a genuine understanding of some significant sources of value which are neglected by traditional PAT. Hence

we hold that to fully understand the enhanced operating performance *post*-LBO it is useful to complement the rather narrow agency theory explanation contained in Baker and Wruck with resource based arguments, especially with respect to managerial cognition of productive opportunities (Barney, 1986) and the existence and development of firm-specific organizational capabilities (Teece, Pisano & Shuen, 1997; Winter, 2000).

In the present paper, we will argue that the O.M. Scott case as reported in Baker and Wruck (1989) actually contains some yet under-exploited empirical facts consistent with a resource based perspective on changes in capital structure. Notably, we establish that, beside the incentives of high leverage, the change of dominant shareholders brought about by the LBO (1) reduced value destroying cognitive cost by conferring more "coordination control"<sup>3</sup> over internally generated resources on incumbent management who gained the status of genuine entrepreneurs and (2) simultaneously stimulated a learning process allowing for the dynamic adaptation of organizational capabilities (e.g. more efficient management of working capital by changed routines of production) to perceived changes of the firm's environment<sup>4</sup>.

The chapter is structured as follows. In the first section, we briefly recall the principal events of the O.M. Scott case as well as the main conclusions drawn by Baker and Wruck. In the second section, the major shortcomings of traditional capital structure analysis as well as one possible way of pushing our understanding further will be discussed. Sections three and four highlight and reinterpret some of the empirical evidence contained in the O.M. Scott case concerning respectively the impact of varying degrees of cognitive cost and of learning new organizational capabilities. Section five concludes insisting on the complementary contributions of PAT and resource based theory to our understanding of how performance is linked to specific sources of capital, with especially strong implications for entrepreneurial finance (refer also to Wirtz, 2011).

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