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DO FIRMS DOWNSIZE TO PLEASE INVESTORS?

Understanding factors that condition investor response

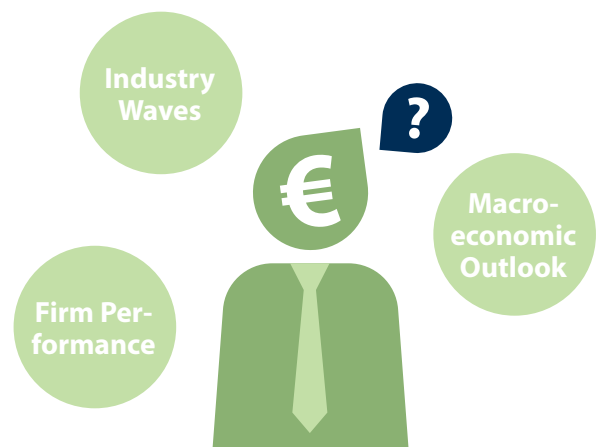
Investor responses to downsizing activities depend on different factors. Firm performance, industry waves and the macroeconomic outlook play an important role.

Workforce downsizing, defined as the intentional reduction in workforce to improve firm performance, is a frequently used practice by managers. It is a widespread answer to industry downturns and wider economic crises, with the aim to achieve improved future competitiveness and performance. A popular belief that is frequently propagated in public media is that companies undertake downsizings to please financial investors. In line with prior academic studies in the field of strategic human resource management and organizational restructuring, the empirical study by Matthias Brauer, Professor of Strategic and International Management, on investor response to firm downsizing challenges this widely-held belief. Drawing on behavioral theory, Professor Brauer and Martin Zimmermann argue and find that investors are much more likely to respond negatively to workforce downsizing announcements. Moreover, their large scale empirical study extends prior academic work on the performance implications of workforce downsizing by specifying the contingencies under which workforce downsizing is viewed more or less favorably by investors. This contingency approach takes into account that investors are boundedly rational and their evaluations of downsizings are affected by various cognitive biases. Importantly, these cognitive biases are argued and found to be more or less prominent depending on when and under what conditions the decision to downsize is taken.

Investor decision-making is partially biased

In particular, the researchers specify four influencing factors which they consider relevant for investors' perception of downsizings. As a starting point, they hypothesize that greater downsizing magnitude is in fact associated with a particularly negative investor response because large scale downsizings entail a severe disruption of a firm's organizational routines and structures. Large scale downsizings are also likely to cause severe survivor effects, which include losses in overall productivity because of lower motivation and commitment among remaining employees ("survivors") in post-downsizing periods. Moreover, the pronounced negative investor response is argued to stem from increased

uncertainty with regard to the future viability of the firm following large scale downsizings. Subsequently, the two scholars examine under which conditions investors might perceive downsizings of different magnitude either more or less favorably. In contrast to prior research studies, they not only explore firm-level contingencies but also examine how industry-level and macro-level factors shape investor response to workforce downsizing. Building on insights from behavioral theory, they propose that investors react particularly negative to downsizing announcements in times of industry downsizing waves and in times of deteriorating macro-economic outlooks. In short, they suggest that the amplified negative investor response is due to a so called pessimism-bias among investors which means that negative information weighs especially strongly in investor judgements. Moreover, the amplified negative investor response under these conditions is argued to stem from the fact that investors are likely to perceive the downsizing as "herding behavior" on part of the firm. Firms which downsize when all their other industry peers downsize are penalized by investors because these firms seem to act less strategically and independently in the eyes of investors. Finally, the authors argue and find that investor response to workforce downsizing is even more negative when executives are found to have been poorly responsive to the need to restructure. Specifically, their empirical findings suggest that downsizings which occur after the financial performance of the firm has deteriorated over multiple years are received particularly negatively by investors.





Workforce downsizings should be conducted with great care

What major insights can managers draw from Brauer and Zimmermann's empirical study that is based on a sample of roughly 700 downsizings by US Fortune 500 companies during the time period of 2001-2012? Most importantly, the study reminds executives that downsizings bear substantial risks for a firm's short-term market valuation. Consequently, workforce downsizing should be considered as a restructuring action of last rather than first resort. For those cases in which alternative restructuring measures do not seem viable, the study advises managers to carefully consider the extent of the downsizing as well as the timing of the decision to downsize. Especially large scale downsizings are heavily

penalized by investors and the study's results indicate that for large scale downsizings, investors are greatly sensitive about the timing. In particular, the study suggests that downsizings should be undertaken before a company gets into a financial downward spiral. Moreover, the empirical findings suggest that executives should not blindly follow the restructuring behavior of industry peers but act proactively and countercyclically.

Brauer, M., Zimmermann, M. (2017). Investor response to workforce downsizing: the influence of industry waves, macroeconomic outlook, and firm performance. Journal of Management: JOM. <https://doi.org/10.1177/0149206317734901>. Print version forthcoming.



ABOUT MATTHIAS BRAUER

Professor Brauer holds the Chair of Strategic and International Management at the University of Mannheim. His primary area of expertise is Strategic Business Development and transformation. Recent papers on these research topics have been published in leading academic journals including the Academy of Management Journal, Strategic Management Journal, Journal of Management Studies, or Journal of Management. As part of the core faculty of the Mannheim Business School (MBS), he actively serves as an instructor and coach for companies in the automotive, energy, financial services, healthcare, software, transportation and utilities industries.



DOES PLATFORM OWNER'S ENTRY CROWD OUT INNOVATION?

Managerial choices in governing a platform ecosystem

Platform firms have attracted much public attention for competing actively with associated firms in ecosystems. But does competing with complementors really hurt innovation? Latest insights indicate that such competition can actually enhance innovation.

How innovation ecosystems work

Producing and selling goods used to be clear and easy. Firms invented a product, built and sold it independently of their competitors. Companies executed value-adding processes internally and competitors were kept away from the core functions of a firm's value chain which resembled a pipeline.

Starting in the domain of information technologies, a shift away from orchestrating pipelines occurred, as some companies initiated a platform strategy to gain momentum. Tech firms redefined the division of labor with partnering firms to foster complementary innovation. In simple terms: they deployed hard and software ecosystems on the basis

of open standards which provided incentives for partnering firms to develop yet embedded but complementary products and services. A popular example is the mobile operating system Android for which a myriad of devices, applications ("apps"), and gadgets have been provided by autonomous third party vendors. Without these innovative complements, the Android system would be far less powerful. Google, the developer and owner of Android, benefits from this layered but integrated product pool, increases the attractiveness and value of its software ecosystem, and attracts new complementors. Thus, its role changed from managing a pipeline towards orchestrating a platform as a guarantor for innovation and progress.

Competing with complementors

Although the success of platform firms depends on the capabilities of its complementors, they sometimes have to spur their complementors by competing with them on their own platform. Google, Apple, and Microsoft frequently enter niches of their complementors with own products and services, thereby seriously challenging their partners' businesses. As platform operators are often significantly larger and more powerful than complementors, this crowding-out behavior has attracted much public attention in the past, from Microsoft's Antitrust Trials in the early 1990s to the current investigations of the European Commission against Google. However, the impact of platform owners' competition with complementors has remained largely unexplored. Armin Heinzl, Professor of General Management and Information Systems, has been working on this topic. Together with his Mannheim scholar Jens Foerderer, his former scholar Thomas Kude, now ESSEC Business School, and his colleague Sunil Mithas, University of Maryland, he has explored the phenomenon for three years (2015-2018). With the study "Does Platform Owner's Entry Crowd Out Innovation? Evidence from Google Photos", the authors examined the consequences of a platform owner's actions in a unique setting provided by Google's entry into the niche market for photography apps within its own Android platform in 2015. They studied Google entering the ecosystem niche with an own app in order to investigate whether such entries hurt complementors' innovation activities or whether it provides innovation enhancing effects.

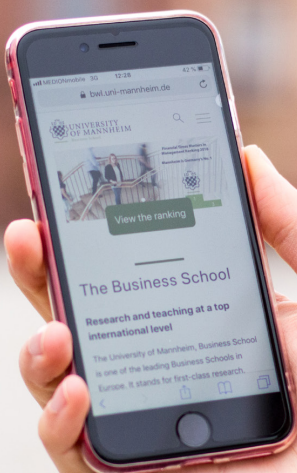
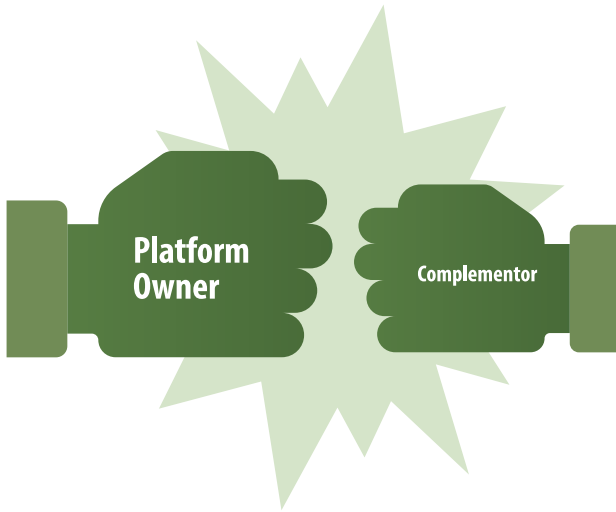


Photo: Xenia Würstlerkötter



Based on a profound analysis of download numbers and app releases in Google's app market Playstore, the findings suggest that at least this entry was followed by an increase in innovation: complementors were more likely to incrementally innovate their photography apps and release new app versions in the affected market niche. The researchers have estimated that the entry caused an increase in the likelihood of major app updates by 9.6% for apps affected by Google's entry, as compared to control groups where no crowding-out behavior took place.

Launching a rival product: spurring innovation in ecosystem niches

The increase in innovation is related to a surge in consumer attention and demand for photography apps caused by

Google's market entry, thereby creating new and strong incentives for complementors to innovate. The effect is even more pronounced for larger and diversified complementors who are in a position to leverage the increase in consumer attention and demand. In other words, the study reveals that competing with complementors does not always hurt innovation, at least in the short-run. On the contrary, platform owners can stimulate innovation by entering the platform ecosystem with own products. The increase in complementary innovation is likely to result from an attention spillover that particularly benefits resourceful complementors. These actors may even perceive a platform owner's entry as an opportunity rather than a threat, and they may direct their efforts toward that particular market segment in order to profit from the "growing pie" created by the attention spillover.

The study's findings provide valuable insights regarding the innovation consequences of managerial choices in governing a platform ecosystem. Software firms, software developers, app developers and entrepreneurs can benefit from the recommendations of the study. Furthermore, the findings are important for policymakers who work on anti-trust policies and regulations of dominant digital platform ecosystems. They should fully understand the impact of the regulatory actions.

Foerderer, J., Kude, T., Mithas, S., Heinzl, A. (2018): Does Platform Owner's Entry Crowd Out Innovation? Evidence from Google Photos. Information Systems Research, 29(2): 444-460.



Photo: Siegfried Herrmann



ABOUT ARMIN HEINZL

Armin Heinzl is Professor and Chair in General Management and Information Systems at the University of Mannheim. His research and teaching interests are IT management, IT enabled work processes, and digital platform ecosystems. He received his Masters' degree in Business Administration at the University of Frankfurt in 1986, his doctoral degree in 1990, and his habilitation in 1995 in Information Systems at the Koblenz School of Corporate Management (WHU Koblenz). Heinzl was holding visiting positions at Harvard, Berkeley, Irvine, ESSEC Paris, and London School of Economics. He was a founding co-director of the Mannheim Business School. He currently acts as the academic director of the Digital Academy, the head of the supervisory board of Ameria AG, member of the executive board of Baden-Wuerttemberg Connected e.V. (bwcon) as well as the Treasury Intelligence GmbH, Walldorf. Furthermore, he serves as a Vice Editor in Chief of the academic journal Business Information Systems Engineering (BISE).

RISK-SHARING BETWEEN EMPLOYERS AND EMPLOYEES

The impact of labor representation

Firms can protect their employees against layoffs during adverse industry shocks. In return, employees receive lower wages. Such implicit contracts work out – as long as employees have enough political clout.

Board-level employee representation has re-entered the political agenda. Even countries that have traditionally been skeptical about giving employees better representation and more say in corporate decision-making now discuss board-level employee representation. Prime minister May suggested changes in this direction in the UK in 2017, and Senator Warren has introduced a legislative proposal to the same end in the US in 2018. While the political debate continues to be heated and controversial, rigorous academic evidence is scant.

In a recent empirical study, Ernst Maug, Professor for Corporate Finance, together with his co-authors E. Han Kim (University of Michigan) and Christoph Schneider (Tilburg University), analyze board-level employee representation in Germany and argue that labor participation in the company's management facilitates risk sharing between employers and employees.

Human capital arguably represents the largest source of risk in the world of work. During economic recessions, employers might be forced to downsize their workforce in order to maintain their current position in the market. Thus, losing

their job as a consequence of economic stress is a widespread fear among employees. Economic theorists have long argued that optimal risk sharing would involve an implicit contract, an arrangement in which employees receive employment protection in exchange for lower wages, which they would accept as an insurance premium. However, it is unclear how firms could commit to such an arrangement, in which they uphold employment even during economic downturns. In addition, workers must be willing to compensate firms for the job guarantees they receive from their companies. Ernst Maug and his co-authors argue that codetermination is such an institution that allows firms to make credible commitments, which workers are willing to honor through lower compensation as a quid pro quo.

Codetermination enforces the implicit contract

The authors use plant-level data from Germany, which is ideally suited for such an analysis. The country was at the forefront of labor representation starting in the 1970s and is about average in terms of employment protection rights in the OECD. Since 1976, so called parity-codetermination has been in place. This means that 50 percent employee representation on supervisory boards is required by law, for firms that have a workforce of 2,000 employees or more.

The analysis covers data for the years 1990 to 2008. The study investigates whether employment and wage insurance is



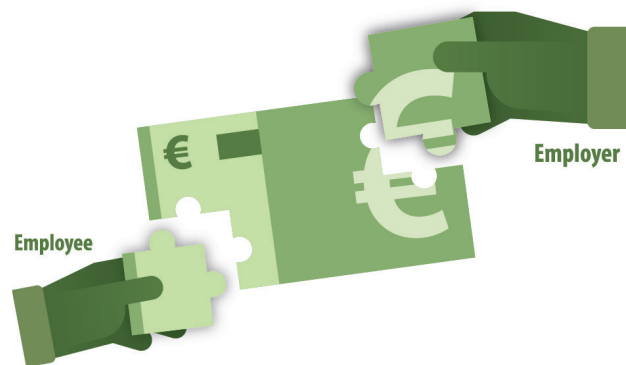
Photo: Felix Zeifler

provided and if so, whether it has an influence on the firm's performance. The study's results indicate that in case of parity-codetermination, two groups of employees are indeed successfully protected: white-collar and skilled blue-collar workers benefit from the arrangement. These workers profit from an employment protection that employees in non-parity companies do not receive. For unskilled blue-collar workers however, not even parity-codetermination does the trick. The authors attribute the unfortunate position of this group to the fact that it is never represented on supervisory boards. Unskilled blue-collar workers, about 20 percent of the work force, participate in the elections of board representatives, but their interests do not appear to be represented sufficiently well, so as to enforce implicit contracts, which emphasizes the importance of participation in governance.

Shareholders do not profit, only skilled workers capture the gains

The study reveals that employees with higher educational qualifications, a group that largely overlaps with white-collar and the skilled blue-collar workers, accept lower compensation of 3.3 percent when they work for a parity-codetermined firm. In exchange, the group benefits from employment insurance and the company can put the savings aside for a potential recession phase. Inevitably, this finding leads to the question whether this is enough to overcome downturns. Do parity-codetermined companies survive periods of recession? Do shareholders even profit from the implicit insurance model? Or does the employment insurance stemming from parity-codetermination put the firms in a bad financial position in the long run?

Ernst Maug and his co-authors find that in fact, compared to non-parity firms, economic shocks hit parity firms particularly hard. But the savings from the wage concessions seem to compensate the loss. The study analyzes the companies through the whole business cycle, including different states of the economy, and finds no long-term differences in performance and valuation between parity and non-parity firms. However, this means that workers profit from employment insurance, while shareholders are not rewarded with any gain. The authors draw the conclusion that, therefore, firms will not voluntarily install labor representation in their governance structure. Regulatory intervention might be needed when the employment insurance should be spread.



Kim, E H., Maug, E. and Schneider, C. (2018). Labor representation in governance as an insurance mechanism. Review of Finance, 22, 1251-1289.

ABOUT ERNST MAUG

Ernst Maug has been professor for Corporate Finance at the University of Mannheim, Business School since February 2006. He served the School as Associate Dean for Research and director of the Business School's doctoral programs. In 2018, he is president of the European Finance Association. Before coming to Mannheim, he taught at the Department of Business and Economics at Humboldt, the Fuqua School of Business (Duke University), and the London Business School. Professor Maug was visiting professor at the University of New South Wales, Duke University, and the London School of Economics, from where he obtained his Ph.D. in 1993.

Professor Maug's main research interest is in Corporate Finance with a particular emphasis on Corporate Governance. Recent work focuses on the interface between financial markets and labor markets. His prior research analyzes executive compensation contracts, the role of blockholders, corporate boards, and shareholder voting. His research was published in the American Economic Review, the Journal of Finance, the Journal of Financial Economics, the Review of Financial Studies, and other journals, and has won several prizes.



Photo: Siegfried Herrmann





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