Young Innovative Firms, Investment-Cash Flow Sensitivities and Technological Misallocation

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Can technological misallocation generate financial frictions? We build a theoretical model with testable implications, in which the misallocation between R&D and production activities generates borrowing constraints. The investor offers the innovator a rent that is contingent to the success of its project in order to make them exert an incentive-compatible effort level. However, this rent distorts the allocation of effort between activities. Specifically, it leads to a suboptimal level of effort impulsing a reallocation of resources from production to R&D. Consequently, the investor cannot appropriate the surplus resulting from innovation. This distortion increases the cost of external financing for firms that have large amount of intangible assets. Using Compustat data for manufacturing firms in the United States between 1982 and 2007, we show that cash-flow sensitivities are positive and increasing in firms with high R&D intensities.