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Abstract

This paper proposes a novel channel through which innovation externalities can affect firm performance. I find cross-sectional evidence that the positive innovation outputs of customer firms increase their supplier profitability as measured by firm *ROE*. This result is robust to the inclusion of industry fixed effect, a control for both supplier and customer characteristics, such as *ROE*, advertisement expenditure, capital expenditure, firm age, industry concentration, institutional ownership, dividend yield, and a control for industry spillover or geographical spillover. To identify the causal effect of customer innovation outputs on supplier performance, I study an exogenous shock—State Street Bank and Trust Company v. Signature Financial Group, Inc.—and find that an increase in granted customer patents causes an improvement in future supplier performance. This effect is mainly driven by the demand channel and the knowledge diffusion channel from customers to suppliers.