Quality Investments in the 11th Hour*

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Abstract

We study optimal product quality investment of a firm that goes out of business when its reputation falls too low. If the firm does not know its own quality, we show that the firm stops investing when its reputation gets close to the exit threshold and its life-expectancy vanishes. If the firm knows its own quality, to the contrary, we show that the firm optimally invests until its reputation falls to the point where the low-quality firm exits the market. While the life-expectancy of a low-quality firm vanishes, investment remains profitable because investment success, that increases the firm’s quality, averts exit.

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