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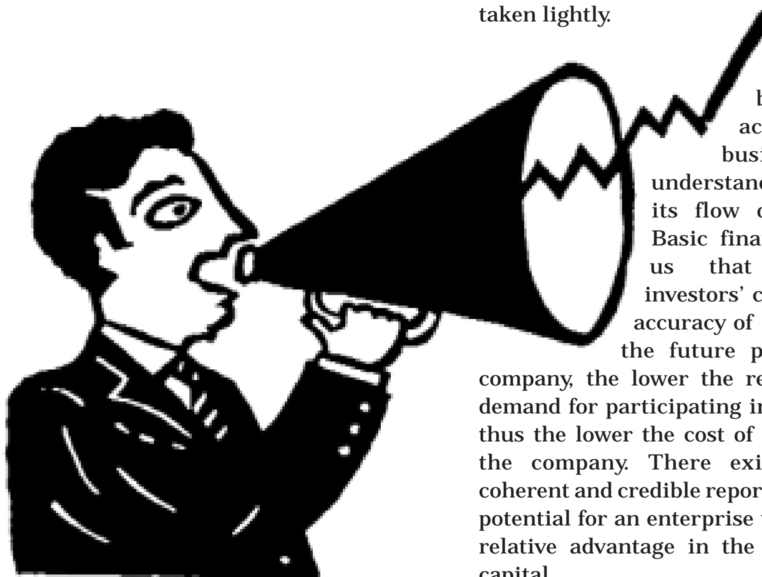
Winning the competition for capital

Gone are the days of minimalist reporting. Investors are increasingly rewarding coherent corporate communications with trust – and lower stock price volatility.

Calls for increased corporate 'transparency' are becoming ever more frequent and detailed. Whereas investors may have simply been looking for a stable pattern of earnings growth and/or dividend distributions in the past, today they wish to project trends for the key drivers of future value creation such as new product development and innovative use of new business practices. Year after year surveys (see endnote) show a growing demand by the investment community for high quality data on a broad range of such indicators. These demands pose a dilemma for managers, however, as communicating such information in a credible fashion is a complex and expensive business. The cost of gathering data can be substantial. Add to that the potential proprietary costs that accompany the disclosure of strategic insights and it is apparent that the decision to improve the quality of corporate communications is not one that should be taken lightly.



And yet, there are clear benefits that accrue to the business that understands and controls its flow of information. Basic finance theory tells us that the greater investors' confidence in the accuracy of their analysis of the future potential of the company, the lower the returns they will demand for participating in that stock, and thus the lower the cost of capital faced by the company. There exists, through a coherent and credible reporting strategy, the potential for an enterprise to gain a critical relative advantage in the competition for capital.

So, how can we evaluate the benefits of reporting on the various corporate value drivers? To date, leading consultancies in this area have tried to assess the appetite for information through surveys of the investment community. However, the 'wish lists' generated through these surveys are unable to answer the one critical question: "If I improve communication in the areas identified, will I be rewarded with lower stock price volatility?"

The rewards of disclosure

To address this question, we need two building blocks of information.

Firstly, we need to be able to assess the quality of the reports currently issued by one company relative to its peers. Note that it is the quality, and not the quantity, that is important in this analysis as it is only through a change in the quality of the information provided that a manager might hope to shift an investor's level of confidence in his earnings model for that company relative to the investment alternatives in the group.

Secondly, we need to have a model for understanding the current sources of stock price volatility for that company relative to its industry peers. This will allow us to assess whether relative price moves are associated with the release of certain types of information.

With these two building blocks of information we can analyse whether there are certain elements of a communication strategy that are resulting in undue fluctuations in stock price. Is the volatility in share price associated with the release of information in areas that score badly on the quality measure? If so, by improving the quality of reports to the investment community, a manager might expect to be rewarded through lower price volatility. If not, the manager may be wise to avoid the additional expense of adding to the information set already provided to the investment community.

The first block

So, to begin our analysis we need a methodology for analysing, in a consistent and credible fashion, the quality of information reported by companies in multiple industries and in multiple territories. This is no trivial matter. However, after four years of global capital market and industry research, PwC has launched a framework that makes this assessment possible.

Based upon multiple industry and capital

market surveys, the ValueReporting framework (see Figure 1) offers a holistic model of corporate reporting. It argues, through the four broad categories of information that it highlights, that investors need to be presented with an overview of the management's understanding of the dynamics of its industry and its position within that industry. A clear, detailed articulation of the company's strategy should then be given. The financial outcomes and risk controls associated with the implementation of this strategy need to be made explicit. And furthermore, investors need to understand how well management is controlling the critical activities and relationships that underpin future value creation, classified here in the Value Platform.

So, building upon this understanding of value creation by industry, PwC has developed a tool that allows the user to benchmark the quality of reporting by companies across the key measures of success. These are the measures that the investment community has asked for. These are the measures that, if ignored by the investor relations department, will lead to an unnecessarily high degree of uncertainty about the future prospects of the firm.

The methodology behind the benchmarking of corporate disclosure embodies the philosophy of the ValueReporting initiative, namely that management should quantify where possible. They should provide historical trend data so that performance may be monitored in a consistent fashion. Forward-looking targets are desirable, as indeed are figures that provide an industrial context for the performance. This rigorous scoring methodology across the 180 or more measures that underlie a tailored ValueReporting framework is applied to three primary channels of communication: the annual report, the company's web sites and investor briefings. The result is a detailed analysis of the quality of reporting by one company relative to its peers

Figure 1: ValueReporting framework

Market Overview	Value Strategy	Managing for Value	Value Platform
• Competitive environment • Regulatory environment • Macro-economic environment	• Goals • Objectives • Governance • Organisation	• Financial performance • Financial position • Risk management • Segmental	• Innovation • Brands • Customers • Supply chain • People • Reputation *– Social* *– Environmental* *– Ethical*

The second block

However, benchmarking the quality of reporting for all the key drivers of success within an industry is just the start. To develop a coherent reporting strategy, management needs to consider whether moving towards best disclosure practice will unambiguously reduce the volatility of its stock price. Similarly, it needs to understand where effort should not be expended – where superior reporting is unlikely to be rewarded by the capital markets.

To begin this second phase of the investigation, it is important to make explicit the fundamental relationship between information and uncertainty (which manifests itself as stock price volatility and a higher cost of capital) in the capital market. In order to do this, we need to delve deeper into the make up of the investment community.

So who are these people who make the decisions on whether to buy or sell shares in a company? And how do they come to their decision on what constitutes fair value for a stock?

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The capital market players

The first important point that needs to be made explicit is that not all investors are created equal! The mandates of the portfolios managed by investment professionals vary from the long-term, as in the case of a pension fund, to the supremely short-term horizon of a day trader or arbitrageur. Why is this distinction important? Well, if a company attracts a lot of the short-term investors into its stock, the company will experience a high degree of volatility in its stock price, which increases uncertainty. Greater uncertainty about future outcomes means greater risk. This volatility therefore lessens the attractiveness of the stock to the long-term investor. In order to be compensated for this additional liquidity risk, the long-term investor will demand higher returns and the cost of capital that the company faces thereby increases.

So what can be done to take control of the profile of investors that own a company's stock? A critical first step is to recognise the role that the information provided by the company can play in making a stock more or less attractive to a given group of investors. What information can a company provide to increase the comfort that a pension fund investor feels in his projections of future cash flows and thus the value of the firm? Additionally is there any type of information that, if released, lessens the potential for website chat rooms to create an arbitrageur's heaven?

Research by PricewaterhouseCoopers (for details visit www.valuereporting.com) has tried to address this question by examining the different pools of information that are required by long-term investors within major industry groups. The findings of the many industry surveys demonstrate several over-riding themes. To begin with, investors agree on the types of information they would like. However, on average, less than 30 per cent of the critical indicators cited by respondents are currently covered by standard financial reporting standards. Although the rest may be discussed by management within the body of a report and accounts, we find universal dissatisfaction in the quality and credibility of this non-financial information.

The conclusion from surveys therefore is that the information companies provide is generally of insufficient quality for investors to differentiate good management from bad. It is consequently insufficient for investors to gain the degree of confidence in their projections of future growth required to afford a company a full valuation. In short, an increase in credible, consistent and timely data is essential if a company is to keep the arbitragers at bay.

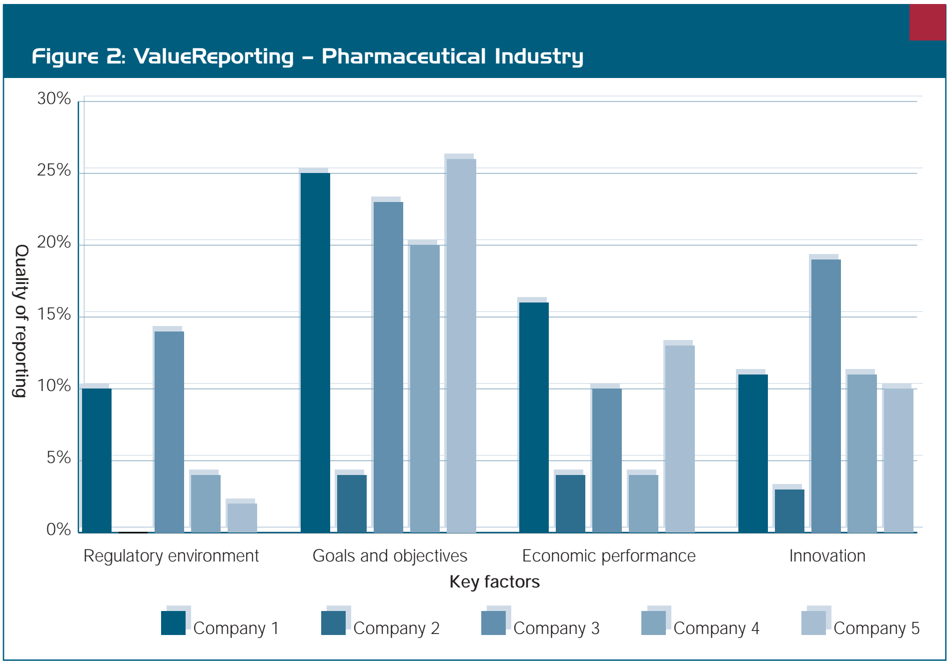


Figure 2: ValueReporting – Pharmaceutical Industry

Taking theory into practice

An example from the pharmaceutical sector

So how do we use these findings to develop a coherent economic framework for a reporting strategy? How can we provide a methodology for assessing whether a company is likely to be rewarded by the capital market for incurring the costs involved in undertaking incremental disclosure? Such a methodology is still evolving, though some interesting first steps have been made.

Take, for example, the pharmaceutical industry in the UK. A global survey of the Chief Financial Officers, 'buy' side and 'sell' side analysts in the sector has generated a better understanding of the key drivers of future success for the pharmaceutical industry. This allowed the generic ValueReporting framework to be tailored to reflect the specific dynamics of the sector, with Regulatory Environment (in the Market Overview section), Goals & Objectives (Value Strategy), Economic Performance (Managing for Value) and Innovation (Value Platform) all considered key in this case.

Using this tailored model, the quality of the reporting of the majors in the group was evaluated using the quantitative benchmarking techniques discussed earlier. The findings, which are summarised in Figure 2, show a significant variation in the standard of the information presented by the various industry players about these critical success drivers.

But, does having substandard reporting in any given element of the framework matter? By moving to best practice is a company likely to see a reduction in volatility? The Disclosure Tracker is PwC's diagnostic tool that aims to determine these questions.

The Disclosure Tracker starts by analysing the number and nature of the communications made by both companies and the investment community that have resulted in a significant relative share price movement.

This first cut of the data provides a very high level insight into the number of times a significant relative movement in share price may be associated with a disclosure by either the company or the analyst community (see Figure 3). By inference, therefore, it also illustrates the number of volatile stock price days that have no matching disclosure – days when the rumour mill is potentially in overdrive.

At issue then is whether a company is being harmed through a weakness in any particular aspect of its communications strategy. Taking the communications that are associated with large fluctuations in stock price, the Disclosure Tracker allows the analyst to drill down further, to analyse exactly what type of information tends to be behind the volatility.

Figure 4 looks at the nature of any communication that is associated with volatile days. It shows that Company 2, for example, is experiencing a lot of volatility relative to its peer group around the information that it is putting into the public domain concerning its position within the competitive environment. Similarly, volatility for Company 1 is dominated by news about its research programme. By contrast, for Company 3, it appears that the research pipeline is far better anticipated by outside market commentators such as analysts.

These observations may simply reflect the fact that life is full of surprises! Externalities will impact every company at some stage... It is natural to question therefore whether these findings get one any nearer to building an understanding of a communication strategy.

By bringing together analysis of the

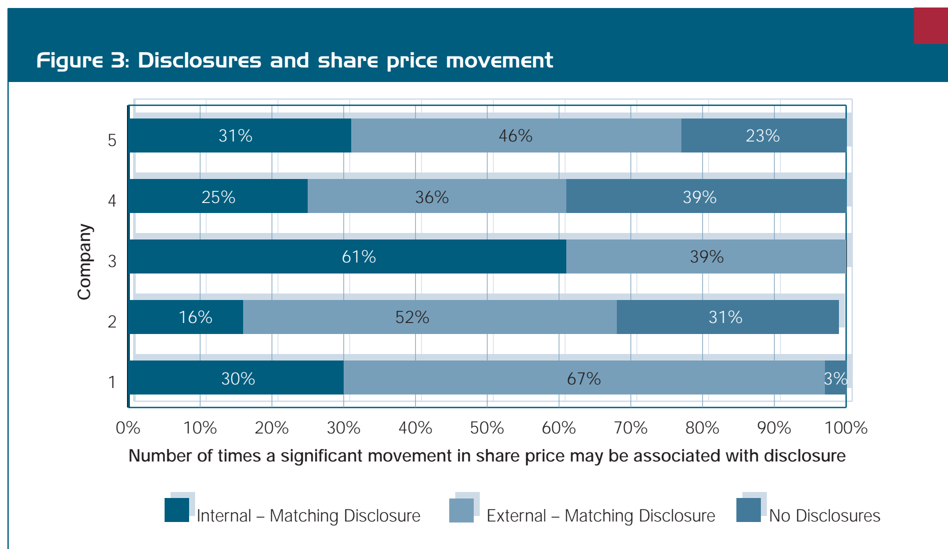
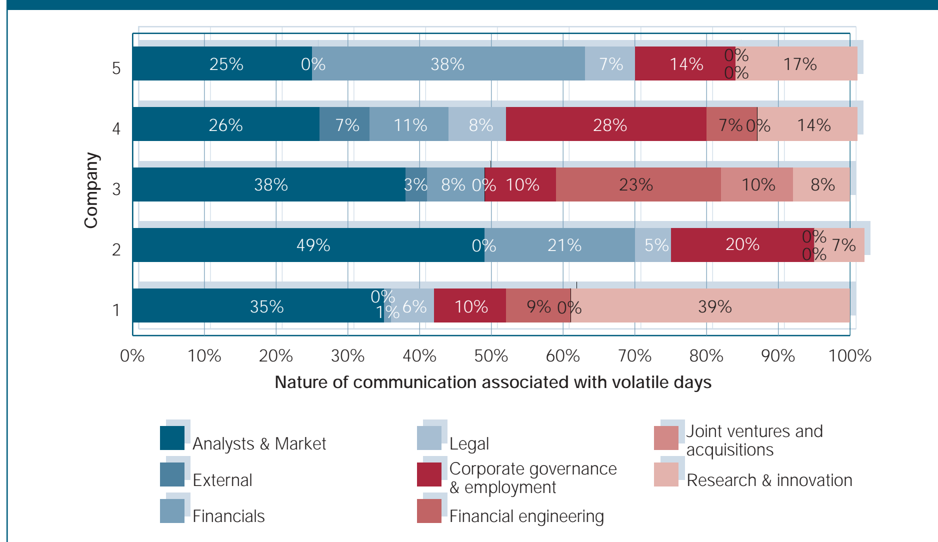


Figure 3: Disclosures and share price movement

Figure 4: Nature of communication



disclosures that are associated with stock price volatility with the ValueReporting score, new insights can be gained. As a measure of the quality of the information that is released by management into the investment community, the VR score gives the potential to analyse whether a company that appears to generate a relatively high degree of volatility in its stock price when talking about certain elements of its business also scores badly on the quality of its disclosure in that particular space. The methodology thus allows a company to assess whether a low score for any particular element of the reporting framework is currently affecting its cost of capital.

Figure 5 illustrates the power of the analysis. Here we see that Company 2, which in Figure 4 was seen to be subject to significant volatility around its communication of its competitive position, actually scores nothing in this area using the ValueReporting methodology. Equally, we observed that Company 1 experienced a relatively high degree of volatility when talking about its research and development. It scores less than the industry average in the Value Platform category of the ValueReporting framework (which is dominated by the innovation element of reporting for this industry) and is substantially worse than Company 3, which was seen to generate little volatility in this space. This suggests possible avenues for exploration for both Company 1 and Company 2 in future iterations of their communication strategy... iterations that may now be monitored for effectiveness against a clearly defined economic framework.

The Disclosure Tracker does not offer fixed solutions for all companies. From this work one cannot prescribe a mode of action that can be slavishly applied in all cases. However, it does allow managements to question whether their reporting strategies are negatively affecting their stock prices relative to their peers. It allows management to assess whether absorbing the costs of moving to best reporting practice is likely to result in lower volatility. Furthermore, it will allow such decisions to be monitored for their effects over time. An economic and coherent framework for evaluating a corporate communication strategy is no longer a dream.

References

See, for example, the publications area of www.valuereporting.com;
Improving Insights into Enhanced Business Disclosure, Financial Accounting Standards Board, (2001); the British Banking Associations guidelines for environmental reports, (2001); ERM Consulting's survey of the top 25 UK pension funds (2000)

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Figure 5: Communication versus Volatility score