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ARTICLE PUBLISHED IN
« LES CAHIERS ERNST & YOUNG »
FEBRUARY 1999

FROM SHAREHOLDER COMMUNICATION TO FINANCIAL MARKETING

The preeminence of financial markets is an essential trend that corporations must not underestimate. First of all, the expected bankruptcy of our European retirements systems will inevitably lead us to a situation similar to that of the United States with its pension funds. Also, Euro and globalization of markets will make comparison between European companies easier. This will result in an increasing competition for access to financial resources and the least performing companies will suffer severely from this situation. Lastly, the expansion of financial markets will benefit from the need to offer employees stocks or stock options to attract the best talents people.

This revolution gradually shifts corporate managers and their financial managers from a status of resource buyers to that of equity sellers. To ensure their long-term competitiveness, companies must excel both on their "real" market and on the "financial" market. On both markets, competition is tough, and no company can neglect anyone of these battlefields without adverse effects. Now, traditional marketing for customers is inevitably complemented by financial marketing for shareholders, and big companies that succeed in mastering the latter will have a competitive edge in the coming years.

Financial marketing must not be confused with financial communication. Indeed, as shown by the recent events on financial markets, "conventional" communication can only play a very limited role. One must not be surprised. Financial communication seeks to influence the behaviors of particularly sophisticated players². Therefore, its task is tough, and any company wishing to master partially the expectations of its shareholders must adopt a more clever approach.

To meet the need for growingly complex information, companies must implement a genuine financial marketing approach.

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² There is a consensus on the fact that markets are "semi-efficient", i.e. prices reflect entirely and immediately the information communicated to the public.

Meeting complex needs

The shareholder's goal is to have his invested capital grow in proportion with the risk he is bearing. His primary concern is therefore Value, a basic and synthetic indicator which amount and evolution enable him to make a simple criteria to make investment and disinvestment decisions.

One of the investor's major concerns is to judge the management's capacity to increase and accelerate the generation of cash flow, to reduce its volatility, and to maximize the value of the tangible and intangible assets (trademarks, for example) at the source of these cash flow.

For an investor, the value of an asset is equal to the discounted present value of the cash flows (dividends and capital gains) he expects to receive in the future. Numerous academic researches have shown that, when valuing a stock, the market: a) integrates the long-term perspectives included in corporate investment decisions, b) is able to distinguish between companies' value-adding and value-destroying policies, c) does not take into account changes in accounting techniques or policies that artificially impact results without affecting the company's cash flow.

As a general rule, the investor is interested in the company's ability to create one or several competitive advantages that, by definition, are durable, defendable, and decisive and which, by freezing competition mechanisms, cause the company to benefit from an economic rent³. The investor also seeks to assess the management's capacity to take advantage of future development opportunities, as the value of a company has two components: on the one hand, the value of its existing projects, and, on the other hand, the value of its future growth opportunities (for example, a patent that entitles it to exploit a market in the future).

The understanding of all these elements is critical for the investor, and it is clear that it takes more than purely financial information to make his decisions. A survey conducted recently by Ernst & Young⁴ in the United States showed that 35% of investment decisions were based on non-financial indicators. The most decisive relate to its strategy execution (is the company able to execute its strategy, whatever it may be?), the top management's credibility, the quality of the strategy, the capacity of the organization to innovate, to attract and keep talented people, the company's market share, the management's experience, the alignment of compensation on value creation, and the quality of the company's major processes.

Actually, this percentage can only grow in the future. Indeed, the investor's analysis grows more and more complex with the surge of the connected economy⁵ where intangibles play an essential role: value becomes more volatile and less controllable. This change affects altogether the offer, the market, and the means of production.

³ Financially, this is reflected by investment projects whose economic return exceeds the cost of the capital (Positive net present value)

⁴ Measures that matter, Ernst & Young LLP, 1997.

⁵ *Blur, the speed of change in the connected economy*, S. Davis and C Meyer, Addison Wesley, 1998

The offer's nature is changing and it gives birth to complex exchanges with a three-fold economic, informational, and emotional dimension - the latter two being particularly difficult to value - both on the buyer's and on the seller's side. A new economic logic is also emerging. It favors "relational strategies" between the economic actors, with consequences that are more difficult to evaluate than those of conventional competitive strategies. Also, the rise of the intangible's portion in the economic capital of companies is one of the changes that most impact the traditional valuation methods⁶.

In parallel, one can observe that value shifts quickly from one company to another within a given industry or between several industries. This phenomenon often called «Value migration», itself reflects the volatility of competitive positions and the considerable technological changes under way. Even for companies that manage to create value and to emerge as leaders, competitors' financial, commercial, or intellectual resources can upset the situation overnight. Let us not forget that speed is one of the major characteristics of the new economy.

Facing shareholders' complex needs, companies still respond too often with conventional financial communication. Unfortunately, although this communication is very important and, sometimes mandatory, it cannot satisfy the financial market. This information is historical, periodical, standardized, and based on accounting results. It is therefore meaningless to investors who seek to anticipate on a permanent basis (as they must act in real time) in accordance with economic and strategic data, and, if possible, using proprietary information.

This is the reason why the company is only one of the investor's sources of information. For the shareholders to be fully aware of the situation of the company, many other sources are appropriate: customers, suppliers, partners, present and past employees, newspapers, competitors, financial analysts, and other shareholders. The American environment prefigures what European companies must master tomorrow. New technologies strengthen the consumer's power on the real market, and the shareholder's power on the financial market (e.g. Internet newsgroups, where shareholders and employees can share their ideas and opinions about the company).

The growing porosity of the borderline between the company and the outside world, and the construction of complex business webs, are altogether strategic musts in the new economy and constraints for shareholding marketing. The company must base its relationship with its shareholders on its strategic and organizational real situation. It must give up easy, but inefficient, advertising messages.

Financial marketing consists of making the relationship between the company and its financial market more professional. It is a set of actions intended to analyze the company's financial market and to implement the means for satisfying it. The company must therefore work in two directions. It must improve its "shareholder connections"⁷ and implement a value discipline.

⁶ A recent survey (P.Artus, F. Hubert, N. Verlé, Caisse des Dépôts et Consignations, no.98-20 of July 17th, 1998) showed that, for French companies, intangible assets are valued four times their accounting value over the last three years

⁷ Modern marketing grants a growing role to "customer connections" in reference to a book written by Ernst & Young (see "Customer Connections", R. Wayland et P.Cole, Harvard Business School Press, 1997)

Building "shareholder connections"

The purpose of "shareholder connections" is to help investors better assess the future profitability of the company. The management's role as a salesperson is to help the market make the most genuine estimate of the company's situation.

First of all, this requires a better knowledge of the shareholder. Beyond databases that identify investors and their basic strategies, the company must set up an organization, technologies and procedures through which it can collect systematically ideas and opinions of shareholders and observers, but also those of its major competitors, both listed and unlisted. Although this is typical competitive intelligence monitoring, it must be oriented towards an understanding of the market's financial and strategic expectations. « Customers connections » techniques can also be used to acquire a better understanding of shareholders' need and expectations.

In addition, the corporate management must focus particularly on key investors. Stock prices are primarily driven by these "lead steers" who are generally very few in the ownership of a listed company. The constant dialog that must be set up (road shows and direct conversations) constitutes a unique opportunity for the company to confront its point of view with that of professional investors. These people obviously have less in-house information than the management, but they have more points of comparison and financial experience. The information collected through that permanent process must be considered as a real strategic one that needs to be considered by the highest executives of the company.

Of course, sell-side analysts are also a significant target for the company. However, their power must not be overestimated. When one looks carefully at the price of a company and brokers investment advises, the market's capacity to anticipate these recommendations is striking. Aside from a few stars, analysts are too gregarious⁸ or insufficiently independent. That is why they are not closely followed by investors who play their own game. However, they do have a useful role. On the one hand, they are a source of information from which the investor can find already processed data. On the other hand, they make it possible for investors to confront their own anticipation with those of a market consensus, which reduces the cost of information and indirectly increases the value of the analyzed companies. That is the reason why it is highly recommended for a company to be monitored by the largest number possible of financial analysts.

Also, it is possible to further understand what are shareholders' expectations. The above-mentioned survey by Ernst & Young made it possible to develop, through sophisticated statistical techniques, a methodology for performing a genuine market analysis in order to identify investors' non financial expectations with respect to a company and compare them with their expectations regarding its major competitors. Wise managers make sure to have a market study before bringing any new product in the market place. Why should one act differently on the financial market?

⁸ What analysts and cattles have in common, Matt Siegel, Fortune 17/8/98.

Investors' expectations must be compared with the company's capacities. The market value of a company is both a sign of its strategic success and a key for its future development to occur. To be an effective indicator for the management, it must be representative of the company real future profitability. Too high a share price would impose growing constraints to the management. Too low, it eventually slows down the company's development.

The second level of understanding therefore consists of identifying what is the expected shareholders' return. Contrary to conventional wisdom, this is not the cost of capital, but the future economic return implicitly contained in the company's price. Investing at a return that exceeds the cost of capital and ensuring a positive and growing differential⁹ is not enough to create value. Indeed, the price of a company integrates the estimated return of all its future investments. If it appears that these investments (although their NPV is positive) will generate a return that is less than expected, the stock price will inevitably drop.

It is therefore critical for the management to understand, given the cost of capital and the value of the company, what economic return and competitive advantage period are embedded in the share price, and to compare them with the company's own estimates in order to take any necessary corrective action (either an alteration of the signals issued to the market, or a change in strategy). That analysis is based on the basis of the market consensus and the management business plan, using forecasting tools. In that respect, probabilistic simulation models (such as Monte-Carlo simulations) are extremely useful, as they enable managers to better understand the degree of uncertainty that affects their result and cash flow forecasts. The dialog with their shareholders is therefore based on much healthier criteria.

The understanding of the shareholders and the alignment of their expectations on the actual or future capacities of the company are only the first phase of the financial marketing. The market requires permanent information to support its choices. The management's responsibility is therefore to implement a genuine value discipline that will enable investors to be reassured on the company's capacity to create and sustain competitive advantage over time.

Implementing a value discipline

In the connected economy, it is useless to hope luring investors through effective communication aimed at offsetting mediocre results or hiding a weakened strategic position. Sooner or later, the market will detect the trick. The listed company has no other choice than to promise that which it can deliver, and to deliver that which it has promised.

With the new connected economy, new organizational models are required. They will favor versatility, innovation, flexibility, experimentation, and the porosity of companies' borderlines in order to ensure a better integration in an environment that presents similar characteristics¹⁰. Durable performance will result from managers' capacities to create organizations on the verge of

⁹ Which is a typical prescription in EVA approaches.

¹⁰ See Blur.

chaos, and to resist to centralization and shift decision-making power to the outskirts, where the action is located. That situation may drive strategic consistency problems if no clear goal is assigned to the multiple decision centers. The value discipline constitutes the necessary compass such companies need.

Many companies misunderstand the content of that discipline. It certainly consists in introducing, in the performance management system new indicators more significant of the value that has been created by the company. However, indicators are not the most important issue. Value is primarily created by strategic decisions that make it possible to build long-term competitive advantage: management need to focus on decision making if it wants to tackle the real value challenge.

In order to create a true competitive advantage, the company must introduce a financial dimension into its strategic analysis, seek organizational and strategic flexibility, and favor direction over precision. It must also choose a financial policy that communicates clear signals to the market regarding its intentions and operational positions.

The introduction of the financial dimension into the decision-making process makes it possible to better understand where value is created and destroyed, and to better anticipate operational risks. Beyond the information provided by systematic simulations before any decision is made, that discipline makes it possible to gradually change the managers' culture, making them aware of the financial stakes of their operating decisions. That cultural change is one of the conditions that will make it possible to achieve a better osmosis between the real market and the financial market.

Also, in its strategic and organizational choices, the company must favor flexibility and optionalities. Shareholders prefer to invest into companies that are able to take advantage of future opportunities occurring on their markets, than by those that display a detailed strategy that they claim to cling to whatever the future strategic situation be. To make its choices, the management can usefully rely on the framework offered by the options theory. The value of a company is dependent on its option portfolio. To increase the options component of the company's value, the management must review, and make the strategic and operational decisions that affect those components positively.

The table below¹¹ lists some of the strategies that contribute to that goal.

Determinants of value of financial options	Current Value of underlying asset	Strike price of the option	Variance of underlying asset	Dividend paid on the underlying asset	Time to expiration on the option	Riskless interest rate (duration of the option)
Determinants of value of real options	Present value of expected cash inflows	Present value of expected outflows	Uncertainty of expected cash outflows	Value lost by waiting to exercise	Investment opportunity duration	Riskless interest rate
Management of real options	Increase	Reduce	Increase	Reduce	Increase	Not manageable
Examples of associated blurred strategies	Create Business webs with low-cost suppliers	Invest in intellectual capital, not on tangible assets	Accelerate innovation and R&D	Lock-up critical resources	Create Business webs with customers	
	Create standards and platforms	Design assets to be easily reconfigured	Let the market manage offer	Develop structural capital	Maintain technology lead	
	Increase Marketing expenses	Leverage economies of scale	Organize for instability and adaptability	Lock-up customer base	Lock-up distribution channels	

Lastly, the complexity of the environment requires the monitoring of value creation not only through financial indicators, but also through non-financial indicators. Value Based Management still consists too often in implementing one or several financial indicators on which people are required to focus on, without attempting to understand the strategic, organizational, and human factors that will enable the company to create a real long-term value. On the contrary, those are the factors to focus on, after understanding their relationship with the share price.

One of the most effective techniques for identifying these factors is the construction of value scorecard for each business unit within the company. Based on a very participative approach, it consists of creating, within a management team, a consensus around the strategic goals and the competitive edges required for success. Then, the major key value drivers in a shareholder / customer / process / human resources perspective, and their interactions are identified within the context of value creation. Finally, a few relevant indicators are determined on the four above-mentioned axes. These scorecards are then drilled down at every operating level of the strategic unit. They offer the management precious indications about the company's management, which can be reused within the context of "shareholder connections".

These three axes tend to reassure the shareholders on the company's capacity to execute its strategy, and we have already mentioned how vital this can be for the share price. Obviously, these operating decisions must be complemented with significant and consistent financial policies.

¹¹ Measuring value in the connected economy, J-F Rérolle, Prométhée, Londres, 24 juin 1998.

Financial decisions (dividend policy, stock buyout, demergers, financial structure, etc.) do not create value as such. However, they support operating decisions and make it possible to send strong signals to the market. For example, the decision to buy out stock falls within the scope of a mature company that no longer has enough investment opportunities to use its cash. Alternatively, cutting dividends for a company crippled by debt helps it notify the market of its decision to return to a leverage through which it can benefit from tax cuts without suffering from an excessive risk premium. Obviously, these signals are extremely difficult to handle and require a perfect understanding of the way financial markets operate in general, and of shareholder behavior in particular.

In the connected economy, the company has no other choice than to excel on the financial market. That is why it must develop a genuine financial marketing that consists of setting up a constant dialog with its shareholders and to communicate, above all, on its capacity to deliver its promises. Strategic execution and option management become vital.

Facing this new environment, managers must change their attitudes radically. They must accept the market's sanction, and seek a balanced and honest dialog with investors. More risky for them, they must grant their shareholder more frequent access to their organization and accept to set up direct debates with their executives. The osmosis between the real market and the financial market also consists of increasing the porosity of their respective borderlines.

Well conducted, financial marketing will provide the market with the means to value the company better. Then, the price of the stock will gradually become an essential management indicator for managers.

February 1999