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## Measuring The ROI Of Investor Relations

Management effectiveness is often assessed by the market price achieved for a public company's common stock. Not only is share *appreciation* an important component of shareholder return on investment, but a company's market *valuation* is mission critical to the public company's cost of capital. In its core business operations, an enterprise may have only a handful of direct competitors. But in the capital markets, that same enterprise competes with more than 12,000 publicly-traded U.S. rivals – for scarce investment capital.

High quality, transparent disclosure of material corporate information is the fundamental underpinning for maximizing shareholder value. It is also the basis for pursuing "best practices" investor relations. This principle has been reinforced by academic studies, including "Investor Relations, Firm Visibility, and Investor Following," by Brian J. Bushee (The Wharton School) and Gregory S. Miller (Harvard University in January 2005; "Corporate Disclosure Policy and Analyst Behavior," by Mark Lang and Russell Lundholm, *Accounting Review*, 1996; and "Disclosure Level and the Cost of Capital," by Christine Botosan, *Accounting Review*, 1997.

The search for shareholder value – and share price – is one of the most daunting challenges faced by the public company manager. Every executive aims to allocate scarce capital to its most productive uses, but to generate lasting economic value (and to attract and retain investors), managers must earn rates of return for their shareholders that exceed the returns offered by other investment instruments. In addition, the manager must earn a rate of return in his operations that is higher than the cost of the capital used to fund the enterprise.

It is problematic that the returns on capital usually lag its investment. A company's quarterly research & development expenditures might take years to recover with the sale of a new product. A new advertising campaign will take weeks or months to design and implement – but often longer to realize a significant improvement in revenues.

A capital investment in investor relations is no different. Most public company managers acknowledge the importance of effective communications with the capital markets, but the return gained from an investment in investor relations is still largely viewed as intangible – and difficult to quantify.

Nothing could be further from the truth. Investor relations is a vital means for bridging the time difference between capital investment and economic return in the company's business operations. Moreover, quantifying the returns from investments in investor relations is as methodical a process as managing every other aspect of the business.

Management's principal fiduciary duty is to achieve the highest sustainable fair market value for its securities. The mechanism of capital allocation known as the stock market is neither infallible, nor entirely automatic. Based on all available information, investors constantly revise their estimates of future economic value a company might generate. The dynamic and complex nature of the capital markets must, by necessity, challenge management to isolate the effects of effective communications from broader market forces. Sadly, management's dissatisfaction with its communications effort often arises after an "earful" from one or more outside shareholders.

But the enlightened public company manager is increasingly proactive. He or she knows that effective communications (i.e., "best practices" IR) will have a profound impact on three measurable results:

- Company Valuation
- Share Liquidity
- Composition of Share Ownership

### Benchmarking

The first step toward measuring the impact of IR is to thoughtfully assess the company and its current strategies for enhancing stockholder value. The assessment

includes a calculation of financial ratios commonly employed by professional investors, as well as non-financial, company-specific criteria. Understanding “where we are” and “what we are doing” are necessary steps to achieving “where we want to go.” Toward this end, management must place itself in the shoes of the professional investor evaluating a company from the outside in.

### Valuation Benchmarks

How the stock market values a company and its prospects is reflected in its market capitalization. Numerous models are available to estimate a company’s intrinsic net worth on a discounted cash flow basis. These may be derived from such factors as its operating profit margins, forecasted long-term growth rate, cost of capital, and other inputs. And yet, fluctuations in market sentiment lead to alternating periods in which the shares of a company will sell at a significant discount or premium to its “rational” value.

A more useful method for benchmarking a company’s current valuation is to compare it to its peers. Usually viewed by industry sector, they may also be considered according to market capitalization or growth characteristics. This benchmarking process determines how the market is valuing a company relative to its “comparables” based on key valuation ratios: price-to-earnings, price-to-earnings growth, price-to-cash flow, price-to-sales, price-to-book value, or “enterprise value” to EBITDA, for example.

To be comprehensive, a study of comparables should also analyze financial performance metrics, such as sales growth, operating margin, asset turnover, and return on equity, among others. The relative weight given to each of these metrics will vary, and should reflect those considered most important by professional investors who specialize in a particular industry or sector.

If this analysis identifies a valuation gap that cannot be accounted for by financial performance, then a more comprehensive investor relations program is mandated. For example, if a company is growing sales and earnings faster, and with a higher return on equity than its peers, but its price-to-sales and price-to-earnings ratios are *lower* than its peers, then there is a valuation gap. The corporate story needs to be more effectively communicated to the capital markets. The current IR effort is simply not getting the job done.

### Liquidity Benchmarks

No less important to measuring an investment in corporate communications is the liquidity for a company’s shares. Rightly or wrongly, valuations in modern capital markets are largely driven by professional or institutional investors. Insufficient share liquidity (which al-

lows the larger investor to buy and sell larger size positions) is a major barrier to stock sponsorship by these sophisticated investors. This hinders achieving sustainable share valuation.

Like valuation, liquidity can also be benchmarked. What is the average daily trading volume for a company’s shares? More subtly, what is the spread, or point differential, between the bid and ask prices? How does volume and spread compare to other companies with similar market capitalizations, or vs. companies with a similar number of shares in the publicly-traded “float?”

A “liquidity gap” impairs the stock’s marketability and contributes to excessive volatility. Both of these factors can cause the market to discount share prices. Consequently, a liquidity gap increases the cost of capital. If the company needs to sell more shares to secure growth capital, a lower priced company will necessarily suffer greater dilution of its ownership.

### IR Activities

Finally, in determining what sort of IR program might be required, management needs to dispassionately benchmark its current IR initiatives. Compared to its peers, what is:

- The frequency of press releases?
- The level of forward-looking guidance provided?
- The detail and quality of voluntary disclosure?
- The relevance of investor information kits?
- The adequacy of the investor section of a company website?
- The participation in investor conferences?
- The attendance on conference calls?
- The coverage in financial and trade press?
- The number of sell-side analysts covering the company?
- The percentage of shares institutionally owned?

In addition to these measurable elements, accurate benchmarking also employs interviews with a cross-section of the investment community. What are current investors’ perceptions of the company? What are the concerns expressed about the company by security analysts who are knowledgeable about the industry? If the external analysis of the company’s prospects and competitive position varies significantly from that of management, then there is a “communications gap” that can only be bridged by a more effective IR effort.

### **Budgeting An IR Program**

Once a company has been thoroughly benchmarked by valuation, liquidity and current IR considerations, management is in a position to make an informed judgment. Is the current IR program adequate? If not, what is the expected magnitude of improvement from investing in a comprehensive, “best practices” IR approach? Such an

analysis is crucial to evaluating a proper expenditure level.

Cost items included in the investor relations function will allow for consulting fees, internal personnel directly allocated to the function, appropriate indirect support, and direct expenses such as travel, wire services, website design, and printed materials. They will also include the company's investor materials: annual report, Form 10-K, Form 10-Q, and proxy statement. Many companies are already spending money to produce these documents. But are they producing them with their maximum potential shareholder benefit in mind?

Excluded from the investor relations expense calculation are legal expenses related to the Form 10-K, 10-Q or proxy, preparation of SEC filings such as Form 8-K, as well as other public relations, marketing or advertising expenses.

There are four common ways for budgeting the investor relations function:

1. Percentage of revenues
2. Percentage of S,G,&A
3. Percentage of market capitalization
4. Event-driven

Companies that have revenues growing at a faster rate than S,G,&A might favor the percentage of revenues model. In the case of a company with \$50 million in sales, an annual budget of one-quarter of one percent (\$125,000) to one-half of one percent (\$250,000) would be appropriate. Development stage companies with little or no revenues should favor the percent of S,G,&A model.

Since the cost of capital is a function of market capitalization, and since many executive compensation packages are structured to increase with the growth of the company's market capitalization, employing the percentage of market capitalization model is popular. For example, if a Nasdaq-listed company has a market capitalization of \$100 million, it would be appropriate to budget one-quarter of one percent of the market cap (\$250,000) and adjust the budget as the market cap changes. A number of core expenses required for servicing shareholders exist regardless of company size. Therefore, it is appropriate to budget a higher percentage of market cap for early stage companies, and a smaller percentage as a company grows and matures.

The fourth budgeting approach for IR is event-driven. If a new element to the business plan is being introduced, such as an acquisition, new product line, or key management addition, then disproportionate expenditures in IR can promote market recognition of these positive developments. The company might even rationalize a portion of the higher IR expenditure to be a capitalized cost — linked to an acquisition transaction.

However, there is a downside to trying to build an IR initiative purely on an event-driven basis. Management will lose its credibility if investor communications are seen as inconsistent, or transparently related to financing needs. Moreover, short-term efforts that are not part of a long-range IR strategy contribute to increased share price volatility. In turn, this increases the company's cost of capital by raising the "hurdle rate" of return that investors demand for high beta stocks.

The aforementioned academic studies note the close connection between share appreciation, market visibility, trading liquidity — and direct meetings with management. Indeed, rational analysis makes a case that the cash expense required to execute an investor relations program based on best practices is trivial in relation to the potential rewards. The more serious issue may be the opportunity cost that investor relations activities (or lack thereof) impose on senior management — time that could otherwise be devoted to managing operations and evaluating new growth opportunities.

Especially for emerging growth companies, institutional investors expect the opportunity to evaluate corporate strategy and the quality of management through personal contact with senior officers. CEO's and CFO's might *budget* 10% of their time to deal with investor-related issues, but such matters often *consume* 40% to 50% of senior management's time.

This is where an outside IR firm makes a difference. By helping investors through the myriad of initial due diligence questions, the IR professional can reduce the amount of time spent by the CEO or CFO explaining the business to people just *considering* an investment in their stock. By actively screening the seriousness of interest from either buy-side or sell-side analysts, as well as prospective individual shareholders, it is possible to improve the "yield" realized from time spent in meetings with the investment community.

In budgeting the IR function, *the company should aim to build an investor relations program that achieves its strategic objectives even while leveraging management's time to its greatest effect.*

### Measuring The Returns

The benchmarking process described earlier provides us with a basis for measuring improvements in valuation, trading liquidity, and share ownership.

Obviously, the most direct measure of IR performance is share price performance relative to an appropriate market index, industry peers, and the company's own price/earnings multiple trend line. If in the benchmarking process a clear valuation gap was discernable, one expects a newly installed IR program to produce higher share prices and an expansion of the P/E ratio relative to

the broader market and its industry peers. *The transparent disclosure of company events and material information communicates the clarity of the business model and the visibility of projected future growth.* Consequently, the company may receive a higher valuation in the capital markets.

Equity research by sell-side firms is a treasured commodity these days. If a company has NO sell-side coverage, adding even one analyst is a major investor relations achievement. Additional analysts will validate the story and future earnings targets. A good investor relations effort also encourages analysts to publish their thoughts about the company more frequently. In addition to issuing notes on earnings reports, a proactive analyst also comments on corporate milestones being achieved. So, in this case, the measures are how many Wall Street firms are covering the company and how frequently are they writing?

Efficient market theory suggests that a company's shares will be positioned in an optimum "trading range" once trading volume increases, improving share liquidity. The level of liquidity, or lack thereof, significantly influences the "equity risk premium" reflected in the share price. Various academic studies support this premise, including "Disclosure Policy, Information Asymmetry, and Liquidity in Equity Markets," by Michael Welker, *Contemporary Accounting Research*, 1995; "Determinants of Bid-Ask Spreads in the Over-The-Counter Market," by George J. Bentson and Robert L. Hagerman, *Journal of Financial Economics*, 1974; and "Is Information Risk a Determinant of Asset Returns?" by David Easley, Soeren Hvidkjaer, and Maureen O'Hara, Cornell University, 1999. In short, an increase in the frequency and quality of disclosure should result in measurable improvements in daily trading volume, as well as a reduction in the bid-ask spread.

Today's financial marketplace is dominated by institutional investors, particularly the new breed of professional investor represented by hedge funds (proprietary investment partnerships). Consequently, increasing institutional ownership can be one of the most important catalysts to sustainable share price appreciation. Broadening the composition of share ownership, particularly increasing institutional "sponsorship," is an important and *measurable goal*. It may be challenging for small companies, but a realistic goal after implementing a best practices IR program is to increase institutional ownership to 5% to 10% of the public float.

### The Payoff

The process of creating lasting shareholder value is achieved by aligning best practices IR activities with a clearly articulated growth strategy. It also helps to nur-

ture a corporate culture where the creation of economic value permeates every level of management decision-making.

If through an effective investor relations program the company could increase its price/earnings multiple from 15X to 20X, then a stock trading at \$4.50 would rise in share price to \$6.00, or roughly 33%. The result of this valuation shift is a dramatic reduction in the cost of capital.

Allocating the proper resources to a professional, "best practices" investor relations effort produces measurable benefits, rewarding all shareholders.

*Equally important, it contributes significantly to the company's competitive position because additional capital is raised with less dilution. It also allows management to provide better rewards to employees through stock options. And finally, management can more effectively use its common stock as an alternative currency in prospective M & A transactions.*

A corporate culture focused on value creation, when combined with appropriate performance incentives for management and an effective investor relations program, creates an environment where truly spectacular shareholder return is created over time.



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