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Christian Nielsen, Edward Vali, Rene Hvidberg,
Jesper Timmermann Jensen & Thomas Pihlkjær Madsen

Business Models, transparency and efficient stock price formation: Conclusions and practical advice from a research project into Investor Relations best practice

Accounting
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Authors

Christian Nielsen, Edward Vali, Rene Hvidberg, Jesper Timmermann Jensen & Thomas Pihlkjær Madsen

Department of Business Studies

Aarhus School of Business, University of Aarhus

Denmark

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Executive Summary

The purpose of this research project has been to clarify and provide expert advice on how to create a sufficiently transparent business model. Too many companies are assessed solely on the basis of factors that have direct influence on their share price, for example changed depreciation principles and the lack of growth of competitors. This is a problem, because the company is deprived of having its own direct influence on its share price, which often leads to hasty short-term decisions in order to meet the expectations of the market and to benefit its shareholders in the short term. On the basis of this, our hypothesis is that if it is possible to improve, simplify and define the way a company communicates its business model to the market, then it must be possible for the company to create a more efficient price formation of its share.

To begin with, we decided to investigate whether transparency has an impact on a company's price formation. In this respect, we analysed whether those companies that publish a lot of information that may support a business model description tend to have a more efficient price formation. Next, we turned to our sample of companies, and via interview-based case studies, we managed to draw conclusions on how to construct a comprehensible business model description.

The business model explains how the company intends to compete in its market, and thus it gives an account of the characteristics that make the company unique. The business model constitutes the platform from which the company prepares and unfolds its strategy. In order to explain this platform and its particular qualities to external interested parties, the description must provide a clear and explicit account of the main determinants of the company's value creation and explain how the operational and tactical strategies complement each other. This brings us to the following definition of a business model:

A business model is a representation of the company's concept. The concept shows in what way the company is trying to establish a unique identity in the market in comparison to its competitors. The business model description must therefore give an account of the platform that makes the company competitive, and it must be consistent with the company's objectives, means and strategy in relation to its value creation. Thus the business model reflects the relation between the resources, processes and services that make the company profitable in the long term. The main conclusions of our analysis are stated in the following. These conclusions form the basis of the 10 practical guidelines in the last section of this research note, which provide recommendations on how a company should explain its business model to external interested parties.

Conclusion A:

The information provided in the annual report is no longer regarded as a satisfactory proxy for the company's total information and communication level. To overcome this problem, we have constructed a Transparency Index which includes an account of the investor relations division's activity level as well as the more indirect information level through annual reports, stock exchange announcements or homepages. Among the most important factors are:

- The paramount factor which correlates with the level of information on the homepage is the size of the company. The fact that large companies use homepages to a much larger extent than small companies is a paradox since this information channel is one of the cheapest ways to mass-communicate with the capital market.
- In line with Verrecchia's ´Cost of Disclosure` theory, our analysis showed that the larger a company is, the more information will be communicated to the market.
- Type of industry was not found to have any impact on the companies' level of transparency.
- The study indicated that there was a negative correlation between P/BV and transparency. This is quite surprising, since the common perception is that companies with a great difference between book value and market value have greater incentives to inform the market of their true value.
- The companies that had a large amount of shares tied in strategic investments, i.e. less free float, had a higher level of information. This result is quite interesting, since companies with a large free float typically are associated with high levels of information.

We would like to have answered the following question:

What effect does IR have on price formation?

The answer to this question could be found by relating the IR activities to transparency. However, due to the nature of the data and the low response rate, it was difficult to incorporate IR into the regression. Therefore, the IR activity level was compared to the spread in consensus estimates, and these were then incorporated into the regression. Tests based on more detailed data may be carried out in future work, but this will require answers from a relatively large population and preferably from more companies than there are members of DIRF at the moment.

We are able to conclude, however, that there will be a positive, significant coefficient to the consensus estimates in the years to come. This indicates that if the companies intensify their IR activities, the standard deviation of the consensus estimates will increase. This is due to information confusion. Turning to the information value in relation to the consensus valuation for the period that stretches more than a year, we see a negative correlation. This means that the companies that communicate a lot of information may have lower standard deviations in the long term. As a result, the information that comes from IR may be of a more strategic or market oriented nature and thus long-term.

As expected, the group of companies that had the highest degree of transparency also had the lowest cost of capital. Oppositely, we were quite surprised to see that the companies placed in the middle group had the highest costs of capital. Our results thus indicate that it is advantageous to either communicate a lot of information or not to communicate any information at all.

Conclusion B

When communicating a company's business model, it is important to differentiate between private and institutional investors. The first question is therefore: Who do we wish to attract? Thus we operate with two different scenarios; one for the private and another for the institutional investors.

Scenario 1: The company wishes to attract private shareholders and other private individuals, for example potential employees etc.

- This group does not consist of professionals. The group members need to know which variables drive the company's competitive strength and results, and this should be presented to them in a structured and straightforward manner.
- Non-financial information in the form of figures and text does not necessarily need to be closely linked to financial outcomes with detailed causal relationships. Rather, when communicating to this group, the non-financial information should be accompanied by statements on how the company's goals are supported by action plans.
- Information regarding the company's business model should be published in the annual report or on the company's homepage. The same structure should thereafter also be applied, when communicating information about the company in e.g. company presentations to these private investors.

Scenario 2: The company is primarily interested in attracting institutional investors, analysts etc.

- This group is likely to possess thorough knowledge of the company, and the members may have followed the company for a long time. The group is particularly interested in detailed financial information to update the mosaic of information that it already has.
- Here the role of the company's business model is threefold:

  1. It may function as the investor relations division's own structure for the underlying equity story and thus improve the consistency of the communicated information.

  2. It may form the basis of a talk between the analysts and the company about which information in relation to the different elements of the business model the analysts and the investors would like to receive. The company may benefit from the analysts' and investors' opinions about the business model, and it may therefore be a good idea to discuss the following questions with them: Do you agree that this is the right business model for our company? Would a different business model make the company more profitable?

  3. It may be an explicit model that structures the non-financial reporting.

Conclusion C:

It is not the aim of this project to work out a tight model of how companies should report their business models to the outside world in the style of the Danish Guideline for Intellectual Capital Statements. However, we will provide some guidelines and give a few examples of how companies can improve their business model practices. It is a good idea to incorporate non-financial information into the management commentary, and this should then be distributed via the annual accounts or another public medium, e.g. the internet. Below, we give three metaphors for the business model, namely the story, the value chain and the onion.

1. In order to provide the reader with a full understanding of the business model, it is important to present a coherent story about the company's value creation, e.g. by providing insight into the interrelations that induce value creation which are present in the company. Moreover, the non-financial information should include a follow-up on the company's strategy plans and the status of the development in the business model in order to ensure consistency over time.

2. A business model can be seen as a regression of the company's value creating elements, where the elasticities belonging to the identified variables are explained in words or by figures, and where

the connections between the value creating elements are explained. However, a business model should not necessarily be understood as a value chain, and it should therefore not necessarily be reported as one.

3. An alternative way of looking at the business model is through the so-called onion metaphor. Here, we start by describing the core, namely the company's cash flow, and then we move outwards through the different layers of the company. The further away from the core (cash flow), the better view of the size of the onion we get. We will fairly quickly be informed of the most important aspects of the company's value creation, and we may stop, when we feel that we have gained sufficient knowledge about the company

Conclusion D:

Transparency can be linked to a high level of information, but it is often also associated with a simple way of communicating. Many respondents seem to believe that transparency can be gained by structuring communication around a model of how the company creates value. However, we only found a few good examples of how this can be carried out in practice. The companies incorrectly assume that the receivers of the company's communication have the same perception of the company's logic/model as the company itself.

- Transparency differs in the short and the long term. In the short term, it is a question of accessibility and newsflow, whereas in the long term, it is about strategy, access to resources and market prospects.
- Transparency also differs in terms of private and institutional investors. For private investors, transparency is associated with getting a quick and precise understanding of the concept behind the company. For the institutional investors, being able to screen and structure the enormous amounts of information that they have access to in their decision-making is the essence of transparency. In both cases, the company's business model is a useful tool.
- In some cases, the external partners' impression of a company's transparency has nothing to do with the disclosure level or the IR activity level. Rather, transparency is related to the company's policies regarding internal control and governance, i.e. governance structures and structures concerning risk handling and knowledge sharing.

Conclusion E:

A business model description is a forward-looking statement which goes beyond an identification of the company's immediate cash flows. In capital market language one would say: It is a statement about how the company will survive longer than till the end of the budget period. This means that when describing ones business model, it is not enough to talk about the company's historic development, not even if it includes a historic value creation, the company's concept and how the company's objectives and strategy have turned out.

Another central tool when describing a company's business model is to support facts by non-financial performance measures. One thing is to state that one´s business model is based on mobilizing customer feedback in the innovation process, another thing is to explain by what means this will be done, and even more demanding is proving the effort by indicating: 1) how many resources the company devotes to this effort (in turn revealing management´s focus on the issue); 2) how active the company is in this matter, and whether it stays as focussed on the matter as initially announced; and 3) whether the effort has had any effect, e.g. on customer satisfaction, innovation output etc.

Conclusion F:

The term consistency plays a vital role in relation to transparency. However, different perceptions of what consistency actually means exist. Thus we identified two different approaches, namely consistent information and consistent communication.

- Consistent information, i.e. reporting the same information every year on the same pages in the annual report. This makes it easy for the external reader to find the information he needs. This perception of the term was held by the CFO group of our respondents.
- To the investor relations group, consistency had a different meaning. Here, the term was associated with giving the same information at the same level of detail to all interest groups, preferably at the same time. Thus – consistent communication across information channels.

Conclusion G:

A business model description does not have to be a 100-page document. It may appear as part of the management commentary or a figure illustrating the organisation´s structure and value creation. The core of a business model description, or the elevator pitch, may be even shorter. Here are a few examples:

Danske Bank: The IT platform that we use means that our organisation is able to achieve larger synergies when buying up competitors. It enables Danske Bank to pay a larger premium, and by this, Danske Bank has more acquisition possibilities. At the same time, restructuring costs can be minimized.

Vestas: Vestas' ideas about windmill construction are built upon tight control and vertical integration. At present, Vestas is moving beyond its role as technology leader and innovative windmill manufacturer to providing windmill projects.

LM Glasfiber: As opposed to Vestas, LM Glasfiber believes that within the windmill industry, it is advantageous to be specialised, and thus not vertically integrated.

GN Store Nord: Technological trendspotter of headsets

In this way, the idea behind a company's business model can be described in few, and even very few, words – just like an elevator pitch.

Conclusion H:

As we have seen, the elevator pitch provides a precise account of the core elements of the company's business model. However, it is also important that the company is able to explain how its business model performs, i.e. how do the operations of the business perform? How does the strategy work? How do the elements that the company use to become unique interact?

In the case of Coloplast, for example, it is essential that the company actually manages to use customer feedback in connection with the implementation of new products.

In the following, we list a number of questions that a company may ask itself in order to produce a description of its business model. A business model is basically concerned with explaining the factors that make the company competitive; however the company should ask itself:

1. Which proposition about value creation do we wish to sell to our customers?
2. Which elements do we wish to optimize through the company's value creation?

3. In what way is the company's performance unique compared to its competitors?

- Do we have a strategy that differentiates us from our competitors?

4. Are there any critical connections between the different phases of the company's value creation?

- Can we illustrate this graphically?
- Can we describe the efforts that we are undertaking in order to improve ourselves?
- …and can we support these by performance measures?

5. Which resources, systems and competencies must we possess in order to maintain our strategy?

6. What risks can undermine the success of this model?

- What do we do to control or minimize these risks?

7. What measures do we take to ensure that we possess the competencies needed, and what do we do to develop and upgrade these competencies?

8. Can we measure the effect of the initiatives that we have carried out in order to improve ourselves, become more innovative or more efficient?

- I.e. by other means than the bottom line?

Conclusion I:

Investor relations are primarily directed towards the institutional actors in the market for information. However, although the investor relations activities are not aimed at private investors (i.e. in influencing the investor types in the shareholder base, institutional investors are of primary interest), the business model may form an excellent basis for a general and down-to-earth description of the company's activities.

10 guidelines for communicating the Business Model

On the basis of the main conclusions of this project, presented in Section 1, we have prepared 10 guidelines that can be useful to companies when explaining their business model. These guidelines express the subjective conclusions of what we believe is the easiest way of explaining a business model in practice.

1. Describe the strategy platform

A business model describes the platform by which the company puts its strategy into practice. This platform may differ significantly between companies. In the case of Danske Bank, the IT platform is the key that enables a smooth M&A. In Coloplast, the customer feedback platform is leading the company to innovative products. B&Os products are based on the design-, functionality- and lifestyle-platform. In A.P. Møller, it is their cultural and financial platform that makes the company unique. And Bavarian Nordic's technological platform may in time blaze the trail for new market segments.

The business model framework provides the companies with a tool to structure their information and communication – their supplementary report/management review/non-financial reporting and the investor site on the company's homepage.

2. Create a connecting story of value creation

It is crucial for the readers' understanding of the business model that the company presents a coherent picture of the company's value creation, e.g. by providing an insight into the interrelations that induce value creation in the company. Moreover, the non-financial reporting should follow up on the strategy plans and development in the business model in order to ensure consistency over time. A business model can be seen as a regression of the company's value creating elements, where the elasticities belonging to the identified variables are explained in words or by figures, and where the connections between the value creating elements are explained. However, a business model should not necessarily be understood as a value chain, and it should therefore not necessarily be reported as one. An alternative way of looking at the business model is through the so-called onion metaphor. Here, we start by describing the core, namely the company's cash flow, and then we move outwards through the different layers of the company. The further away from the core (cash flow), the better view of the size of the onion we get. We will fairly quickly be informed of the most important aspects of the company's value creation, and we may stop, when we feel that we have gained sufficient knowledge about the company

3. Focus on the connections and the interrelations

The core of a business model description is the connections between the different elements that we traditionally divide the management review into. Companies often report a lot of information about e.g. customer relations, employee competencies, knowledge sharing, innovation and risks, but this information may seem unimportant, if the company fails to show, how the various elements of the value creation interrelate, and which changes we should keep an eye on.

4. Be explicit about the organisation's whereabouts in the value chain

Place the company in the industrial value chain and use this as a basis for comparing the company with its closest competitors. What are the advantages of the different ways of controlling resources and customers both upstream and downstream in the value chain? An example of this could be a comparison of LM Glasfiber and Vestas' different perspectives on the value chain in the wind energy sector, or DLH's approach to import of wood.

5. Avoid empty expressions and buzz-words

Avoid empty expressions such as: ”We are innovative”. What is really interesting is why and how the company is innovative. The reader wants to know in what way the company differs from its competitors. Other empty expressions could be: “We want to be market leaders” and “Knowledge is our greatest asset”. Furthermore, it is important to avoid buzz words, especially if the company has many private investors.

6. Be aware that transparency has different meanings

- Transparency means being able to explain the different aspects of value creation across the value chain, and how these aspects affect the company's bottom line.
- Transparency varies according to the time horizon. In the short term, creating transparency is concerned with accessibility and news flow, whereas in the long term, transparency is concerned with creating an understanding of strategy, access to resources and market developments.

- Transparency varies between private and institutional investors. For private investors, transparency is about creating a simplified understanding of the company's concept. For institutional investors, transparency is about filtering and structuring the massive amounts of information available for their decision-making. In both instances, the company's business model is a good point of departure.

7. The broad information channels have the highest influence on transparency

The wide information channels still have the greatest influence on transparency. Communication via the company's homepage thus proved to have the most significant influence on transparency. The paramount factor correlating with the use of homepages was the size of the company. Thus large companies use homepages to a much larger extent that small companies, which is quite a paradox since the internet is one of the cheapest ways to mass-communicate with the capital market.

8. Use the spread in consensus estimates as a measure of IR success

Use the spread in consensus estimates as a useful indicator when the company is followed by more than five analysts. There is a positive, significant correlation between the company's IR activities and the consensus estimates for the coming year. This could indicate that if the company intensifies its IR activities, then the standard deviation for the consensus estimates will grow. This may be due to information overload.

Consensus estimates with a time horizon beyond one year will give a negative correlation. This means that companies with higher information levels may have lower standard deviation levels in the long term. The information that is conveyed through IR is of a more strategic and market-oriented type and therefore concerns the long-term perspective. Companies with a large amount of shares tied in strategic investments, i.e. less free float, had a higher level of information. This result is quite interesting since companies with a large free float typically are associated with high levels of information.

9. Explain the Business Model as a forward oriented statement

A business model is a forward-looking statement which goes beyond an identification of the company's immediate cash flows. In capital market language, one would say: It is a statement on how the company will survive longer than till the end of the budget period. This means that when describing one´s business model, it is not enough to talk about the company's historic development, not even if it includes an account of the company’s historic value creation, the company’s concept and how the company’s objectives and strategy have turned out.

10. Establish trustworthiness through performance measures

Another central tool when describing a company’s history is to support facts by non-financial performance measures. One thing is to state that one´s business model is based on mobilizing customer feedback in the innovation process, another thing is to explain by what means this will be done, and even more demanding is proving the effort by indicating: 1) how many resources the company devotes to this effort; 2) how active the company is in this matter, and whether it stays as focussed on the matter as initially announced; and 3) whether the effort has had any effect, e.g. on customer satisfaction, innovation output etc.

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Department of Business Studies

Aarhus School of Business
University of Aarhus
Fuglesangs Allé 4
DK-8210 Aarhus V - Denmark

Tel. +45 89 48 66 88
Fax +45 86 15 01 88

www.asb.dk