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The Complexities Of Corporate Signaling

William J. Dragon

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Monitoring corporate signaling practices can and should play an important role in competitive intelligence practitioners' repertoires (See "Competitive Insights From Corporate Signaling" *Looking Out,* December 2007). Changes to dividend policy are often regarded as one of the most salient signaling mechanisms. More often than not, however, organizations will use a suite of signaling techniques tailored to meet the unique environment in which they operate. In other words, industry structure, competitive market forces, and the competition's intent all play a role in management's signaling strategies.

And this makes sense. There is real benefit to be had -- such as lowering cost of capital -- from disclosing relevant information about the directionality of an organization's revenue streams. Fortunately, there exists a delicate balancing act that management must conduct when choosing between the benefits of releasing proprietary information and the associated costs. It is in this balancing act that insight can be had.

For example, consider firms that operate in industries with relatively low entry barriers. These firms are less inclined to rely solely on accounting disclosures as the cost associated with releasing proprietary information likely exceeds costs associated with stock repurchases and/or dividend policy alterations. So what might this mean for an intelligence professional?

For starters, an analyst whose knowledge of an industry is more robust might spend less time poring over SEC filings and annual reports, choosing instead to monitor changes in capital structure and alterations in an organization's payout policy. Moreover, that same analyst might be more apt to recognize that a voluntary accounting disclosure represents a major signal about the future prospects of the organization, its strengths and weaknesses, or trigger a more detailed investigation.

Similarly, the nature of the competitive environment can play an important role in an organization's signaling strategies. Firms operating in industries with high concentration ratios (a measure of the relative size of firms relative to their industry as a whole) often have higher political costs and will shy away from signaling via accounting disclosures to avoid government attention. In such cases, analysts would be wise to focus on a firm's dividend and repurchase policies.

But that's not all. Consider the insight that might be had from changes in payouts from a firm in a nearly monopolized industry. What might a substantial payout convey about the prospects of the organization, pending regulation, or the industry as a whole? While this question can't be answered with signaling analysis alone, this new piece of intelligence can add depth and texture to competitor and industry assessments.

Just as an intelligence analyst should pay attention to industry structure and the competitive environment, she should also be wary of her competition's short and long-term objectives. To be sure, organizations keen on delivering growth tend to re-invest excess capital. What if the proportion of excess capital retained begins to decline? Does that mean the organization anticipates slower growth? Again, the answer isn't going to be apparent but if our analyst knows that the competition has stated that its goal is to grow for its share-holders, faltering re-investment rates may signal an important and/or deliberate organizational change.

Unfortunately, these are not hard and fast rules. Careful judgement must be exhibited when conducting signal analysis and individual data-points are not likely to yield epiphanous insight. Nevertheless, these examples illustrate two things. The first is that monitoring the suite of corporate signaling efforts can play an important role in garnering insight on the competition. Importantly, however, these examples also illustrate that signal analysis can be much more valuable if it is paired with complementary analytical techniques, industry and competitive awareness.

William J. Dragon
Will is a Senior Consultant at Outward Insights, a Boston-area strategy and competitive intelligence consulting firm. He can be reached at wdragon@outwardinsights.com.
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