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Advertising expenditure, intangible value and risk: A study of restaurant companies

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Abstract

This study investigates the relationships between advertising expenditure, intangible value, and risk in stock returns of restaurant firms between 2000 and 2005. Tobin's Q was used to examine intangible value, and the variance of common stock return was used to measure the investment risk. The results indicate that the level of advertising expenditure has a significant positive effect on the intangible value of the firm, suggesting that advertising expenditures could help generate intangible value in restaurant firms. However, this study did not support a significant relationship between the advertising expenditure level and the stock return risk of restaurant firms.

Keywords: Advertising; Restaurant firm; Risk; Intangible value; Tobin's Q

1. Introduction

Advertising expenditure is one of essential budget items to support marketing activities for most companies (Zinkhan and Zinkhan, 1997). Researchers from many disciplines have attempted to identify the effects of advertising activities on corporate performance (Singh et al., 2005; Chauvin and Hirschey, 1993; Rao et al., 2004). According to Srivastava et al. (1998), advertising can create market-based assets that can contribute to the revenue increase, thereby enhancing overall shareholder value. Moreover, advertising expenditure is also found effective in creating awareness, enhancing consumer knowledge, and influencing both short- and long-term consumer preferences, and thereby generating additional revenue (Hirschey, 1982). Jones (1995) stated that advertising has multi-period effects on sales and market share and it could be a durable source of profit. Related empirical studies have reported that advertising expenditure has a positive relationship with a firm's intangible assets (Chauvin and Hirschey, 1993; Rao et al., 2004). Simon and Sullivan (1993) added that advertising positively affects brand equity through brand associations and perceived quality. However, despite the abundance of literature on advertising effects, there is no consensus on whether corporate advertising can create shareholder value and reduce risk for businesses at the same time.

Traditionally, advertising activities of restaurant companies aim to create awareness and to persuade consumers by establishing brand identity, creating demand, and positioning the brand (Mittal and Baker, 2002). According to Nation's Restaurant News (1999), there are more than 100 restaurant chains in the marketplace in the US market alone. Under the competitive environments of the industry, restaurant companies often spend more than million of dollars on advertising to promote their brands and to maintain their sales each year. Restaurant firms such as Yum! Brands, Inc., McDonald's Corporation, and Wendy's International, Inc. were listed in the Top 200 advertisers from July 2003 to May 2004, as revealed by the TNS Media Intelligence Company. However, regardless of the importance of advertising for restaurant firms, little has been done to investigate whether advertising expenditure can really be viewed as a form of investment in intangible assets with predictably positive effects on restaurant firms' market performance and stability. Thus,

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the aim of this study is to make a contribution to the stream of strategic management research by investigating the impact of advertising on intangible assets and risk/stability of restaurant companies. The results of this study can provide information on the benefits of investing in advertising and can help the management of restaurant firms to make marketing strategy and efficient resources allocation. In addition, this study can be helpful to stock investors in understanding the relationships of advertising expenditure to firm value and stock return risk and, consequently, can be beneficial to making investment decision for restaurant companies.

2. Literature review

2.1. Advertising expenditure and intangible value

According to Erickson and Jacobson (1992), advertising can enhance brand name recognition and create a brand premium so that the brand can command a higher price relative to competing products with almost identical physical features. Moreover, advertising can create an entrance barrier to prevent potential competitors from entering market because of the amount of money that must be spent on advertising to overcome the established brand loyalty of existing competitors.

The value relevance of advertising investments was first investigated by Comanor and Wilson (1967), who provided early evidence for the usefulness of advertising intensity as a proxy for product differentiation and entry barriers. They found a consistent relationship between firm-specific profit rates and advertising intensity. Following the work of Comanor and Wilson (1967), a growing number of studies have analyzed whether the effects of advertising are lasting. Peles (1970) examined the rates of amortization of intangible assets created by advertising in the beer, cigarette, and automobile industries and reported significant future effects of advertising in beer and cigarettes industries, but not in automobiles. Also, Hirschey (1982) examined the relationship between market values of firms and current period advertising, and concluded that advertising is long-lived and should be capitalized and amortized over time, rather than expensed at a period. Following Hirschey's (1982) study, Hirschey and Weygandt (1985) examined the relationship between the ratio of the market value of firm assets to an estimate of the replacement cost of those assets and firm ratios of advertising expenditures to sales. Their results concluded that advertising expenditure has positive and significant systematic influence on a firm's market value. Similarly, Chauvin and Hirschey (1993) confirmed Hirschey and Weygandt's (1985) conclusion. Recently, Joshi and Hanssens (2005) analyzed the direct and indirect effects of advertising on firm valuation and stated that advertising has a positive, long-term impact on a firm's market capitalization. Furthermore, McConnell and Servaes (1990), Morck and Yeung (1991), Bharadwaj et al. (1999), and Rao et al. (2004) all found advertising expenditure improves a firm's intangible assets.

Another stream of studies holds a different view on the effects of advertising. Bublitz and Ettredge (1989) compared the association of cumulative abnormal stock returns with unexpected advertising and R&D outlays; they concluded that R&D is long lived but advertising is not. Ravenscraft and Scherer (1982) also claimed that the effect of advertising is usually limited to the short term. Landes and Rosenfield (1994) argued that ignoring differences in firm-specific factors resulted in a substantial overestimate of advertising's useful life. In addition, Pauwels et al. (2004) stated that both advertising expenditures and new product introductions positively affect sales revenue in the short term and the long term, but only the strategy of new product introduction has significant and positive impact on shareholders' value. Marketing promotions not only have a negative long-term impact on a firm's market performance but also more than offsets its short-term benefit.

In sum, previous studies in economics, strategic management, and marketing provide theoretical and empirical support for the positive relationship between advertising and firm performance (e.g., Comanor and Wilson, 1967; Hirschey and Weygandt, 1985; Bharadwaj et al., 1999; Rao et al., 2004). Accordingly, we hypothesized a positive relationship between advertising expenditure and intangible value of restaurant firms.

H1. Advertising expenditures have a positive impact on restaurant firm intangible value.

2.2. Advertising expenditure and risk

While many studies examined how advertising spending influences a firm's profitability or market value, little has been done to link advertising expenditure to corporate equity investment risk (Singh et al., 2005). According to the theoretical framework developed by Srivastava et al. (1998), advertising can create market-based assets that may lower costs of sales, create price premiums through brand equity, and generate competitive barriers, therefore enhancing and stabilizing cash flow. Market assets also can increase shareholders' value by reducing cash flow vulnerability and volatility. Lower volatility and vulnerability reduce the risk associated with cash flows resulting in lower capital cost (Srivastava et al., 1998). Singh et al. (2005) argued that advertising could reduce a firm's risk by augmenting cash flow by increasing sale revenues and market share and by facilitating introduction of new products. Furthermore, they contended that advertising could create and sustain product demand, which in turn reduces the sensitivity of firm sales to external shocks. However, under the current US GAAP (Generally Accepted Accounting Principles), advertising and promotional expenditures are expensed in the same period incurred and they cannot be capitalized. When a firm expenses for advertising, there is an immediate effect of