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On the Value Relevance of Retailer Advertising Spending and Same-store Sales Growth

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Abstract

In response to recent calls to study factors that determine a retailer's stock price, this study draws on signaling theory to examine the impact of two key marketing metrics that are widely disclosed by retailers to investors, advertising spending and growth in same-store sales (COMPS), and highlights the moderating role of various firm- and sector-specific factors. Using a stock-response model estimated on a sample of 1,646 observations for 257 retailers, the authors find that the value relevance of advertising spending and COMPS depends on the financial condition of, and the competitive pressures faced by, the retailer. In addition, the positive effect of COMPS on stock returns is found to be stronger in the presence of decreases in advertising spending.

Keywords: Value relevance; Advertising spending; COMPS; Same store sales growth; Earnings; Leverage; Firm value

Introduction

In spite of recent assertions that "it would be particularly useful to develop an understanding of the factors that influence a *retailer's* stock price" (Petersen et al. 2009, p. 106, italics added), few studies have considered if (and how) investors react to unanticipated changes in marketing metrics in the *retail* industry. This is surprising, as an increasing number of studies have recently examined whether marketing metrics are value relevant, i.e., whether unanticipated changes in marketing metrics have a significant effect on stock returns, above and beyond the effects of conventional accounting and financial metrics (see Srinivasan and Hanssens 2009 for a recent review).

Interestingly, most prior research on the value relevance of marketing metrics either uses a cross-industry sample where retailers constitute only a small portion of the sample (e.g., Bharadwaj, Tuli, and Bonfrer, 2011; Mizik and Jacobson 2008),[4] or focuses on other industries, such as automobiles (Srinivasan et al. 2009) or pharmaceuticals (Gu and Li 2010). However, significant cross-industry differences are known to exist in the financial valuation of marketing metrics (see Jacobson and Mizik 2009). Accordingly, the primary objective of this study is to examine whether, and to what extent, two marketing metrics widely reported by retailers, advertising spending and growth in same-store sales, are valued by investors. The study draws on signaling theory (see Aboody and Lev 2000 or Cohen and Dean, 2005; see also Kirmani and Rao 2000 and Joshi and Hanssens 2010 for recent discussions in a marketing context), and seeks to contribute to the literature along three key dimensions.

Value relevance of advertising in a retail setting

First, the current study presents perhaps the first examination of the value relevance of advertising spending by retailers. While prior research has examined the link between advertising spending and financial performance for manufacturing firms or for a broad cross-section of industries, the findings have been mixed; some studies find a positive link, others, a negative link, and still others, an insignificant link (Kim and McAlister 2011).

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4 For example, the retail sector accounts for approximately 30% of the observations in Bharadwaj et al. (2011, p. 94).

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In a meta-analysis of 88 models linking market value to advertising spending, Conchar, Crask, and Zinkhan (2005) find the observed range of values for their effect to be very wide, ranging from −5.98 to +9.50, without a modal effect size. Moreover, most of the models studied were specified in levels, and therefore susceptible to the well-known spurious-regression phenomenon (Srinivasan and Hanssens 2009). Among the more limited set of studies with a change or growth measure as criterion variable, an insignificant meta-analytic effect was found.

Importantly, the question whether the same principles that apply for manufacturers hold for retailers as well remains unanswered (see Petersen et al. 2009, p. 109). While many retailers spend a significant portion of their marketing budget on advertising (Ailawadi et al. 2009, p. 52),[5] most prior research on advertising's effects on investors has taken a manufacturer's point of view (for example, Joshi and Hanssens 2010 focus on personal-computer and athletic-shoe manufacturers, while Srinivasan et al. 2009 study automobile manufacturers). However, there is a growing awareness of important differences between manufacturers and retailers in their communication objectives, tools and outcome measures (see e.g., Ailawadi et al. 2009, Table 1 for a recent overview). For example, Kumar, Shah, and Venkatesan (2006) argue that while manufacturers focus on brand performance, retailers are interested in the performance of an entire category or chain (Raju 1992), rather than in specific brands within that category (chain). Given these differences, it is important to also examine the value relevance of advertising spending in the retail sector.

Value relevance of COMPS

Second, the current study examines the value relevance of growth in same-store sales, an important metric that is widely reported by retailers. Growth in same-store sales is the year-to-year percentage change in the sales of stores open for at least 12 months. This industry-specific metric is often referred to as "COMPS" by analysts (e.g., Cole and Jones 2004), and is argued to be the most closely watched metric to assess retail performance (Curtis 2007). In their review of marketing metrics, Farris et al. (2006) call COMPS "at the heart of retail analysis" (p. 106), while Maxham, Netemeyer, and Lichtenstein (2008) include it as one of the most important store performance metrics. Importantly, analysts consider COMPS a credible signal of the marketing performance of a retailer (e.g., Carroll and Cwynski, 2006). For example, Motley Fool, one of the largest investor information websites, in describing the signaling value of COMPS, notes:

> "First and foremost, rising COMPS are good. They indicate that more people are coming to buy things at the stores, or are paying more for the same things they bought a year ago, or some combination of the two. Either way, sales are increasing without the added costs associated with opening new stores. This shows that marketing is doing well and that the brand is popular with consumers . . ." (Motleyfool.com, 2007, p. 1).

Moderator analysis

Third, the current study contributes to extant literature (see Table 1) by improving our understanding of contextual factors that affect the degree to which investors value marketing-related metrics, such as, advertising spending and COMPS, as recently called for by Kimbrough and McAlister (2009, p. 318). Developing hypotheses on, and empirically testing the role of moderators is important, as it advances theory development by identifying boundary conditions for existing theory. Whetten (1989, p. 492), for example, argues that "contextual factors set the boundaries of generalizability, and as such constitute the range of the theory." (For more recent arguments in support of the role of moderators in theory development, see MacInnis 2011, p. 144 or Yadav 2010, p. 7). Prior research (see Table 1) has predominantly focused on the main effects of advertising spending and COMPS. In contrast, we also examine the moderating impact of various contextual factors.

Specifically, we examine the degree to which the value relevance of COMPS is affected by unanticipated changes in advertising spending. This is important, as it allows us to assess the combined (and possibly synergistic) effect of two key marketing metrics disclosed by retailers. We also investigate to what extent the value relevance of both COMPS and advertising spending is contingent on signals of the firm's financial condition (i.e., firm earnings and leverage), and assess the moderating impact of a key indicator of the competitive environment faced by the firm, sector concentration.

We proceed as follows. First, we provide the conceptual background. Next, we describe the dataset and introduce the modeling approach used to test the hypotheses. After that, we discuss the empirical results, and conclude with a discussion of the implications of the study.

Advertising and comps as signals for investors

According to the efficient-markets hypothesis, the stock price of a firm reflects the discounted net present value of future cash flows (Fama 1998). Stock returns, therefore, reflect investors' opinion about a firm such that a positive (negative) stock return indicates a more (less) favorable investor evaluation of the firm. As such, if a marketing metric is likely to influence future cash flows, an unanticipated change in this metric (i.e., a change not expected by investors) is likely to have an effect on the stock returns of the firm (Mizik and Jacobson 2004; Srinivasan and Hanssens 2009).

Publicly-listed firms disclose both accounting and non-accounting metrics to investors in order to lower the information asymmetry between the investors and managers (see Aboody and Lev 2000; Cohen and Dean, 2005). This information asymmetry exists as a firm's managers will have more accurate information about the firm's future prospects as compared to investors (see Akerlof 1970). As such, unanticipated changes in such metrics constitute valuable signals for investors (Joshi

[5] In 2009, publicly-listed retail firms spent almost $29 billion on advertising. This figure is obtained by summing the disclosed advertising values in COMPUSTAT for all retail firms (SIC code 5000–5999).