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Organic growth and shareholder value: A case study of the insurance industry

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A B S T R A C T

This paper examines organic growth and its impact on shareholder value creation. At a conceptual level, organic and external growth are readily defined; yet, at a practical level, decomposing revenue growth into its constituent elements presents methodological challenges. We develop a method to decompose revenue growth into organic growth, external growth, exchange rate effects, and under- or outperformance. Using extensive data from three insurance companies, AXA, Generali and ING, we analyzed the period from 1995 to 2005. Exchange rate effects were of minor importance, unless companies entered markets at inopportune times. Primarily, the findings indicate that only organic revenue growth enhanced shareholder value. Therefore, managers should focus on marketing as a key driver of organic growth to create value.

1. Introduction

The realization of superior growth is of paramount importance to managers and shareholders (Srivastava, Shervani, & Fahey, 1999; Stremersch & Tellis, 2004). Growth strategies fall into two broad categories: organic, or core, growth and non-organic, or external, growth (Dalton & Dalton, 2006; Pecotich, Laczniak, & Inderrieden, 1985). Effective marketing can contribute to a firm's organic growth through better anticipation of market opportunities and calibration of risks, a tighter linkage of technological possibilities with market concepts, faster adjustments to shifting market needs and competitive moves, and winning and retaining customers (Day, 2003; Day & Fahey, 1988). Defining and decomposing revenue growth is the first critical step in assessing marketing's contribution to growth and value creation. At a conceptual level, it is possible to clearly define organic and external growth; however, at present there is no widely accepted method of delineating between the medium- and long-term impacts of organic and external growth strategies or a methodology to decompose revenue growth (Hess, 2006).

This paper fills a gap in the literature by developing a method to decompose revenue growth into three components: organic revenue growth, external revenue growth (due to mergers, acquisitions and divestitures), and exchange rate effects. After identifying the components of revenue growth, the impact on shareholder value can be assessed. As marketing is one of the main drivers of organic revenue growth, determining organic revenue growth and its impact on shareholder value is an indirect approach to measuring the relevance of marketing. The study focuses on the insurance industry due to the good access to market- and firm-specific data on revenue growth. The method of decomposing revenue growth can be applied to any industry, and the persistence modeling could be extended by inserting marketing-related variables to obtain a direct measure of the impact of marketing on organic growth and value creation.[1] We analyzed the revenue growth of three leading European insurance companies, namely AXA, ING and Generali, and addressed two research questions: (1) Do insurance companies rely primarily on organic or external revenue growth? (2) Does organic or external revenue growth enhance shareholder value?

The paper is structured as follows. First, following Srinivasan and Hanssens (2009) and Srivastava et al. (1999), who analyzed the relation between marketing and shareholder value creation, the conceptual framework is established. Second, a methodological discussion follows, highlighting the sample selection and the approach to defining and decomposing revenue growth. Third, the empirical analysis shows the importance of organic revenue growth in the insurance industry and assesses the impact of revenue growth on value creation. The concluding remarks stress the main contributions and limitations of this research and identify directions for future research.

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[1] Using marketing-related variables is not feasible in the insurance industry due to reporting issues (see Section 2.3).

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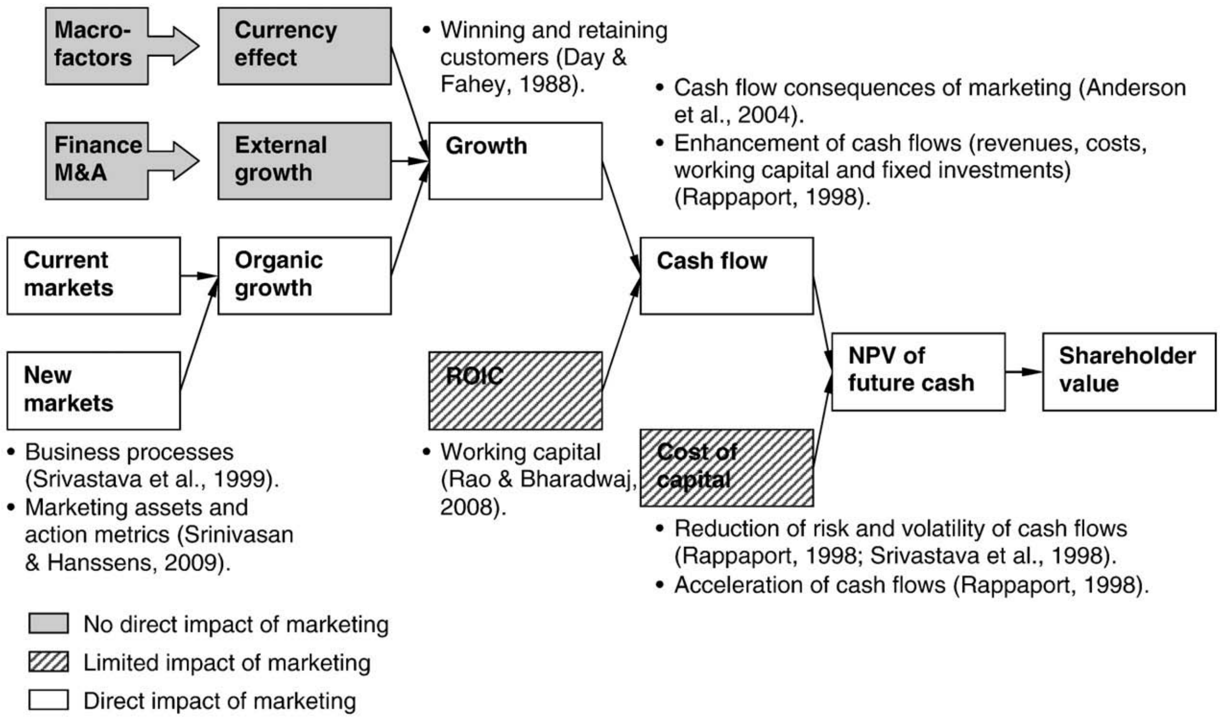

Fig. 1. Conceptual framework.

2. The conceptual framework

2.1. Value drivers, marketing and value creation

Srinivasan and Hanssens (2009) highlighted the marketing assets and action metrics that could affect shareholder value, and Srivastava et al. (1999) focused on a business process perspective of marketing. These studies established the relationship between marketing and value creation. A number of marketing scholars have focused on the cash flow implications of marketing (Anderson, Fornell, & Mazvancheryl, 2004) and the ability of marketing to enhance cash flows by increasing revenues, reducing costs, and reducing working capital and fixed assets (Rappaport, 1998). In addition, Rappaport (1998) stated that marketing could reduce the volatility of cash flows, which in turn would lower risk and thus reduce the cost of capital. Furthermore, Rappaport (1998) argued that marketing increases the speed of cash flows.

Despite a stream of research focusing on the impact of marketing on cash flows and the cost of capital, questions regarding its efficacy persist due to the influence of other firm- and industry-specific factors, which lead to endogeneity and causality issues. In particular, the impact of marketing on the cost of capital seems to be rather small, where capital structure, interest coverage, and risk premiums predominate as discussed in the finance literature. While marketing can influence cash flows, its effect on costs and fixed assets (e.g., property, plant and equipment) — as suggested by Rappaport (1998) — does not seem to be of major importance. Although Rao and Bharadwaj (2008) argued that marketing might reduce working capital and thus limit invested capital, which in turn would increase profitability (ROIC),[2] the magnitude of this impact is likely to be small due to other drivers of ROIC (e.g., asset utilization, industry-specific effects). According to Day and Fahey (1988), who stressed that the main function of marketing is winning and retaining customers, revenue growth seems to be the main lever for the marketing-shareholder value relationship.

External macroeconomic shocks (e.g., inflation, interest rates) cause exchange rate changes and affect reported revenue growth, meaning that growth due to currency effects does not reflect marketing practice. Companies can deliver revenue growth through mergers and acquisitions (M&A) or retrench business through divestitures. These external means of revenue growth depend on financial considerations (e.g., valuation levels, synergies, costs, and sources of finance), with marketing playing a subordinate role in these transactions (e.g., assessment of revenue synergies though cross-selling). Contrarily, organic revenue growth is influenced mainly by marketing (e.g., distribution channels); thus, we need to isolate organic revenue growth to determine the role of marketing in value creation. Fig. 1 illustrates the theoretical underpinning of the relationship between marketing and shareholder value creation.

2.2. Organic and external revenue growth

Interestingly, the most frequently used growth strategy in the past two decades has been M&A (McNamara, Haleblain, & Johnson, 2008), although mergers often fail to deliver the expected increase in shareholder value (Andre, Kooli, & L'Her, 2004; Dunis & Klein, 2005). Meer (2005) suggested that organic revenue growth is the most important driver of shareholder value. These empirical findings and past experience seem to affect decision-makers. For instance, Wulf Bernotat (CEO of E.ON) stressed that “Following years of mainly growing through acquisitions, E.ON will focus on organic growth going forward” (13th May 2009).

Organic revenue growth is defined as an organization's growth rate, excluding any scale increases from M&A (Dalton & Dalton, 2006). This is sometimes referred to as core growth and is derived internally by harnessing an organization's competencies and capabilities. Core growth is often manifested in improving customer relationships, building new relationships, and enhancing innovation capacity. Pursuing an organic growth strategy requires the organization to focus on its core competencies and capabilities and leverage them with a focus on customer needs (Beijerse, 2000; Kautz & Thaysen, 2001).

[2] ROIC refers to the return on invested capital.