IR Insight

October 2013

*Prepared by Tokyo consultancy Investor Impact, Inc., **IR Insight** provides analysis about the latest IR trends and recommendations on communications strategies that positively impact corporate value.*

INVESTOR IMPACT

Optimizing Investor Relations (IR) for Corporate Management Purposes

While the general public may be unfamiliar with U.S. economist Oliver Williamson, he received the 2009 Nobel Memorial Prize in Economic Sciences. He has been called a member of the "System Studies" school of economic thought and has been described as the scholar who brought the ideas of Ronald Coase[1], who passed away in September 2013, to their current stage. Coase, who dealt with the question of why there are organizational structures in markets, is best known for two articles in particular that deal with the economics of organizations[2]: *The Nature of the Firm* (Economics of Internal Organizations) and *The Problem of Social Cost* (Economics of Transaction Costs). In this issue of Investor Impact's *IR Insight,* we will use the ideas of Williamson and Coase to explain the positive benefits of IR.

IR and Transaction Costs

We have selected those parts of Williamson's theories that have close relationships with the theme of this thought piece and have presented them here. These concepts might be summarized as follows: "To begin with, there are limitations on the judgmental powers

---

1 R.H. Coase received the Nobel Prize in economics in 1991 for his 1937 article, *The Nature of the Firm.* The article was published in Japanese by Toyo Keizai Shimposha in 1992 in Chapter 2 of *Corporations, Markets, and Law*, which contains articles translated by Kenichi Miyazawa and others.

2 See *The Economics of Corporate Systems* by Mitsuharu Miyamoto, published by Shinseisha (Saiensu-sha Co., Ltd.) in 2004.

and awareness of human beings (bounded rationality). Therefore, transactions that take place in markets must be monitored for wrong doing, and negotiations must be conducted. This is the cost of transactions. Also, under certain conditions, opportunistic behavior (the pursuit of self-interest without hesitating to resort to misrepresentations and deceit) will escalate, and this raises the cost of not being deceived in market transactions." The "certain conditions" referred to here are the filtering of information among participants in transactions and the resulting uneven distribution of information.

If we apply this line of thought to IR, the markets in question are the capital markets and the transactions are the buying and selling of securities. Investors look for stocks to buy, do research on them, and then invest. Reaching the point of investing, however, involves considerable costs. Moreover, investors must bear the cost of monitoring the companies whose shares they have purchased to make sure that the management does not become opportunistic and betray the shareholders (monitoring cost). Since there is a large gap in terms of information between investors and corporate management, and for companies that do not disclose information properly, the cost to investors can become very substantial. These costs influence the discount rate (the interest rate, shareholder capital cost, and the rate of return desired by stockholders), or, in other words, the return that investors anticipate to receive for their investments, and they, as matter of course, want a return on their investments that exceeds their cost of capital as shareholders. *In other words, by at least disclosing management information properly to reduce the information gap between investors and corporate management and, thereby, deepen mutual understanding, the transaction costs of both investors and corporations can be reduced. This is precisely the raison d'être of IR and enables us to think that IR has a positive impact. In fact, research has verified that the quality of disclosure has an effect on the cost of capital*[3].

4

Positive Benefits of IR for Investors and Corporate Management

Conceptually, it appears that we have explained the relationship between the cost of capital and IR, but, more specifically, how can implementation of IR activities be of use in the management of corporations? For example, one of the key indicators of management performance is return on equity (ROE). Reduced to simplest terms, this indicator tells us how much net income was earned on the capital investment in the

---

[3] Kazuhisa Otokawa, "The Effects of IR Activities in Reducing the Cost of Capital," published in *Kaikei* No. 158 (4), pages 73 to 85.

company. Therefore, it is an indicator that makes it easy for investors to see the results of management efforts and the return on their investments. In other words, if the ROE of a company exceeds the cost of capital, the investment is generating a positive return. Nevertheless, how corporate managements measure the cost of shareholders' capital and how they use this indicator in setting management objectives arise as issues to be addressed. There are a number of methods for estimating the cost of capital, including the capital asset pricing model and the Olson model. We will not go into detail here, but in IR it is necessary to indicate how the company's estimate of the cost of capital was calculated and then used to set the company's hurdle rate for ROE. Next, it is important to conduct an IR communications program and activities that show how the company has set management objectives that are reasonable and reflect an awareness of the return expected by shareholders and investors as well as present a persuasive account of how the company is working to meet its targets. With such an IR program, it will be possible to monitor the company's progress toward its goals, and we can expect the realization of an appropriate shareholders' cost of capital that reflects the true condition of the company. In addition, as the company makes efforts to attain reasonable management objectives, the likelihood that the company will continue to improve its performance will increase, and the capital market will perform a corporate governance function. As these observations suggest, IR activities can have a major positive impact on corporate management and on capital markets.

Investor Impact Seminar on the Cost of Capital

Here, we will not go into the specifics of how the cost of shareholders' equity can be measured and how this should be used in the management of corporations. To delve deeper into this subject, Investor Impact will hold a seminar on November 29, 2013 on how the cost of capital is used by corporate management. The seminar will be conducted jointly with Ibbotson Associates, a world-leading consulting company with expertise in the measurement of the cost of capital, and Credit Pricing Corporation, which specializes in valuation of credit risks, financial assets, and corporations. The seminar will provide clear explanations of numerous case studies. We will shortly post further information on the seminar on the Investor Impact website (www.investorimpact.com). We look forward to welcoming a wide range of corporate executives and IR practitioners to the seminar.

Rika Sumi
Representative Director and Vice President
Investor Impact, Inc.

References

1. Masayoshi Miyanaga (2012), "Using 'Cost of Shareholders' Equity' to Rejuvenate Japan's Equity Investments," *Securities Analyst Journal*, October 2012, pages 27 to 42
2. Katsunari Yamaguchi (2007), "Risk Premium in the Japanese Economy—Reading the 'Invisible Return' from Long-Term Data," Toyo Keizai, Inc.

Feel free to contact the following with your comments on or questions about IR Insight:

C. Tait Ratcliffe
Tel: +81-3-6417-4932, Email: tait.ratcliffe@investorimpact.com
Thomas R. Zengage
Tel: +81-3-6417-4933, Email: thomas.zengage@investorimpact.com
Rika Sumi
Tel: +81-3-6417-4935, Email: rika.sumi@investorimpact.com

Investor Impact, Inc.
8th Floor, Gotanda KY Building, 2-18-2 Nishi-gotanda,
Shinagawa-ku, Tokyo 141-0031, Japan
Tel: +81-3-6417-4930   Fax: +81-3-6417-4931
info@investorimpact.com
www.investorimpact.com