

# Business Valuation Digest

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## A Firm's Image – How Valuable Can It Be?

by Marc Deegan, MBA, CBV

### Introduction

There are so many companies today that outsource everything from production, research and development, service centers and many more business activities. What is left of these companies in the way of tangible assets? In many cases, the intangible assets such as technology and customer lists are now the key value drivers for a company in a global based economy. As valuers, we must be aware of this trend and continue to learn and share our knowledge regarding the factors that impact the value of intangible assets.

This article endeavours to show that a **firm's image** can be considered as a **valuable intangible asset**. Although the results of a strong firm image are often difficult to quantify, we see them everyday in our own lives. Why do we seek employment at a particular firm? Why do we purchase a certain type of automobile or certain articles of clothing? There are other factors that influence the decisions regarding these questions, however one cannot omit the impact that a firm's image has and how it effects our daily decisions.

### Firm Image

The role of image in economic activities was first discussed by Kenneth Boulding in the middle 1950's (Lindquist, 1975). He theorized that human behaviour is not entirely directed by explicit knowledge but also information is a product of perceived images. Since that time, image research has been extended to consumers, users and stores (McDougall & Fry, 1975); to products and services (Keller, 1993; Nagashima, 1977; Ofir, 1986) and to organizations and management (Dierickx & Cool, 1989; Lindquist, 1975). Of particular relevance to this discussion, management literature has shed light on the positive effects of firm's image (Dutton & Dukerich, 1991; Gatewood, Gowan & Lautenschlager, 1993; Dutton, Dukerich & Harquail, 1994).value's relative contribution to the total present value of cash flows pursuant to various assumptions about the DCF model.

In general, these efforts suggest that a firm's image should be considered as a multidimensional construct that refers to individuals' rating of a firm's various attributes. These dimensions can be classified into tangible and intangible factors that affect image perceptions and serve as a means of understanding the often-ambiguous nature of the construct. In essence, image is a construct that can be attached to different referents (e.g. firm, brand, country-of-origin) and can be identified for different constituencies (e.g. the employees' image of the firm, external stakeholders' image of the firm).

Marketing literature that has addressed such topics as brand image and country of origin effects on consumer behaviour provides a good basis for conceptualizing the image construct and understanding the factors that might affect a firm's image (Jaffe & Nebenzahl, 1984; Keller, 1993). In general, image is conceptualized as the physical and psychological meaning assigned to a specific referent. For our

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purposes, image results from individuals' attempt to assign a meaning to experiences and this meaning affects future behaviour. As such, image is derived through the perception-based interaction of the referent (e.g. the firm's attributes), the individual perceiver and the situation. Thus, while this complex interaction suggests that image cannot be directly manipulated by the organization, it does identify the specific factors that must be studied (i.e. the organization, the individual perceiver, and the situation) and the perception process by which an image is derived.

The firm's image's value can be seen through at least three avenues. First, image as formed by the judgements of the organization's employees (and potential employees) is important because it represents these individuals' best guess at what characteristics non-members are likely to ascribe to on the grounds of their organizational affiliation (Crocker & Luthanen, 1990). **Thus, at the very least, firm image is an important component of a company's ability to attract, develop and keep talented people** (Gray, 1986). Image may also influence employees' performance through its ability to affect the amount and type of motivation employees' exhibit. (Crocker & Luthanen, 1990; Dutton & Dukerich, 1991).

Rynes (1991) suggested that given the small amount of information applicants have early in the job choice process, initial application decisions are heavily based on general impressions of organizational image. One empirical study by Belt and Paolillo (1982) determined the favourableness of twenty fast-food establishments and selected one very highly rated and one very poorly rated restaurant. Recruitment advertisements were written that manipulated the names of the two organizations and the specificity of required applicant qualifications. In this study's results, image was a main effect: applicant response to the organization with the better image was significantly higher. Based on this and other studies, there is empirical evidence to support Ryne's suggestion that corporate image is highly related to potential job applicant's intentions to pursue further contact with a firm (Gatewood, Gowan & Lautenschlager, 1993).

A second issue that reinforces the value of a firm's image is the link between an organization's objectives and the behaviours of constituencies who may be targets of efforts directed at achieving those objectives. For example, Gray & Smeltzer (1985) suggest that the effectiveness of a

strategic effort is contingent upon the image held by the target of the strategy (e.g. customers). Specifically, they say that a negative impact perceived by any of the company's publics indicates either an inappropriate strategy or a failure to communicate that strategy effectively. Others state that image management is important toward any target group whose attitudes have some level of significance for an organization (Alvesson, 1990). **Thus, the success of any given strategy is contingent upon the perceptions held by those whom the firm wishes to attract or affect.**

In the early 1990's appalled customers left Nike products on the shelves when they found out that this sports giant was employing children to make shoes in illegal sweatshops in Indonesia. In essence, the company was perceived a certain way by their customers. As a result, sales suffered and Nike had to work on improving their image in order to mitigate any further damage. Nike agreed to sign up to a code of conduct that all its products would be made under ethical conditions. They also made a financial contribution to the International Youth Foundation in order to enhance their image amongst their clients. As a result of these efforts, Nike went on to be a powerhouse in the sports industry largely because of their perceived image in the eyes of consumers.

Finally, actions that lead to a positive image held by external stakeholders will decrease the risk and increase the expected return of existing strategic opportunities and it will increase the opportunities available to strategic decision-makers. Similar to the effect of increasing trust in a relationship, positive changes in image decrease the perceived uncertainty associated with a firm. As a result, companies will tend to gravitate towards firms with a positive image, **thus increasing the number of opportunities available to a firm.**

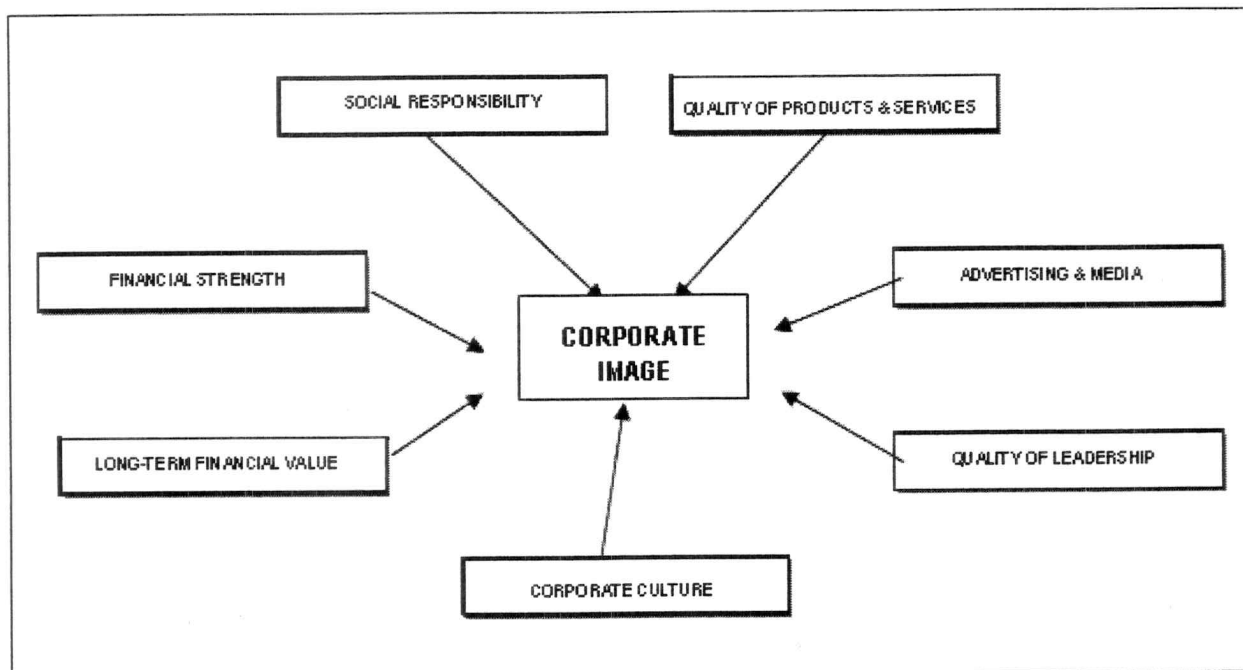
Firms with negative images will be at a competitive disadvantage because of the lower number of strategic opportunities available to them and the accompanying higher risk and lower return combinations of those that are available.

**Thus, the above suggests that a firm's image is a potentially valuable intangible asset through its ability to attract, retain and motivate employees, through its ability to affect the success of the strategic effort of a firm and through its ability to affect the opportunities available to a firm.**

## Variables that Contribute to a Strong Firm Image

The strength of a firm's image as a valuable intangible asset relies on seven underlying variables: *social responsibility; quality of products and services; advertising and media; quality of leadership; corporate culture; long-term financial*

*value; and financial strength.* This list is not exhaustive, rather it is based on practical business experience and a review of business and academic publications.



**Social Responsibility** – The perception of a firm's agenda pertaining to society plays an important role in the evaluation of a company's image. A high degree of social responsiveness indicates that a firm has been proactive in establishing powerful relationships in their community. The visibility and involvement is an investment in the company's image as a member of a community. Firms can signal their social concern by creating foundations, contributing to charity, volunteering their human resources and by adopting an employment equity plan. Managers presume that social responsiveness generates goodwill from employees, consumers, and other stakeholders that enhance the long-run profitability and viability of firms.

**Quality of Products and Services** – Today's business environment has shifted towards the client. Customer satisfaction and quality are key variables when evaluating the image of a corporation. In order to succeed in a global business environment, successful organizations must focus their resources on insuring an optimal level of product quality and customer service. To

beat out competitors, companies know that they must incorporate their client's needs and wants into their product quality and performance.

The results of superior quality reflect positively on a firm's image. It also tends to enhance profitability. Winners of the Malcolm Baldrige National Quality Award, which represents companies in the U.S.A having the highest level of commitment to quality management, have regularly outperformed their peers in terms of return on investment. The Commerce Department in 1996 reported that an investment of \$1,000 in the respective stocks of the Baldrige award winning companies would have outperformed the S&P stock index by approximately 3 to 1. In nearly all cases, these companies achieved greater customer satisfaction, increased market share and improved profitability (Evans & Lindsay, 1999).

The Strategic Planning Institute (1998) studied the impact of higher relative product quality and found a significant positive correlation between relative product quality and return on investment. In a subset sample of 525 mid-size business units, those with high relative product quality

characteristics earned nearly 59% more than the low-quality business units did. Their premium quality allowed them to charge a premium price. They also benefited from more repeat purchasing, consumer loyalty, and positive word of mouth. Another study indicated that companies can improve profits anywhere from 25% to 85% by reducing customer defections by 5% (Reichheld, F. & Sasser, J, 1990).

**Advertising & Media** – Using the media, companies attempt to influence constituents through positive and frequent encounters. The information is disseminated through networks of interpersonal relations or interlocking corporate ties and through press articles and mass media presentations. The media act as vehicles for advertising. They are also active agents through editorials and opinions that shape the future of the company. There is also a substantial investment that must be made to create a positive corporate image through visible spokespersons and innovative advertising. In most cases, messages delivered by attractive or popular sources achieve higher attention and recall. Credibility is also an important factor in the success of attracting a customer's attention (Kotler & Turner, 1998). Many firms continue to focus on advertising by spending important sums of money in order to create and reinforce their overall image.

**Quality of Leadership** – Successful global strategic leaders achieve reputations for trustworthiness through exemplary management practices by empowering and retaining employees and instilling shared pride. Great leaders are also masters at selecting, synthesizing and articulating an appropriate vision of the future (Bennis & Nanus, 1986). They earn reputations for credibility among investors by showing profitability to individual and institutional stockholders, maintaining a stable return on investment and nurturing financial growth prospects. Leaders obtain reputations for reliability among customers and suppliers by ensuring quality, service and innovation. They gain reputations for responsibility among community and public constituencies by prudently stewarding organizational, social and natural assets. A successful leader is a key player in establishing and reinforcing a strong firm image.

**Corporate Culture** – A corporate culture is a system of shared values and beliefs that interact with an organization's people, structure and

systems to produce behavioural norms. These tools are so common in a system that they tend to perpetuate themselves. Corporate culture comes to shape in many ways. Some organisations instil values that promote a positive and strong corporate culture. Some of these values are employee involvement, customer delight, teamwork and empowerment. Other corporate cultures stem from a strong leader within an organization. A strong, widely internalized corporate culture helps energize people throughout the company to do their jobs in a strategy-supportive manner (Thompson & Strickland, 2001). It is also extremely difficult to replicate, thus contributing to a sustainable competitive advantage (Harvey, D & Brown, D, 1996).

Long-Term Financial Value - Investors' expectations regarding a company's performances have increased exponentially with the returns investors' were receiving in the latter part of the 1990's. However, an argument can be made for a company that can consistently deliver solid results over the medium to long-term. Management's challenge is to have a long-term view in decision-making. Some of the ratios that measure long-term financial value are as follows:

- Return on Equity
- Return on Assets
- Gross Profit margin

We can see that companies that focus on long-term financial value enjoy a strong following amongst customers, investors and lenders.

**Financial Strength** – A company has a duty towards its stakeholders to make prudent, strategic financial decisions to grow their respective businesses. Many business models in the 90's dot.com gave way towards investor speculation and outrageous market capitalizations. A company requires a solid financial foundation in order to grow and prosper. This foundation also impacts the firm's image and how customers perceive it.

Some of the measures of financial soundness come in the form of financial ratios and analysis. A few important financial ratios (indicators) are as follows:

- Current Ratio
- Quick Ratio

- Long-term debt to equity ratio
- Interest Coverage Ratio

Many more ratios can be applied. The important issue is to benchmark these indicators to leaders within specific industries or with a total index (i.e. S&P 500) to be able to assess a company's strengths.

As previously mentioned, the variables highlighted above do not make up an exhaustive list, rather they are some of the more important variables that can have a positive impact on a firm's image. It is important for valuers to have a basic understanding of these variables and how they impact a firm's image.

## Can a Firm's Image be Transferred?

In most cases, a firm's image is specific to the firm to which it is attached. It can not be easily earned, purchased, or transferred (Dierickx & Cool, 1989). In the context of an acquisition or merger, the specifics may not allow for a direct transfer of a firm's image. That is, the corporate image is not likely to remain intact under new ownership. The factors surrounding the acquisition or merger and the image of the purchasing organization or the new ownership group are likely to interact with the existing image to produce new perceptions about the purchased organization. Earning a positive image requires time and a continuous focus on the contributory variables mentioned above.

## Conclusion

As valuers, we are well versed in preparing financial models and analyzing financial statements. However, we must go beyond our formal training in finance and accounting and seek knowledge in the softer areas of an organization to fully understand the nature of intangible assets such as a firm's image. By looking into other disciplines such as psychology, sociology and anthropology, we can combine concepts into new ideas that we can use in our approach towards valuation mandates involving intangible assets.

A firm's image through its ability to attract, retain and motivate employees, through its ability to affect the success of the strategic efforts of a firm and through its ability to affect the business opportunities available to a firm is a valuable intangible asset.

Based on today's global competitive landscape, more decision-makers will focus on their firm's image while crafting their strategic posture vis-à-vis competitors. Given the fact that an image is hard to replicate, it may represent one of the only investment opportunities available that can provide a sustainable competitive advantage for a firm. This is a rather valuable asset in a global economy where the notion of "sustainability" is often hard to find!

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## An Analysis of the Relationship of Publicly Traded Stock Multiples to Closely Held Firm Value Multiples

By Dr. Charles John Conrick IV, CPA CFA CFP

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### Abstract

The purpose of this study was to examine if there was a statistically significant difference between price to earnings (P/E) ratios and price to gross

sales (P/G) ratios based on the size of companies and selected standard industrial classification (SIC) codes by the leading two digits of the SIC code. Approximately 18,000 cases of privately held business sales transactions were compared to nearly 20,000 randomly selected public stock price data to compare and test.

A Kruskal-Wallis nonparametric test, Multivariate analysis of variance (MANOVA) tests and t tests were utilized to investigate for significant differences in P/E and P/G ratios based on size and SIC code. The findings of the study were that there was a statistically significant difference in P/E and P/G ratios based both on size and selected SIC codes.

### Part One: Purpose of the Study

The purpose of the study was to examine the relationships between price to gross (P/G) and price to earnings (P/E) ratios between large publicly traded companies and small, closely held businesses. In addition, the P/G and P/E ratios of large and small companies were further examined by selected SIC codes to determine if different industries had significant differences in P/G and P/E multiples among themselves based on size.

The review of the literature indicates that valuations of large, publicly traded firms and small closely held businesses are founded in the same theoretical basis. Valuators and analysts use publicly traded firm data as indicators of risk measurement and pricing due primarily to the ease of access to vast amounts of data. Coupled with the ease of data acquisition are the tenets of the efficient market hypothesis (EMH) which postulate that market prices are reflective of accurate estimates of value. This leads to conclusions that publicly traded firm data and certain multiples can be used to also accurately estimate small closely held businesses. For example, one technique, the guideline company method, specifically uses data generally from publicly traded firms to establish multiples of value. After adjusting certain financial data of the guideline companies or the subject company being valued, the guideline company multiples of value are applied to the subject company to estimate value.

A valid argument can be made that publicly traded firms have different risk criteria, time horizons, and investment goals than small businesses. This could well be indicated in different proportions of valuation multiples, which may render the guideline company method