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# Investors' evaluations of price-increase preannouncements☆

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ABSTRACT

Several firms preannounce their price increases with the expectation that such announcements will be evaluated favorably by investors. However, little is known about the actual effect they have on shareholder value. Accordingly, the authors present the first systematic empirical examination of investors' evaluations of 274 price-increase preannouncements (PIPs). Results show that whereas the average increase in abnormal returns following a PIP is 0.51%, almost 41% of the PIPs result in negative abnormal returns. To explore this heterogeneity, the authors propose a conceptual framework that focuses on three key pieces of information that investors can use when evaluating a PIP: information on the nature (time to implementation and magnitude) of the preannounced price increase, the stated attribution for the preannounced price increase (demand and/or cost based), and information on prior PIP occurrences by the firm and its competitors. Results indicate that PIPs with greater time to implementation, higher own precedence and greater competitive precedence result in lower abnormal returns, while PIPs with higher magnitude and PIPs with an explicit demand attribution result in greater abnormal returns.

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Price increases are widely viewed as one of the most effective marketing instruments to increase profits (Meehan, Davenport, & Kahlon, 2012). Consulting and popular-press reports as well as industry experts frequently underscore the importance of price increases. For example, Deloitte Consulting reports that the effect of a price increase on profits is 4 times that of other initiatives (Hayes & Singh, 2013). McKinsey & Company reports that a 1% increase in product price can boost the operating profits of a typical Global 1200 firm by 8.70% (Baker, Marn, & Zawada, 2010). The investment community also endorses the importance of price increases. Warren Buffet, for example, suggests that the ability to raise prices is investors' "single most important decision in evaluating a business" (see Frye & Campbell, 2011, p. 1 for the full statement). Similarly, Reuters identifies a firm's ability to raise prices as the key concern for investors in 2017 (Subhedar & Rees, 2017).

Against this background, it is not surprising that several firms publicly announce their price increases ahead of their actual implementation to signal to investors their ability and willingness to do so (Calantone & Schatzel, 2000). For example, during 2010–2014, Starbucks made 10 price-increase preannouncements (PIPs), J.M. Smucker made 7 PIPs, while Peet's Coffee made

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just one such preannouncement. Analysts tend to view a PIP as a valuable signal as it communicates potential future earnings to investors, and allows customers to make budgetary adjustments (Marn, Roegner, & Zawada, 2004; Smith, 2011). A PIP can also act as an important competitive signal that may well influence competitors' subsequent pricing decisions (Heil & Langvardt, 1994; Prabhu & Stewart, 2001).

Anecdotal evidence, however, shows that investors do not always share a unanimous positive view about PIPs. For example, when J.M. Smucker preannounced a price increase 9 days before its implementation in February 2011 (J.M. Smucker Company, 2011), it resulted in an abnormal increase of 0.76% in its stock price.[1] However, when it preannounced another price increase almost 2 months before its implementation in September 2011 (Ziobro, 2011), its stock price had an abnormal decrease of 0.40%. Similarly, when Starbucks made a preannouncement of a 1% increase in its prices in June 2013 (Kavilanz, 2013), it resulted in an abnormal decrease of 0.72% in its stock price. This decrease stands in stark contrast to the 4.5% price increase that was preannounced in June 2014 (Ausick, 2014), where its stock price experienced an abnormal increase of 1.85%.

Given the oft-mentioned importance, combined with the contradictory anecdotal evidence, it is surprising that there is no systematic examination of investors' evaluations of a PIP. Accordingly, we draw on multiple secondary data sources to present the first large-scale empirical study of investors' evaluations of PIPs. Using an event-study approach, we measure investors' evaluations by calculating the abnormal returns following 274 PIPs between 2010 and 2014. We find that, on average, a PIP results in abnormal returns of 0.51%. There is, however, significant underlying heterogeneity, as almost 41% of the PIPs result in negative abnormal returns. Therefore, we develop a conceptual framework to identify conditions under which investors will react more or less positively (negatively) to a PIP. In doing so, we respond to recent calls for more research to examine investors' evaluations of a firm's pricing decisions (Edeling & Fischer, 2016, p. 533), and complement existing studies on price increases that almost exclusively examine customer reactions (Homburg, Hoyer, & Koschate, 2005; Homburg, Koschate, & Totzek, 2010).

Following the announcement of an upcoming price increase, investors may decide to buy or sell stock, a decision that depends on the performance (cash-flow) implications they expect that this increase will entail and, relatedly, on the reasons they think the firm may have to not only increase its prices, but to also preannounce that increase. These performance implications, in turn, are likely to be a function of the reactions of both customers and competitors. Indeed, customers may remain loyal to the brand (in which case a higher per-unit margin on a comparable sales volume could be obtained), or switch to cheaper alternatives (in which case the total revenues may even decrease). Similarly, competitors may either mimic the increase, which would mitigate any market-share losses, or maintain (and even decrease) their own price to improve their competitive position. Relatedly, the firm may raise its prices because of higher demand and a strong belief that its customers will stick with the brand despite the higher prices (which could be labelled a demand-dominant motivation). Alternatively, the firm could preannounce the price increase because it expects its competitors to follow, which would cause the average price (and profit margin) in the industry to increase (a setting that could be labelled competitor driven), or it may explicitly communicate that its costs are/have been rising, in which case the price increase is meant to pass on some of this cost increase to its consumers (a cost-based scenario). Or maybe the firm is just unsure about the price sensitivity of its customer base and uses the preannouncement as a price sensitivity probing mechanism.

Unfortunately, neither the customer and competitive reactions nor the underlying reasons for the price increase are known to investors at the time of the preannouncement. Because of that, investors have to infer these latent variables from information that is available and observed at that time. We postulate that investors are likely to draw such inferences from three key drivers of a PIP. First, we posit that investors will take information on the implementation of the preannounced price change into account, i.e., when it will become effective and the extent of the increase (i.e., implementation information). Second, investors can consider whether an explicit reason for the increase is offered in the announcement (i.e., attribution), and if so, whether the price change is attributed to an increase in demand and/or to an increase in the underlying costs. Finally, investors' evaluations of a PIP are likely to also be affected by prior PIP occurrences by the firm and/or its competitors (i.e., precedence).

Results provide strong support for the conceptual framework. Consistent with our emphasis on implementation information, we find that time to implementation has a significant negative impact on abnormal returns. In contrast, magnitude has a significant positive impact. Underscoring the importance of attribution, we find that a PIP is likely to result in a significant positive effect on abnormal returns if a firm provides a demand attribution. Results also support expectations about PIP precedence by both the focal firm and its competitors. Specifically, higher PIP precedence by the firm has a significant negative effect on abnormal returns. In addition, we find a significant negative effect of competitive precedence on abnormal returns following a PIP. Taken together, the results present a nuanced picture that enables senior managers to identify conditions under which PIPs are more likely to be evaluated (un)favorably by investors.

## 1. Conceptual framework

Price changes are an important facet of a firms' marketing strategy. Firms can decide to increase or decrease their prices in response to changing circumstances ranging from adjustments in consumer demand and competitive imperatives (Prabhu & Stewart, 2001) to factors affecting its operations such as input prices (Homburg et al., 2005). Interestingly, while publicly-listed firms frequently make PIPs, they very rarely (if ever) announce upcoming price decreases.[2] As such, we focus on the former.

[1] An abnormal increase in stock price is an increase in the stock price that is not predicted by taking into consideration fundamental financial factors.

[2] In fact, a careful search of pricing related announcements by publicly-listed firms in the calendar year 2014 did not yield a single price decrease announcement.

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