Pergamon

European Management Journal Vol. 24, Nos. 2–3, pp. 117–127, 2006

0263-2373 $32.00

doi:10.1016/j.emj.2006.03.002

Valuing Announcement Options

ANNA DEMPSTER, *Birkbeck College, University of London*

This paper introduces a theory of corporate announcements based on the new concept of an *announcement option* which has not been previously recognized in the literature as an independently valuable real option de-coupled from strategy implementation. While contributing to the strategy and real options literature, the paper also bridges the corporate disclosure literature and theories of signalling. By conceptualising corporate announcements as real options, the paper provides a framework and focuses on a methodology for precisely valuing announcements. To illustrate the use and valuation of announcement options, the historical case of Prudential plc's announcements concerning its internet venture Egg is analysed.

Keywords: Announcements, Real options, Decision making under uncertainty, Strategy and firm performance

Introduction

In this paper I propose that a real options perspective can contribute to our understanding of a topical and important research question concerned with the opportunity for firms to release information to the marketplace – including what, when, why and how they release it. The discussion of corporate disclosure in general and *voluntary* disclosure in particular has become increasingly critical in the aftermath of major corporate scandals such as Enron, Worldcom, Tyco, Winstar, Parmalat, Shell and others. The voluntary disclosure debate presents an alternative perspective to many of the standard propositions that optimal levels of disclosure should and can be set by regulators, carefully monitored and enforced.[1] The study of corporate disclosure, and more specifically what firms should be legally required to disclose to investors and the marketplace, has traditionally been firmly in the domain of accounting research (see Healy & Palepu, 2001, for a review of this extensive literature). Professional accounting bodies such as the Institute of Chartered Accountants of England and Wales (ICAEW) see *'improving information available to capital markets by improving business reporting'* as part of their ongoing remit.[2] More recently, however, the role of disclosure has also been investigated in the behavioural finance literature, which considers how firm's disclosure policies might affect competition and/or highlight or amplify financial market inefficiencies (Admati & Pfleiderer, 2000; Lang and Lundholm, 1996).

Most importantly, across the various streams of research investigating corporate disclosure, there is a growing recognition that the various announcements that firms make are not simply disclosures of particular given 'facts', but have inherent strategic value in their power to influence external perceptions directly and firm performance indirectly. I extend this line of enquiry by proposing that corporate announcements are central to the strategic process of every firm[3] and argue that strategic announcements should be more actively and centrally studied by strategy and business policy scholars. The paper thereby revisits the 'conundrum' presented by Richard Bettis (1983) which questions the discrepancies between finance and strategy research, namely that while *'modern financial theory suggests disclosing additional information about a project or strategy can positively affect the value of the firm, strategic management research has stressed only the value of such information to a firm's competitors.'* Rather than focussing on the disadvantages of releasing sensitive information to competitors (Heil & Robertson, 1991) or the negative effects of false announcements to deter competitors from entry (Bayus, Jain, Rao, 2001), this paper highlights the positive *real option value* of announcements used strategically by firms.

Here, I propose the concept of the *announcement option* that is the (real) option available to a firm to voluntarily disclose information (usually about itself) to the marketplace. Although it has not been previously considered as such, the conceptualisation of an announcement as an option bridges a number of streams of enquiry aiming to understand the role of corporate announcements by allowing the *precise quantification* of the value of specific announcements.

The option to announce, or not announce, a strategic decision is a particularly powerful option available to firms because it influences investor perceptions and expectation about the present value of its future expected growth and opportunities. Thus it affects precisely the *intangible* component of market value which is so difficult to assess and evaluate.

The option to announce is naturally available to all firms and the value of corporate announcements is widely recognised by industry practitioners. Furthermore, the use of announcements in a way that strategically benefits the firm is not only commonplace but appears historically to be more prevalent in periods of high market and environmental uncertainty. This is consistent with real options theory which states that the value of an option increases with an increase in the underlying uncertainty. For example, from mid-1990 to the early 2000's announcements were regularly and widely used by start-up firms which were operating in conditions of extremely high environmental and technological (e.g. internet) uncertainty. Illustrative of the intrinsic value of announcements themselves is the exclamation of one dealer in December 1999 that '[the] *Internet is the magic word on this market right now. All we needed was the announcement and a flood of 'buy' orders started pouring in. Right now everyone's buying it, be they speculators or not*' as the Banca Nazionale del Lavoro (like so many others in the finance industry) announced that it had formed an internet unit called Newco. com. [4] This paper will examine in detail a case study from this period to develop and illustrate a valuation methodology for announcement options with generalisable implications.

The strategic use of announcements, timed and worded in conjunction with market expectations, has often been dismissed simply as a form of market manipulation (Heil & Robertson, 1991). Indeed, there is evidence to suggest that announcements are more widely and heavily used (and mis-used) in industries where product development schedules and uptake are extremely difficult to predict such as the software and games industries (Bayus, Jain, Rao, 2001). A more positive interpretation however, of carefully timed and strategically used announcements, is that they provide an opportunity for managers to communicate to the marketplace that they are aware of, and up-to-date with, current investor demands and interests. For example, in their study of the market impact of e-commerce announcements, Subramani & Walden (2001) argue that the reason for the significant positive abnormal returns they found were in part because investors viewed the announcement of such initiatives as favourable signals of firm attributes such as ''*forward looking*, *profit driven*, and *willing-to-innovate* management'' [original italics] p.149. This type of argument suggests that being in tune with the marketplace and communicating with it – via strategic announcements – is an important and valuable option in its own right which can ultimately give firms a competitive edge over their rivals. The signalling nature of announcements has also been noted by Westphal and Zajac (1998), who, while conducting an event study to measure the impact of announcements of changes in corporate practice, observed that the stock market reacted favourably to such announcements, *even if* the announced plans were not implemented. In the concluding sections where they develop the theory of *symbolic management*, they infer that the *announcement itself* sends a signal regarding the alignment of CEO and shareholder interests which is strong enough to affect market perceptions concerning the firm.

Archival and interview based evidence suggests that firms communicate with the external marketplace in a substantive and influential way through the disclosure of information released by means of corporate announcements. These send desired signals that both inform marketplace perceptions and guide market expectations. Although announcements are a commonplace characteristic of modern corporations, we do not to date have a strategic management *theory* which places *announcements* at the core of the management and strategic decision making process even though Heil & Robertson (1991) noted some time ago that the time for such a theory is long overdue.

This paper seeks to address this need by introducing a theory of strategic announcements and illustrating how, once conceptualised as options, they can be valued. While the theory and valuation model are generalisable, they can in present form be applied to specific cases such as the one illustrated below. To inform the theoretical discussion in the section, ''Outline of a Theory of Announcement Option Valuation'' below, the paper draws on a number of divergent strands of literature including theories of signalling and the debate on corporate disclosure which is central to the accounting field, in the section, ''Review of Relevant Literature'', below. To illustrate the use of the proposed *announcement option*, a case study of the insurance company Prudential plc and its internet venture Egg is presented in the section, ''Valuation Case Study'', below. The historical context of the case is described in detail as is the specific use of announcements by the two firms involved to provide the detailed data used in the analysis. To value the announcements, real options analysis is applied. The final section of this paper concludes by arguing that given the wealth of anecdotal evidence and widespread practitioner recognition of their intangible value, as well as growing academic interest from a range of disparate directions, the time is ripe for a theory focussed specifically on *strategic announcements* which is compatible with quantitative methods appropriate for their precise valuation. Other aspects of announcement options, such as environmental responses, timing and competitive implications, are explored in related research and developed in companion papers.