Press Release

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PolyU Study Finds Promotion-Focused Advertising Increases Firm Risk for Restaurants

Advertising expenditures lead to increased risk for publically listed firms in the US restaurant sector, argue Dr YongHee Kim of the School of Hotel and Tourism Management (SHTM) at The Hong Kong Polytechnic University and co-authors in a published research paper. The researchers analyse the financial data of firms listed as ‘retail-eating places’ by the US Securities and Exchange Commission and find that contrary to intentions, advertising expenditure actually increases total and firm-specific risk. Restaurants, they argue, need to change the focus of their advertising from short-term promotion-related gains to the “unique benefits” they offer to “enjoy more stable cash flows”.

“Advertising expenditures”, write the researchers, are usually considered to be “an essential budget item for a firm”, with effective advertising increasing the firm’s profitability, intangible assets such as brand equity and customer awareness, and thus increasing stock returns. Publically listed restaurant firms in the US spend millions of dollars annually on advertising – US$607 million in the first six months of 2011 alone. Yet, it has never been entirely clear whether such efforts produce the desired results.

Although advertising can build brand equity and help to reduce the cost of retaining customers, the flip side of this situation is the potential risk that publically listed restaurant firms face when they commit to advertising expenditure. The researchers delineate three types of relevant risk: total, systematic and unsystematic. Total risk is the “variation of historical stock returns of a firm”, and reflects investor uncertainty over future cash flows. More specifically, as the researchers put it, “total risk erodes an equity holder’s value and impedes a firm’s strategic management”. In other words, investors avoid firms with higher total risk.

Systematic risk is manifested in the extent to which movements in the prices of restaurant stocks are associated with general stock market movements, which are usually caused by “market-level economic factors” such as recessions, inflation or interest rate changes. Unsystematic risk, in contrast, “is the variability of historical stock returns unexplained by the stock market movement”. It reflects how firm-specific events such as product or service defects affect stock returns.

The effects of marketing strategies on unsystematic risk have not received sufficient attention, argue the researchers. They suggest that “expenditures used for sales promotion or price-oriented media advertising” could actually increase unsystematic risk, given that they are focused on short-term results. This is the case simply because “restaurant customers attracted mainly by a discounted price or sales promotions are likely to switch to other restaurants when the promotion ceases”.

The researchers thus set out to determine whether restaurant firms have short- or long-term goals when advertising, and how that affects the level of risk they face as determined by stock price volatility. Their main conjecture was that the “advertising expenditures of restaurant firms increase their total, unsystematic, and systematic risk given promotion-oriented ad spending increases the volatility of future cash flows”. They collected financial report and daily stock return data for 89 publically listed US restaurant firms over the 1982-2008 period, obtaining 575 usable firm-year observations.

A key consideration in analysing the data was “the extent to which a firm allocates its available resources to advertising”. In general, the firms spent 5% of their total assets on advertising, suggesting a sizeable commitment across the board. Also considered were firm size, the extent to which the firms were leveraged and thus able to repay debt, return on assets and the market-to-book ratio for each firm, which “indicates investor expectations of greater future cash flow growth”.

Against the grain of common expectations, the researchers found that advertising expenditures were significantly related to total risk – variation in historical stock returns – and firm-specific unsystematic risk, but not market-level systematic risk. They explain the latter finding by suggesting that larger amounts of advertising, regardless of whether it is short- or long-term oriented, may create investor “familiarity” with a stock that buffers its sensitivity to market movements.

Yet in terms of firm-specific unsystematic risk, the market is much more interested in the type of advertising expenditure. The researchers argue that generally, “investors consider high advertising spending of restaurant firms as a signal of high volatility of future profits”. More specifically, it seems that the stock market does not view the promotional type of advertising in which these firms generally engage to build firm equity, a key market-based asset.

Returning to the concept that short-term advertising strategies increase customers’ price sensitivity, the researcher note that when this occurs “their advertising harms the stability of future earnings and increases the cost of capital for funding the firms’ operations in the long run”. In short, price-based promotions harm publically listed restaurant firms.

Although price promotions may bring immediate increases in customer traffic, they do not boost customer loyalty. Hence, suggest the researchers, they “may raise advertising costs with little contribution to the creation of market-based assets”. The short-term focus of restaurant advertising also leads to another problem – promoting “the consumption of unhealthy food”, which “undermines public health”. This, in turn, leaves listed restaurant firms open to charges of social irresponsibility and creates negative reputational effects that will ultimately influence their market performance.

What, then, is the way forward? “Restaurant firms may need to shift their advertising focus from price competition and sales promotion to product differentiation”, the researchers believe. Customers are willing to pay a premium for healthier and other specialty items, and thus advertising messages that emphasise the particular benefits that a restaurant has to offer customers are likely to have a larger impact on firm value than those emphasising usual offerings at slightly lower prices. Yet the researchers do caution that they did not differentiate the firms they considered by segment, such as fine dining establishments versus fast food outlets, and there may be some variation in the firm risk that advertising expenditures pose to individual firms.

Ultimately, as the researchers put it, their findings “provide restaurant firms with a better understanding of the effectiveness of their current advertising campaigns in terms of risk reduction”. With advertising expenditures that not only fail to reduce risk but actually increase total and unsystematic risk, restaurants’ experience should sound a more general warning to the entire hospitality section. The researchers express the hope that their efforts will “encourage managers in hospitality firms to look into their advertising expenditures and help them to allocate their marketing budgets more effectively”.

Kim, YongHee, Kim, Min Chung and O’Neill, John W. (2013). Advertising and Firm Risk: A Study of the Restaurant Industry. *Journal of Travel & Tourism Marketing*, 30(5), 455-470.

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