Todd Zenger is the Robert and Barbara Frick Professor of Business Strategy at Washington University in St. Louis's Olin Business School.

STRATEGY: THE UNIQUENESS CHALLENGE

Promising corporate blueprints are often hard to understand—and too few market analysts are willing to make the effort.

by Todd Zenger

CEOs often complain that the financial markets just don't get their companies' strategies. For years I assumed that this was just sour grapes and that capital markets were actually rather good at assessing the quality of corporate strategies. Along with most other academics and the financial community, I reasoned that good strategies should follow the market's wisdom. After all, isn't creating value for investors the goal? Why not give them what they want?

Then, in 1999, a former student of mine, who worked at Monsanto, sent me a report on his company by an analyst at PaineWebber. At the time, Monsanto was a portfolio of businesses—bundled under the label "life sciences"—that used chemistry and biotechnology to develop innovative agricultural

ILLUSTRATION: MEGAPONT

products, seeds, food ingredients, and pharmaceuticals. The theory was that these businesses could share their mutually beneficial R&D, and the portfolio strategy reflected a belief that the growth prospects of pharmaceuticals and agricultural biotechnology were significantly better than those of the chemicals industry.

The capital markets, however, didn't buy into this theory. Seeing little value in keeping the various businesses together, analysts began pressuring Monsanto to unbundle. The push was fueled in part by Monsanto's introduction of the arthritis drug Celebrex, which was seen as a blockbuster. Investors thought that agricultural biotechnology would be a drag on the stock price. But that wasn't the only reason. As the PaineWebber analyst put it:

"The life sciences experiment is not working with respect to our analysis or in reality. Proper analysis of Monsanto requires expertise in three industries: pharmaceuticals, agricultural chemicals and agricultural biotechnology. Unfortunately, on Wall Street...these separate industries are analyzed individually because of the complexity of each....At PaineWebber, collaboration among analysts brings together expertise in each area. We can attest to the challenges of making this effort pay off: just coordinating a simple thing like work schedules requires lots of effort. While we are willing to pay the price that will make the process work, it is a process not likely to be adopted by Wall Street on a widespread basis. Therefore, Monsanto will probably have to change its structure to be more properly analyzed and valued."

Talk about the tail wagging the dog! Because analysts with differing expertise could not coordinate work schedules, this PaineWebber report suggested that Monsanto incur tens of millions of dollars in investment banking and other transactions fees—not to mention the loss of synergies the company perceived—to unbundle itself. Worse, the report candidly admitted that analysts' choices about what companies to cover were based in part on how much effort was required to do so. In other words, the primary benefit of Monsanto's unbundling would be that analysts could more easily understand the company.

The report piqued my interest as a researcher: Were unique or complex strategies being systematically ignored by analysts or undervalued by capital markets? With my colleagues Patrick Moreton (now at Duke University) and Lubomir Litov (now at the University of Arizona), I undertook to investigate that question.

The High Costs of Unique and Complex Strategies

My colleagues and I examined all 7,630 companies that were publicly traded in U.S. capital markets from 1985 through 2007. We determined each company's uniqueness by measuring how its sales were distributed across Standard Industrial Classification (SIC) codes in comparison with the industry average. The more the company diverged from that average—in sales focus or in pattern of diversification—the higher its uniqueness measure. Simply counting the number of SIC codes in which a company reported participating gave a measure of its complexity.

To determine whether uniqueness and complexity affected the level of analyst coverage, we counted the number of analysts covering each company and how many other companies each of those analysts covered—an indication of whether covering the company in question was particularly time-consuming. We also calculated what percentage of industry analysts were covering it.

Our analysis determined that although many factors—such as company size and trade volume—influence analysts' decisions about which companies to cover, the greater effort required for a complex or unusual strategy discourages coverage. We found that analysts who do study companies with such

MONSANTO

Who Had the Last Laugh?

By 1999 the "life sciences" conglomerate Monsanto had carefully constructed a portfolio of businesses in multiple sectors, from chemicals to agricultural biotech. Faced with criticism from PaineWebber and other analysts and additional financial pressures, the CEO caved and proceeded to break up the company. The traditional chemicals business, and later NutraSweet and other divisions, were sold or spun off. The remaining entity was sold to Pharmacia, which was in turn rather quickly acquired by Pfizer. After holding on to the agricultural biotech business for two years—long enough for the Internal Revenue Service to approve a tax-free spin-off to shareholders—Pfizer spun off the entire unit in 2002 as the new Monsanto. At the time, analysts saw that business as basically worthless. They proved to be wrong: In May 2013 Monsanto's market cap touched $57.5 billion.

Idea in Brief

THE PROBLEM
The financial markets systematically undervalue companies with unique and complex strategies—even though these strategies are often the most valuable.

WHY IT HAPPENS
Unique or complex strategies take longer to evaluate, so analysts often avoid covering them. But simple or common strategies are also the most easily copied and therefore the least sustainable.

THE SOLUTION
Companies can try to improve the market's access to information about their strategies, which may include paying for independent equity research. Or they can look for more-patient investors, which may well involve going private.

strategies tend to cover fewer companies overall. And although our uniqueness measure is, as strategy logic might predict, actually associated with higher market value, on average, this premium is lower than it would be if the company received more analyst coverage.

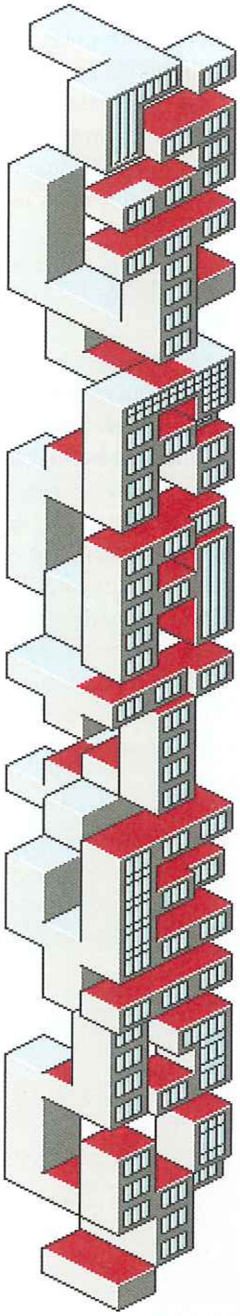
Other research supports our findings. Ezra Zuckerman, of MIT, has found that the markets discount companies that don't fit analysts' narrow categories of specialization. Mary Benner, of the University of Minnesota, has shown that analysts tend to discount strategies involving radical new technologies in favor of those that extend and preserve old technologies. The conclusion is inescapable: The capital markets routinely undervalue companies with complex and unique strategies. Why?

Selling Strategies in a Lemons Market

The answer is that the market for corporate strategies suffers from the famous lemons problem identified by George Akerlof, who shared the 2001 Nobel Prize in economics (with Michael Spence and Joseph Stiglitz) for his work on the topic.

In a lemons market the quality of goods and services cannot be directly observed or measured. A classic example is the used car market (which has changed considerably in recent years), in which buyers usually don't know the quality of the cars. Sellers, who do know, can exploit this situation by selling low-quality cars. Sellers with high-quality cars have no way to credibly signal that to the market, so high-quality cars are simply withheld, to the point where the market consists only of "lemons" with prices that reflect their lower quality.

Managers face an analogous problem when they attempt to sell their strategies in the capital markets. The quality of a strategy is extremely difficult to assess—even for the manager proposing it—and is revealed only as strategic actions are pursued and



results observed. Accordingly, managers can at least temporarily disguise a low-quality strategy as one of high quality. And those that actually have high-quality strategies have difficulty convincing the capital markets of this.

The dot-com boom (and bust) illustrates this nicely. During the late 1990s scores of internet start-ups developed websites, articulated strategic messages connecting their websites to future value creation, and put those messages in IPO prospectuses that solicited investors. Many of these companies had no revenue. Few had profits. Nearly all had only vague theories about their path to cash flow growth. Historical accounting methods provided no real basis for evaluating their quality.

Consequently, market analysts focused on the few available "performance" measures—in particular, the number of hits a company's website received. Unsurprisingly, management teams, in turn, focused on generating web traffic quickly instead of thinking about how to actually make money from their sites. When the party was over, it became clear just how deficient many of these dot-com strategies were. What's more, because good strategies were equally difficult to discern, companies that had them suffered sharp discounts for a long time.

To be sure, this is an extreme example. Yet decision makers in companies of all types and sizes confront the challenge of selling difficult-to-evaluate strategies in a market with a restricted ability to evaluate. And the more unusual and complex the strategy, the harder is the task of selling it. The solution seems obvious: Sell the market a simple and familiar strategy, and the discount goes away.

But short-term logic doesn't sustain long-term performance. As Amazon and Apple have proved, the most valuable strategies are almost of necessity the most unusual, and therefore more costly to evaluate. Indeed, all paths to value creation require discovering unique positions and exploiting unique assets—uniqueness that managers must sell to the capital markets.

The Dimensions of the Challenge

A good way to understand the challenge this poses is to categorize strategies along two distinct dimensions: quality, measured by a strategy's ability to generate cash over the long run, and ease of evaluation, measured by the effort required to estimate this future performance.

These two dimensions generate four potential strategy categories (see the exhibit "The Two Dimensions of Strategy"). Two of these categories are likely to be poorly populated and therefore of limited interest: Type 4 strategies are low in quality and difficult to assess, making them universally unattractive. Type 1 strategies are high in quality and easy to assess and are rare, because a strategy that is easily evaluated is typically easy to replicate—which quickly undermines its value. That leaves most strategy makers with a choice between high-quality strategies that are difficult to assess (Type 3), and lower-quality strategies that are easier to assess (Type 2).

One might expect strategy makers to opt for a unique approach, regardless of evaluation difficulties. Unfortunately, incentives lead most of them in the opposite direction. That is because governance as practiced today focuses on resolving the famous agency problem identified by Michael Jensen. Because management incentives are designed to create current shareholder value, executives avoid valuable strategies that will be discounted by investors.

This battle is fundamentally over who should control the company—managers or investors. Often we see it waged quite publicly. In July 2013 Nelson Peltz, a founding partner of the hedge fund Trian, strongly advocated in the media and in a formal "white paper" (that is, a PowerPoint presentation) that PepsiCo separate snack food and beverages into two companies.

He offered two rationales rather similar to the criticisms made by the PaineWebber analyst quoted earlier. First, in Peltz's view, any synergies between snacks and beverages were dis-synergies: The cultural fit was bad, and the combination encouraged value-destroying decisions, particularly around capital allocation. Of course, PepsiCo management, which saw an abundance of synergy between snacks and beverages, strongly disagreed.

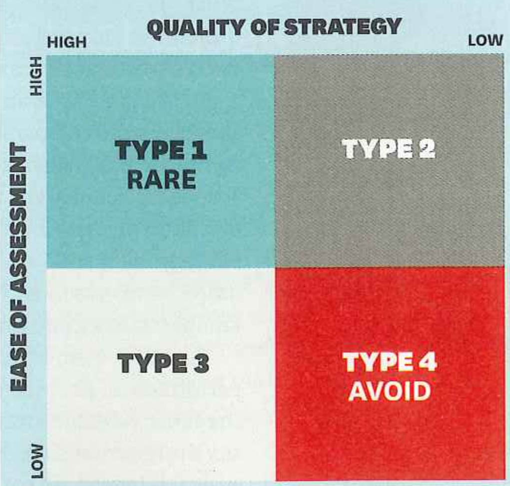
Second, and seemingly more important, Peltz argued that PepsiCo was a difficult-to-evaluate company that was correspondingly discounted—a snack food company evaluated by beverage analysts, who assigned PepsiCo a lower earnings multiple than Coca-Cola's and, worse, assigned snacks an incorrect multiple on the basis of beverage industry comparables. On this point PepsiCo seemed to offer no comment—because, I suspect, it agreed.

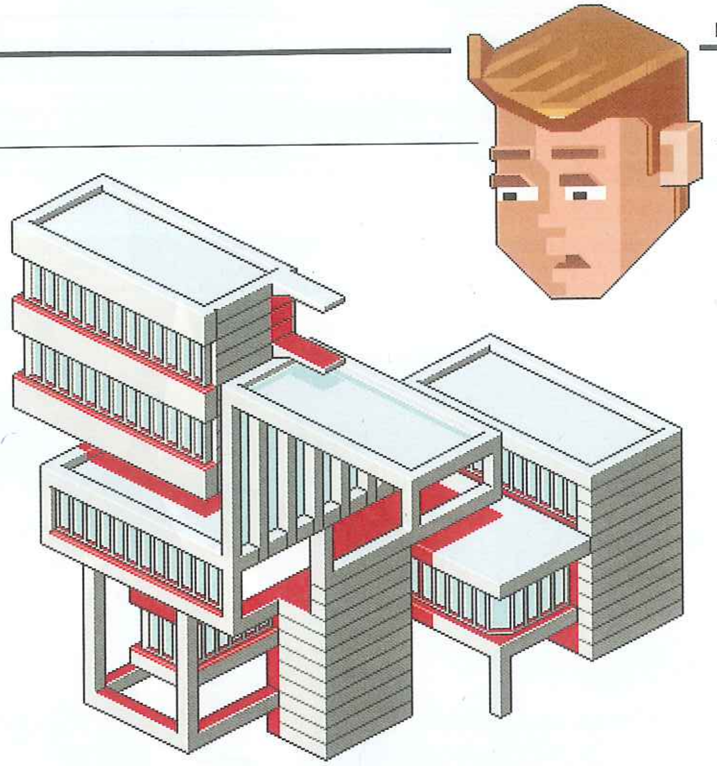
Fixing the Problem

Managers in this position who are convinced that they are likelier than the markets to be right have essentially only two ways to correct the lemons problem: They can make strategic information more accessible, or they can find investors who take the long view. Which they choose should depend on how extreme the problem is.

THE TWO DIMENSIONS OF STRATEGY

When corporate strategies are categorized according to quality (the capacity to create sustainable value) and ease of assessment, it becomes clear that companies must often choose between those that are easy to understand (and so command a price premium in the financial markets) but create little sustainable value and those that are hard to understand (and so suffer a discount in the financial markets) but create sustainable value. Strategies that rank low on both measures are obviously to be avoided, while those that rank high on both are necessarily rare—because easy-to-understand strategies are usually easy to copy, which makes them less valuable.





Improve the markets' access to strategic information. Managers who believe that better communication will solve the problem can push analysts and investment banks to devote greater resources to analyzing their strategy. An extreme approach, now largely out of favor, is to issue a tracking stock for a neglected portion of the business. Tracking stocks trade on the operating performance of divisions within the company. An investment bank that covers the primary security is pretty much obligated to provide coverage for any tracking stocks. Alternatively, managers can campaign for attention by marketing directly to investment banks. Or they can pay for independent equity research, an option that has become increasingly common in recent years. Depending on the year, about a third (or even more) of all publicly traded companies get no coverage whatsoever from security analysts. Given the significant difference that having coverage makes, paying to get it is probably worthwhile.

Find more-patient investors. If improving communication doesn't work, managers' only option is to find sympathetic investors who believe in the company. That may mean taking the company private. Anecdotal evidence suggests that companies with unique or complex strategies are moving in this direction.

Private equity regularly supports new and highly uncertain technology ventures, which are difficult to understand and costly to evaluate. Conglomerates have the same characteristics. Their disappearance from public equity markets over the past two decades has been extensively documented, but conglomerates have by no means disappeared. They have merely become private equity companies, and as such they appear to be flourishing. These complex bundles of unrelated businesses are clearly expensive to analyze in the composite. Going private ensures that your investors have an incentive to incur the costs of accurate analysis and investment.

The 2005 privatization of Georgia-Pacific by Koch Industries was motivated by this logic. Georgia-Pacific was described in the *Financial Times* as an "awkward mix of assets that [were] difficult to value together" and as "trading at a significant discount to the sum of its parts." The acquisition gave Georgia-Pacific patient investors and allowed managers to carry out their corporate strategy and reveal the company's potential value. And, of course, Georgia-Pacific's discount in the market created value for Koch Industries.

Paying for independent equity research has become increasingly common.

Who Should Guide the Ship?

The task of the CEO is to compose a strategy or vision—what I have called a corporate theory (see "What Is the Theory of Your Firm?" HBR June 2013)—that provides ongoing direction for the enterprise, and then to solicit the financing to pursue that strategy. The challenge is that investors have their own theories about the optimal strategic path. That means CEOs sometimes have to decide whether to maintain the course they have set or the one demanded by the markets.

In deciding, they often end up asking themselves, Is my task simply to please the markets, or is it to be creative and clairvoyant, envisioning and executing a path to value creation that investors cannot see? Yes, the strategies most valuable over the long term are also the most unusual and difficult to evaluate, and they are therefore discounted in the present. But what if the crowd really is wise in this case? And how can CEOs know whether their vision is correct?

The answer, of course, is that they cannot. All they can do is build on the resources available to create value and a good theory about how to navigate. And the longer they can keep performing on the basis of that theory, the more the markets will appreciate it.

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