

How product development and innovation influence the market value of a business

The next time you see a successful new biscuit that has caught the fancy of kids or a new bike that's making the youth go into a frenzy, go back and look up what this new product is doing to the company's shares over a period of time, this will tell you a good story.

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Among all the activities taken up by a firm, 'new product development' must rank as one of the riskiest. Many times, the product developed is a 'first' for the organisation and the markets addressed are new. The unknowns are very high. However, this activity has begun to be considered critical not just for growth but even for the survival of firms in the marketplace.

New product development activity is done for a variety of reasons. For example - Colgate launching yet another variant in Ved Shakti is aimed to take on Patanjali's Dant Kanti (one more addition to the already rich and bulging Colgate product portfolio).

The success of the recent One plus cellphone has shown us how there is room for yet another new product in what was already a crowded mobile phone category. From an organisational perspective, new products are developed and launched either in order to fill a gap in the market or to make their existing products more competitive or take advantage of a new technology- so on and so forth.

But how does one assess a company's performance in this area? New product development and innovation are closely linked. And an organisation's innovativeness can be measured in many ways. One is to look at the sheer number of new products that are launched in the market.

Relatedly, the revenue turnover through this stream can give a fair idea of the innovative capability of a firm. According to Dr Vijay Govindarajan (Professor, Tuck University, Dartmouth), creativity is different from innovation as the former only looks at the potential of product development of the firm and this may be evident through patents, IPR, etc.

Whereas the market commercialisation of a new product activity gets captured through Innovation. This requires capabilities like collaboration, stakeholder management, scale up etc. Needless to say, a highly creative organisation may or may not be a highly innovative one, if it doesn't possess the skills for a marketplace launch of the new product developed. 3M is an example of a highly creative and innovative organisation that has frequent introductions in the market.

But how does this new product activity help in shaping perception in the stock market? Do the valuation of shares go up because of a perceived heightened innovative potential? And exactly how does this happen? This article tries to give a peek into that.

Shareholder's value maximisation principle is perceived to be the core of strategic decision making in publicly traded companies. Firm value is determined by the discounted value of estimated future cash flows from a firm's existing business and new business opportunities. The incremental cash flow, used as an input in the discounted cash flow model, largely depends on the ability of firms to generate earnings from successful commercialisation of new product in the market. New product launch signals favourable information about a firm's future outlook and investors' expectations are factored in the stock price and price-earnings multiple (P/E ratio).

This is because from a market standpoint, developing and launching new products shows an organisation's expertise in that category or domain. An example would be Nestle India -whose aggressive growth strategy brought new innovative products in the market that contributed to increase in the revenue from 2.5% (in 2017) to 3% (first half of 2018).

This improved the market capitalisation of Nestle India that stood at Rs.1.1 lakh crore in August 2018. Tesla Motors'(founded by Elon Musk), focus on innovation (specifically on electric vehicles), has helped create a niche for the company. The successful commercialisation and capitalisation of these innovative products would revolutionise the auto market itself.

Investors are betting high on the innovation output of Tesla Motors, though the company has not even started making money from customers. This shows that compelling innovation stories are rated highly in the market and increase the value of a firm. Apple over the years has come up with many new revolutionary products in the market. Apple's innovative product launch starting from iMac G3 in 1998, first iPod in 2001, first iPhone in 2007 (many variants of the same in later years), first iPad in 2010 and iWatch in 2014 has created a lot of buzz in the consumer market and the same is reflected in Apple's soaring share price (average return of 32% until 2018).

However, the inability of the firm to meet investors' expectations on product offering could influence market value to a great extent, which is evident from the recent trend of Apple's share that has lost more than a quarter of its value as on February 2019 though it claims a market dominance in the smartphone segment.

Growth companies are perceived to be innovative and are expected to generate high value and earnings in future. Therefore, they have a high price to earnings multiple (P/E ratio) indicating that investors are willing to pay a high premium for expected future value. Investors' expectations were high on new product offerings from Amazon that ranges from online stores to subscription services. The recent trend of Amazon's quarterly result, however, suggests that Amazon's key business segments are indicating a declining growth trend (23% from the third quarter of 2017 to 12.5% in last quarter of 2018).

A key component of the stock market's reaction to an organisation's performance is its innovative ability. The sustainability of higher expected returns (investor's expectation) is linked to the potential of the new product to generate incremental cash flow that positively influences the reported earnings. This can be achieved through successful commercialisation and capitalisation of the new product.

So the next time you see a successful new biscuit that has caught the fancy of kids or a new bike that's making the youth go into a frenzy, go back and look up what this new product is doing to the company's shares over a period of time, this will tell you a good story.

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