



Value Added Communications

## **Getting Back to Basics:**

# **What Matters in Today's World of Low Investor Expectations and High Volatility**

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# Getting Back to Basics: What Matters in Today's World of Low Investor Expectations and High Volatility

**It's time to revisit how you communicate your company's opportunity, strategy, and deployment of capital to create value**

Stock prices move in tandem with investor expectations. As we have recently witnessed, the direction is not always up. In fact, earnings expectations have a defined life cycle of their own (Appendix 1).<sup>1</sup> At one extreme, we've seen the result of rising expectations, evidenced by upward revisions to earnings estimates. At the other end, companies find themselves almost shunned by investors, where rumors abound of restructuring or takeover.

Today many of our clients find their stock prices suffering from low expectations. Even though business prospects appear positive and goals are being achieved with respect to revenues and earnings, investors are paying greatly reduced multiples on earnings, cash flows, and book value.

To add insult to injury, fear, rumors, and overall uncertainty have driven stock market volatility to its highest level since the Great Depression. This uncertainty has caused the S&P 500 to swing at least 1% in either direction on over 50% of all trading days year-to-date. No one can look into a crystal ball to determine when this whipsaw action will wane, however preparing for the calm after the storm that will ultimately ensue is certainly prudent. With calendar first quarter earnings season just around the corner, companies will have a timely opportunity to revisit their corporate opportunities and strategies, both operational and financial.

Whether your stock has suffered from an "overnight" change in expectations, or a more gradual market-based reduction, the game plan is the same in terms of communicating with your analysts and new investors. You need to have a clear strategy that includes all the elements for analysts to be able to model future earnings and cash flows. And it's not just about earnings - the balance sheet is also under the microscope.

We recognize that providing guidance is most difficult under present economic conditions. Therefore, in lieu of more detailed guidance, investors are back to running the basic research drill. Starting with your industry, your competitive position, pricing power (or lack thereof), cost structure, profitability, cash flows, and capital needs. In our view, this is the "cost of entry" into a new portfolio. In the end, the analyst should be able to map your strategy to the key drivers for growth and value creation. The weak links in the so-called value map will also show you where to refresh your message.

We suggest the following steps for conducting an effective investor message audit:

- Study the last conference call Q&A for clues on what's missing or needs more clarity.
- Review your quarterly earnings release with a critical eye - How much more work (and time) is required for investors to put your periodic results in the context of the bigger picture?
- Make sure that your balance sheet is connected to the business strategy.
- Since earnings do not tell the entire story, be prepared to defend your company's capital investment strategy and the anticipated returns on such projects.
- Are you talking about intangibles as value-creating assets?
- Upgrade your investor "tool kit" and other resources available on your web site.

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<sup>1</sup> Richard Bernstein, "The Earnings Expectation Life Cycle," *Financial Analysts Journal* (March/April 1993)

Jeffrey Bronchick, Chief Investment Officer of Reed, Conner & Birdwell stated, “As people start to believe we’re in a recession, there’s been an aggressive readjustment of earnings and cash-flow expectations...All and all, it’s fairly ugly. When the going gets tough, the tough do research. Don’t stare at the red numbers on the screen – call companies, call industry contacts to hear what’s really going on, dig for new ideas and just look to take advantage of the volatility. Markets like today’s make it ever more obvious that volatility in stock prices can enormously exceed actual changes in fundamentals...Our best investments often come from looking beyond a cyclically down period at how a company will perform on the other side of it.”<sup>2</sup>

Consider a case of market volatility taken to extremes, where a flip-flop in expectations can torpedo an entire industry group in a matter of days. The most recent example is the Managed Care sector, going from "hero to zero." The group had been generally outperforming the broader market indices for some time. It only took a negative surprise from one of the leading players (WellPoint) to reset expectations lower across the board. The issues specific to WellPoint raise larger industry questions from analysts that can certainly impact future revenue growth rates, profitability, and return on investment including:

- Rising medical costs
- Lower enrollment growth
- Pricing power
- Economic weakness and competition
- Adverse customer selection
- Market share losses
- Higher physician and hospital costs
- Quality of earnings

This list represents some of the key inputs to a managed care earnings model, but it is also representative of a much broader review taking place across all industries.

### **Buy, Sell, or Sell Short?**

So who's right? Is the market correctly setting the price? Are investors overly pessimistic? Is the stock a value trap? Those are the key questions for an investor. While annual reports and 10-Ks will help an analyst fill in some of the information, market dynamics and other disruptive forces are causing many to go right to the most valuable resource - management. Short of a face-to face meeting, the conference call is the next best thing. We have observed that the number of conference call participants is growing, the calls are lasting longer, and the level of questioning is much deeper than in recent memory.

It's one thing to reduce earnings estimates based upon lower economic activity, customers being more cautious in their ordering, and cost pressures from raw materials and fuel. In this case, a portfolio manager can build a worst-case earnings model and try to determine if the market has overly discounted a company's prospects. The notion is that "good companies" bounce back and at times can be bought on the cheap.

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<sup>2</sup> “Open Season,” *Value Investor Insight* (January 31, 2008)

However, given the volatility in the housing markets and financial sector, the declining U.S. dollar, and rising commodity prices, we observe that investors are showing a greater level of scrutiny on the basics of the business. In making a purchase decision, an analyst needs to justify the idea to a portfolio manager or investment committee. This is unlikely to happen if an analyst perceives a fundamental problem.

According to Ed Wachenheim, Chairman of Greenhaven Associates, “A lot of the analysis is done to understand the company and its markets so well that we can make a sound judgment on whether the problems are short-term or permanent ones...The goal is to form an opinion on the returns from the business over time and how sustainable those returns are.”<sup>3</sup>

### **Return on Invested Capital is Still a Reliable Report Card**

Despite where a company finds itself on the earnings expectation life cycle, shareholders are entrusting management over the long term to create value. Companies create shareholder value when they generate returns on investment in excess of their cost of capital.

Jeffrey Bronchick of Reed, Conner & Birdwell commented, “In assessing the business, our focus is on returns on invested capital and trends therein. You have to look back over a number of cycles – a company with an average return on invested capital of 17%, ranging from 12% to 23%, is a pretty good business when the average cost of capital is 9%. This helps us define the discount from our fair-value estimate we’ll require to own it...If I was stuck on a desert island and had to make a decision on management talent, I’d choose a summary of past returns on capital over a cell phone to call people.”<sup>4</sup>

In the end, most investors are employing some form of a discounted cash flow model to determine the intrinsic value of a company. However, the current market turmoil illustrates a couple of challenges with this approach: 1) long-term earnings growth is difficult to forecast; and 2) high returns on investment are hard to sustain. It seems that expectations for growth and future returns on investment were mispriced, reflecting the height of optimism.<sup>5</sup>

### **The Difficulty with so Many Industries in Flux**

As we review earnings reports, conference calls, and Wall Street reactions, the expectations have been reduced for a number of reasons, ranging from company-specific events, to larger industry trends, to cyclical influences in the domestic or international economies. For instance:

- Manufacturers have been facing higher raw material prices, and in some cases shortages;
- Interest-sensitive stocks have been impacted by the prospect of higher inflation and interest rates;
- Retailers are threatened by the demise of the consumer given housing market woes, high gas prices, and other inflationary trends;

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<sup>3</sup> “Survival of the Fittest,” *Value Investor Insight* (February 29, 2008)

<sup>4</sup> “Open Season,” *Value Investor Insight* (January 31, 2008)

<sup>5</sup> Michael Mauboussin, “Death, Taxes, and Reversion to the Mean,” *Mauboussin on Strategy* (December 14, 2007)

- Analysts who follow basic industrials are having to adjust their price targets based on peak cyclical earnings, with wide views on where we are in the cycle;
- Restaurants are still facing higher food costs and a slowdown in customer traffic;
- Technology equipment (telecom and PC) providers have been hit by deferred purchases, muted IT spending and competitive pricing;
- Educational stocks have had their "profit horizon" drastically reduced with potential cuts in federal funding for student loans;
- Pharmaceutical companies are confronting a record number of patent expirations in conjunction with weaker pipelines and a regulatory crack-down by the FDA;
- Homebuilders have watched their market capitalizations vanish virtually overnight as the glut of supply became evident, easy credit dried up, foreclosures spiked, and land values were forced to be written down.

### **The Conference Call Q&A is a Good Place to Start Looking for Answers**

With most of our companies having recently reported quarterly results, the Q&A session of the conference calls usually contain timely clues regarding ways to enhance your investment message.

In reviewing investor concerns, we have to distinguish between those questions from the sell-side analysts and the (buy-side) portfolio managers. In their attempts to refine quarterly earnings models, sell-side analysts are naturally all over issues regarding the income statement. Details, details, details.

Meanwhile, the true long-term investors need much more information. You will see a noticeable change in the line of questions (management grilling) once the discussion on earnings models has finished. These questions are typically more to the point regarding corporate strategy, cash flow generation, asset turns, and use of capital. This discussion should remain high-level, so try to keep it simple and focused.

Based on recent client conference calls (small cap and larger cap), investors are still struggling with understanding the fundamentals of the business, as well as management's strategy to create long-term shareholder value. Below is just a sampling of comments and questions from a variety of our clients and industries:

- *"I'm trying to get my hands around the business."*
- *"I know your recent acquisition adds value, but I am unsure about the future of the market at this point."*
- *"I'm confused over different brands, product categories and end markets"*
- *"What is your sales visibility? Do you have long-term contracts?"*
- *"How do you think about market share? Did you pick up any share last year at least where you compete directly?"*
- *"Can you characterize the pricing environment versus last year? Are customers more willing to tolerate price increases and provide advance payments?"*
- *"What is the barrier to entry for other companies to get into your business?"*
- *"Are you getting new customers, or selling new products to existing customers?"*

- *"You've explained this business to us many times, but what gives you optimism that this can be a growth business once some of your existing contracts begin to wind down?"*
- *"Can you give a view on the consumer and how they are responding to higher menu pricing? Do you think you can pass through higher prices without affecting your guest traffic?"*
- *"What is the timing of getting new capacity up and running?"*
- *"Any noticeable changes in the competitive environment?"*
- *"The return on incremental investment has been much higher at one concept compared with the others, so why not spend more of your resources on the one and less on the others?"*
- *"Your bookings are turning into 2009 revenues. How can you insure against raw material fluctuations?"*
- *"What are your long-term goals for gross margins, SG&A, and R&D as a percent of sales?"*
- *"Could you review the capital expansion plans underway and the timing to make sure we are all on the same page?"*
- *"Because of your profitability in the farm sector, have you been raising prices or would you rather generate higher volumes at the same price?"*
- *"Are the new sales hires productive?"*
- *"There have been suggestions by analysts that a change in the (political) administration might be a drag on military contracts. Do you share those concerns?"*
- *"How much longer are you going to invest before you start getting results?"*
- *"Maybe I'm wrong, but my sense was that the incremental margins were not as strong as we've seen in the past. It seems like the upside in your revenue didn't quite flow through to the operating margin as much as I would have expected."*
- *"I see that your receivables and inventory were up fairly considerably and have been for two or three quarters. Is that related to one particular division or something in general?"*
- *"If acquisitions are hard to come by, what are your alternative plans for growth?"*
- *"What do you plan to do with your cash?"*

There are many more questions, all along the same lines, and all of which demonstrate the lack of understanding about a firm's positioning, what customers actually pay for, and how the firm generates and uses its cash. On any given day, portfolio managers are trying to decide where to invest. A big part of this exercise is in estimating the intrinsic value of a firm, and then determining if the market price offers upside potential.

This is basic stuff, something a prospective owner of your business is entitled to know. It's also the crux of the real conversation long-term investors want to have with management. Think of someone who has seen it all, a seasoned and skeptical portfolio manager, and yet they are taking the time to learn more about your firm. Often we find providing a great deal of background information in advance will make for a much more productive dialogue at in-house meetings and investor presentations. The focus should be on strategy and capital.

## **Explain to Investors How You Manage the Firm's Assets**

Businesses are complex. As such, investors cannot possibly understand and forecast all of the intricacies of a firm's business segments with any accuracy. One way to counter this is to focus on your approach as an "asset manager" – how you deploy capital, what level of returns you can realistically achieve, how sustainable these returns are, and how you manage risk associated with capital-intensive projects. A value investor, for example, does not expect a high level of certainty in the form of earnings guidance. (The sell-side has to grapple with that.) On the other hand, a portfolio manager is trying to determine what your firm is capable of producing over the next few years. In order to do that, you need to provide a future context (the business environment), your strategy for competing profitably (either through cost leadership or differentiation), and how you plan to allocate capital (what gets re-invested, what goes to debt reduction and what gets returned to shareholders).

## **Position Intangibles as Value-Creating Assets**

In contrast to the fixed assets on your balance sheet, investors are often left in the dark regarding investments in "soft" assets, or intangibles. Footnotes provide the accounting treatment but very little insight. Yet, it is these very assets, e.g. brands, patents, software, R&D, skilled workforce, customer relationships, operating systems, manufacturing processes, etc., that are core to a firm's competitive advantage. Research has shown that investors systematically misprice the shares of intangibles-intensive firms. In today's current market environment, investors are likely underpricing these assets, raising the cost of capital, and hampering management's efforts to take advantage of growth opportunities.

For example, in fiscal 2007, Microsoft spent nearly \$7.1 billion on research and development—certainly a form of investment—and only \$2.3 billion on capital expenditures. Microsoft is most certainly making healthy investments in its business, but most of those investments are reflected on the income statement as an expense, versus on the balance sheet as an asset.

There are at least two implications for investors. First, understanding the nature and potential payback from intangible investments is more important than ever. Today's accounting conventions, which were developed to capture the condition of largely tangible-asset businesses, does a substandard job of capturing the essential features of intangible investments. Second, since the investments of intangible-centered companies tend to show up as expenses on the income statement, these companies frequently generate high cash flow-to-earnings ratios.<sup>6</sup>

## **Reconstruct Your Message Map Then Upgrade Your Investor Toolkit**

The goal is to determine if your messages "map" to the right categories that allow analysts to model future performance and thereby, set appropriate expectations. You can't assume even the most seasoned portfolio manager knows your industry or competitive strategy, for example. Maintaining a consistent message is also key.

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<sup>6</sup> Michael Mauboussin, "What You See and What You Get – Why Cash Flows Are More Important Than Earnings," *Mauboussin on Strategy* (July 23, 2007)

As Robert Lietzow, Portfolio Manager at Lakeway Capital said, “You can put a lot of faith in a great management team, but some of my biggest drubbings have come from not responding quickly to inconsistencies in what management is saying over time or in different forums. Changing stories are a huge red flag.”<sup>7</sup>

Lietzow also commented, “We’ll take a quick look at the financials, to understand the track record and the basics of the balance sheet. To know whether it’s something to look into further can literally take five minutes.”<sup>8</sup>

A complete review of your message framework might also reveal the weak links or possible disconnects in your story - something that would cause a seasoned investor to take a pass in the first five minutes. In this case your opportunity cost for attracting a new buyer is huge.

With declining analyst coverage, particularly among smaller cap companies, your web site will likely be the first stop for most investors. We suggest that you audit all relevant materials, including the investor section of your web site, quarterly press releases, slide presentations, and fact books or other supplemental information. A review of your current MD&A might also reveal the need to offer additional insights into your industry, cost drivers, and risks to be managed, for example.

Finally, take heart that even if your company might be temporarily "revenue- or profit-challenged" your current owners and prospective investors are keenly interested in what you are doing to improve the value of your enterprise over the long-term. Make sure you are absolutely clear on this point.

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<sup>7</sup> “Survival of the Fittest,” *Value Investor Insight* (February 29, 2008)

<sup>8</sup> “Survival of the Fittest,” *Value Investor Insight* (February 29, 2008)

# Appendix 1: Earnings Expectations Life Cycle

**Growth:** Once earnings momentum continues for a long enough period, a stock is termed a "growth" stock. Earnings expectations are very high resulting in maximum risk of disappointment.

**EPS Momentum:** Investors that follow earnings momentum themes begin to buy the stock as estimates and reported earnings continue to rise and year-over-year comparisons improve.

**Positive Surprise:** Eventually a low-expectations company begins to disseminate more optimistic information resulting in increased investor attention and research coverage.

**Deep Value:** Earnings expectations become so low that only "contrarian" or "deep value" investors are interested in these stocks as most investors find them unattractive or overly risky.

**Torpedo:** When an earnings disappointment occurs, the stock is "torpedoed." Earnings expectations and stock price sinks.

**Estimates Lowered:** The consensus begins to lower earnings estimates. However, some analysts tend to lag because they do not believe the earnings shortfall is a sign of a fundamental problem with the company.

**Neglect:** Investors become so disinterested in the stock or the sector that sell-side firms believe that research coverage is no longer warranted or profitable.

