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Divesting proactively

Most companies wait too long to divest. They should sell off businesses long before they become a burden.

Lee Dranikoff, Timothy M. Koller, and Antoon Schneider

Breaking up, it turns out, really *is* hard to do. For many executives, the prospect of selling a business triggers a vague sense of dread. Perhaps the sale will seem like a tacit admission of failure or evidence of poor management. In some close-knit corporate cultures, it may even smack of treason.

It should not be surprising, then, that when executives do divest, it is nearly always in response to pressure—maybe the divested business is suffering heavy losses, the parent has a suffocating debt burden, or Wall Street analysts have turned negative. Among 50 of the largest divestitures completed over the past four years, we found that more than three-quarters were completed under pressure, most of them only after long delays when problems became so obvious that action was unavoidable¹ (Exhibit 1). Furthermore, in our study of the 200 largest US corporations during the 1990–2000 period, fewer than half divested three or more substantial businesses—those with a disclosed worth of at least \$100 million. Only one in five divested more than a half dozen substantial businesses. Taken as a group, the companies we studied bought 40 percent more businesses by number of transactions than they sold.²

We believe that such a bias against divestitures serves companies poorly and that most CEOs can boost performance by thinking about divestiture more proactively. Prior research

by McKinsey colleagues demonstrates that companies that create the most shareholder value are those that actively acquire and divest their portfolios.³ Indeed, a hundred dollars invested in the average active corporate portfolio manager in January 1990 would have been worth \$459 by the end of the decade, but would have grown to only \$353 if invested in the average passive portfolio. Companies that tilted toward acquisition lagged significantly behind those that balanced their acquisitions with divestitures.

Holding on can be costly

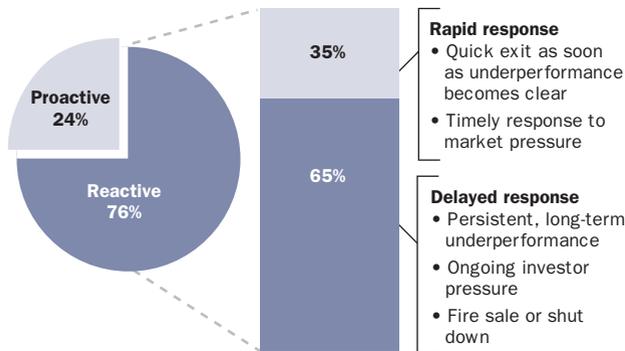
Of course, the desire to hold onto businesses, particularly successful ones, is strong. A unit may provide strong cash flow. It may deliver marketplace advantages through its relationships with key customer groups. Or it may represent a sentimental attachment for employees or other stakeholders, forming an important component of a company's identity.

But holding onto a unit too long also imposes costs—both on the entire corporation and on the unit itself. These costs often far outweigh the benefits of keeping the business and can include the following:

Costs to the corporation. The stability that well-established, profitable businesses provide is a mixed blessing. True, stable businesses can produce cash and help keep earnings smooth

Exhibit 1. Most divestitures are reactive, in response to pressure on the parent or the unit

100% = 50 divestitures



Source: McKinsey analysis

and predictable. But they can also dampen a company's impulse to create new, high-growth businesses. Determined business building often springs from a sense of crisis—a clear and pressing need for growth. The sense of comfort that surrounds seemingly stable businesses can temper any sense of urgency, causing a company to stagnate.

A stagnant portfolio of stable businesses can also drain precious resources and hinder exploration of new opportunities. Specialty-packaging-products provider Pactiv reviews the role of each business unit every year, as part of the overall company's strategic-planning process, and sees divestiture as a powerful way to free up resources. In 1999 the company sold its aluminum business despite its strong cash flow. Says CEO Richard Wambold: "It was using resources and management time we could use better elsewhere, and its cyclical nature [made Pactiv] more difficult for investors to understand. It did not offer the same potential as the other businesses."

Costs to the unit. Every corporate parent has different skills and resources. Some, like

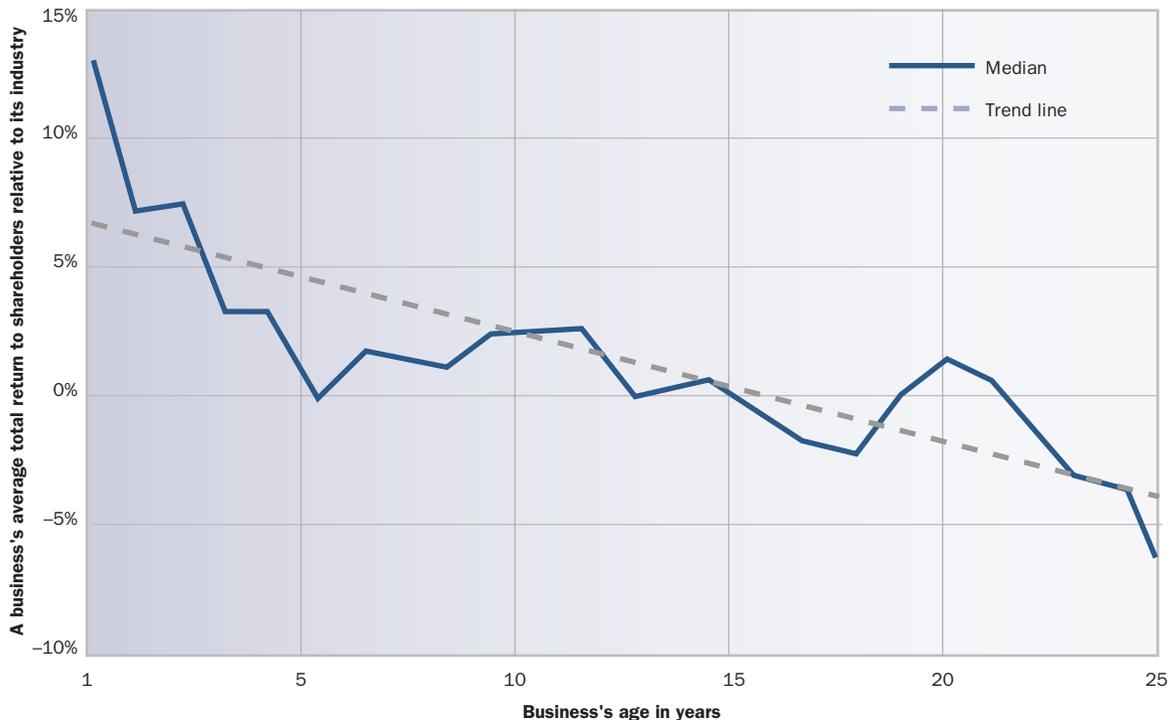
strong venture capital firms, understand how to seed a business, providing important capabilities in such areas as product development, sales and marketing, and alliance creation. Some excel in growing businesses, offering expertise in, for example, operational planning and capital management. Others know how to manage mature businesses, providing assistance in making operations more efficient or helping them to better manage costs.

Rarely does a parent have the expertise required to help a business through every stage of its life cycle. When a corporate parent stops adding distinctive value, it is no longer the natural owner of a unit and should consider selling it or spinning it off. That is what Wambold did with Pactiv's polyethylene-packaging business. Although the unit was the largest player in its market, the polyethylene industry remained highly fragmented. Wambold saw that Pactiv did not have the resources to lead further industry consolidation. As a result, Pactiv was not best positioned to take the unit to the next level of performance. So in January 2001, Pactiv sold the unit to Tyco, which wanted to expand its polyethylene business. As Wambold explains, "You have to know what business you are good at and let someone else manage the rest."

Depressed exit price. Postponing divestitures can exact another cost through direct impact on shareholder returns. As with acquisitions, a well-timed divestiture can contribute to shareholder value, and a poorly timed one can destroy value.

Naturally, timing the market perfectly is impossible. But we find that a company's timing can improve considerably by using a simple rule of thumb: *sell sooner* (Exhibit 2). In the vast majority of divestitures we have

Exhibit 2. Time is the enemy of business



Source: McKinsey analysis

studied, it is clear that selling earlier would have generated much higher returns. Why? Downward adjustments of business valuations by outsiders or capital markets typically lag behind any decrease in true value of a business as it matures and generates lower economic performance and/or growth because outsiders have incomplete information. That asymmetry of information can give companies a window of opportunity to sell a business at an attractive price once it becomes evident internally that growth and performance are on the decline.

Making it happen

Most coordinated divestiture programs happen as a result of a change in a company's leadership. Indeed, more than 50 percent of all significant divestitures take place within two

years of the appointment of a new chief executive. Fresh to the role, the incoming CEO can assess the situation without bias, make decisions without fear, and take the hard actions necessary to unload businesses.

But incumbent CEOs can achieve the same results. By following a rigorous, carefully managed five-step process, companies are more apt to get a proactive divestiture program off the ground, build support for it throughout the ranks, and ultimately make it a core element of their corporate strategies (Exhibit 3). Two of these steps—structuring the deal and communicating a difficult decision—are likely to be familiar and intuitive, similar to components of any important strategic transaction. The other three we will examine more closely here.

Exhibit 3. Five steps of proactive divestiture

Prepare the organization	<ul style="list-style-type: none">• Explain to employees the rationale for the divestiture and why it is essential to the corporation's health.• Introduce forcing mechanisms to ensure that managers actively consider divestiture.
Identify candidates	<ul style="list-style-type: none">• Establish concrete criteria for determining candidates, including a unit's impact on the rest of the corporation, the corporation's impact on the unit, the unit's ability to meet or surpass market expectations, and the optimal portfolio for the company.• Analyze the practical issues (such as taxes, availability of buyers, and so forth) to narrow the list of candidates.
Structure the deal	<ul style="list-style-type: none">• Identify buyers and determine how best to structure the sale (for example a simple sale for cash, a spin-off to shareholders, or complex structures involving two-step transactions and contingent compensation).• Ensure that employees are not distracted during the sale process, perhaps by offering them additional incentives.
Communicate the decision	<ul style="list-style-type: none">• Hold off on the sale announcement until the completion of the deal seems likely.• Communicate the reason for the sale concisely and simply.
Create new businesses	<ul style="list-style-type: none">• Reinvest the funds, management time, and support-function capacities in attractive new growth opportunities.

Source: McKinsey analysis

Prepare the organization

Because the stigma surrounding divestiture is so strong, people will naturally resist it, at least initially. It is critical, therefore, that senior managers rigorously communicate the rationale for divestiture and why it is essential to the corporation's health. PerkinElmer's leadership team, for instance, prepared the ground for its divestiture program⁴ by talking directly and repeatedly with people throughout the organization. CEO Greg Summe held regular "town hall" meetings with each of his businesses, explaining the company's strategy and divestiture's role in it. In time, as a company begins to enjoy the results of proactive divestiture, the stigma should fade, and divestiture should become an expected event in a business unit's life cycle. Until then, though, management will have to assure employees that divestiture is not a sign of failure but an emblem of strategic strength.

When a company is in the early stages of building its divestiture skills, it can be useful to introduce some formal forcing mechanisms to ensure that divestiture is routinely considered. A company might, for instance, impose limits on portfolio size, set fixed ratios of divestitures to acquisitions, or hire people with trading mind-sets to sit on boards or fill key roles. Or, as private equity firms have done for years with strong results, a company can "date stamp" all its businesses. The idea is not to force any divestiture by a specific date but rather to ensure that divestiture is seriously considered at regular intervals.

Identify candidates

Perhaps the biggest shift in embracing a proactive approach to divestiture is thinking about selling off good, profitable businesses. That can be quite a shock to many people, even in the most senior management ranks. It

is important, therefore, to establish concrete criteria for analysis and apply them objectively to every unit. Four factors, in particular, should be weighed:

The business unit's impact on the rest of the corporation. What effects, positive and negative, does the business unit have on other units and on the corporation as a whole? A cultural audit, for example, can help assess whether a unit's culture clashes with the parent corporation. Examining the CEO's calendar can identify units that consume a disproportionate share of management time. Interviews with unit managers and a review of denied capital spending requests can identify opportunities that have not been explored because of competitive conflicts. Conversely, a review of each unit can reveal whether it offers ongoing synergies in terms of growth options or valuable benefits such as shared R&D resources.

The corporation's impact on the business unit. Any evaluation of a business unit should be two-way. What value does the parent corporation add to the business unit, relative to other potential owners? relative to what other owners bring to similar units at competitors? Analysis of matching skills, cultural fit, and synergies then have to be compared with what another owner could offer the unit in order to assess the premium another owner might pay to acquire it.

The unit's ability to beat market expectations. Do the capital markets currently overvalue or undervalue the business? This analysis can be difficult—management needs to estimate the unit's value based on future expectations for performance and compare that number to the unit's implied market value embedded in the stock price. Difficult? No question. But this

Divestiture is not an end in itself but rather a means to building a company that can grow and prosper over the long haul.

analysis is essential because it will show executives whether the unit can realistically create future value for the company's shareholders. When the analysis reveals that existing businesses are overvalued by the capital markets, executives will tend to be much more aggressive in selling off units to outsiders who lack in-depth information into true business performance and growth prospects.

Sometimes, the divestiture candidates pinpointed by this analysis even include cash cows. Why sell cash cows? Because they are likely to be in mature industries and have limited potential for achieving growth beyond the market's expectations. Cash cows benefit companies by providing protection during downturns, for example, or being a source of funding for new investments. But they usually contribute little to shareholder value. They can also be risky to hold if they lose market share, which is virtually inevitable among high-market-share businesses, because their market value will likely decline sharply.

The corporation's overall portfolio. If the previous steps identified candidates for divestiture, it is this final step that must determine which divestitures to push forward. Only a sound portfolio strategy can determine what is the best combination of businesses for the company to hold, the critical size for the organization, and the desired market

perception. By examining the portfolio that would remain if different sets of divestitures occurred, it is possible for a CEO to see the impact on the overall company and evaluate how the remaining portfolio fits with the company's long-term strategy. This analysis must be forward looking; a business unit that does not fit with a company's portfolio today might fit exactly with the portfolio it intends to develop.

It is important to note that no one type of portfolio is best for every company. The purpose of a divestiture strategy should not be simply to transform a diversified, multi-business company into a focused, single-business company. In fact, the capital markets actually reward a moderate degree of diversification. Between 1980 and 2000, moderately diversified companies delivered shareholder returns that were at least as strong as, and in some cases stronger than, those of focused companies and consistently stronger than those of highly diversified companies.⁵

These four analyses will highlight attractive candidates for divestiture. Management can then apply practical considerations—tax implications, availability of buyers, market reaction, payment mix, use of divestiture proceeds, and dilution of earnings—to narrow the list and set timing. Some executives would argue that the practical issues are so important that they should be considered first. We disagree. Many corporations overemphasize the practical issues and thus presume that divesting is impossible. By focusing on more strategic considerations at the outset, companies build momentum for divestiture and look at the practical constraints as problems to be overcome rather than as roadblocks to action—an important distinction.

Create new businesses

Divestiture is not an end in itself but rather a means to building a company that can grow and prosper over the long haul. Wise executives divest businesses in order to create new ones and expand existing ones. All the funds, management time, and support-function capacity that are freed up through a divestiture should therefore be reinvested in creating shareholder value. In some cases, this will mean returning money to shareholders. But more likely than not, it will mean investing in attractive growth opportunities. In companies, as in the marketplace, creation and destruction go hand in hand; neither flourishes without the other. **MoF**

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¹ See also, D. Ravenscraft and F.M. Scherer, "Mergers, sell-offs, and economic efficiency." The Brookings Institution, 1987, pp. 167, which found that divested units had below-average operating profits for seven years prior to being sold.

² See also, Constantinos Markides, "Diversification, refocusing, and economic performance." Massachusetts Institute of Technology, 1995, pp. 62, which found that large companies completed 34 percent more acquisitions than divestitures during the 1980s.

³ Jay Brandimarte, William Fallon, and Robert McNish, "Trading the corporate portfolio." *McKinsey on Finance*, Number 2, Autumn 2001, pp. 1–5.

⁴ The company completed 11 acquisitions and 6 divestitures over 3 years between 1998 and 2001.

⁵ Neil Harper and Patrick Viguerie, "Beyond focus: Diversifying for value." *McKinsey on Finance*, Number 3, Winter 2002, pp. 1–5.

What makes your stock price go up and down?

Identifying and understanding important individual investors can help corporate executives predict the direction of share prices.

Kevin P. Coyne and Jonathan W. Witter

CEOs always want to know how the market will react to new strategies and other major decisions. Will a company's shareholders agree with a particular move, or will they fail to understand the motives behind it and punish the stock accordingly? And what can management do to improve the outcome?

Trying to predict stock price movements is necessary, of course. After all, when stock prices fall, the cost of borrowing and of issuing new equity can rise, and falling stock prices can both undercut the confidence of employees and customers and handicap mergers. Unfortunately, however, most of these predictions are no more than rough guesses, because the tools CEOs use to make them are not very accurate. Net present value (NPV) may be useful for estimating the long-term intrinsic value of shares, but it is famously unreliable for predicting their price over the next few quarters. Conversations with sample groups of investors and analysts, conducted by the company or by investment bankers, are no more reliable for gauging market reactions.

But executives *can* dramatically improve the accuracy of their predictions. By adopting a more systematic, rigorous approach, corporate leaders can learn to understand individual investors as thoroughly as many companies now understand each of their top commercial customers. By identifying these critical individual investors and understanding what

motivates them, executives can predict how they will react to announcements—and more accurately estimate the direction of stock prices.

Armed with solid insights about how critical investors behave in specific situations, executives can make strategic decisions in a different light. Knowing what makes crucial investors buy, sell, or hold the company's stock allows CEOs to calculate what its share price might be after an announcement and to factor this calculation into their strategic and operating decisions. To head off short-term selling, a company could manage the timing, pace, or sequencing of strategic announcements. It could introduce a new management team before announcing an acquisition. It could also test an important new product in selected markets before the nationwide rollout.

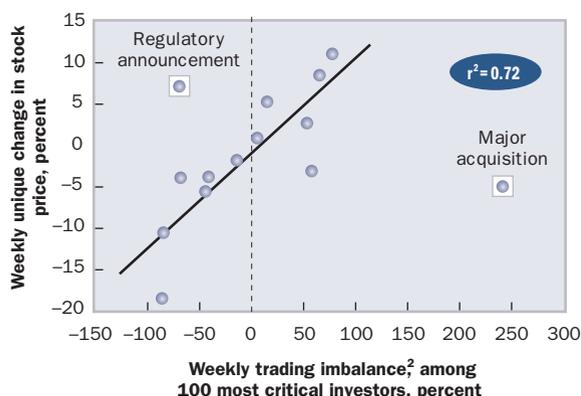
A CEO even has the choice of forging ahead in the face of adverse predictions, using the information to manage the expectations of the board. An executive may, for instance, consider bold strategies even though they could push some critical investors to sell the company's stock.

The few that matter

It should come as no surprise that big trades can significantly move the needle on a company's stock price. When the Bass family

Exhibit 1. A few large investors drive stock prices

Analysis of weekly trading volume of a large European industrial company¹



r^2 = the proportion or percentage of variance explained by a regression

¹ Points represent every week during 2-year period in which stock price changed >2% relative to market index and change wasn't reversed during the following week.

² Calculated as net purchases + net shares repaid – sales – net shares borrowed.

Source: McKinsey analysis

of Texas, for example, sold a 6.2 percent stake in Disney in September 2001 in response to a margin call, Disney's stock fell by 8 percent.

But typically short-term changes in a company's stock price are not the result of a single big trade. In our research on the changing stock prices of more than 50 large US and European listed companies over two years,¹ we consistently found that the majority of unique changes² in each company's stock price resulted from the net purchases and sales of the stock by as few as 30 but at most 100 investors who traded in large quantities. Further analysis attributed 60 to 80 percent of all unique changes, quarter by quarter, to the net trading imbalances of these investors.

Consider a snapshot of trading in the shares of a large European industrial company. Exhibit 1 shows the relationship, over a period of two

years, between the net buying and selling of its top 100 most critical investors, captured weekly, as well as the fluctuation in its stock price relative to the market index.³ In 11 of the 14 cases when the company's stock price moved significantly, the price went up or down in concert with the net buying or selling of these very investors.

Of course, the correlation between the buying or selling of large investors, on the one hand, and the price of a stock, on the other, can never be perfect. Smaller investors sometimes act in sync and overpower larger holders—as happened twice in two years with the shares of the European industrial company. News, rumors, and world events can spark broad market swings. But among the companies we have studied, the correlation is remarkably persistent (Exhibit 2).

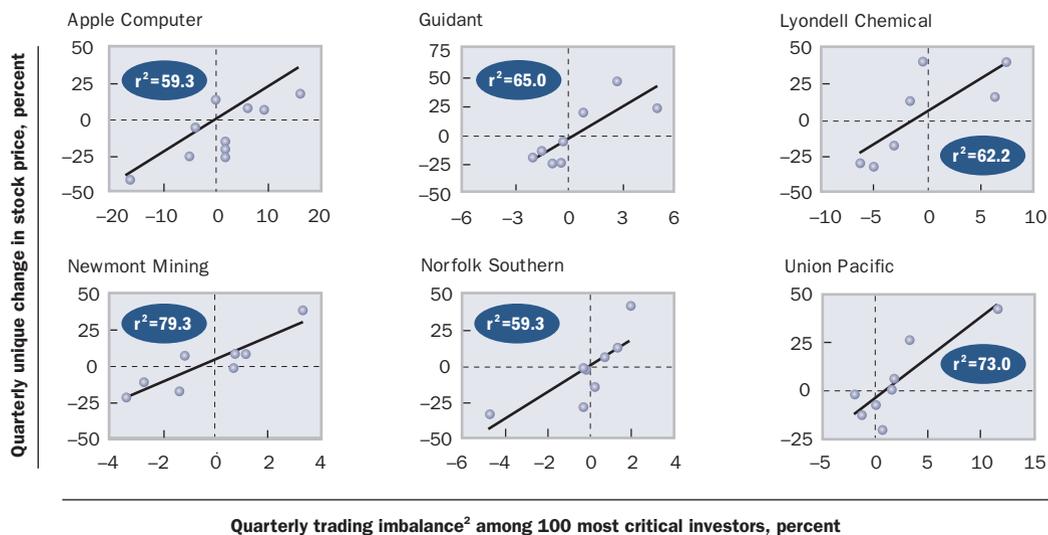
Industrial marketing for investors

Few companies today get to know their top investors well enough to predict with any accuracy what will make those investors buy or sell their shares. The CFO of a large financial company, on the verge of announcing a major divestiture, believed he was “right on top of [our] investor base.” Indeed, in a general way, the company's executives knew the big investors well—what they thought of management, the credit-worthiness of the company, and so on. But executives did not know what investors thought about specific potential strategies.

To develop the ability to predict shareholder behavior, companies should identify their stock price movers and calculate how many additional shares will be offered or sought in reaction to specific announcements. Through background analysis and interviews,

Exhibit 2. A persistent correlation

Correlation between quarterly unique changes in stock price and trading imbalance among most critical investors,¹ percent



r^2 = the proportion or percentage of variance explained by a regression

¹ Stock prices indexed and deflated by the S&P 500 index, adjusted for splits and other corporate changes.

² Calculated as net purchases + net shares repaid – sales – net shares borrowed.

Source: Thomson Financial (ShareWorld); LionShares; Yahoo! Finance; McKinsey analysis

companies must then analyze in depth the trading behavior of these movers, developing trading profiles for each of them. Finally, companies should use the information in the profiles to predict which movers would react to specific corporate announcements by selling or buying stock and then calculate the implications for share prices.⁴

Getting to know investors is not a one-shot process. Companies must continually reexamine who is moving their shares. Our experience suggests that the most critical investors typically stay around for six quarters—long enough to make building a profile worthwhile but short enough that new critical investors must also be constantly evaluated. An ongoing dialogue deepens a company's knowledge of its critical investors and, over time, sharpens its ability to predict their actions.

Identify the critical investors

A company should begin its assessment by asking who has the potential to move its stock price. Some could be among a company's smaller shareholders who want to increase their ownership. Others will be among the company's largest current shareholders—though not necessarily. Shareholders such as family holdings or trusts that have owned big blocks of the company's stock for a long time do not move share prices from quarter to quarter. Neither do index funds, unless the company's status on an important index changes (or unless the fund's assets change dramatically). Among the largest 20 investors of one big pharmaceutical company we studied, only 10 were movers, and this proved to be typical of the companies we studied. Furthermore, nearly half of the large movers of the pharmaceutical company stock over eight

Exhibit 3. Profiling big investors

Situation: Chemical company considers spinning off specialty business

Key question: Will this investor sell?

Inputs: Outside-in analysis, interviews

Sample profile

How does investor make decisions?

Valuation characteristics

- Invests primarily in companies with highly cyclical products
- Analyzes depressed sectors to determine which may have better news or forecasts over coming year
- Values selected metrics, such as sales and price of particular commodity in key markets

Structural and behavioral characteristics

- Follows automatic decision-making process (tied to analysis of underlying commodity market)
- Buys only once, sells quickly
- Doesn't necessarily wait for full expected peak price
- Will often sell at 5% discount

How does investor view announcements?

Valuation characteristics

- Focuses only on how strategy affects commodity cycle

Earnings surprises

- Doesn't want earnings trouble in rest of core business to affect commodity prices

Management changes

- Views management as credible but would be satisfied with any experienced management team—so long as it doesn't become distracted from commodity business

Complex events

- Doesn't want to trade after earnings shortfalls
- Doesn't want to trade after earnings shortfalls

How will investor likely react?

Insight: Investor purchased stock in belief that share price would rise as commodity market recovered

Prediction: Investor will sell entire holding in spun-off company immediately and hold stock in parent company until commodity-cycle peak

Source: McKinsey analysis

billion investment fund that had been an active trader in other, similar chemical companies and liked to buy assets at the bottom of a cycle. At the time, the sector was depressed, so for this and other reasons we added the investor to the company's list of movers. A few months later, the investor purchased more than five million of the company's shares.

What do these movers have in common? They are active stock-portfolio managers who regularly buy and sell large quantities of shares in the company or in similar companies—typically, managers of mutual, pension, or hedge funds or even individual large investors. In other words, critical investors have both weight and a propensity to throw it around. Although the actual calculations needed to put together the list of movers are complicated—requiring more discussion than we can present here—a likely mover is someone who does or could account for at least 1 percent of a stock's trading volume for one quarter.

To determine how many investors should go on the list, a company should test the accuracy of its predictions over previous quarters. Too few will yield poor correlations between activity and stock prices; too many will add to the cost and complexity of the process.

Moving the movers

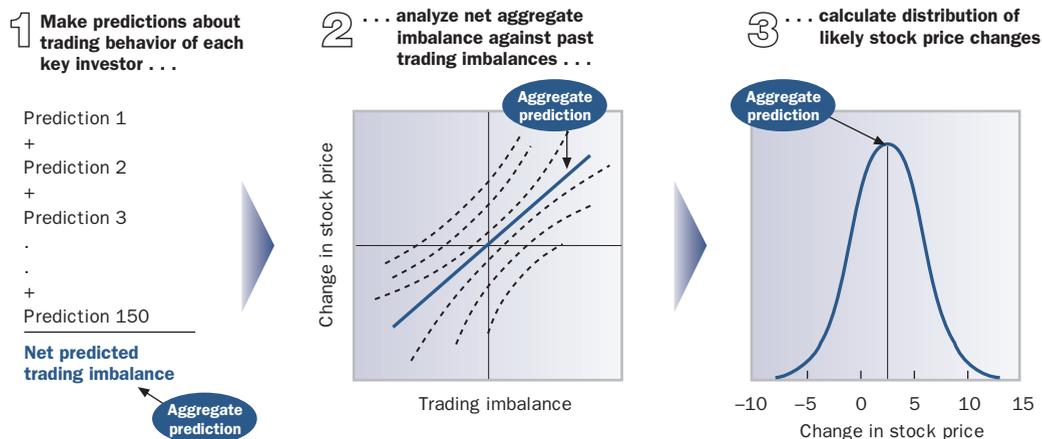
Once a company has identified its movers, the next step is to develop thorough profiles of all of them. This begins with an outside-in analysis of each mover, including its stated investment criteria and objectives and its trading patterns.

Subsequent discussions with investors can fill in the gaps and confirm hypotheses about

quarters from 1999 to 2001 were not among its 20 largest investors in any single quarter.

Still others will be *potential* investors, those who have invested in other industries in similar circumstances. Those who bet on the right players in one industry that consolidated, for example, may now be eyeing other sectors on the verge of consolidation. Potential movers might also include investors who own shares in a company's upstream or downstream suppliers, or those who have a taste for betting on companies that use certain capital models (high cash flow, say, or high leverage). For one large chemical business in our study, potential movers included a \$22

Exhibit 4. Putting it all together



what movers trade and why. A profile should include what an investor wants to invest in and what valuation models the investor uses. How is it likely to react to events or to data, which can be interpreted in many ways? Are its investments subject to any constraints, such as their size and frequency? A profile should also describe each investor's views on issues that the company might face—such as any new strategies (for instance, whether the company should go into China), pending earnings surprises, and changes in management. Of course, companies should remain vigilant of a US Securities and Exchange Commission (SEC) regulation that prohibits companies from disclosing material information to some but not all investors.⁵

The precise format of profiles will vary from company to company, depending upon the decisions and events it expects to face. However, the content of each profile should focus on predicting how each investor will react to specific corporate events (Exhibit 3). Companies will want to collect the information in a database where it can be updated regularly.

Making predictions

With the movers identified and profiled, investor relations staff and executives can make reasonable judgments about who will sell, buy, and hold and in what quantities. They can be guided by such details as the average trade an investor makes and whether the investor historically *bleeds* (buys and sells incrementally over time) or *blasts* (buys and sells quickly and in large blocks).

Such information gives a company an idea of the extent of the trading imbalance that will likely occur as a result of the announcement. Executives, guided by past imbalances in the company's stock and the way they moved prices, can use this estimate to make a rough assessment of how the stock price will react (Exhibit 4).

Although the process itself is straightforward, making these predictions can be quite complex. Nonetheless, several companies we have worked with have performed the necessary calculations and used the information to guide their strategic decisions. One company, recognizing that its share price

would take a hit, decided there was little it could do except to prepare and manage its board. (In this case, estimates of what would happen to the stock price were extraordinarily accurate.) Another company decided to postpone a restructuring when it realized how far its stock price was likely to fall. Profiling helped the companies in each case to tailor their communications to investors.

Building the capabilities

Companies will need to make at least two key changes to build their capabilities. First, they must stop viewing the market as a monolithic entity that judges performance in an adversarial way. When a company's stock price changes, executives should not ask why the market moved; they should pinpoint who bought, who sold, and why. In fact, managers should view investors much as managers in private companies view their corporate owners—and understand them just as well.

Second, a company's investor relations unit will have to take on a more strategic role, almost as an adjunct to strategic planning. It will be responsible for managing the key-account process to identify movers and understand their behavior. Its staff will have to test all major plans and announcements for their effect on the price of the company's shares and suggest modifications to those plans to bring them into better alignment with the views of key shareholders. Investor relations leaders will have to be able to stand up to the CEO and deliver bad news when necessary and be capable of handling tough interviews with investors pressing for SEC-restricted or competitive information they cannot divulge. For the first time, the investor relations unit will become an important adviser to the CEO.

Taking a more rigorous, structured approach to investor relations and stock price predictions clearly requires resources, including the time and attention of senior management. But given the importance of share prices, why would a CEO ever want to be left guessing? **MoF**

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This is an excerpt from an article of the same title in The McKinsey Quarterly, © 2002 Number 2, pp. 28–39.

- ¹ The companies in our study compete in a variety of industries, including financial services, industrial services, packaged goods, pharmaceuticals, and transportation. Their market capitalizations ranged from \$800 million to \$170 billion, and each had institutional ownership greater than 40 percent.
- ² Relative to the rest of the market.
- ³ The 14 plot points represent every week during a two-year period when the price changed by more than 2 percent relative to the market index and the change was not reversed during the course of the following week.
- ⁴ Of course, occasionally an investor will make big trades for reasons that have little or nothing to do with corporate announcements and everything to do with the investor. Only by understanding the investor deeply can one even hope to anticipate these kinds of actions.
- ⁵ Although this article is no substitute for legal counsel, we have reviewed the topic extensively and believe that the SEC regulation (Reg FD) neither restricts a company from putting questions to an investor nor precludes the investor from sharing his or her views with a company. Further, the regulation does not prohibit companies from conducting a detailed or focused discussions with particular investors so long as the additional information does not violate the test of materiality for the broader investor community.

Who's afraid of variable earnings?

Many companies waste effort smoothing short-term earnings. They would be better off focusing on long-term profit and return on capital.

Timothy M. Koller and Singenellore R. Rajan

It is increasingly obvious that the market's obsession with short-term earnings has pushed many companies into unwise or cosmetic business practices. Tactics such as accelerating revenue recognition and managing accounting reserves to smooth earnings are based on the assumption that investors will pay a premium for steady and predictable earnings growth. As confirmation, some point to Jack Welch, whose management of GE's accounting reportedly smoothed the company's earnings and earned its stock a so-called Jack Welch premium.¹ Executives today regularly cite stable earnings growth as a reason for strategic actions. For example, the CEO of Conoco justified its pending merger with Phillips Petroleum in part by asserting that the merger would offer greater earnings stability throughout the commodity price cycle.²

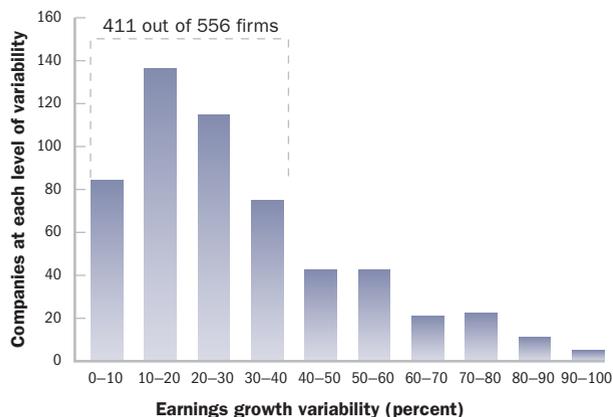
It would seem to make sense that the market should place a higher value on companies that exhibit steady profit growth quarter after quarter, year after year. Yet in today's environment, in which financial accounting is closely scrutinized, emerging anecdotal evidence indicates that the market is increasingly suspicious of overly smooth and predictable earnings. When companies beat analyst estimates by exactly one penny, for example, quarter after quarter, it is

typically their lack of variability that raises eyebrows.³

So the fundamental question remains: does the market value steady and predictable profit growth, and if so, how much? We examined how earnings stability was related to total returns to shareholders (TRS), the market-to-book value ratio, and the price-to-earnings (P/E) ratio. We found that variability in earnings growth rates had little effect on TRS. It is true that as earnings stability decreases, TRS declines, but the magnitude of these effects are small, especially when compared to the effect of fundamental drivers like earnings growth and return on invested capital (ROIC). Similarly, greater earnings stability results only in a small increase in market-to-book ratios and has no effect on a company's P/E ratio.

We also found that going through accounting contortions just to meet analyst expectations is overrated. While the short-term effects of meeting or missing projections can be significant, fundamental performance drivers are much more important over time. Comparing actual earnings results to the consensus predictions from analysts, we found that while positive earnings surprises led to positive excess returns⁴ and negative surprises to negative excess returns, the relationships to excess returns were very weak.

Exhibit 1. Most firms have earnings growth variability between 0% and 40%



Earnings growth variability = standard deviation of earnings growth
Source: McKinsey analysis

Earnings stability and shareholder returns

To understand the link between earnings stability and shareholder returns, we measured the variability of growth in earnings per share (EPS) for more than 550 companies⁵ between 1996 and 2000 (Exhibit 1). We compared each company's *annual* earnings growth to its *average* earnings growth over the entire period and noted each company's growth variability.⁶ Walgreens' earnings per share, for example, rose steadily from \$0.32 in 1995 to \$0.77 in 2000. Its average annual growth rate over that time was 19 percent, with variability of four percentage points, i.e., 15 percent to 23 percent. The higher a company's variability range, the more its annual earnings vary up or down from its average growth over time.

When adjusted for underlying performance—that is, the effect of earnings growth and ROIC—the relationship between earnings stability and market performance measures (TRS, market-to-book ratio, and P/E ratio) was weak. Long-term earnings growth and

ROIC combined explained 51 percent of TRS for the entire sample over a five-year period, but earnings stability explained only an additional 2 percent of TRS.

We then sorted the data into low- and high-earnings growth groups to isolate the effects of earnings stability from that of earnings growth. For both groups, firms with higher variability do see a decline in TRS (Exhibit 2), but the effect is slight. For example, if a firm with an annual TRS of 13 percent and earnings growth variability of 30 percent were to increase its variability even by as much as 20 percent,⁷ its annual TRS would decrease only to 12.4 percent.

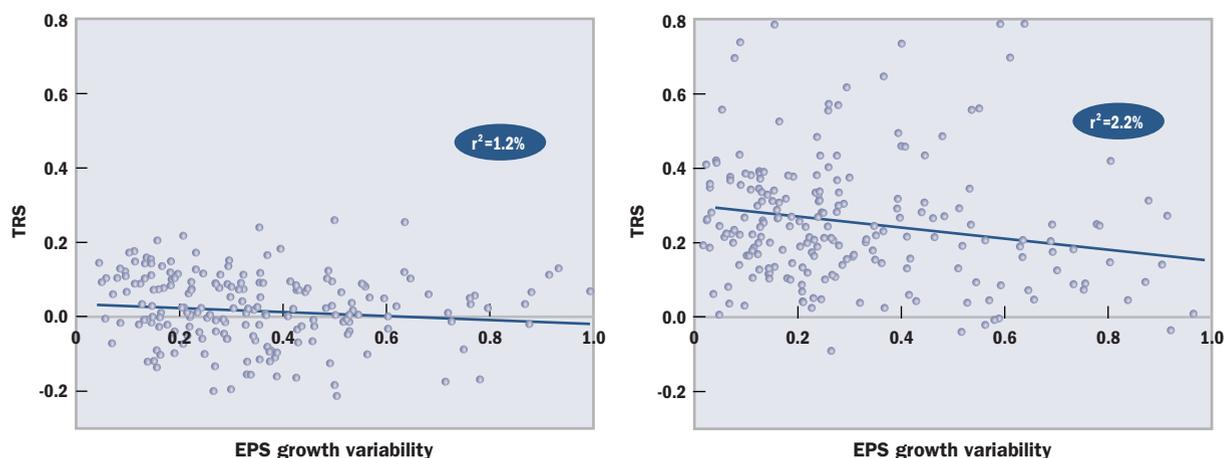
Nor do companies whose earnings vary more widely receive lower valuation multiples. An increase in variability of about 20 percent (as in the previous example) would result in only a 2 percent reduction in the market-to-book value multiple. There was no measurable effect on the P/E ratio.

Meeting analyst expectations and shareholder returns

Managers often lament having to set aside attractive investments in long-term growth opportunities in order to meet near-term earnings expectations and avoid a possible decline in share price, despite having themselves set expectations in the first place. We tested 735 companies⁸ between 1991 and 2000, comparing the effect on TRS of discrepancies between actual results and analyst forecast estimates at 12 months and 3 months out.

As would be expected, forecasts are more accurate the closer they are to the release date of actual results⁹ and investor response to

Exhibit 2. Increased earnings growth variability does not affect TRS significantly in low-growth firms (left) or in high-growth firms (right)



Source: Compustat, McKinsey analysis

over- or underperformance indicates their awareness of the impact of timing. Indeed, if a company sets earnings expectations of \$1.00 a few weeks prior to the actual earnings release, and then delivers only \$0.90, investors should be disappointed. Such a shortfall calls into question the internal controls and systems of the company more than anything else. Yet while the effect of missing a three-month forecast can be significant, the effect of missing a forecast made a year ago should be weaker, since negative performance can be ascribed to many factors such as changes in the economy, interest rates, technology, and competition. A 10 percent gap between actual results and three-month forecasts leads to approximately a 4 percent drop in the share price over the three-month period of the forecast, whereas a shortfall of 10 percent between actual results and 12-month forecasts leads to approximately a 1 percent drop in the share price over the 12-month period of the forecast (Exhibit 3).

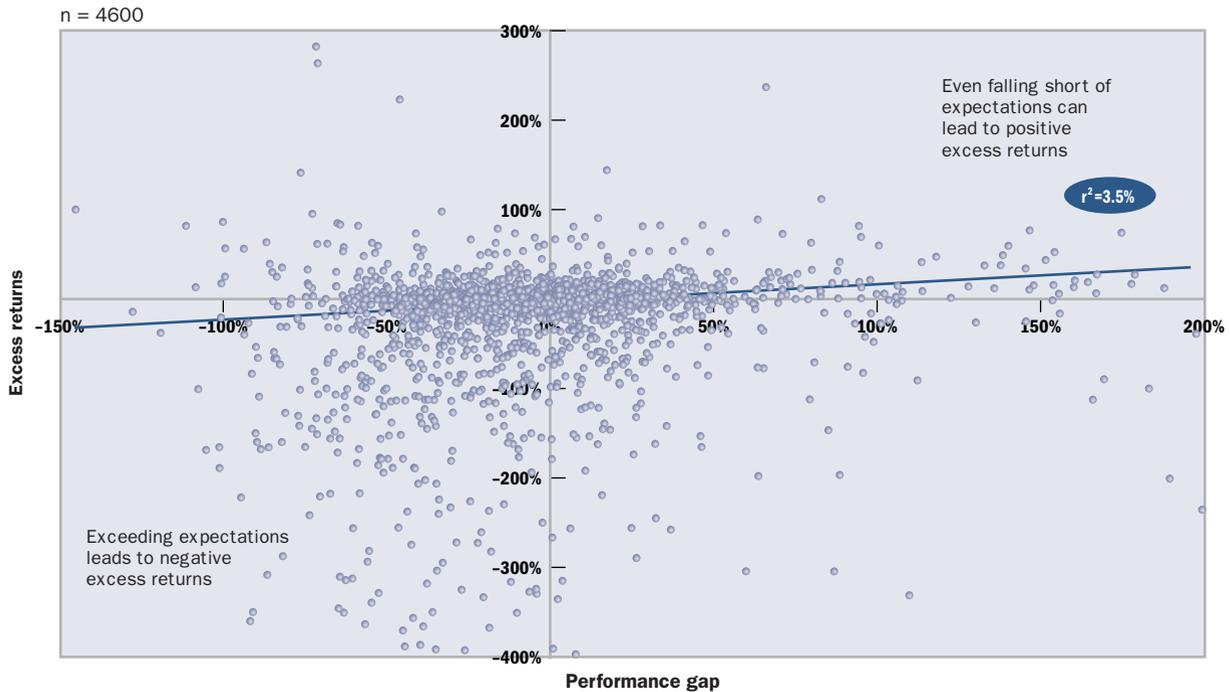
Yet over- or underperformance relative to forecasts still does not explain most of a

company's actual share price change.

Obviously, meeting expectations is only one of many factors driving share prices and investors do look beyond a company's performance relative to expectations to the reasons behind its performance. For example, when Arrow Electronics announced first-quarter earnings of 30 cents per share at the end of April 1999, it fell short of analyst estimates by 34 cents. The company attributed its underperformance to oversupply in its sector, to pricing pressures, and to higher interest expenses following two acquisitions. Yet in the three-month period from April to June, Arrow had excess returns of 14 percent compared to the S&P 500. The market, presumably, was focused on expected performance improvement as oversupply conditions eased.

McKinsey research has found that the effect of missing analyst forecasts is shaped by three factors: whether or not the deviation was expected; the degree of surprise (or the amount by which forecasts were missed); and whether the deviation was anticipated to be temporary or long term. Indeed, the market

Exhibit 3. The relationship between excess returns and predictability is very weak



Excess returns = actual returns minus a risk-adjusted market return

Predictability gap = actual EPS minus 12-month analyst-predicted EPS divided by actual EPS

Source: Compustat, McKinsey analyses

reacts three times as strongly to unanticipated news with long-term impact than to anticipated news with long-term impact or unanticipated news with short-term effects. This has important implications for company executives whose communications with analysts, investors, and the media are a crucial part of shaping expectations and perceptions of long-term performance. Managers should typically be more forthcoming rather than less in order to ameliorate the impact of surprises.

Meeting short-term expectations may be important, therefore, but it is not paramount. The market constantly evaluates a business's long-term potential, and investor reaction to short-term earnings surprises is really linked to whether the underlying cause has the potential to alter long-term performance.

TRS and long-term earnings predictability

When we examined the effect of long-term earnings predictability on TRS, we found that while companies whose earnings are more predictable did earn higher cumulative returns, the correlation was weak. We defined a long-term measure of predictability as the average difference between actual results and 12-month estimates over ten years.¹⁰ We then compared it with ten-year cumulative returns.

Among nearly half of the firms we analyzed, actual earnings performance averaged within 20 percent of annual predictions over ten years. A 20 percent difference in average performance relative to annual predictions

corresponds to only an 8 percent difference in the cumulative excess return over the same period, or 0.8 percent annually.

When we isolated earnings predictability from earnings growth, we found that predictability explained only an additional 4 percent of shareholder returns beyond what EPS growth and ROIC change could explain. The weakness of that correlation is easily illustrated by high-predictability firms with low returns and vice versa. For example, both McDonald's and Sherwin Williams produce notably predictable earnings, with each company's earnings varying on average less than 3 percent from annual forecasts over the ten years we studied. But they have underperformed the S&P 500 on a risk-adjusted basis, with ten-year cumulative excess returns of -21 percent and -57 percent, respectively. On the other hand, Southwest Airlines and Biogen are both considerably less predictable, varying annually by nearly 30 and 50 percent, respectively, on average from forecasts. Southwest fell below one-year forecasts in three and Biogen in five of the ten years. Yet both of those companies have outperformed the S&P 500 with ten-year cumulative excess returns of 109 percent and 164 percent.

Companies should pay attention to short-term earnings, but they should not go through accounting contortions to do so. Even for firms renowned for delivering steady year-on-year double-digit earnings growth, shareholder returns can be largely explained by the magnitude of their overall long-term earnings growth rate. Only a small portion of the TRS is assignable to a premium for the lack of variability in their earnings. Actions to

improve short-term results that involve borrowing from next quarter's performance perpetuate a short-term mind-set, and put companies in an increasingly perilous wager that performance in future quarters will not only cancel previous quarters' deficit, but will also show growth. Markets will increasingly call their bluff.

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- ¹ "There are no markets without trust," *Wall Street Journal*, March 27, 2002.
- ² Analyst Teleconference, November 19, 2001.
- ³ See, e.g., "What earnings reports don't tell you," Morningstar.com, July 3, 2000.
- ⁴ Excess returns are defined as the difference between actual return and the risk-adjusted S&P 500 return.
- ⁵ US firms with greater than \$500 million in revenues in 2000, positive EPS, and no operating profit swings greater than 100 percent in any year, excluding financial services firms.
- ⁶ Or average standard deviation from the mean.
- ⁷ In other words, its standard deviation rising to 36 percent.
- ⁸ US firms with fiscal years ending on December 31, with EPS estimate, TRS, and beta available for 1991-2000, excluding financial services firms.
- ⁹ While 42 percent of 12-month estimates are within 10 percent of actual results, 58 percent of 3-month estimates meet the same standard. This is consistent with earlier research illustrating the overoptimism of analyst forecasts. See also, Marc H. Goedhart, Brendan Russell, and Zane D. Williams, "Prophets and profits," *McKinsey on Finance*, Number 2, Autumn 2001, pp. 11.
- ¹⁰ We defined overall predictability as the average annual gap between actual and analyst-predicted performance over ten years (absolute values averaged). The predictability was then correlated to the cumulative excess return compared to the S&P 500 over the same time frame.

Stock options—the right debate

Reformers want companies to treat executive stock options as a cost. The real question is whether shareholders are getting what they pay for.

Neil W. C. Harper

And you thought accounting was dull? After staging a highly public debate last year over how to account for goodwill in mergers, Washington lawmakers and business lobbyists are at it again in a high-profile battle over another seemingly arcane accounting rule—whether employee stock options should be treated as an expense. A high-powered lineup that includes, among others, *über*-investor Warren Buffett, President George W. Bush, and Federal Reserve chairman Alan Greenspan have weighed in on the current accounting rules, which do not require companies to include the value of most stock option grants as employee compensation and, hence, to subtract them from pretax profits. Critics argue that the practice permits companies to inflate reported earnings and, presumably, stock prices.

There is plenty of heat in this debate, but unfortunately far too little light. Indeed, the discussion of accounting treatment and its effect on share prices is something of a red herring, distracting discussion from the more important issue: do stock options as they are currently structured do a good job of aligning the interests of shareholders, who own companies, with the interests of the executives who manage them?

For the most part, they do not. Particularly among mature companies, much of the share

price movement over a three to four year period is driven by environmental factors that are beyond management's control. Among the factors they can control, it is clear that managers have ample—some would say too ample—opportunity to behave in ways that are not necessarily in the interests of the shareholders they serve.

What is really at stake?

Since 1993, when the US Financial Accounting Standards Board last grappled with the issue, corporations have had a choice as to how they treat stock-based compensation in their financial statements. The first option, under Accounting Principles Board (APB) Opinion 25, requires expensing the difference between stock price and option-exercise price. Because most option grants are made at an exercise price equal to current stock price, this sum is typically zero and produces no impact on reported earnings. The second option, under Statement of Financial Accounting Standard 123, is to expense the fair value of the options on the date they are issued, estimated using an option pricing model.

Given their focus on earnings, it is not surprising that most CEOs typically opt for the APB 25 approach. In fact, while 99 percent of the companies making up the S&P 500 offer employee stock option plans, only

two, Boeing and Winn-Dixie Stores, report the cost of options as expenses on their financial statements. Whatever their accounting approach, companies typically deduct options as an expense for tax purposes, calculating the deduction as the difference between the share price on exercise and the option-exercise price.

This divergence in the way companies account for options has caught the eye of lawmakers. A bill introduced in February in the US Senate would force companies to expense options against reported earnings. Many CEOs and investors fear that the reduction in reported earnings from such a change would reduce share prices. We believe that this concern is misplaced. If reported earnings are to be at all comparable across corporations, the fair value of option grants should be deducted from earnings. Furthermore, it is unlikely that the change in treatment will have a significant impact on stock prices. Many studies have demonstrated that accounting changes, and indeed accounting differences across companies, have no significant stock price impact. Capital markets are able to see through such differences, as long as the relevant information is publicly disclosed.

Refocus the debate

A more valuable debate for shareholders would be to examine the structure of stock options. Consider that in recent years stock options have reached 50 to 60 percent of the total compensation of CEOs of large US corporations. Most are issued with an exercise price at or above current market price, and as the share price rises, the management team earns additional compensation.

At first glance this seems a logical way to align the interests of managers and shareholders, since in theory option-holding

executives would have a common interest with shareholders in seeing stock price appreciation. But the theory can be thwarted in two important ways.

Not all stock price appreciation is equal.

When a stock rises as a result of good strategic or operational decision making by the management team, additional compensation through option value gains is well deserved. However, stock options can also gain significantly in value as a result of several additional factors—the general economic environment, the interest rate environment, leverage, and business risk. All else being equal, as the economic environment improves, as interest rates fall, as leverage rises, and as business risk rises, the value of an executive's options will also rise.

However, interest rate related gain is not the result of management's actions, and increasing leverage or business risk (for example by taking on new risky business-development opportunities) is not necessarily in the best interests of shareholders. In addition, improvement in the general economic environment is clearly outside of management's control.

From the executive's perspective, stock options that decline in value as interest rates rise can hardly be considered a motivation. Similarly, most dedicated executives are unlikely to opt to be compensated merely for changing the risk profile of the business, preferring instead to be compensated for clear, transparent actions, on both the strategic and operational front, that improve business performance.

There are limits to downside risk. Even if option contracts were structured to more closely tie executive reward to value-creating

actions, the current structure of most company options plans places less risk on managers in the case of poor performance than on shareholders. If unsuccessful strategic and operational decision making leads to a stock price decline, shareholders continue to lose until the decline bottoms out. Managers, though, have a limit to their downside exposure through option holdings; once the stock price falls significantly below option-exercise price, their options are essentially worthless (unless there remains a significant time period before exercise date). Their downside to this extent is limited. Furthermore, they can frequently expect to be issued repriced options at the new lower stock price, further limiting their overall downside.

Correcting for the variables of interest rate movements, economic cycles, and other environmental issues is not as straightforward as it appears. Companies, compensation consultants, and academics have pondered the issue for decades without coming up with easy solutions, precisely because fully aligning incentives via a compensation plan is so complex. Executive option contracts could be structured to adjust for economic conditions as reflected, for example, by overall market or sector performance, interest rates, leverage, and risk. Some commentators have even proposed so-called outperformance options, in which value creation is linked to an executive's ability to generate returns that outperform those of peers. These approaches can improve alignment between shareholder and manager interests, but only to some extent.

On the question of shareholders' greater exposure to downside risk, one possible solution would be to begin to move away from such a heavy focus on options in favor of

compensating executives with a greater proportion of, for example, restricted stock—equity securities where the potential to sell is limited for some period of time. Direct equity securities of the type held by ordinary shareholders would seem to align shareholder and management interests well. Moreover, if they represent a sufficiently significant proportion of the net worth of each member of the management team, they would ensure that each executive has sufficient interest at play. In the case of such securities, the executives would presumably have to be compensated for the restriction on their ability to diversify their investment portfolio. This could be done simply, for example through issuance at an appropriate discount to market value.

While this is an area in which more research has to be done, it is clear that a framework and tools already exist to develop potential solutions to better align incentives.

How stock options are accounted for is unlikely to have any significant stock price impact. Those debating the issue today would better serve investors and business at large by agreeing to treat options as an expense and move the debate forward to the issue of option structure and executive compensation more generally. That debate, at least, has much more potential to improve alignment of incentives and allow executives to clearly see and benefit from their value-creating actions.

MoF

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