JANUARY 2013

CORPORATE FINANCE PRACTICE

Avoiding the consensus-earnings trap

The promise of meeting or beating consensus estimates and the peril of missing them are profoundly overstated.

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At most public companies, the pressure to meet or beat consensus-earnings estimates is strong. Do so consistently, many executives believe, and investors will reward the company over the longer term with a higher share price. Report earnings below consensus estimates—even by a small amount—and investors will penalize them with a lower share price, they worry. A striking example: in early 2005, eBay reported that it had missed the fourth-quarter 2004 consensus estimate by just one penny and saw its share price plunge 22 percent.

As a result, executives often go to some lengths to meet or beat consensus estimates—even acting in ways that could damage the longer-term health of the business. It's not uncommon, for example, for companies to offer customers steep discounts in the final days of a reporting period in order to stoke sales numbers, in effect borrowing from the next quarter's sales. As other companies have shown, executives may forgo value-creating investments[1] in favor of short-term results, or they might manage earnings inappropriately to create the illusion of stability.[2]

Yet our analysis of large US companies over the past seven years shows that these fears are unfounded.[3] In the near term, falling short of consensus-earnings estimates is seldom catastrophic. Even consistently beating or meeting consensus estimates over several years does not matter, once differences in companies' growth and operating performance are taken into account. In fact, a company's performance relative to consensus-earnings estimates seems to matter only when it *consistently misses* them over several years.

This doesn't mean that companies should ignore consensus estimates, which can hint at what is on investors' minds and why. For example, how does the industry-growth outlook of investors compare with that of executives? The consensus can also be used to assess how well analysts and investors understand the drivers of a company's performance. Our findings demonstrate that investors consider more indicators of financial health when valuing a company than just whether a company meets its consensus-earnings estimates. Thus companies need not go to extremes to meet or beat analysts' expectations if it means damaging the long-term prospects of the company.

The markets shrug

Most executives haven't personally experienced many catastrophic share-price drops after minor earnings misses, and so they conclude such misses are rare. The mechanics of earnings estimates lend some support to that perception. After all, analysts' estimates are typically overoptimistic at the beginning of the financial year, but by the third quarter, it's reasonable to expect them to fall roughly in line with the eventual reported earnings—a pattern borne out by previous research.[4] According to standard practice, a company has beaten the consensus estimate if its actual earnings are greater than the last available estimate for the year (almost always projected after the year is over), and as such, one would expect analyst estimates at that stage to be accurate (see sidebar, "Which earnings estimates count?"). Moreover, executives tend to focus on dramatic press accounts of earnings mishaps that are among the most extreme outliers, like the eBay example, where missing the consensus forecast led to a sharp drop in share prices. In addition to believing that missing earnings estimates is rare, they assume that even small misses lead to dramatic share-price declines.

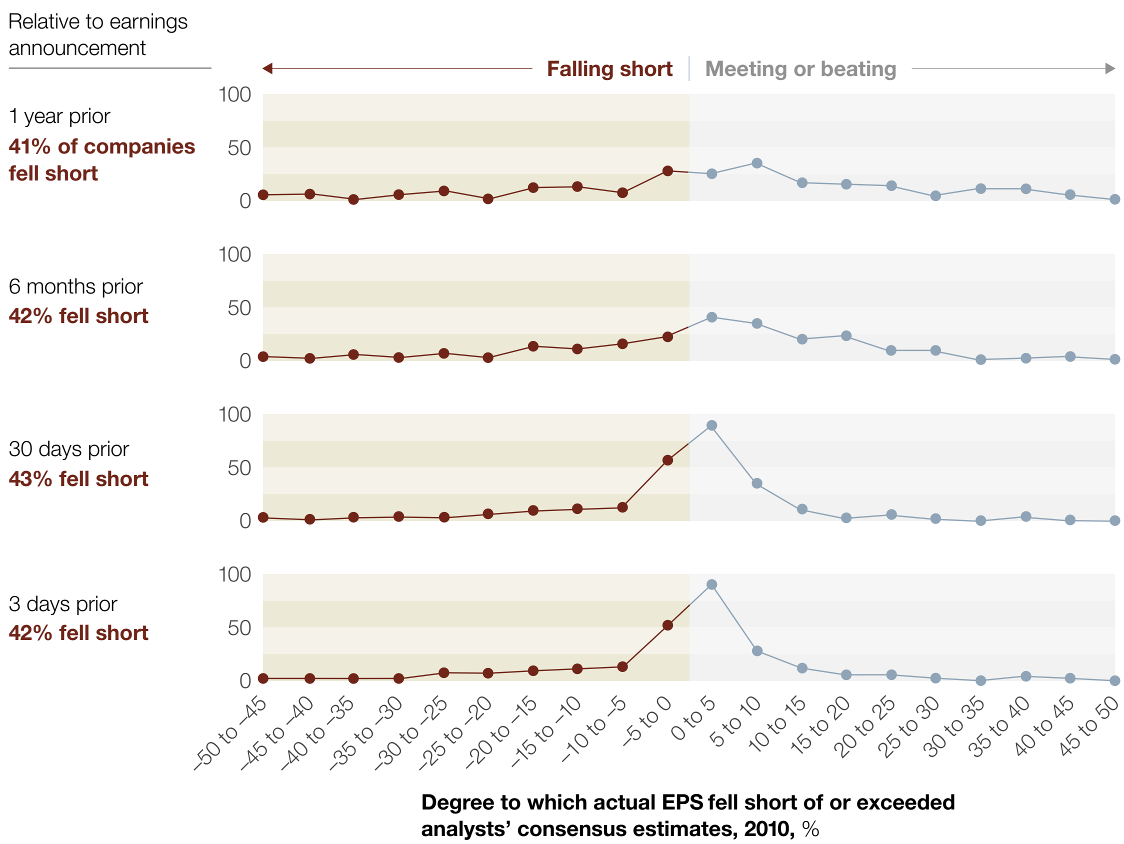
Which earnings estimates count?

There's a fair amount of confusion about what it means to beat, hit, or miss the consensus-earnings estimate. Suppose Company A reports earnings of $2.00 per share for the year that ended December 31, 2011, on January 15, 2012. On January 1, 2011, at the beginning of the year, the consensus estimate was $2.10. On January 1, 2012, after the year was over, but before earnings have been released, the consensus had fallen to $1.98. Did Company A beat or miss the consensus estimate? According to conventional practice, a company has beaten the consensus estimate if its actual earnings are greater than the last available consensus estimate (which is almost always after the year is over). So Company A has beaten the estimate, even though its earnings were ten cents less than the consensus at the beginning of the year.

Exhibit 1

Companies often fall short of consensus-earnings estimates.

Distribution by gap between earnings per share (EPS) and consensus estimates, number of companies[1]



[1]Analysis of 266 companies, excluding outliers. Total number of companies falling within +/– 50% of consensus estimates: 1 year prior = 209, 6 months prior = 229, 30 days prior = 250, and 3 days prior = 252.

Source: Standard & Poor's Capital IQ; McKinsey analysis

In fact, falling short is common, and the effect is benign. More than 40 percent of companies generate earnings below consensus estimates—whether those estimates are compiled an entire year or just three days before an earnings announcement (Exhibit 1). Although some academics have documented a correlation between the change in a company's share price before and after the announcement of earnings and the degree to which it meets the consensus-earnings estimate, the size of the effect is small. Indeed, our analysis suggests that missing the consensus by 1 percent would lead to a share-price decrease of only two-tenths of a percent in the five days after the announcement. In other words, missing the consensus estimate by a penny or so just doesn't matter.

Executives concerned about their company's performance relative to consensus estimates should also consider that 40 percent of companies saw their share price, adjusted for the market, move in the *opposite* direction of their earnings miss. For example, when PPG Industries, a global supplier of paints, coatings, and chemicals, announced earnings for 2010 that were 4 percent below the consensus, the market reacted positively with an excess return of 7 percent. Why? On digging deeper, investors saw that the long-term outlook had improved. Sales were stronger than expected in nearly all business segments. The CEO also announced some investment initiatives that investors viewed as having the potential to create value in the longer term.

Conversely, when North American brewing company Molson Coors beat the consensus estimate by 2 percent in 2010, the market nevertheless reacted negatively—with an excess return of –7 percent. Investors saw that the company's sales volume had declined by 2 percent and that margins were also down—it only beat the consensus because of a lower-than-expected tax rate. The market reacted to the fundamental drivers of performance, volume and margin, rather than earnings per share (EPS) itself.

As the Molson Coors example demonstrates, meeting or missing the consensus is less important than how the earnings were reached. That's because investors are continually assessing other news, such as whether the company met the consensus estimate for revenues as well as earnings. They are also able to see through cases where one-off items are responsible for meeting the consensus. Meanwhile, earnings announcements themselves often include information that helps investors reassess a company's long-term performance outlook. Earlier McKinsey research[5]

has shown that the market reaction at the time of an earnings announcement is influenced more by changes in analysts' expectations for longer-term earnings than the most recent results. That research found that a company might fall short of current-year earnings estimates and still see its share price increase if analysts revised their earnings estimates upward for the next two years (Exhibit 2).

Just as critical, the notion that markets reward companies with higher share prices when they consistently beat the earnings consensus turns out to be wrong. Here again, while some researchers[6] have found this to be true, their analysis doesn't take into consideration the underlying performance of companies as measured by revenue growth and return on capital. Once adjusted for performance, the apparent effect of consistently beating the consensus, which we define as four or more years out of seven, disappears. Companies with strong growth or return on invested capital had high shareholder returns regardless of whether they consistently beat the consensus. Only those companies that consistently missed it—again, in four years out of seven—showed a statistically significant negative effect from doing so (Exhibit 3).

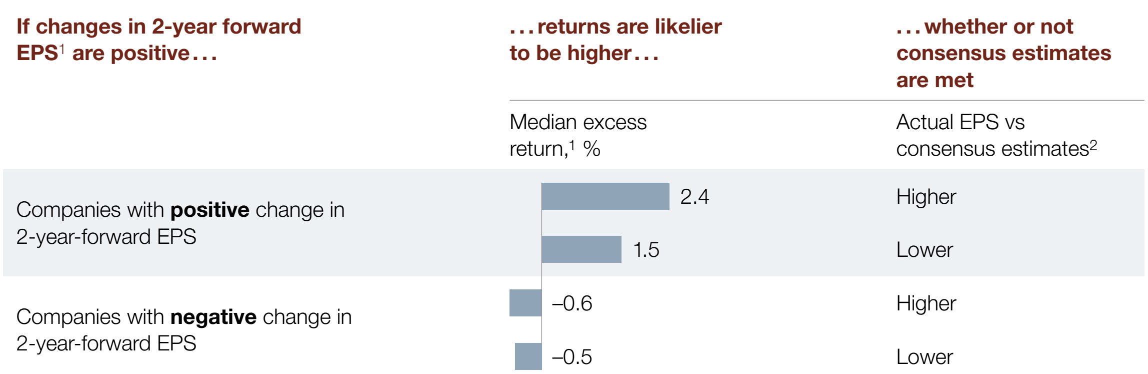
A needed focus on growth and returns

Two pieces of earlier McKinsey research have shown that companies that provide EPS guidance are not valued higher than those that do not[7] and that reducing earnings volatility does not drive valuation levels.[8] Those findings, com-

Exhibit 2

A change in forecast EPS is more important than an earnings surprise.

Analysis of 590 announcements of fiscal-year earnings for 2007 by European companies



[1]EPS = earnings per share; median excess return = excess return over market return.
[2]Sample size: positive and lower = 127, positive and higher = 203, negative and lower = 118, negative and higher = 142.

Source: Marc Goedhart, Tim Koller, and David Wessels, *Valuation: Measuring and Managing the Value of Companies*, fifth edition, Hoboken, NJ: John Wiley & Sons, 2010; McKinsey analysis

Exhibit 3

A company's performance on fundamentals is more important than its performance versus consensus estimates.

Median excess return vs sector return,[1] 2005–11, %

	High growth + high ROIC[3]	High growth + low ROIC[3]	Low growth + high ROIC[3]	Low growth + low ROIC[3]
Consistently beating[2]	4	3	0	–2
Inconsistent[2]	2	0	0	–3
Consistently missing[2]	0	–5	–5	–6

[1]Company's total returns to shareholders (TRS) minus median TRS of the sector. Sample size is 243 nonfinancial S&P 500 companies with December fiscal year-end.
[2]Difference between actual earnings per share and consensus estimate 30 days prior to earnings announcement. "Consistently beating" defined as beating expectations by >2% at least 4 out of 7 years, 2005–11. "Consistently missing" defined as missing expectations by >2% at least 4 out of 7 years. Companies consistently meeting expectations (by +/– 2% at least 4 out of 7 years) are not shown due to small sample size.
[3]ROIC = return on invested capital (2005–11); growth = compound annual growth rate of revenue (2004–11). Companies categorized as high ROIC or high growth exceeded the absolute reference points of 15% for ROIC and 7% for growth or the median of the respective sector in the sample.

Source: Standard & Poor's Capital IQ; McKinsey analysis

bined with our current analysis, suggest that companies are spending too much time trying to manage their earnings without seeing any benefit to their share price.

While we realize it would be unrealistic for companies to ignore consensus-earnings estimates, we believe that there are practices that companies should avoid:

- At the beginning of the year, managers shouldn't shape their earnings targets or budgets just to meet consensus estimates. We've seen companies do that, typically by reducing spending on product development, sales and marketing, or other costs associated with long-term growth. In doing so, they essentially are handicapping long-term performance for the appearance of short-term strength. Managers know much more than investors about what is happening inside their company and in their markets and about what the long-term growth opportunities are.

- As the year progresses, managers should likewise avoid costly, shortsighted actions to meet the consensus. As mentioned earlier, we've seen companies offering customers end-of-year discounts to boost their current-year sales with next year's orders—or even cutting the travel budgets of the sales force, effectively borrowing from future sales to meet this year's consensus estimates.

- At year-end, never resort to using cosmetic quick wins to meet estimates, such as creative accounting with accruals. Investors recognize these for what they are. Instead, focus on the company's underlying fundamentals and on communicating those to investors. That's what is most important for your share price.

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Executives commonly believe that missing consensus-earnings forecasts will penalize their share price. We have found that is not the case, and executives should not take extreme measures to meet or beat estimates. Doing so may damage business health over the longer term. Rather, leaders should keep their focus on creating value, since that is the only reliable way to create durable shareholder returns.

[1] John R. Graham, Campbell R. Harvey, and Shiva Rajgopal, "The economic implications of corporate financial reporting," *Journal of Accounting and Economics*, 2005, Volume 40, Number 1, pp. 3–73. The authors found that a majority of CFOs would "avoid initiating a positive NPV project if it meant falling short of the current quarter's consensus earnings."

[2] See Peggy Hsieh, Tim Koller, and S. R. Rajan, "The misguided practice of earnings guidance," mckinseyquarterly.com, March 2006.

[3] We analyzed Fortune 500 companies, excluding financial companies and those with a fiscal year-end other than December 31, ultimately considering a total of 266 companies.

[4] See Marc Goedhart, Brendan Russell, and Zane Williams, "Prophets and profits," mckinseyquarterly.com, October 2001.

[5] See Marc Goedhart, Tim Koller, and David Wessels, *Valuation: Measuring and Managing the Value of Companies*, fifth edition, Hoboken, NJ: John Wiley & Sons, 2010.

[6] See Ron Kasznik and Maureen McNichols, "Does meeting earnings expectations matter? Evidence from analyst forecast revisions and share prices," *Journal of Accounting Research*, 2002, Volume 40, Number 3, pp. 727–59.

[7] See Peggy Hsieh, Tim Koller, and S. R. Rajan, "The misguided practice of earnings guidance," mckinseyquarterly.com, March 2006.

[8] See Bin Jiang and Tim Koller, "The myth of smooth earnings," mckinseyquarterly.com, February 2011.

The authors wish to thank Akanksha Bareja for her contribution to this article.

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