The McKinsey Quarterly

Corporate Finance

January 2009

Opening up to investors

Executives need to embrace transparency if they want to help investors make investment decisions. But what should be disclosed?

Robert N. Palter and Werner Rehm

McKinsey&Company

As the credit crisis sorts itself out, one outcome investors and regulators will almost certainly demand is more transparency into the strategy and the underlying operating and financial performance of companies—not only the financial ones at the storm's center but all companies. Managers should enthusiastically embrace such reforms.

In our ongoing research into investor communications, we've concluded that companies should provide more detail about how their businesses create value, give an honest assessment of performance, and provide guidance on the most important operating metrics that illuminate what underpins value creation in the medium to long term. Too often, managers are cowed by fears that a more detailed discussion of the issues and opportunities facing a company would reveal sensitive information to competitors, generate too much work for the investor relations department, or create excessive pressure to report too many numbers or to meet unrealistic performance expectations. As a result, managers typically provide only the data required by generally accepted accounting principles—leaving the more detailed and specific performance and value contributions of the business's various pieces hidden from investors, who are left to wonder what the company is hiding.

More transparency would benefit all investors but should prove particularly attractive to those seeking to build a deep understanding of a company's strategy, current performance, and potential to create long-term value.[1] The better informed these intrinsic investors are about the true value of a business, the more likely the share price will reflect an alignment between market value and intrinsic value.

Our discussions with investors and our own experience in helping companies estimate value suggest at least three ways for them to be more forthcoming.

More detail

Disclosure limited to the data required by securities regulators and accounting procedures may give executives considerable leeway to interpret the rules. But more important, such limited disclosure often obscures the metrics investors need most to make informed investment decisions. For example, both international financial reporting standards (IFRS) and US generally accepted accounting principles (GAAP) require a company to disclose sales, a profitability metric, depreciation and amortization, capital expenditures, and some balance sheet items for each significant business segment. However, this information does not always allow investors to assess value across business units with very different economics—such as widely different operating leverage or working-capital intensity.

One large global electronics company, for example, in a section of its 10-K, reports gross margins by geographic segment as a metric of segment profitability. In another section, it reports sales and gross margins of both product and service businesses. Nowhere does it provide operating margins for various products targeting business and consumer markets—information that is crucial to help investors value businesses with different intensity of R&D and of selling, general, and administrative costs (SG&A). A failure to report such information often leaves investors with the impression that management does not understand what really drives value or is trying to obscure some underlying performance issues. In another case, a US media conglomerate provides detailed income-statement information by business unit, but the schedules leave it to the investor to sort out the balance sheet by business units as different as movie production (which capitalizes costs) and traditional paper publication (which does not).

How much detail is enough? In the case of financial data, it depends on whether the information is critical to assess value creation. IBM discloses constant currency growth below the business unit level. Nestlé does so on a product and regional level. This kind of detailed financial information is very helpful to investors and doesn't give competitors any insight that they wouldn't already have into business models or sources of strategic advantage. As a rule of thumb, to determine the optimal level of disclosure, companies should provide a detailed income statement, down at least to the earnings before interest and taxes (EBIT) level, for each business unit. They should also provide all operating items in the balance sheet (if not a full balance sheet), reconciled with the consolidated reported numbers required by securities regulators and accounting procedures. Even companies in a single line of business can improve their disclosure without giving away strategically sensitive information. Whole Foods Market, a US grocery chain, provides a return-on-capital metric by age of store. This gives investors deeper insights into the economic lifecycle of different businesses and assets, as well as the trajectory the company expects for economic profit under different growth assumptions.

On the operating side, what to disclose depends on the key value drivers of a business or business units. Ideally, these should be the metrics management uses to make strategic or operational decisions. Each quarter, the IT research firm Gartner Group, for example, discloses a narrow but detailed set of metrics for each of its three business units. As Gartner's CFO explains,[2] the firm publishes only the most important of the metrics that management uses to examine the performance of the business. Companies in some industries, such as steel and airlines, likewise regularly disclose volumes and average prices, as well as the use and cost of energy—the key drivers of profitability.

Thanks to technology, some companies can make such disclosures almost continuously. Continental Airlines, for example, prominently displays a daily updated load factor, one of the key drivers of value, on its investor relations Web page (one click away from the home page). Some may wonder if such frequent updates are really very useful, but there is no doubt companies can use technology to improve the way they communicate the value drivers that matter most to investors. Executives should ask whether a company discloses enough for an investor to obtain a clear picture of its performance. Such information helps intrinsic investors make informed buy and sell decisions—the foundation of what investor relations should be trying to accomplish.

A common mistake among companies disclosing operating data is to provide different metrics from quarter to quarter, depending on which of them reflects best on the company. One quarter the preferred metric may be unit sales, in the next it could be revenue growth, and in the next growth in Asia. This approach probably hurts more than it helps, because consistency matters. Investors rightly wonder why management has stopped providing the figures for any given metric and, in all likelihood, assume the figures are worse now than they were when the company published them. Instead, a company should change the metrics it reports only when the key drivers of its current growth performance change. In such cases, the company may add to the metrics or substitute one for another, but only if it offers a candid explanation.

In the current environment, transparency is more important than ever and more highly valued by investors. Take the case of Berkshire Hathaway, which had to take accounting losses on some derivative positions in recent months. These losses were determined by a model used internally to assess the value of the positions. The actual method for the valuation was not transparent to investors, and it was unclear whether Berkshire Hathaway had to post collateral against these positions. Only after public discussion and a promise to disclose (in the next annual report) "all aspects of valuation," including "deficiencies in the formula" for pricing derivatives, did investors calm down.[3]

More candor

To make sound investment decisions, intrinsic investors require management to be honest in its public assessments of the business. This is an area executives typically approach quite cautiously. Most management presentations and publications today offer only a celebration of the past year's performance, with limited details or a less than candid assessment of shortfalls. Very few presentations discuss the impact of strategic trade-offs on the numbers—for instance, how a pricing initiative drove growth at the expense of margins. All too often, the only explanation investors receive is a vague letter to shareholders and boilerplate in the "management discussion and analysis" section of regulatory filings. These tend to be tedious descriptions of dollar movements in the accounts, with some detail on the business background. In reality, most astute investors want to understand the drivers of performance in greater detail. The risk in not disclosing this information to the markets is that certain critically important investors won't understand the nuances of what is happening to a company and may thus make incorrectly informed investment decisions—or none at all, since a lack of data tends to create doubt.

Companies that openly discuss what happened during the year and, even in good times, disclose where management has identified pockets of underperformance will help investors to assess the quality of the executive team and thus the potential for future value creation. More important, when strategic decisions go bad, investors want to understand what management has learned. Intrinsic investors, in particular, understand that business is risky and take a relatively long-term view. Such investors value forthrightness and will probably support a company through a course correction.

Consider the case of Progressive Insurance. In the third quarter of 2006, the company lowered its policy rates to encourage faster growth, making what CEO Glenn Renwick described as "an explicit trade-off of margin for longer-term customer growth." He acknowledged that "while we will never know the outcome of alternative decisions, we feel very good about the focus on customer growth." When the strategy did not work out as planned, Renwick addressed the subject directly in the first two sentences of his letter to the shareholders in the 2007 annual report. "Profitability and premium growth are both down and they directly reflect the pricing strategy we enacted," he wrote. That strategy "did not produce the aggregate revenue growth we had hoped for." Long-term investors look for this kind of candid assessment when they decide to bet on a management team.

Better long-term guidance

There is an increasing awareness in the North American business community that quarterly earnings per share (EPS) guidance is not helpful in assessing the value of companies. More and more of them are abandoning the practice, including GE, which announced in December 2008 that it will no longer give annual or quarterly EPS guidance. One reason for the change is that intrinsic investors are less interested than casual speculators in whether a company "hits the numbers." Instead, intrinsic investors look beyond the next quarter and beyond EPS, which can be influenced not only by important value drivers (such as growth and operating margins) but also by tangential items (such as tax effects and share buybacks). In addition, some important measures of value creation, such as capital intensity through depreciation, only indirectly affect EPS, so they are at best a proxy for true economic earnings. Lastly, in the current uncertain environment, promising a bottom-line number for next year's earnings can raise questions about how a company will get there, given the prevailing economic uncertainty. That "how" becomes more important than the actual numbers.

As an alternative, in the normal course of business, executives should provide short-, medium-, and long-term guidance on the real value drivers—and do so in ranges rather than point estimates. Companies as diverse as GE and Arrow Electronics provide target ranges for returns on capital. Other companies provide a range of possibilities for revenue growth under a variety of assumptions about inflation and they discuss the growth of individual business units when that matters (in the semiconductor industry, for example). Other metrics help investors to divide the drivers of income growth into those that are sustainable and those that are not. Humana, for example, provides guidance on estimated membership in its health care plans—including plans whose membership the company expects to decline. Gartner sets out a range of long-term goals, such as growth targets by business unit, margin-improvement targets, and capital-spending goals.

In project-based businesses, a detailed discussion of investments, timing, and targeted returns might be most helpful. One leading North American industrial company with a large exposure to big capital expenditures, for instance, provides more details on the performance of current projects and the timing and expected returns of potential projects than many competitors do. The company's disclosures include revenue risks, estimated equity returns, and debt-to-equity ratios—information that allows investors to assess the growth potential in detail.

Companies coping with complex income streams; changes in the macroeconomic, taxation, or regulatory environment; or significant exchange rate exposure should also provide estimates on nonoperating items if they materially affect cash flows. One European company, for example, provides analysts and investors with a tax estimation tool, which uses the investors' assessments of regional growth rates to provide a best guess on the tax rates the company will face.

In providing such target ranges, management shares with investors its view of how a company will fare, given its estimate of various macroeconomic factors. Investors, of course, may estimate them differently and therefore reject management's view of the company's prospects. It is therefore often best to disclose assumptions about GDP growth, inflation (where it matters), and other underlying drivers. As one investor relations professional explained, “These numbers are simply our best estimate. If you have a different view on the economy, you’re welcome to come up with your own numbers,” using the company’s disclosures about how much the drivers affect its business.

Greater transparency about financial and operational data, an honest assessment of performance, and guidance about the metrics that executives use in running a company all help investors to develop informed opinions about the long-term value creation potential, the quality of management, and the risk profile of its various parts. In the process, management receives valuable feedback from investors who share their own ideas about topics such as the company’s growth and performance relative to peers.

About the Author

Robert Palter is a director in McKinsey’s Toronto office, and **Werner Rehm** is an associate principal in the New York office.

Notes

[1] See Robert N. Palter, Werner Rehm, and Jonathan Shih, “Communicating with the right investors,” mckinseyquarterly.com, April 2008.

[2] See Timothy Koller and Werner Rehm, “Better communications for better investors: An interview with the CFO of Gartner,” mckinseyquarterly.com, November 2008.

[3] Erik Holm, “Buffett will give more information on derivatives,” Bloomberg.com, November 24, 2008.

Related Articles on mckinseyquarterly.com

“Communicating with the right investors”

“Inside a hedge fund: An interview with the managing partner of Maverick Capital ”

“The misguided practice of earnings guidance”

“Don’t expect too much of your share price”

“Better communications for better investors: An interview with the CFO