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Prophets and profits

Executives should be wary of bending strategy to suit the wayward long-term earnings forecasts of equity analysts.

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Equity analysts make their living predicting the future of corporate earnings. Yet while capital markets consider the accuracy of analyst forecasts variable at best, many corporate executives feel pressure to reach or even beat these projections. They often go to great lengths to satisfy Wall Street expectations in their financial reporting and even in long-term strategic moves. Academics call this motivation “earnings management,” and it has drawn increasing attention from regulators and other market observers. Arthur Levitt, former chairman of the Securities and Exchange Commission, expressed concern that the practice “may be overriding long-established precepts of financial reporting and ethical restraint.”¹

So how good are the analysts at predicting earnings and setting forecasts that, whatever their flaws, serve as an important benchmark of the current and future health of companies? To answer this question, and to explore whether there are patterns in analyst forecasts that might enable us to better interpret their projections, we examined aggregate corporate earnings forecasts for companies on the Standard & Poor’s 500 index between 1985 and 2001.² Our research shows that analyst forecasts are most often notably overoptimistic, particularly in periods of declining economic growth. The longer the term of the forecast, the greater the degree of overestimation one usually finds. Moreover,

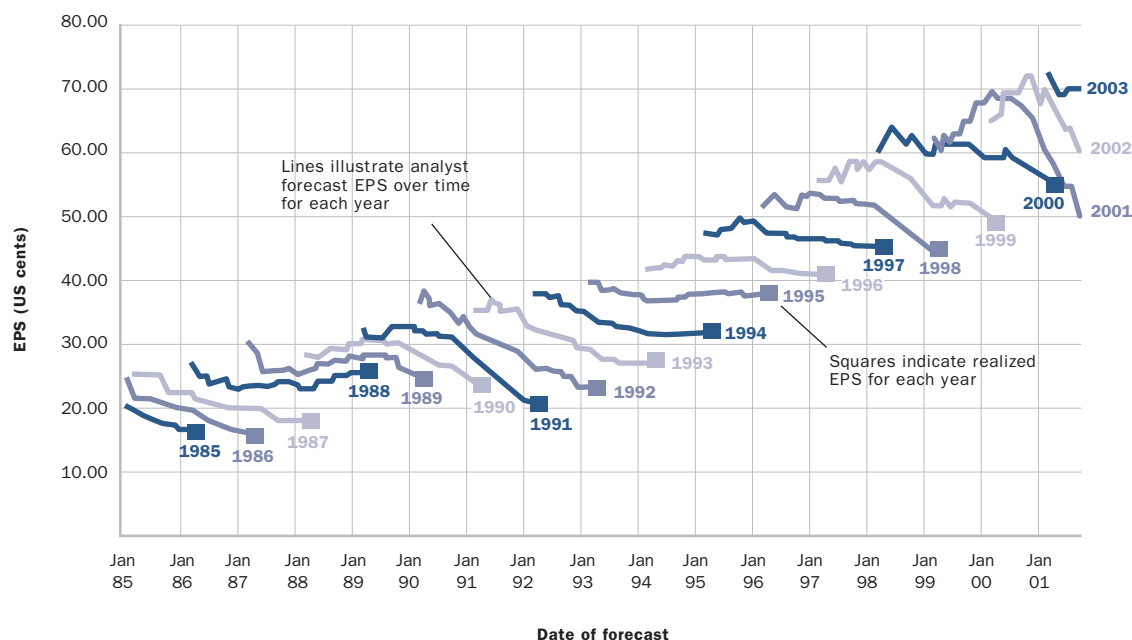
our analysis shows that capital markets see through these overoptimistic analysts’ projections, making them even more questionable as earnings per share (EPS) targets for corporate executives.

Optimism on Wall Street

No question, forecasting earnings with any degree of accuracy one, two, or even three years into the future is difficult. But if the unpredictable nature of companies’ fortunes and the fallibility of human foresight were the only factors in play, one might expect that any inaccuracies in broker forecasts would be fairly randomly spread, canceling one another out over time.

This is not what the record shows, however. In fact, our examination of the forecasts revealed three clear patterns (Exhibit 1). First, at the aggregate level, analysts almost always overestimate corporate profits. The gap between forecast and reported earnings can be wide. On average during the period 1985 to 2000 the aggregate earnings forecast overestimated corporate profits by more than 13 percent. Forecasts exceeded actual EPS by 22 percent at three years out, 18 percent at two years, and 10 percent at twelve months ahead of the fiscal year end.³ Second, the degree of overestimation is generally higher the further out the forecast is made. Typically forecasts are then revised downward until the

Exhibit 1. Aggregate EPS forecasts for S&P 500 companies



Source: McKinsey analysis

forecast is roughly in line with the eventual reported earnings, probably as a result of guidance by corporate executives. Finally, forecast errors are typically larger in periods of declining economic growth, suggesting that analysts are lagging in revising their forecasts to reflect new economic conditions.

Since aggregate earnings growth over time must approximate growth in the real economy overall, we looked at the relationship between earnings, earnings forecasts, and US economic growth. Obviously, as economic growth cycles up and down, the actual earnings reported by S&P 500 companies will occasionally coincide with analyst forecasts, for example, for 1988 and 1994–1997. More frequently, though, forecasts are too high; between 1985 and 2000, earnings for the S&P 500 grew by an

average of 11 percent a year while the average analyst forecast showed 22 percent. Over time, a reasonably consistent pattern emerges: when economic growth accelerates, the size of the forecasting error declines, but when economic growth slows, the error increases.⁴

Overshooting occurs in all sectors

The phenomenon is not limited to companies or industries that are rapidly growing and thus more prone to excessive optimism on the part of analysts. We examined a sample of 14 specialty chemical companies that have grown very slowly over the past decade—with sales increasing less than 3 percent per year. Even with this slow growth, analysts were prone to overestimate earnings and then reduce their forecasts in the last months prior to

announcement. As Exhibit 2 shows, analyst estimates declined in 9 of the 12 fiscal years for which data was available and fell by an average of 7 percent over even the last 12 months prior to the end of the fiscal year.

Analysts also forecast five-year EPS growth rates for these specialty chemical companies, with a median forecast consistently approaching 12 percent per year. Just as consistently, these companies delivered growth significantly below analyst estimates. In fact, they *never* exceeded the five-year growth forecasts (Exhibit 3). And although actual growth in the sector continues to decline dramatically, analysts are still forecasting future growth rates near 12 percent until 2005.

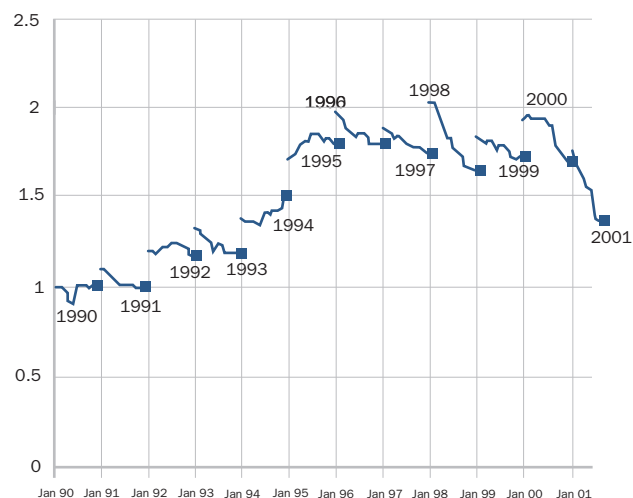
What to expect in the current downturn

We are currently in that phase of an economic cycle where economic growth, at best, has slowed and where, for many companies, earnings are in decline. The forecast for 2001 fiscal year as of September predicts EPS for the S&P 500 of \$0.53, a decline of about 8 percent from the level achieved in the previous year. However, the earnings forecasts for the next two years still include growth in excess of 15 percent.

Are these analyst forecasts reasonable? Forecasts for nominal US gross domestic product (GDP) growth for 2002 and 2003 were around 5 percent in September.⁵ Since 1985, S&P 500 earnings growth has been on average only 3 percent above GDP growth. A difference between S&P 500 earnings and GDP growth of more than 10 percent for the next two years therefore seems quite exceptional, if not unreasonable.

Exhibit 2. 12 month EPS forecasts for specialty chemicals companies

Forecast EPS, last 12 months of fiscal year

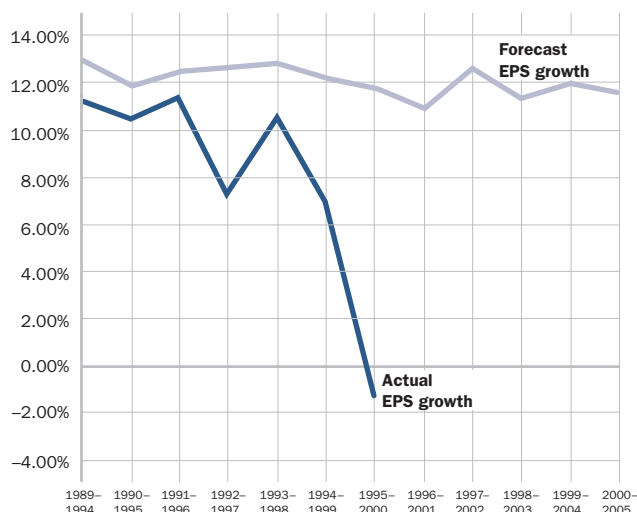


Source: Zacks Investment Research, Inc.

What earnings expectations do the capital markets really take into account? The pre-September 11 level of the S&P 500 seems to have reflected market expectations of growth well below analyst forecasts. As of August 31, the median price-to-earnings ratio of the S&P 500 was 17, which we calculate to be consistent with long-term EPS growth between 5 and 7 percent. A market-implied long-term EPS growth in this range is also more reasonable, considering historical experience. As prior McKinsey research has indicated,⁶ long-term growth in earnings for the market as a whole is unlikely to be significantly different from growth in GDP. Real GDP growth has averaged 3.5 percent over the past 70 years, which would indeed be consistent with nominal growth of around 6 percent given current inflation rates of 2 to 3 percent. Analysts, too, will ultimately lower their forecasts as they pick up on the lower

Exhibit 3. Five-year EPS forecasts for specialty chemicals companies

Median EPS growth over 5-year periods



Source: Zacks Investment Research, Inc.

attention from efficiently running existing businesses to chase transactions designed to boost EPS. For the same reasons, managers should not invest time developing accounting and funding method solutions just to stay on track for analyst EPS forecasts.

It is important to note that analyst forecasts are more reliable in the months immediately preceding earnings announcements. At that point they are typically considered by investors and corporate executives alike to be actual targets and incorporated in market pricing. Indeed, historical evidence suggests that markets are right in taking this view: forecasts three months prior to EPS statements have an average error rate lower than 5 percent. Not unexpectedly, earnings announcements that do not meet short term forecasts are likely to surprise the markets and impact share price. **MoF**

economic outlook that is already reflected in market pricing.

Implications for corporate executives

Managers should not necessarily feel pressured to deliver against longer-term analyst growth forecasts, as these typically reflect a significant upward bias. Nor should they consider these forecasts to be “capital market targets.”

Indeed, the market most likely does not expect them to do so; capital markets have typically already incorporated future forecast revisions into the current share price.

In fact, if managers pursue unrealistic EPS growth to meet longer-term analyst projections, there is a real risk they will actually destroy value if they engage in high-risk, high-growth projects or shift their

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¹ Remarks at the Economic Club of Washington, April 6, 2000.

² We examined the market-weighted aggregates of earnings forecasts, compiled monthly by Institutional Brokers Estimates System.

³ Forecast errors are measured as actual earnings minus forecast earnings divided by actual earnings.

⁴ The correlation between the absolute size of the error in forecast earnings growth and the 12-month trailing industrial production data is a negative 0.56.

⁵ Source: The Economist Intelligence Unit, September 2001.

⁶ Tim Koller and Zane Williams, “What happened to the bull market?” *McKinsey on Finance* Number 1, p. 6.

