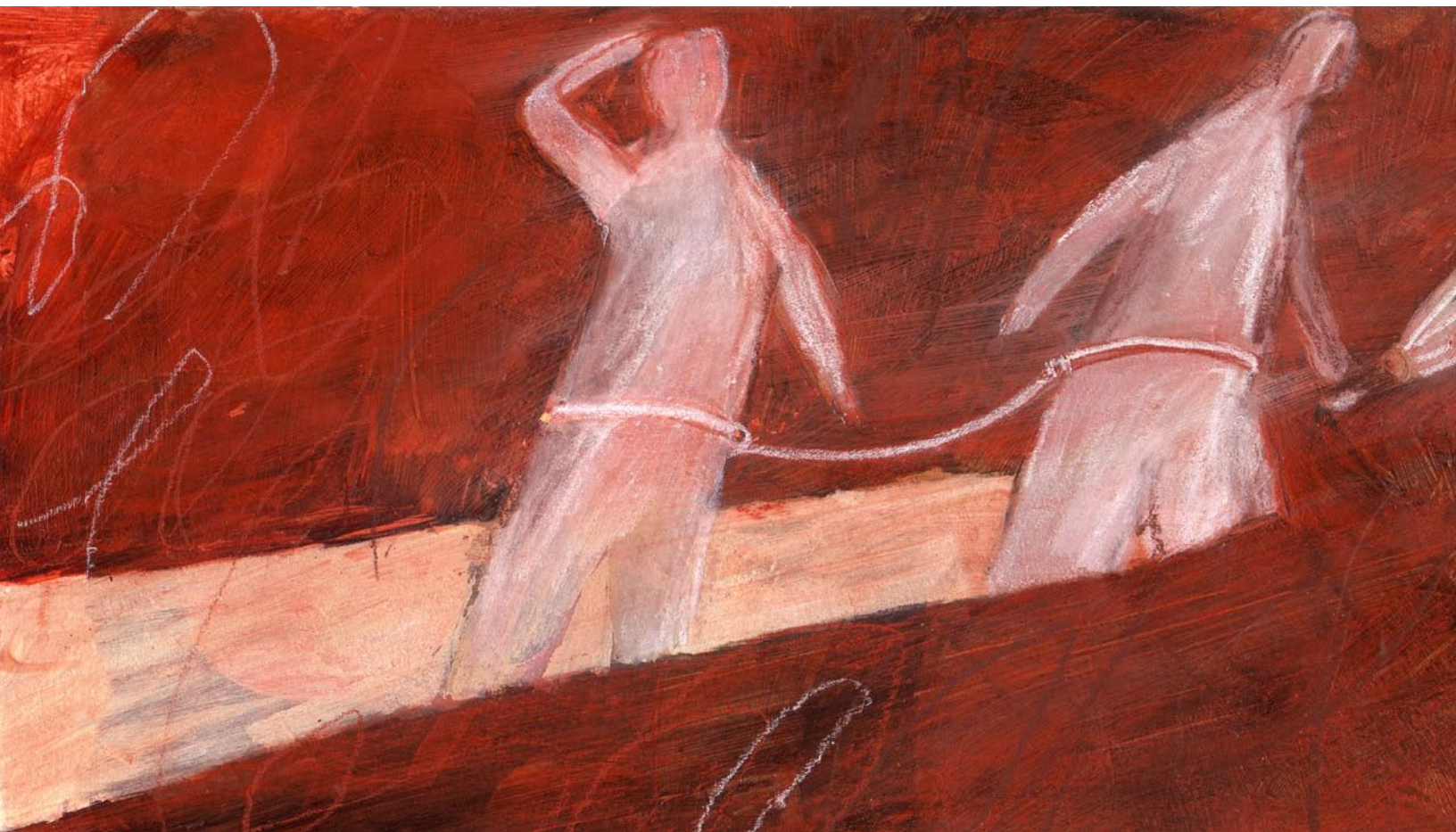


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The misguided practice of earnings guidance 1

Companies provide earnings guidance with a variety of expectations—and most of them don't hold up.

Inside a hedge fund: An interview with the managing partner of Maverick Capital 6

What should a company do when a hedge fund shows up among its investors?

Balancing ROIC and growth to build value 12

Companies find growth enticing, but a strong return on invested capital is more sustainable.

Toward a leaner finance department 17

Borrowing key principles from lean manufacturing can help the finance function to eliminate waste.

The **misguided practice** of earnings guidance

Companies provide earnings guidance with a variety of expectations—and most of them don't hold up.

Peggy Hsieh, Timothy Koller, and S. R. Rajan

Most companies view the quarterly ritual of issuing earnings guidance as a necessary, if sometimes onerous, part of communicating with financial markets. The benefits, they hope, are lower share price volatility and higher valuations. At the least, companies expect frequent earnings guidance to boost their stock's liquidity.

We believe that they are misguided. Our analysis of the perceived benefits of issuing frequent earnings guidance found no evidence that it affects valuation multiples, improves shareholder returns, or reduces share price volatility. The only significant effect we observed is an increase in trading volumes when companies start issuing guidance—an effect that would interest short-term investors who trade on the news of such announcements but should be of little concern to most managers, except in companies with illiquid stocks. Our recent survey¹ found, however, that providing quarterly guidance has real costs, chief among them the time senior management must spend preparing the reports and an excessive focus on short-term results.

These results pose an intriguing question: if issuing guidance doesn't affect valuations and share price volatility, why should a company incur the real costs of issuing it merely to satisfy requests from analysts?

Our conclusion: to maintain good communications with analysts and investors, companies that currently provide quarterly earnings guidance should shift their focus away from short-term performance and toward the drivers of long-term company health as well as their expectations of future business conditions and their long-range goals.² Companies that don't currently issue guidance should avoid the temptation to start providing it and instead focus on disclosures about business fundamentals and long-range goals.

A dearth of benefits . . .

The practice of issuing earnings guidance became more common during the latter half of the 1990s, after the US Congress protected companies from liability for statements about their projected performance.³ Since then, the number of companies issuing quarterly or annual guidance has increased—though in recent years the trend has begun to slow. Our review of approximately 4,000 companies with revenues greater than \$500 million found that about 1,600 had provided earnings guidance at least once in the years from 1994 to 2004. The number of companies that did so increased from only 92 in 1994 to about 1,200 by 2001, when the rate of growth leveled off. The number of companies in our sample that discontinued guidance has also increased steadily, growing to about 220 in 2004 (Exhibit 1).

In our survey, executives attributed several benefits to the practice of providing earnings guidance, including higher valuations, lower share price volatility, and improved liquidity. Yet our analysis of companies across all sectors and an in-depth examination of two mature representative industries—consumer packaged goods (CPG) and pharmaceuticals—found no evidence to support those expectations. The findings fell into three categories:

¹“Weighing the pros and cons of earnings guidance: A McKinsey Survey,” *The McKinsey Quarterly*, Web exclusive, February 2005 (www.mckinseyquarterly.com/links/21063). The survey's respondents included 124 CFOs, CEOs, and board members from around the world, from nine industries and companies ranging in size from \$10 million to \$30 billion.

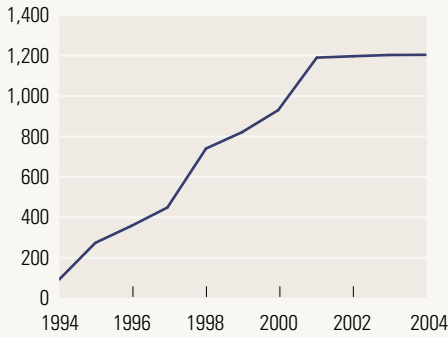
²Richard Dobbs and Timothy Koller, “Measuring long-term performance,” *McKinsey on Finance*, Number 16, Summer 2005, pp. 1–6. (www.mckinseyquarterly.com/links/21167).

³The Private Securities Litigation Reform Act of 1995.

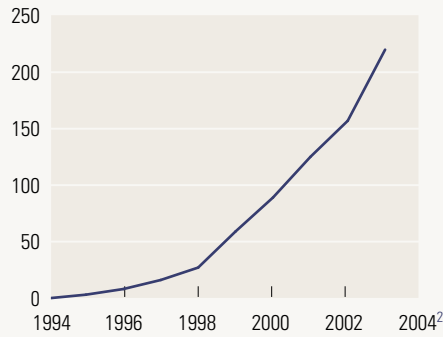
EXHIBIT I

Signs of a trend?

The number of companies¹ providing earnings-per-share (EPS) guidance has reached a plateau . . .



. . . while the number of companies¹ permanently discontinuing EPS guidance continues to rise.



¹Among companies with real revenues >\$500 million at any time from 1990 to 2004.

²Data for 2004 not available.

Source: Thomson; McKinsey analysis

Valuations. Contrary to what some companies believe, frequent guidance does not result in superior valuations in the marketplace; indeed, guidance appears to have no significant relationship with valuations—regardless of the year, the industry, or the size of the company in question (Exhibit 2).⁴ From 1994 to 2004 the median multiples for consumer-packaged-goods companies track one another fairly closely, whether or not they issued earnings guidance. While the median multiple for companies that did issue guidance was higher from 2001 to 2004, the underlying distribution of multiples for both groups was comparable. Indeed, the averages of the two distributions are statistically indistinguishable. Our findings are similar in other industries, though their smaller sample sizes create more scattered data.

Moreover, in the year companies begin to offer guidance, their total returns to shareholders aren't different from those of companies that don't offer it at all

(Exhibit 3). When we compared the TRS of CPG companies in the year they started providing guidance with that of peers that didn't issue it, the distribution of excess returns⁵ was centered around zero. This analysis supports our finding that the market has no reaction to the initiation of guidance. The absence of excess returns also holds for the year after guidance starts.

Volatility. When a company begins to issue earnings guidance, its share price volatility is as likely to increase as to decrease compared with that of companies that don't issue guidance. We looked at the ratio of the standard deviation of monthly TRS in the year of initiating guidance to the previous year and found virtually no difference between companies that do or don't offer it. Of 44 CPG companies that began offering earnings guidance, 21 experienced increased volatility and 23 showed a decrease compared with companies that don't offer it. What's more, the findings were similar regardless of company size.⁶

Liquidity. When companies begin issuing quarterly earnings guidance, they experience increases in trading volumes relative to companies that don't provide it.⁷ However, the relative increase in trading volumes—which is more prevalent for companies with revenues in excess of \$2 billion—wears off the following year. Since most companies don't have a liquidity issue, the rise in trading volumes is neither good nor bad from a shareholder's perspective. Greater volumes merely represent an increased opportunity for short-term traders to act on the news of the earnings guidance and have no lasting relevance for shareholders.

. . . but real costs

Analysts, executives, and investors understand that the practice of offering quarterly earnings guidance can have

⁴We analyzed companies by size—small (\$500 million to \$2 billion), medium (\$2 billion to \$5 billion), and large (greater than \$5 billion)—and by industry, including consumer packaged goods and pharmaceuticals.

⁵Excess returns in this case are defined as the TRS of a company issuing guidance minus the median TRS of companies in the same industry not issuing guidance.

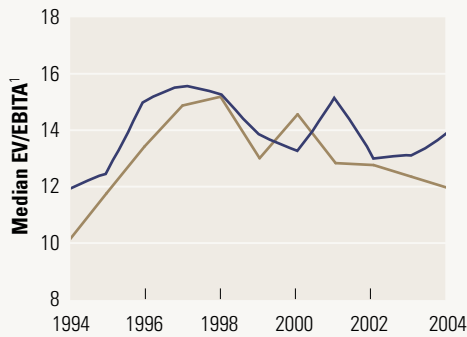
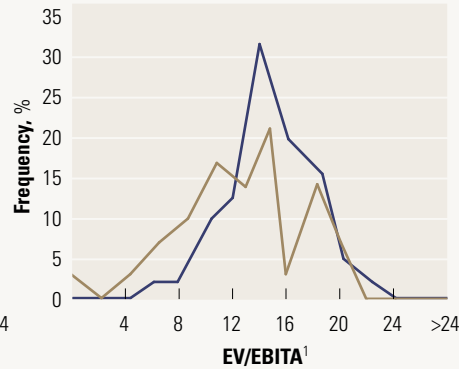
⁶Although increases in volatility were larger than decreases among small and midsize companies, the sample was too small to warrant stronger conclusions.

⁷We determined the relative effect by comparing a trading-volume index for the guiding company to the median index for nonguiding ones in the same sector. The index was created by dividing the trading volume in the year guidance started (normalized by shares outstanding) by the trading volume in the previous year.

EXHIBIT 2

No impact on multiples

For companies in consumer-packaged-goods sector

Median multiples over time**Distribution, 2004**

— Companies offering guidance — Companies not offering guidance

¹EV = enterprise value; EBITA = earnings before interest, taxes, and amortization.

Source: Thomson; McKinsey analysis

intangible costs and unfortunate, unintended consequences. The difficulty of predicting earnings accurately, for example, can lead to the often painful result of missing quarterly forecasts. That, in turn, can be a powerful incentive for management to focus excessive attention on the short term; to sacrifice longer-term, value-creating investments in favor of short-term results; and, in some cases, to manage earnings inappropriately from quarter to quarter to create the illusion of stability.

The practice also bears hard costs. In our survey, executives ranked the demands on management's time as the biggest cost of issuing frequent guidance, followed closely by the indirect cost of an excessively short-term focus. Respondents also cited demands on employees as a cost.

The risks of not providing earnings guidance

Of course, some investors would say that *not* issuing guidance can have real costs as

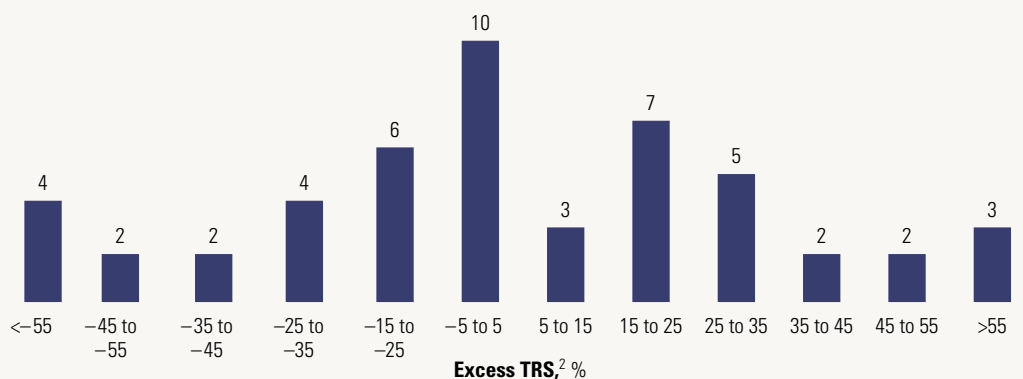
well. On February 1 of this year, Google, the Internet search engine highflier, saw its shares tumble by 7 percent when its fourth-quarter results fell short of the lofty expectations bandied about in the days leading up to the release. Some investors blamed the sell-off on Google's refusal to issue guidance that might have kept expectations in check.

Still, while most companies do offer quarterly guidance, a number of respected and highly visible companies have announced that they will either minimize the practice—offering only annual guidance—or abandon it altogether in favor of longer-range indications of their strategy and business conditions. In January 2006 alone, for example, Citigroup and Motorola announced that they would move away from quarterly earnings guidance, and Intel, asserting that “updates were *increasingly irrelevant* to managing the company's long-term growth,” announced that it would end its midquarter updates on sales and profit margins.

But many companies that currently offer guidance are reluctant to stop: in our survey, executives at 83 percent of them said that they had no plans to change their programs. These executives indicated that they fear the potential for increased share price volatility upon the release of earnings data, as well as the possibility of a decrease in share prices, if guidance were discontinued. The executives also worry that discontinuing guidance will make their companies less visible to investors and analysts.

But when we analyzed 126 companies that discontinued guidance, we found that they were nearly as likely to see higher as lower TRS, compared with the market. Of the 126, 58 had a higher TRS in the year they stopped issuing guidance, and 68 had a lower TRS compared with the

EXHIBIT 3

Little benefit to shareholdersNumber of companies¹**Excess total returns to shareholders (TRS) in the year that companies begin offering guidance**¹50 companies in guidance sample, all from consumer-packaged-goods sector.²Excess TRS for a company is defined as TRS in year guidance began minus median TRS in the same year for companies not offering guidance.

Source: Thomson; McKinsey analysis

overall market. Furthermore, our analysis showed that the lower-than-market TRS of companies that discontinued guidance resulted from poor underlying performance and not the act of ending guidance itself (Exhibit 4). In our sample of 126 companies that stopped issuing guidance, 79 did so as their return on invested capital was already declining, 47 while their ROIC was rising. Of the former group, 50 experienced a lower TRS than the market, while 29 had a higher one.⁸ Among those companies with a rising ROIC, only 18 had a lower TRS than the market, demonstrating that the lower TRS was correlated with a falling ROIC. Last, academic research⁹ also shows that ending guidance doesn't lead to reduced coverage or increased volatility and concludes that the negative shareholder returns of companies discontinuing guidance are the result of poor expectations for future performance and of the decreased accuracy of forecasts after guidance stopped.

To guide or not to guide?

With scant evidence of any shareholder benefits to be gained from providing frequent earnings guidance but clear evidence of increased costs, managers should consider whether there is a better way to communicate with analysts and investors.

We believe there is. Instead of providing frequent earnings guidance, companies can help the market to understand their business, the underlying value drivers, the expected business climate, and their strategy—in short, to understand their long-term health as well as their short-term performance. Analysts and investors would then be better equipped to forecast the financial performance of these companies and to reach conclusions about their value.

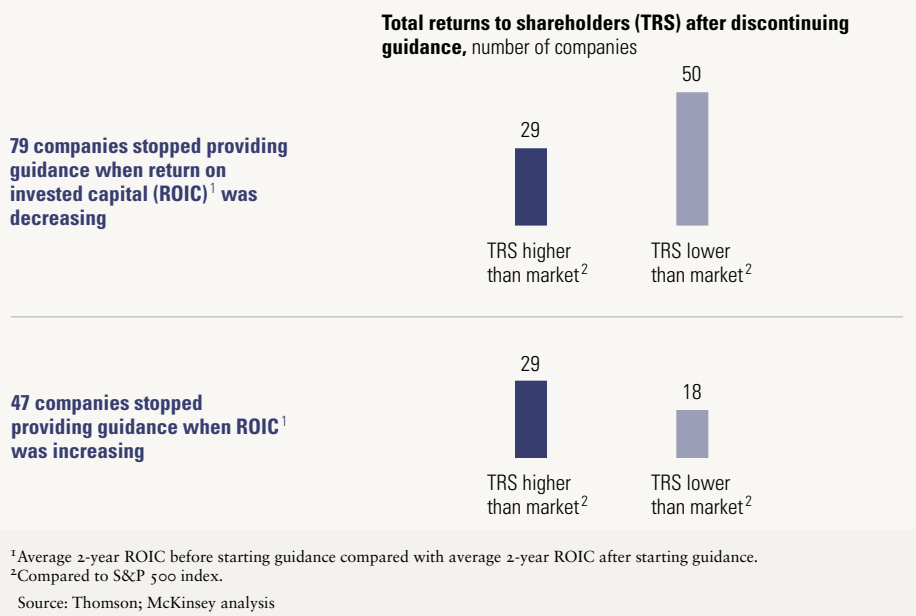
A retailing company, for example, could provide the components of revenue growth (same- and new-store sales growth, volumes,

⁸ Compared with the market in the year that guidance was stopped.

⁹ Shuping Chen, Dawn A. Matsumoto, and Shivaram Rajgopal, "Is silence golden? An empirical analysis of firms that stop giving quarterly earnings guidance," University of Washington working paper, January 2006 (<http://papers.ssrn.com>).

EXHIBIT 4

A matter of performance



growth initiatives, and M&A—not only on earnings but also, more important, on value.

Our approach has the additional advantage of reducing intangible costs. When Coca-Cola stopped issuing guidance, in late 2002, its executives had concluded that providing short-term results actually *prevented* management from focusing meaningfully on strategic initiatives to build its business and succeed over the long term. Instead of indicating weak earnings, Gary Fayard (who was then CFO) believed that the move signaled a renewed focus on long-term goals. The market seemed to agree and did not react negatively, holding Coke's share price steady.¹⁰ Like Coke, companies that reduce or discontinue guidance must clearly indicate that poor expectations of future performance are not the reason.

prices, product mix, and currency effect) and margins by business unit. It could highlight the factors that drive volume growth (disposable income, marketing expenditures, weather patterns), margins (input costs, trade spending, corporate costs), and capital intensity (the number, age, and location of its stores and the efficiency of its working capital) and explain how these factors will likely change in the future. In addition, the company could disclose the drivers of its recent performance as well as management's expectations for the future. Analysts could then build their own models to predict earnings going forward. Moreover, they would be better able to determine the impact of various corporate moves—for example, cost cutting, share repurchases, marketing expenditures, R&D, organic-

The voluntary disclosure of financial information is a key component of high-functioning capital markets. The current trend—more and more companies discontinuing quarterly guidance and substituting thoughtful disclosures about their long-range strategy and business fundamentals—is a healthy one. In this way, companies will better signal their commitment to creating long-term, sustainable shareholder value and encourage their investors to adopt a similar outlook. **MoF**

Peggy Hsieh (Peggy_Hsieh@McKinsey.com) and **S. R. Rajan** (SR_Rajan@McKinsey.com) are consultants in McKinsey's New York office, where **Tim Koller** (Tim_Koller@McKinsey.com) is a partner. Copyright © 2006 McKinsey & Company. All rights reserved.

¹⁰ See, for example, David M. Katz, "Nothing but the real thing," CFO.com, March 2003.

