L.E.K.

EXECUTIVE INSIGHTS

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Market Signals Analysis: A Vital Tool for Managing Market Expectations

With market fluctuations taking valuations on a roller-coaster ride, every CEO and CFO needs to be prepared for the board's inevitable question, "Why is our stock tracking at the level that it is?" Many answers tend to be subjective and are offered with puzzlement if not downright frustration. Other responses can be filled with good quantitative data and logical explanation. This issue provides an introduction to a highly valuable process we call "Market Signals Analysis." Introduced by Al Rappaport over a decade ago, it has been refined by L.E.K. and applied to many of our clients with considerable impact.

The market signals analysis process is meant to demystify the expectations or signals that the buy-and-sell side analysts have about a company. It does so by gathering and analyzing data from both external and internal sources. The comparison of these two sources provides a clearer picture to management about where the perception and/or the strategy gaps exist. By isolating the nature of any gaps, proactive steps can be taken to communicate with the market and hopefully adjust valuations accordingly.

Introduction

The competition for shareholder returns is an odd sport. The winner is determined less by absolute performance than by the ability of a company to outperform the expectations that the market has placed upon it. It is analogous to declaring the winner of a football game to be the team that beat the point spread rather than the team that scored the most points. Management often asks, "Why is our P/E ratio so much lower than that of other companies?" While it is possible that the market is undervaluing any given company, the real implication of a low P/E ratio is that the market is "giving points" or holds lower expectations for that company's performance as compared to its peers.

L.E.K. meets with many senior executives and board members. Often the topic of their company's valuation enters into the conversation. Some executives feel their company is fairly valued and others believe, frankly, that their company is getting the benefit of an industry "halo" or a bullish market. Many, as you might expect, are grumbling because they feel that their company is undervalued. Who is right? The more important question is what actions can an executive take to align the market's evaluation with the company's strategic plans?

To assess whether a company is correctly valued, management must examine the market's expectations for its performance and compare them with what management believes it can achieve. Only then can it be determined whether a relatively low valuation is justified or whether a relatively high valuation is sustainable. Because a large piece of this process involves analyzing the signals the market sends and receives, we call this process Market Signals Analysis.

Market Signals Analysis: A Vital Tool for Managing Market Expectations was written by **Chris Kenney,** Vice President in L.E.K.'s Chicago office. Please contact L.E.K. at strategy@lek.com for additional information.

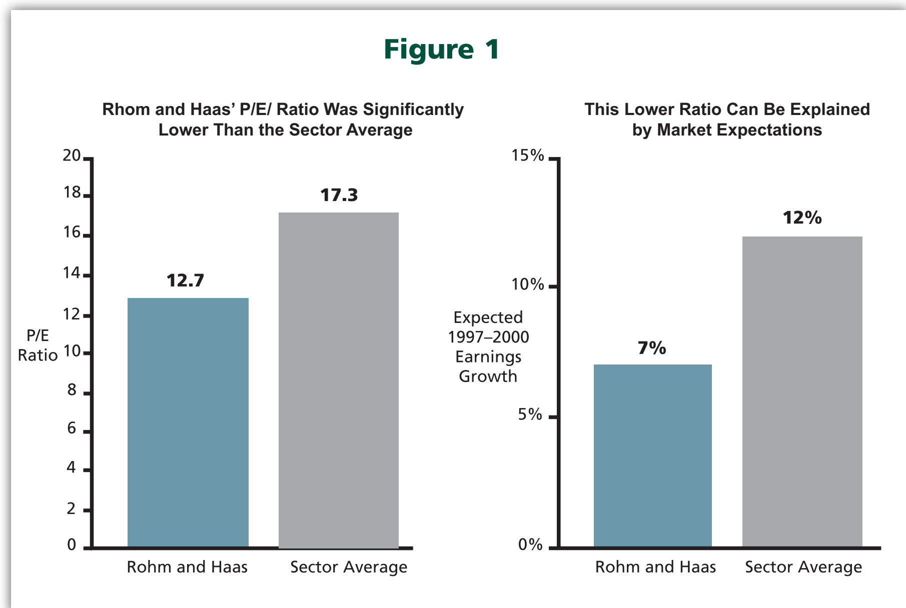
Take for example, the case of Rohm and Haas, a Philadelphia-based chemical company with sales just under $4 billion. In 1996, Rohm and Haas had a P/E ratio of 12.7. Meanwhile, the average for the specialty chemical sector was 17.3 (as illustrated in Figure 1). Was Rohm and Haas undervalued? Why was its P/E ratio so low?

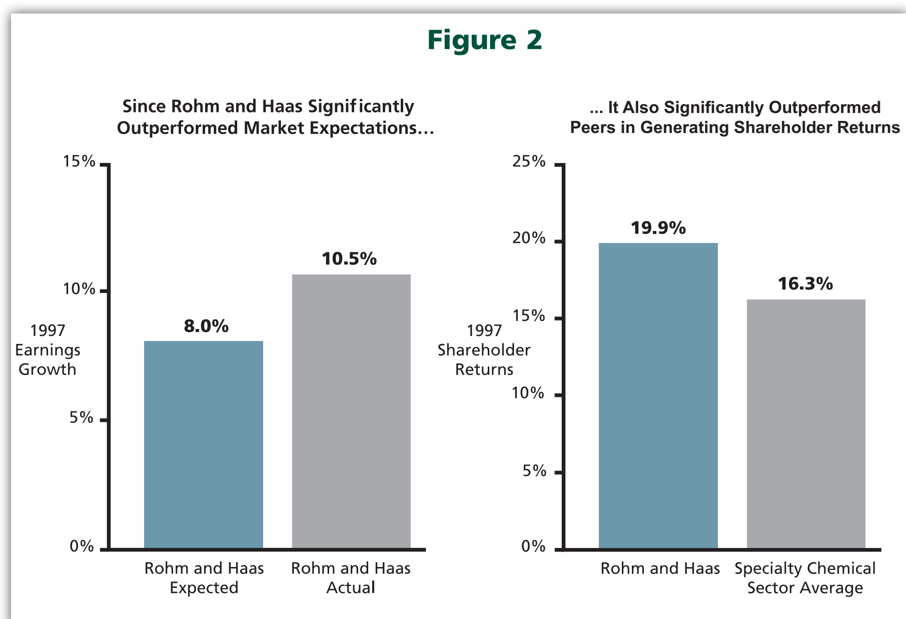
To answer these questions, at year-end 1996, management would have had to determine the expectations of the market for Rohm and Haas' future performance. Value Line was predicting 8% growth in net income for 1997 and 7% through 2000. This is compared to the overall sector earnings growth of 12%. To determine if the company was undervalued, management could have compared these and other analyst expectations to their internal plans. If management felt that they could surpass these expectations, then they would be correct in concluding that their P/E ratio was too low and the company was undervalued.

During 1997, Rohm and Haas generated earnings growth of 10.5%, which was 30% higher than Value Line's forecast. As a result, the company rewarded shareholders in 1997 with 19.9% shareholder returns, an amount that was 22% higher than the sector average of 16.3% (as illustrated in Figure 2).

Rohm and Haas' absolute earnings performance was not high relative to its peers. It fell slightly below sector earnings growth. However, earnings growth did substantially exceed market expectations. By effectively "beating the spread" by more than the average company in its sector, Rohm and Haas was rewarded with above-average returns for its shareholders in 1997.

If generating shareholder returns means exceeding market expectations, then management must incorporate these expectations when setting targets. The following describes a process by which management can ensure that jumping high means jumping high enough to satisfy shareholders and other influencers of its stock price.





Management Promises and Market Expectations

Imagine that you are the new CEO of a private company with one investor who owns 100% of the equity in your firm. You are likely to ask what expectations this investor has for your company's performance. The owner is equally likely to reply, "There is a minimum that I expect, but you tell me what you think you can do and I'll tell you what I expect."

This exchange reflects the role that management serves in setting market expectations. The information that publicly traded firms provide to investors through equity analysts and others is a key determinant of market expectations. However, analysts also refer to other information when developing their forecasts. This information includes the credibility of management, competitive data, expectations for market demand, etc. The result is that analysts' expectations can and do vary significantly from those of management.

Given the role that market expectations play in determining shareholder returns, the first step in the process is for management to gauge the extent to which internal forecasts differ from external expectations. Only then will they be able to determine whether achieving their current targets will translate into superior shareholder returns.

Measuring Market Expectations

There are three steps involved in gauging market expectations:

- Performing investor market research
- Estimating value creation implications
- Determining implications for management

Performing Investor Market Research

The most obvious way to understand market expectations is to ask equity analysts, whose job it is to inform investors, and when feasible, buy-side analysts, whose job it is to make investment decisions. L.E.K. has conducted a significant number of analyst surveys on behalf of publicly traded companies. These surveys are designed to uncover the following types of information:

- Consensus forecasts for revenue, profits and free cash flow for the total business and key business segments/units
- Quality and quantity of information provided by management to investors
- Investors' perception of management and management's ability to consistently meet its public commitments
- Performance indicators that analysts consider most important
- The extent to which analysts feel the total business and the most important units are fairly valued by the market
- The extent to which analysts understand and accept the total business, or unit's business strategy and/or key strategic initiatives
- The strategic fit among the company's portfolio of businesses

These surveys are conducted via telephone and in-person interviews. The objective of the interviews is to identify and to understand the key factors driving analysts' expectations for a company's performance. Many times these objective third-party discussions reveal the bias of selected analysts as they weigh specific factors. They also ascertain the investment community's attitudes on qualitative perspectives that are generally not discussed during analyst meetings. The benefits of these interviews are that they can isolate and clarify specific issues that may be affecting how a company's message is being received.

Estimating Value Creation Implications

The next step involves translating analysts' expectations into a consensus view of the amount of value they expect the business to create over time. L.E.K. defines value creation as follows:

Value Creation = Discounted Cash Flow Business Value – Baseline Value

Where: Baseline Value = Net Operating Profit After Tax/Cost of Capital

Baseline value in this calculation is defined as the value of a business with zero anticipated value creation. Therefore, by subtracting baseline value from the total discounted cash flow business value, we isolate the expected value creation.

The advantage of measuring value creation expectations of analysts is that it provides a true economic bottom line for which to compare value creation anticipated by management's strategic plans. Without this bottom line, it would be difficult to compare an analyst forecast with high cash flow to a management forecast with lower earnings but also much lower investment requirements. This measure of value creation can determine which of these two forecasts generates the most value for shareholders and can be used to further illustrate the strategic thought process used to develop a company's forecast.

Determining Implications for Management

Armed with management and market expectations of value creation, there are three possible scenarios that can be considered, utilizing the following framework (as illustrated in Figure 3).

The three possible outcomes of comparing internal and external expectations imply very different management actions.

Case I – Company Is Undervalued

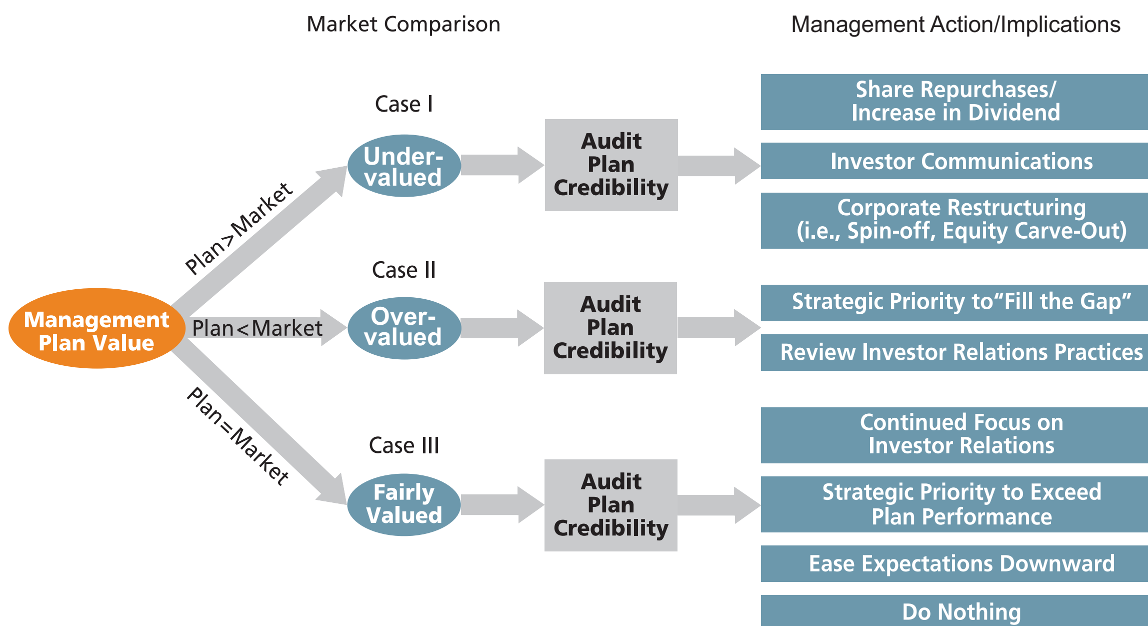
There are two potential reasons that the market may appreciably undervalue the company. First, management's plan may be considered unjustifiably aggressive in the eyes of analysts. This may be a perception gap, and management should examine its track record for delivering against prior forecasts. If a company finds itself consistently below plan, it should critically evaluate its long-term strategy to determine if expected operating performance levels are truly achievable.

If management is satisfied that the strategic plan is credible, then a second possible reason for the undervaluation is that the market has not given this plan fair credit. This "perception gap" could exist because analysts lack necessary information; for example, management may be reluctant to divulge certain information necessary to render a fair judgment for competitive reasons. There are several possible actions:

- First, the investor relations strategy can be altered to improve the quantity and quality of information provided to the market.
- Alternatively, share repurchases (open market or self-tender) can strongly express management's belief that its shares are undervalued without revealing competitively sensitive information. The same is true of an increase in the level of dividends. Personal purchases by senior management are another very positive signal.
- Finally, management may suspect that a particular business unit may be the source of the undervaluation. This can be true of high-growth businesses embedded in low-growth parent companies. In this case, companies should consider selling a portion of the division with bright prospects to the public market. In doing so, the market often receives more information about the unit and is forced to render a judgment regarding its value.

Figure 3

Market Signals Management Framework



Case II – Company Is Overvalued

In the instance that management concludes that its shares are overvalued, management has three potential remedies. First, the business strategy can be re-examined to determine if there are any ways to close this "strategy gap" and to generate the level of performance required to support the current stock price. Examples of ways to create value in line with expectations include:

- Performing synergistic acquisitions – especially deals using high-priced stock as currency
- Entering new geographic markets
- Pruning value-destroying businesses and activities
- Re-examining the firm's marketing and distribution practices
- Selling the business to a synergistic buyer at a hefty premium

If none of these approaches are feasible, management's second option is to communicate to investors that the market is being too aggressive and the company cannot deliver the performance required to justify the current stock price. If management can find no way to justify or deliver high market expectations, it is usually advisable to communicate this to the market rather than remain silent. Doing so strengthens management credibility, which is a critical ingredient in managing investor expectations over the long term.

Case III – Company Is Fairly Valued

In the event that market expectations closely mirror management's plan, the implications are not altogether dramatic but the prospects for value creation are similarly not altogether exciting. Basically, everyone is in agreement. If management achieves its goal, then shareholders can expect to earn only their required return and no more. Therefore, management's focus should be to examine opportunities to exceed its plan. Similarly, performance targets and incentives might be structured to ensure that the plan represents a minimum level of performance.

Case Example – EnergyCo

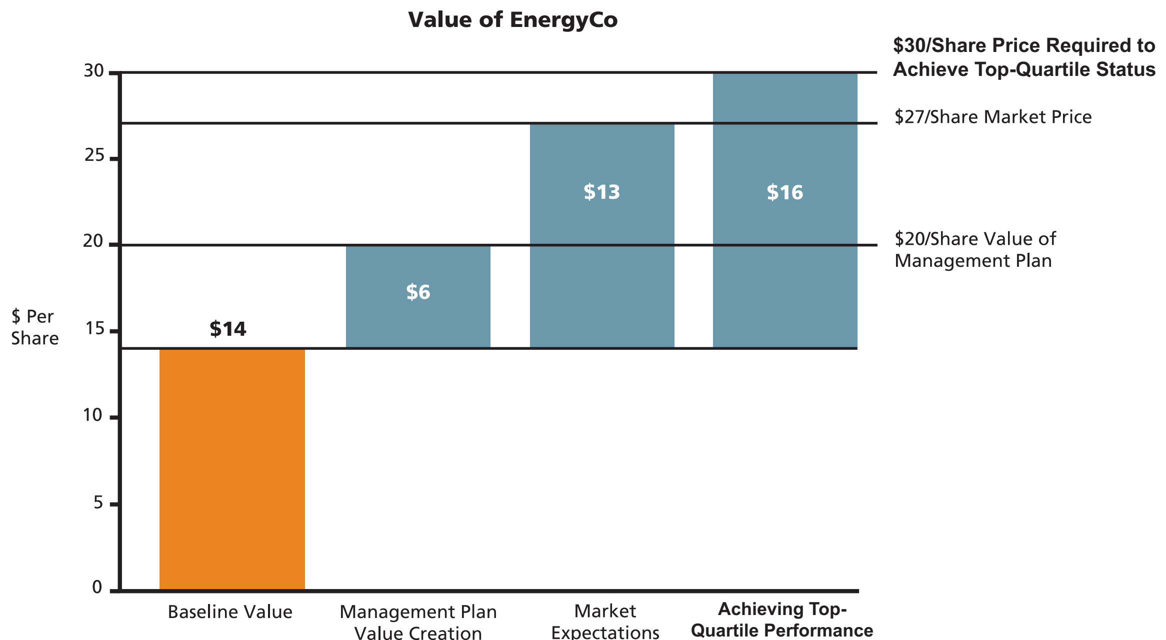
Recently, L.E.K. had the opportunity to work through a market signals analysis for a company we will call EnergyCo. EnergyCo is a leading U.S. energy company that had a strong record of generating substantial shareholder returns. Executive management was compensated on the basis of remaining in the top-quartile of the S&P Utility Index for shareholder returns over a three-year rolling period. Because of this, management was keenly interested in learning what level of performance was necessary to ensure that EnergyCo would be among the top-quartile companies. The first step involved understanding analysts' expectations of performance and comparing these expectations to management's plan.The result of this analysis was as follows:

Baseline value (the value associated with a zero value creation scenario) equaled $14 per share. Management expected to deliver value creation justifying an additional $6 per share. Unfortunately, market expectations were materially higher. The market expected performance justifying an additional $7 per share above management expectations, for a total of $13 per share in value creation and a $27 share price.

How did market expectations get so far ahead of management's plan? First, management had a track record of conservative forecasts. Second, the market was not anticipating major investments required in certain businesses in order to support growth. The result was that just to meet market expectations management had to deliver more than twice the value creation anticipated in its plan.

The picture became worse when we considered management's goal to achieve top-quartile shareholder return performance. Taking into account the average historical shareholder return premium generated by top-quartile energy companies, we concluded that $16 per share of value creation was necessary to have a reasonable assurance of being among top-quartile performers (as illustrated in Figure 4).

Figure 4



L.E.K. worked with management to explore ways to fill the $10-per-share value gap ($16 per share required to generate top-quartile performance less $6 per share anticipated in management's plan).

One avenue involved the company's emerging growth businesses. EnergyCo had several developing businesses, which were not included in management's plan. In discussions with analysts, we were able to determine that they gave no value credit for these businesses, primarily because management had not divulged any information about their prospects. There was no reason for these business units to stand out as significant value and a perception gap formed. Management immediately changed its investor relations practices to include information about these businesses.

Management also increased its focus on strategic alternatives for its core business. This examination led to the implementation of several initiatives that had the potential to close the strategy gap, including:

- Productivity improvements that would lead to cost reductions and better margins
- Merging with another company to expand geographic reach and focus of energy
- Redesigning the electrical power grid to reduce capital requirements

Since completing this process, EnergyCo has remained in the top quartile of companies in its industry. Management credits the evaluation of market expectations for providing the impetus to search for new avenues to create value.

Conclusion

If the contest for shareholder returns were settled like most competitions, the winner would be determined by absolute performance. Companies would only have to worry about outscoring other companies in their industry in order to be rewarded with the highest shareholder returns. But this simple scenario is complicated by the fact that shareholder returns reflect performance relative to investor expectations. Highfliers like Microsoft, GE and Coke find that they have to fly even higher the next year just to meet increased market expectations. This discussion of the contest for shareholder returns has important implications for corporate performance measurement. In order for managers to be confident that they are creating value, they must examine the expectations held by the market and find ways to continually exceed them. The three-step process outlined here for identifying, measuring, and eliminating value gaps provides a systematic approach for managers to ensure shareholder maximization.

L.E.K. Consulting is a global management consulting firm that uses deep industry expertise and analytical rigor to help clients solve their most critical business problems. Founded more than 25 years ago, L.E.K. employs more than 900 professionals in 20 offices across Europe, the Americas and Asia-Pacific. L.E.K. advises and supports global companies that are leaders in their industries – including the largest private and public sector organizations, private equity firms and emerging entrepreneurial businesses. L.E.K. helps business leaders consistently make better decisions, deliver improved business performance and create greater shareholder returns.
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