BRUNSWICK BULLETIN

Strategy & Investor Relations June 2007

Notes from NIRI

The annual National Investor Relations Institute Conference took place in Orlando June 3-6, with more than 1,000 IR officers and others in attendance. The NIRI get-together is a great opportunity to catch up on the latest trends in guidance and disclosure practices, governance, and investment management. The Brunswick group of six that attended would like to share our views of the key points from the conference.

Investor Relations

Although most companies give quarterly earnings guidance, there is a gradual shift toward annual or even no guidance. One of the most debated topics of the conference was earnings and other types of guidance and disclosure. NIRI published its 2007 survey of guidance practices based on 751 responses. Highlights include:

- Some 71% say they provide investors with quantifiable financial performance measurements, which can be revenue, earnings, cash flow, margin, or other financial figures. A slightly higher percentage also give non-quantifiable measures (qualitative disclosure).

- The trend toward annual rather than quarterly earnings guidance continues. Some 58% of respondents provide annual guidance compared with 27% offering just quarterly views.

- More companies are deciding to not give any earnings guidance though the majority still offer guidance. Those that do give guidance cite ensuring a reasonable consensus as the top reason and tend to provide a range.

- Discontinuing guidance altogether appears to have no significant effect on valuation or stock volatility, which was supported by work done by McKinsey & Co.

So there is a trend toward longer-term thinking in giving less quarterly guidance but providing annual or three-year views. Still, there are two distinct schools:

- IROs who favor de-emphasizing near-term guidance and believe in doing so they attract longer-term investors and don't suffer any permanent valuation impairment, and

- IROs who point out that the long run is a series of short runs and there still will be a quarterly consensus figure against which results will be judged. In their view, it's better that the company (which has the most information) has its say, resulting in a narrower estimate range.

Brunswick's thinking is as follows:

- There probably is not one correct answer. Companies that find it difficult to predict their results should favor longer-term or no guidance. Results of the business will win out—not giving guidance hasn't hurt Google.

- Giving short-term guidance is a problem when it influences company behavior such that management foregoes smart long-term decisions to make the quarter. This happens often enough that we prefer companies emphasize annual over quarterly guidance (see the Dell discussion next).

- Studies show that too much forward-looking guidance and milestones such as mid-quarter updates can attract transient investors. Also, it's not clear to us that a narrower range is a good thing. Markets work better with diversity of opinion; they get in trouble when everyone is thinking alike.

- Companies in cyclical industries such as semiconductors might have a legitimate argument for giving short-term guidance because they can forecast the next quarter better than the next year.

- More important than guidance is how the company discusses its business. Transparent, consistent, and balanced quantitative and qualitative disclosure should be the goal. Management credibility is enhanced when companies proactively address the drivers of their business. One successful approach is to describe your business the way you manage it.

Gary Black, CEO of Janus Capital Group, ironically noted that asset management firms tend not to give guidance, so why should they as investors expect it of other companies? It is interesting that the sell side complains more than the buy side when quarterly guidance is taken away.

The case of Dell and its reversal on earnings guidance. Most notable among companies that addressed their guidance policy was Dell. Although the company currently cannot provide guidance due to an SEC inquiry, Dell already had decided to move from quarterly to long-term guidance. The company's IR officers readily admit that management made decisions such as cutting back on customer service in an attempt to maintain its record of meeting or beating quarterly estimates for four consecutive years.

In fact, the IR department pushed for change after studying the issue. IR execs realized that 90% of its earnings call discussions were short-term focused, yet interviews with its 25 top holders found a desire for long-term emphasis. In speaking with other companies, Dell found that 25% of mega-caps were considering ending quarterly guidance.

IR's conclusion was that annual guidance or long-term performance targets would be sufficient and sold this view to the board. When it can talk to investors again, Dell plans to provide 3-5 year earnings growth ranges with discussion of expected puts and takes regarding pricing, unit growth, costs, tax rate, and stock repurchases. It also will correct guidance on a limited basis. For example, when it announced that Michael Dell would resume running the company, Dell also pre-announced an earnings disappointment. Finally, the head of IR said they will change their program and spend 100% of their time with the buy side, no doubt an exaggeration but indicative of a broader trend.

The future of the IR officer is ? The role of the investor relations officer has become more important. Over the last 20 years, most companies have developed a dedicated IR team, improved IR access to top management, and increased IR resources. Technology such as conference calls and web sites has given companies more control over their messaging. Furthermore, the importance of integrated IR and media communications is generally accepted.

Consequently, the comments of Janus CEO Gary Black were interesting and surprising. He saw a declining role for IROs and less capable people filling the position in the future. He pointed to Reg FD limiting IR's ability to add value and the buildup of buy-side research that does its own work. We would add the factor of quant funds. As much as 30% of funds are invested by computer models, which don't care what the fundamental story is or to meet with managements.

Nevertheless, in the foreseeable future we expect IR to remain important. Rivel Research Group found that 82% of 263 investors and analysts said that good IR affects stock valuation. Good IR can add 10% to valuation and poor IR can result in a 15% haircut, a potential 25% valuation swing!

Several CEOs and CFOs speaking at the conference emphasized their reliance on their IRO and the expectation that he or she would "step into their shoes" as necessary. IROs Greg Klaben (Flextronics) and Laura Paugh (Marriott Hotels) highlighted the IRO as one of the few executives who get to see "all the pieces of the puzzle".

Although Reg FD limits comments on near-term performance, it creates more interest in long-term strategies that need to be explained. Legg Mason's Bill Miller has spoken of time arbitrage, the ability to make excess returns by emphasizing a longer investment horizon. Corporate reputation is of rising importance, suggesting active management is required of both investors and the media. Quant techniques might take in more money, but these stylistic approaches tend to be cyclical—more quant competition could lead to lower returns. And many of those LBOs that are currently all the rage will be going public again. No, we wouldn't put the investor relations officer on the endangered list yet.

The differences between mutual funds and hedge funds are narrowing. Gary Black of Janus and Jason Yeung of Morgan Stanley pointed out that the differences between hedge funds and mutual funds are disappearing (except that hedge funds still charge much more, which also could change). Many previously long-only groups such as Janus and Wellington now have hedge funds. Conversely, some hedge funds have long-only vehicles.

Most interesting is the 130/30 model some hedge funds are adopting, in which they are long 130% and short 30%, mimicking a long-only fund that is 100% net long. Hedge funds do short unlike long-only money, but today's short can be tomorrow's covering short or even long investor in your stock. Managements should try to understand why shorts are negative on the stock (and not necessarily the business since even good businesses can be overvalued).

Communicating with hedge funds can be worthwhile. From the company's perspective, hedge funds are often viewed as undesirable investors that can be ignored. Although in the past most hedge funds were what academics refer to as "transient investors," that is no longer true. With assets of $1.3 trillion, or one-tenth of U.S. equity assets, hedge funds have diverse investment strategies. The message at NIRI was that it can be worthwhile to include some hedge funds in a company's IR program.

The question for many IROs is "Which ones?" The key to engaging with hedge funds is preparation and prioritization. We often work with clients to determine where hedge funds sit on the desirability scale. For example, funds such as Lone Pine and Maverick take a long view and should be prioritized as any other major institutional investor. At the other end of the spectrum are hedge funds that are trading-oriented and could be given low priority.

When a public company is doing its homework on a hedge fund, it starts with publicly available information such as 13F or 13D filings and press cuttings, and sometimes websites. The next step is for the IRO to engage directly with the hedge fund to get a sense of the fund's sophistication and investment approach. Then the IRO should be able to decide if it is worthwhile organizing a face-to-face meeting and who at the company is the most appropriate representative. Hedge funds can become strategic holders and provide you with valuable feedback.

The sell side is declining in importance. A common theme in the sessions with IR officers was the waning importance of the sell side and increasing focus on investors actually buying and selling stocks. The decline of the sell side is attributable to (1) a brain drain due to poor sell-side economics because of the separation of banking and research and the rise of electronic trading, (2) the perception that the sell side caters to short-term focused hedge funds, and (3) buy-side firms bulking up their own research efforts.

Jason Yeung underscored that behavior is explained by incentives. Sell-side analysts and fast-money hedge fund managers are paid on annual performance. On the other hand, long-term investors often are compensated for multi-year returns, and companies should be managing for the long term.

We don't think the sell side is going away. It still sets a consensus quarterly earnings estimate that matters though less than it used to. The sell side still has a narrower focus than the buy side and can be more expert on companies and industries. And the sell side is moving away from maintenance to more value-added research.

Still, it's clear that on the margin companies are setting up their own roadshows, spending more time with the buy side, and worrying less about sell-side complaints that companies aren't giving quarterly guidance.

Strategy

Focus still wins. Futurist Edie Weiner made a number of interesting points in arguing that change is accelerating. We are moving from the emotile (emotional and mobile) economy to the virtual economy, where the opportunities will be in innerspace (what makes us tick), microspace (bits, atoms, genes), and cyberspace. We agree with her view that attention is the scarce commodity and companies will attempt to own minds through user addiction to their products.

She explained two key principles: educated incapacity and owning the right of way. Educated incapacity is our difficulty to see things in new ways and to take notice of the background surrounding our primary focus. Right of way asks what business a company really is in. Is Best Buy in the electronics or the warranty business when it makes substantial warranty profits, or is McDonald's in the restaurant or the kiosk business when it derives 40% of revenue from drive-through?

Furthermore, the railroads owned rights of way that they allowed telecom companies access to rather than recognizing that railroads were defining their business too narrowly and could have dominated telecommunications.

Both principles are useful mental models but are limited in going against perhaps the most important business principle—focus. Questioning assumptions and challenging traditional ways of viewing the world are extremely useful. At the end of the day, however, we've found that it's companies that can define and exploit a narrow focus that are the winners.

Best Buy really is in the electronics business, it's just that what a company advertises, sells, and makes money on can be different things. Best Buy might advertise PCs to get customers to visit, push flat screen TVs once the customer is in the door, and make its money on installation and warranties. But it's not in the warranty business per se because that's not how the company is perceived by customers.

The point about railroads was made famous by marketing professor Theodore Levitt in his 1960 article "Marketing Myopia," in which he indicted managements for defining their industries too narrowly. He used the example of railroads losing passenger and freight business to cars, trucks, and airplanes because railroads didn't recognize they were in the "transportation business".

But customers don't think like that. They think in narrow categories, such as airlines, taxis, bus companies, and cruise lines. The railroads that survived went the other way and focused on freight. Railroads didn't have the competencies to succeed in airlines or autos let alone in telecom.

Being a leader in a new category is the holy grail; don't brand extend. We believe that the best companies create a new category (where Ms. Weiner's principles for success can be useful) and set themselves up as the leader. Examples include Red Bull in energy drinks or Amazon in on-line bookstores as explained in our report "Out of Mind, Out of Business".

CEO Clarence Otis, Jr. of Darden Restaurants spoke about his principles of leadership and how they evolved as he came out of Watts to create a successful business career. He mentioned that Darden created a new category—causal dining—that is now $70 billion in revenue and represents 25% of the restaurant market.

Another thing Darden has done right is resist the temptation to brand extend. Successful large companies grow by creating a portfolio of brands with different names as United Technologies and Proctor & Gamble have done. Darden owns Red Lobster, Olive Garden, and Smokey Bones. The consumer has little idea that Darden is the common owner of these restaurants that attack different segments. Would it have worked as well if Darden started as, say, a successful seafood restaurant and then added Italian and Mexican outlets under the same name? We doubt it.

The liquidity bubble is likely to pop. John Thain, CEO of NYSE Euronext, and Joe Rice, Chairman of private equity firm Clayton, Dubilier & Rice, have been around a long time. They both said the economy could suffer in coming years from an unwinding of a liquidity bubble.

That there is excess liquidity is reflected in low interest rates and narrow credit spreads. Thain said the trick is to gently deflate it, perhaps through interest rate hikes, higher margin requirements, and tougher debt covenants. Joe Rice said the private equity cycle probably is peaking and that returns and company prices will decline. He pointed out, though, that the current trend of "covenant-light" (easy terms) credit makes it hard to default on debt even if conditions worsen.

We agree that we are in a liquidity bubble or more specifically a credit bubble. The cause? The Fed as well as new ways to create credit under the influence of investment banks and government agencies such as Fannie Mae. Since the country went off the gold standard, the Fed can't control the urge to print money. Consequently, looking to the Fed to fix the problem is problematic. Eventually the malinvestment of the up cycle (the 1920s) gets unwound in the down cycle (1930s). Managements are advised to use caution because it is unlikely to be a soft landing this time.

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