WHITE PAPER

Hit or Miss – Transparency is Key

Companies that provide earnings guidance and pre-announce their earnings surprises realize superior stock price returns

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Introduction

In the midst of this "Great Recession" and in light of the roles that both Corporate America and Wall Street played in precipitating it, few would argue against the notion that transparency in financial reporting is a good thing. Like other instances of conventional wisdom, however, the real-world value of transparency is rarely examined quantitatively.

We investigated the actual financial results reported by more than 1,000 publicly traded companies for the first quarter of 2009, and the findings conclusively demonstrate the benefits of greater transparency[1].

During the 30-day periods we measured, companies that a) provided earnings guidance, b) promptly adjusted their full-year guidance when quarterly earnings disappointed, and c) pre-announced their anticipated guidance surprises – both upside and downside – delivered stock price returns significantly higher than companies that did not follow these practices.

Our study found that:

- Companies that did not provide guidance were punished far more severely for missing the analyst consensus estimate than companies that did give guidance.
- Pre-announcing a guidance surprise, whether positive or negative, resulted in stronger stock price returns versus not pre-announcing. Contrary to conventional wisdom, companies that pre-announced a downside miss were not "punished" twice. They actually experienced better returns than companies that did not pre-announce.

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[1] Using the eventVestor® analytics platform, we measured "abnormal stock price return" for S&P 500® and Russell 1000 companies in the 10 trading days before and 20 trading days after the pre-announcements and earnings announcements during the first quarter of 2009, based on their guidance practices and their results versus the consensus of analyst estimates. Guidance data was sourced from company press releases and SEC filings. Abnormal stock price return is the difference between a single stock's performance and the average market performance over a set period. In our analysis, we used the S&P 500 index as the benchmark for the average market performance. For example, if a stock increases by 7% on the day a company raises its earnings guidance and the S&P 500 index was up by 2% on that day, then the abnormal return was 5%. On the other hand, if the market reference index performs better than the individual stock, then the abnormal return would be negative.

In addition, companies that pre-announced on the upside were "rewarded" twice. They saw their stock price go up on the day of the pre-announcement and then continue rising in the days immediately following the formal earnings announcement.

- It was consistently beneficial to accompany a guidance miss with a decrease in full-year guidance. Companies that maintained their full-year guidance when reporting disappointing quarterly earnings experienced inferior stock price returns.

Do these findings have predictive validity? Without a doubt, the first quarter of 2009 was an unusually bearish period for the world's capital markets. With fear permeating the trading environment, investors likely placed an exceptionally high premium on corporate financial guidance. If this is true, a similar study conducted during a more bullish period in the market may not yield identical results. Even when considered only as a snapshot, however, the study's findings have provocative implications for the use of earnings guidance in the practice of investor relations.

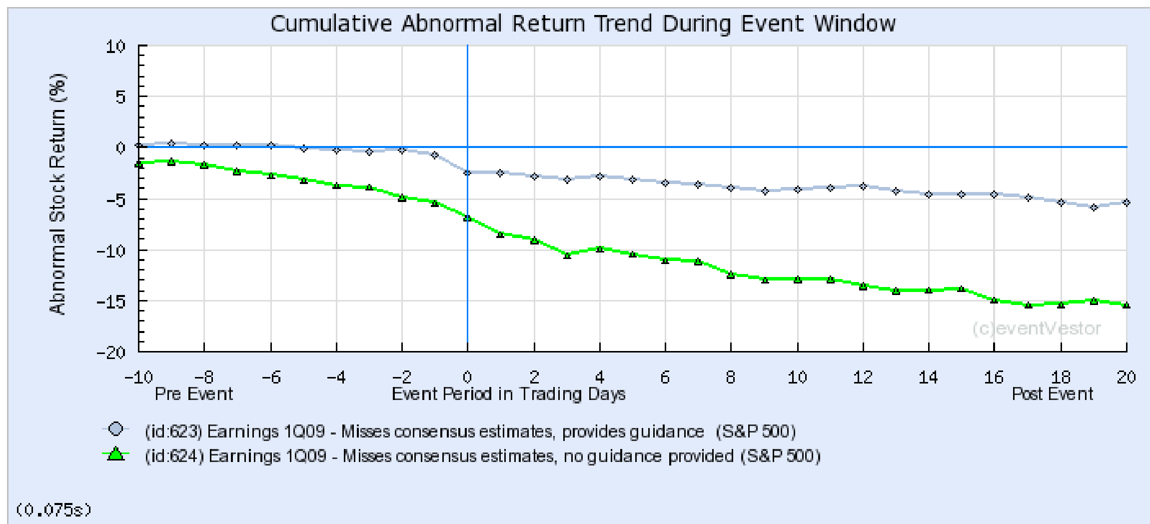
Key Findings

1. Performance versus analyst expectations was critically important to subsequent stock price return, but guidance was a useful buffer.

Our study confirmed the importance of sell-side analyst expectations as a factor in determining stock price increases or decreases following earnings announcements. The relationship between reported earnings and the analyst consensus was closely correlated to abnormal market return.

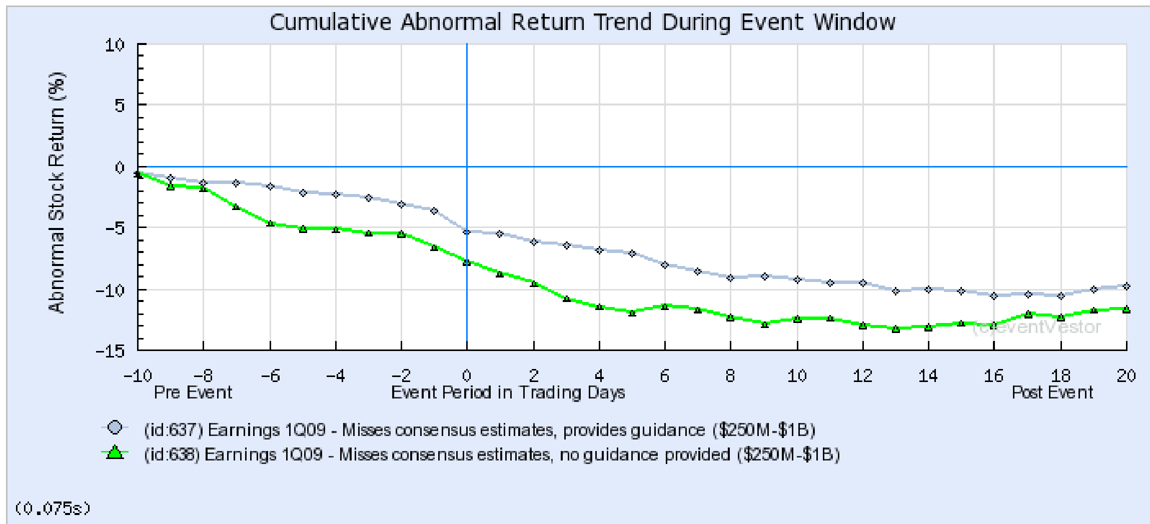
As illustrated in the chart below, S&P 500 companies that provided earnings guidance delivered better market performance on missing the analyst consensus than companies that missed estimates but did not provide quarterly earnings guidance. Those providing earnings guidance saw an average 5.4% decline relative to the market 20 days after reporting earnings compared with 10 days prior to the announcement. Companies that did not provide guidance experienced a 15.4% average stock decline.

Impact of Providing vs. Not Providing Guidance when Missing Consensus – S&P 500



Interestingly, small cap companies ($250 million to $1 billion market capitalization) experienced less of a differential. As illustrated in the following chart, those that did provide guidance experienced an average 9.8% stock price decline after 20 days compared with 10 days prior to the announcement, versus an 11.7% average decline for companies that did not.

Impact of Providing vs. Not Providing Guidance when Missing Consensus – Small Cap



Except for the companies with the smallest market caps, those that did not provide guidance experienced a greater decline in their stock prices in the 10-day period prior to their quarterly earnings announcements. The stocks of those that did provide guidance fell 0.8% in the 10 days prior to the earnings announcement while those that did not fell by 5.5%.

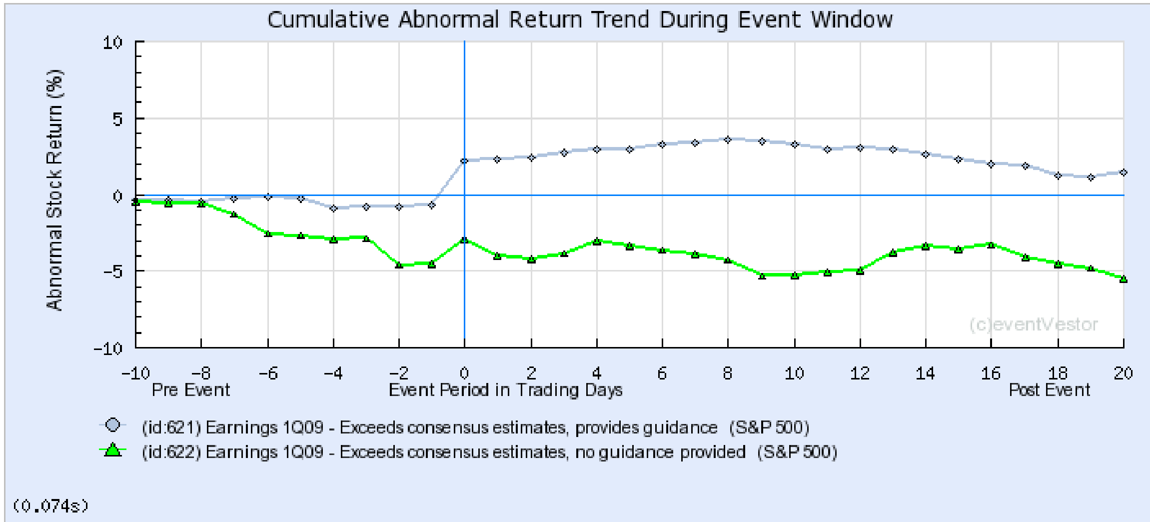
Why was guidance so closely correlated with superior market performance in these instances? Perhaps the reason is that, lacking information to the contrary, investors were expecting the worst.

Companies that provided quarterly guidance experienced better market performance after exceeding consensus than companies that beat estimates but did not provide earnings guidance. After the 20-day period, those that did provide guidance saw a 1.5% positive return compared with 10 days prior to the announcement, while those that did not actually experienced a 5.5% negative return – even after beating consensus.

The effect was less pronounced the larger the market cap. Those with market caps of more than $10 billion experienced a 35 basis point abnormal market return differential while those with market caps between $1 billion and $5 billion saw a 1250 basis point differential.

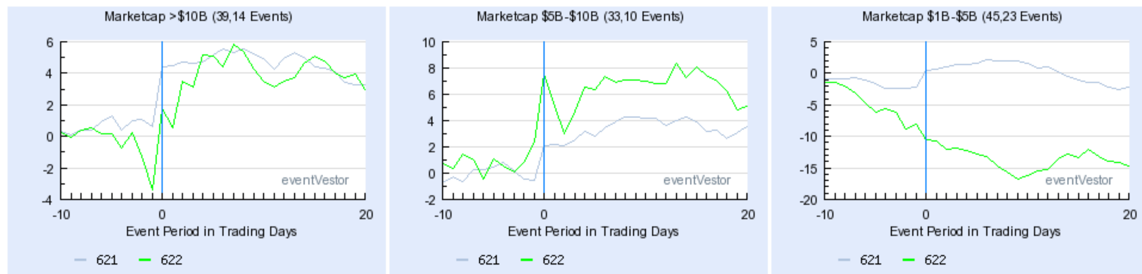
Again, companies that did not provide guidance experienced a greater decline in their stock prices in the 10-day period prior to their quarterly earnings announcement. Those that did provide guidance saw less than 1% decline in the 10 days prior to the announcement in relation to the market while those that did not saw a 4.5% decline.

Impact of Providing vs. Not Providing Guidance when Beating Consensus – S&P 500



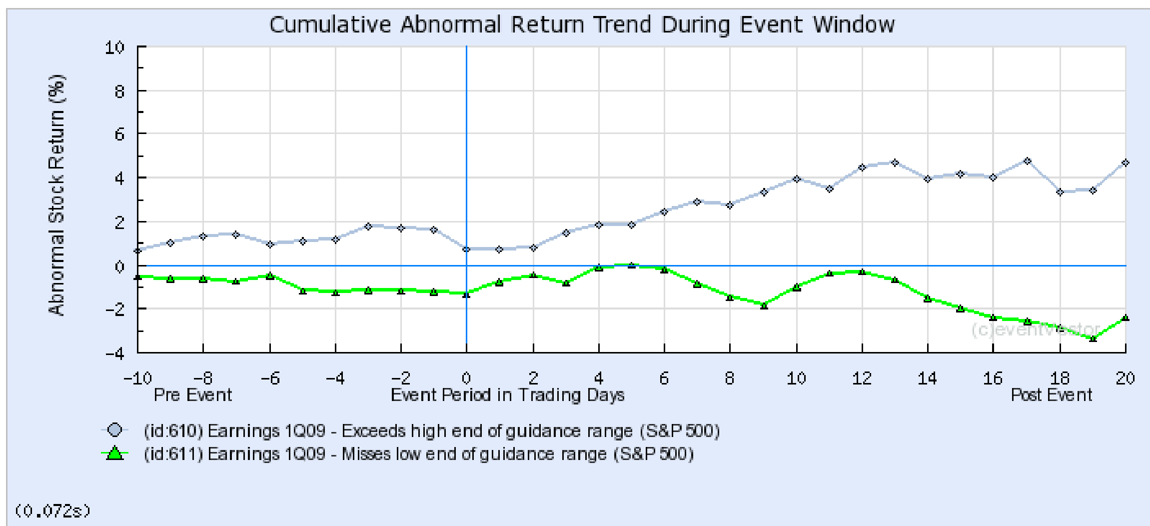
Impact of Providing vs. Not Providing Guidance when Beating Consensus

> $10b | $5b - $10b | $1b - $5b



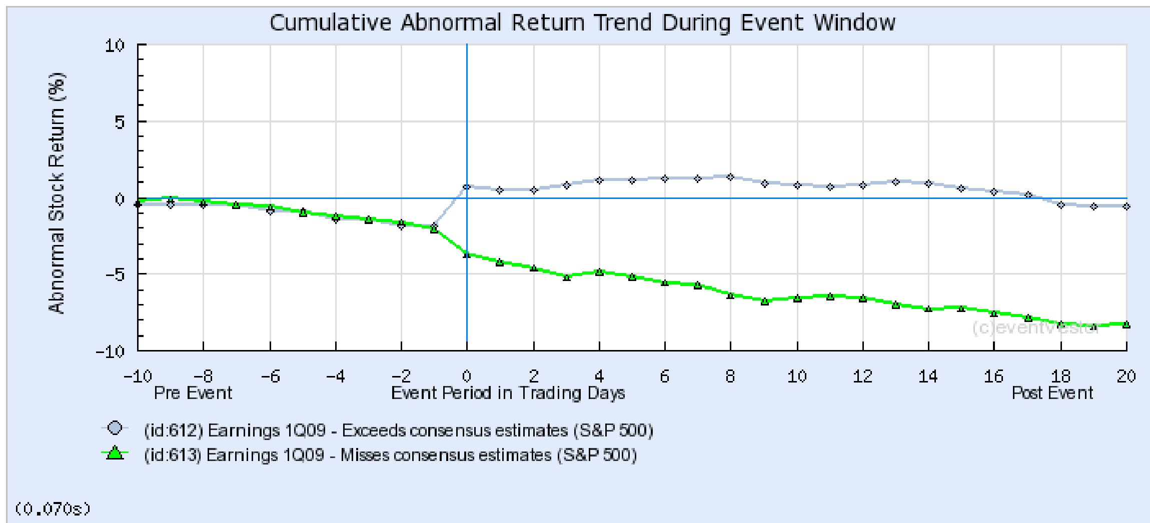
In the first quarter of 2009, companies received more credit for exceeding guidance than punishment for missing guidance. As illustrated in the following chart, those that exceeded guidance saw a 4.0% stock appreciation in the 20 days following the earnings announcement compared with 10 days prior to the announcement relative to the market while those that missed guidance saw only a 1.1% decline. It should be noted, however, that companies beating guidance could have exceeded the analyst consensus by an even larger amount since analyst consensus may have been in the low to mid range of guidance in this market environment.

Impact of Exceeding vs. Missing Guidance



As a corollary to what we discovered relative to missing or exceeding guidance, under conditions that prevailed in the first quarter of 2009, the market punished companies for missing consensus far more than it rewarded them for beating consensus. As illustrated in the following chart, stocks of companies that missed consensus fell by 8.3% relative to the market in the 30-day period while those that beat consensus fell by 0.5%. It should be noted, however, that companies missing guidance could have missed consensus by a lesser amount since analyst consensus may have been in the low to mid range of guidance in this market environment.

Impact of Beating vs. Missing Analyst Consensus



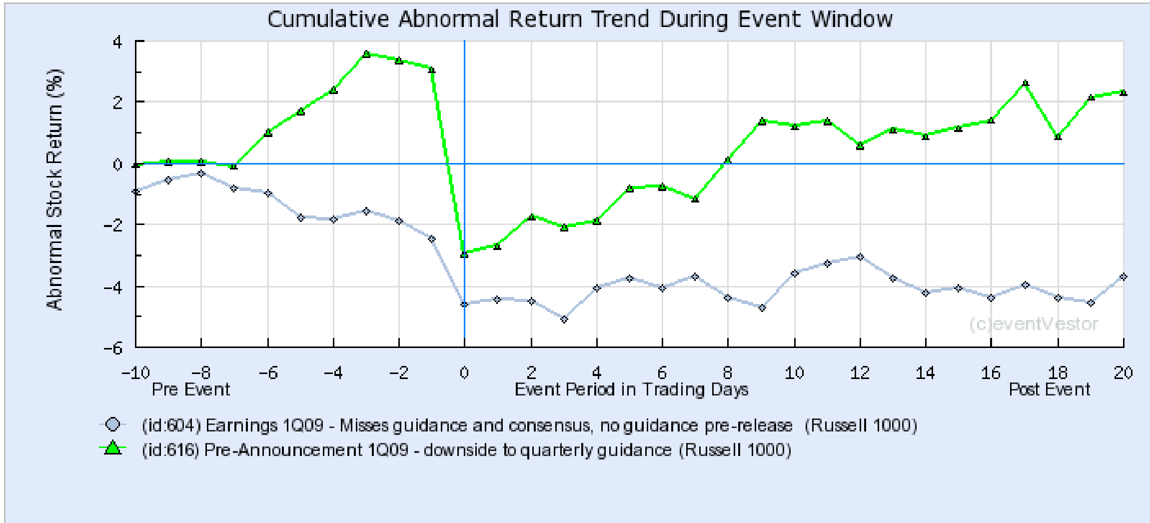
2. Pre-announcing quarterly results that exceeded or fell short of guidance improved stock price return.

Companies that anticipate reporting quarterly earnings that vary significantly from guidance – either on the downside or the upside – often debate the pros and cons of pre-announcing their preliminary results a few weeks in advance of their regularly scheduled earnings release date. One of the reasons executives often decide against pre-announcing is that they are unable to determine the earnings number with a reasonable degree of certainty.

In addition, executives sometimes oppose pre-releasing because they believe companies that pre-announce missed guidance get punished twice: first on the day of the pre-release and then on the day of the regular earnings announcement.

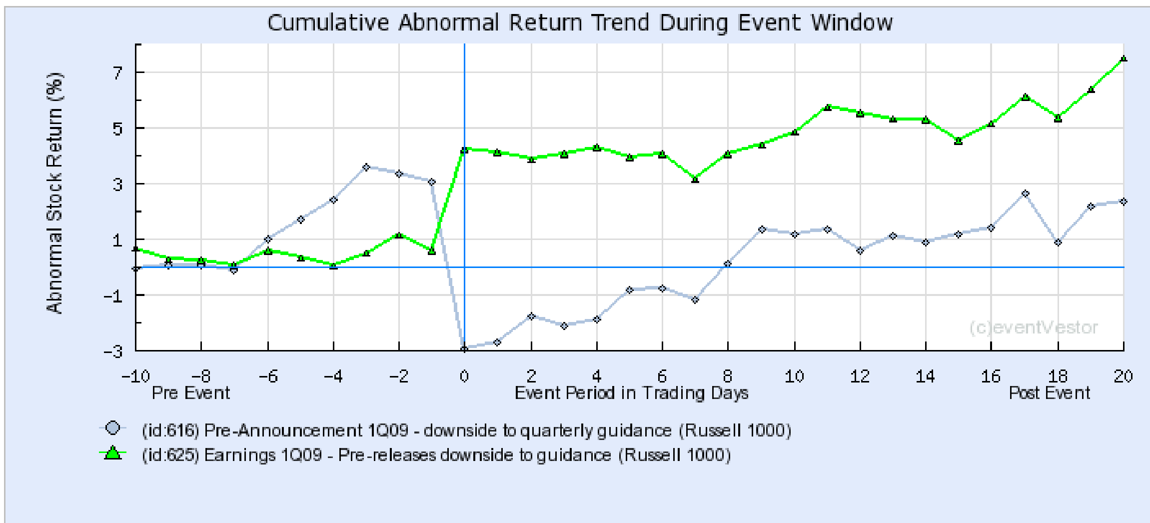
These fears were unwarranted in the first quarter of 2009. Companies that pre-announced a negative guidance miss did see a 6.0% decline in their stock price relative to the market on the day of the pre-announcement. However, in the 20 days after their pre-announcement, their stock prices had nearly recovered from this decline with a 5.3% increase relative to the market.

Impact of Pre-Announcing Guidance and Consensus Miss (from Date of Pre-Announcement), vs. Not Pre-Announcing (from Date of Earnings Announcement)



Compared with companies that did not pre-announce quarterly earnings, those that did pre-announce also experienced superior stock price returns in the 20 days following the formal earnings release. As shown in the following chart, those that did pre-announce experienced a 6.9% increase 20 days after the earnings date (inclusive of the earnings date) relative to the market compared with a 0.7% decline for those that did not pre-announce quarterly earnings.

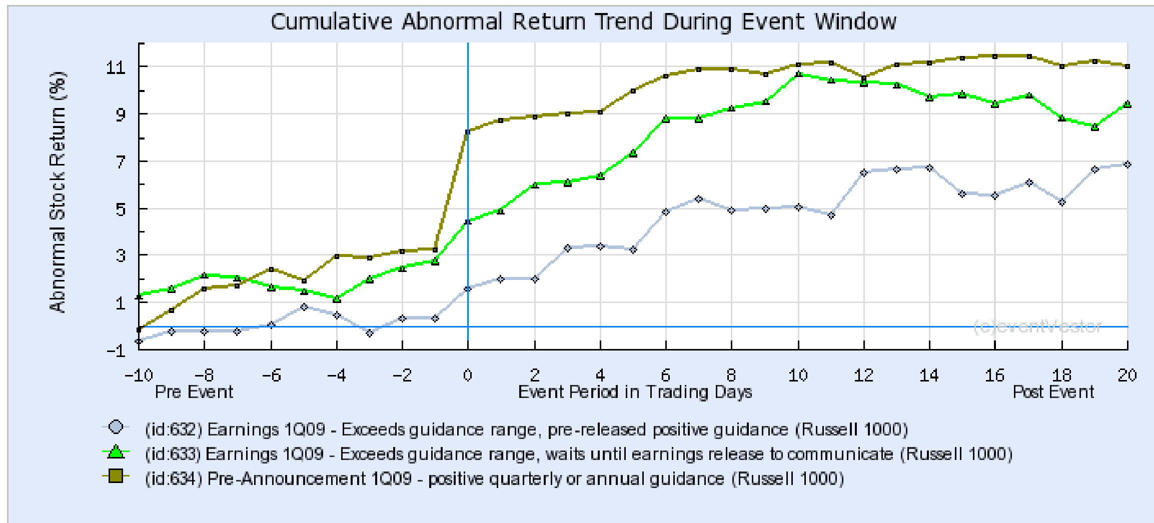
Impact of Pre-Announcing Guidance and Consensus Miss Comparing Date of Pre-Announcement and Date of Earnings Announcement

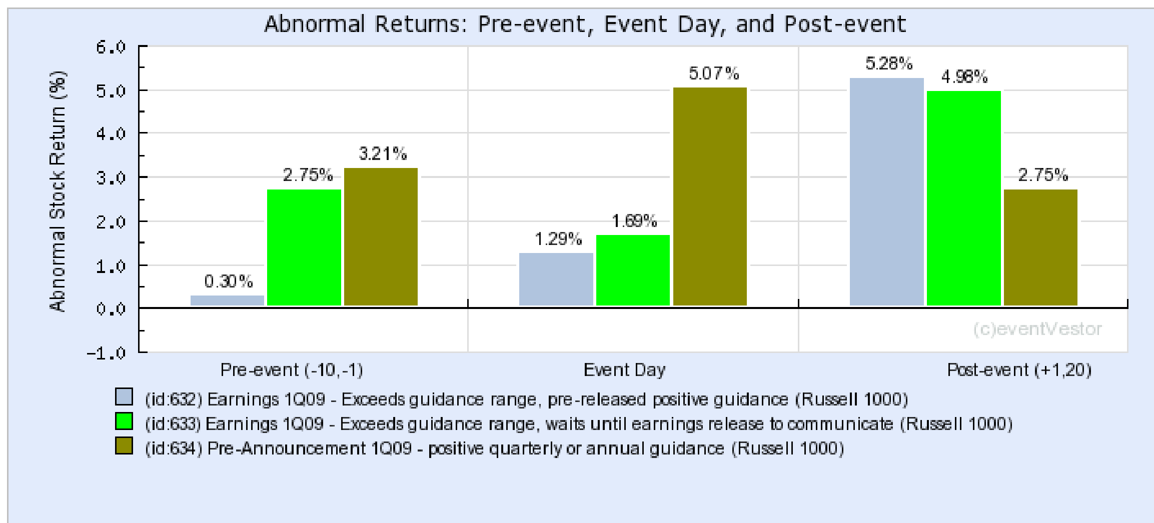


When companies anticipate reporting earnings that exceed guidance, the debate regarding the pros and cons of pre-announcing takes on a different character. Executives usually do not feel obligated to pre-release positive earnings surprises because they perceive limited risk of liability. They also may not expect additional stock appreciation beyond what would occur on and after the date of the actual earnings announcement.

This approach appears to leave some upside on the table. Companies that pre-announced a positive earnings surprise in the first quarter of 2009 appear to have benefited twice: first on the day of the pre-announcement (5.1% increase relative to the market), and again on the day of the formal earnings release (1.3% increase). The stocks of these companies continued to climb in the 20 days following the formal earnings announcement (5.3% increase). As outlined on the following two charts, these benefits were additive, resulting in superior overall returns (11.6% increase) compared with companies that did not pre-announce earnings that exceeded guidance (9.4% increase).

Impact of Pre-Announcing Upside to Guidance vs. Not Pre-Announcing





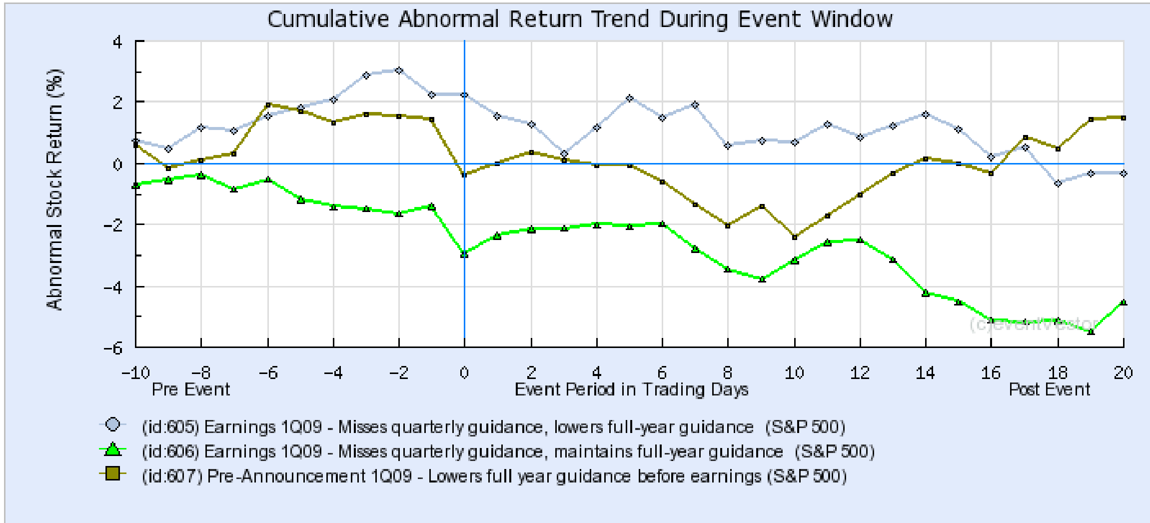
3. Companies that reported a quarterly earnings miss were better off lowering their full-year guidance.

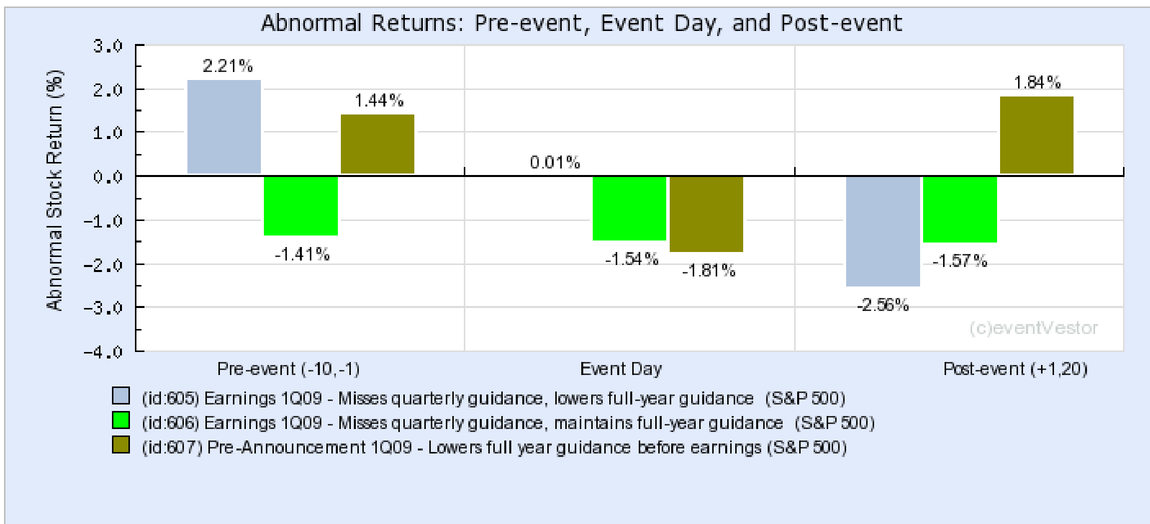
Executives facing the prospect of reporting quarterly earnings below their guidance range often consider the pros and cons of lowering their full-year guidance as part of their formal earnings announcement. In these cases, management often decides to maintain their full-year guidance. Sometimes this is because they believe that results may improve in subsequent quarters. Or they may believe the company's earnings visibility is simply too limited to justify a change at the time.

During the first quarter of 2009 Wall Street appeared to be skeptical in these instances, and management credibility seems to have been negatively affected. Companies that lowered their full-year earnings guidance when reporting a quarterly guidance miss actually experienced superior returns (0.3% decline relative to market 20 days after earnings announcement compared with 10 days prior to announcement) versus companies that maintained their annual guidance (4.5% decline relative to market 20 days after earnings announcement compared with 10 days prior to announcement).

It is important to note that companies which pre-announced missed guidance saw a 1.8% stock drop relative to the market on the day of the pre-announcement. However, that decline was offset by a 1.8% increase in the 20 days following the pre-announcement.

Impact of Lowering Full-Year Guidance when Missing Quarterly Guidance vs. Maintaining Full-Year Guidance





Summary

"To guide or not to guide" has long been a dilemma for public companies, but never more than today. In the aftermath of the market crash of 2008, business results have become notoriously difficult to forecast accurately, making the task of providing financial guidance to Wall Street an arduous exercise. Are the rewards worth the pain?

Companies are increasingly answering "no," and thus leaving the task of forecasting their results to the securities analysts who cover them. According to the eventVestor database sourced from company press releases and SEC filings, the proportion of S&P 500®

companies that provided earnings guidance in the first quarter of 2009 decreased to 61% from 67% a year earlier. Not providing guidance may be a mistake, however.

Our comprehensive scenario analysis of market reaction to various guidance practices found that providing investors with greater transparency resulted in superior stock price returns during the 30-day periods we measured. This was true whether the information came in the form of:

- Providing regular quarterly earnings guidance,
- Pre-announcing quarterly results that exceeded or fell short of guidance, or
- Lowering full-year earnings guidance when announcing a quarterly earnings miss.

Performance versus analyst expectations was critically important to subsequent stock price return, but guidance was a useful buffer. Companies that did not provide guidance were punished far more severely for missing the analyst consensus estimate than companies that did provide guidance.

Pre-announcing quarterly results that exceeded or fell short of guidance improved stock price return. Since the first quarter of 2009 was exceptionally uncertain for Corporate America, a multitude of companies saw a significant divergence between actual and forecasted earnings. Although the majority of these companies "missed their guidance" and also fell short of analyst expectations for the period, results at some firms exceeded guidance and the analyst consensus. In the weeks prior to their formal quarterly earnings announcements, it is likely that many of those companies considered pre-announcing their results.

Our study showed that, compared with companies that did not pre-announce earnings during Q1 2009, those that did pre-release – whether on the downside or the upside – experienced substantially greater abnormal stock price returns in the 20-day period following their actual earnings announcements. Companies that pre-announced a downside miss experienced better market returns than those that did not pre-release. Companies that pre-announced on the upside saw their stock price increase on the day of the pre-announcement and then continue to rise in the days immediately following the formal earnings announcement.

Companies that reported a quarterly earnings miss were better off lowering their full-year guidance. Companies that reported a downside miss from quarterly earnings guidance in Q1 2009 faced an additional dilemma: whether to lower their annual guidance for the full year. Our study showed that, compared with companies that missed quarterly guidance but did not lower their full-year guidance, those that did lower their annual guidance experienced substantially greater abnormal market return in the 20-day period following their formal earnings announcements. Companies that maintained their full-year guidance when reporting disappointing quarterly earnings experienced inferior market returns.

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