What is the **market** telling you about your **strategy?**

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Market expectations are hard for managers to understand and even harder for them to change. But there are ways of doing both that are much more science than black magic.

Many managers are confounded by the conflicting messages the market sends them. Strong improvements in the financial performance of a company can be followed by a sharp fall in the price of its shares. Results that moderately exceed consensus forecasts can propel its share price to new heights, leaving managers to wonder how they can possibly achieve the superhuman feats the market expects from them. Either way, they throw up their hands, rail at the market's irrationality, and go on running their businesses as they always have.

Given the market's habit of regularly defying logic, it is not surprising that many managers do not use total return to shareholders (TRS)—dividends plus

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appreciation in share prices—as their primary decision-making tool. They often look instead to measures of postfinancing returns, notably net present value (NPV) and economic value added (EVA). Such metrics focus on the cash flows of the underlying business and on the ability of initiatives to provide economic returns above and beyond a company's cost of capital.

But running a company is like managing a sports team: owners and fans want a winner. Like it or not, TRS is the way they keep score. NPV and EVA can give you a clearer sense of whether strategies and projects are worthwhile, but these tools don't tell you what you need to know to generate a superior TRS: will the resulting performance exceed the market's expectations?

Of course, most managers frustrated by the share prices of their companies understand that traditional measures, such as price-to-earnings ratios (P/Es), provide some insights into what the market anticipates: a high P/E suggests that they need to deliver strong growth; a low one suggests that the market expects static or declining performance. This understanding is cold comfort, however, because those managers do not know whether their companies are on track to satisfying the market's expectations.

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In reality, the answer to this vexing problem lies no further away than the nearest copy of your daily newspaper: in your company's share price and those of your competitors. But our way of analyzing this information differs significantly from traditional techniques: it not only provides additional insights, turning much of the market's black magic back into science, but is also a valuable strategic tool (*see* sidebar "Choosing your metrics," on the next spread).

Investors and analysts make explicit forecasts about the short-term performance of your company. The market implicitly values its longer-term performance as well. This readily available information allows you to quantify both the magnitude and the timing of the market's expectations for your company. By carefully analyzing these short- and long-term performance expectations and making an honest effort to decide whether the market is actually right, you can come to understand what it is telling you about your strategy.

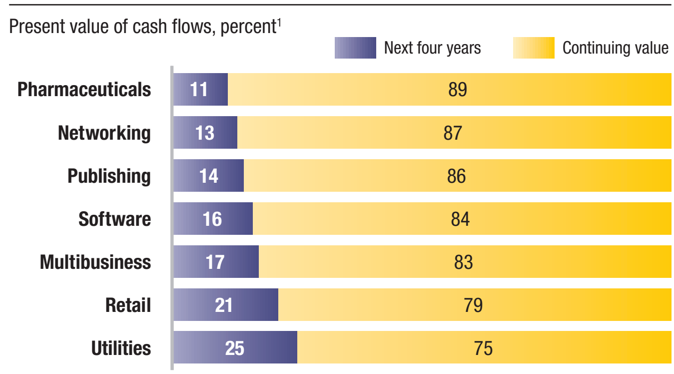
What does the market expect?

To increase the share price of your company, you must know what the market expects of it today. If the market anticipates more than your strategy can deliver, you probably face bad news down the road. If your strategy isn't getting enough credit from the market, you may surprise the stock pickers and hand your shareholders a tidy gift. The key to increasing the price of your company's stock is to raise expectations about growth—particularly long-term growth.

The market uses expectations about the current operating performance of a company and its short- and long-term growth prospects to price its shares. The value the market expects to see from both kinds of growth is actually quite easy to determine. First, identify the portion of your share price that can be linked to expectations about current performance[1] and the portion linked to future growth (the difference between the price of a share and the value of current performance). Second, divide the value expected from growth into its short- and long-term components, treating investors' and analysts' short-term forecasts as reliable. We define short-term expectations as the market's estimate of a company's performance in a definite forecast period—usually two to five years.[2] Long-term expectations reflect a company's performance beyond the explicit forecast period.

EXHIBIT 1

Structure of cash flows by industry



[1]Based on analysts' consensus estimates of five-year growth in earnings per share.
Source: Value Line

Compare the value of your company if it realized the analysts' short-term expectations with the value of its current performance; the difference is the value expected from short-term growth. Whatever gap remains between the short-term value of the company and its share price represents the anticipated value of long-term growth. These long-term expectations of financial performance are particularly critical, for they make up the lion's share of market value (Exhibit 1).

[1]The concept of stock prices formulated by Richard Brealey and Stewart Myers in *Principles of Corporate Finance* (second edition, New York: McGraw-Hill, 1984), their best-selling textbook on the subject, influenced our own conception. Brealey and Myers believe that stock prices reflect (i) the present value of a level stream of earnings and (ii) growth opportunities. A "level stream of earnings" is defined as the "capitalized value of average earnings under a no-growth policy"—that is, no reinvestment or payout of earnings. The value of "no-growth" cash flow is simply earnings per share (EPS) divided by the cost of equity, or EPS/r. Since we do not treat changes in EPS resulting from inflation as contributors to growth, the result is a "no-growth" value of EPS/(r–i). This approach assumes that investment at depreciation suffices to maintain current financial performance and that nonoperating assets are not significant.

[2]Consensus earnings forecasts are readily available from such sources as Zacks Investment Research.

Armed with the knowledge of what the market expects from your company in the short and long terms, you can identify the major strategic challenges you face in generating and sustaining its TRS (Exhibit 2, on the next spread).

The company will fall into one of four classes. The first comprises "world champion" companies, which the market expects to surpass their competitors both in the short and the long term (*see* sidebar "Cisco Systems: Great expectations," on the next spread). Such high expectations set a tough hurdle for managers, since strong improvements in performance are required merely to sustain current share prices. Adequate initiatives must be in place to deliver on the short-term expectations of the market and to maintain its confidence

Choosing your metrics

The decomposition of share prices and total return to shareholders (TRS) has a number of advantages over more traditional metrics: for example, it allows managers to know when anticipated performance improvements are supposed to occur and to isolate management's contribution to past performance. Traditional measures don't do these things at all well.

Analysts' forecasts are useful for several reasons. To begin with, analysts often test their near-term forecasts for a company with its managers, who attempt not to be too positive because they want to avoid the risks of negative earnings surprises. Second, since analysts talk to managers at a number of companies in an industry, the viewpoint of each can be compared with those of other players.

Another metric, the price-to-earnings ratio (P/E), has several benefits: it is easy to calculate, widely and well understood, and accepted as a basis for assessing the plausibility of growth expectations. Even so, P/Es have a number of limitations. They don't reflect a company's previous success in generating the returns that the market anticipated. They fail to distinguish earnings generated by operating assets from those generated by non-operating ones. And they tell you nothing about when the expected performance is supposed to occur—an important failing, since in comparing the performance of companies, it is often more useful to know this than to know the P/E and nothing else.

We looked at some US electric utilities and compared P/Es with short- and long-term growth estimates. The P/Es fell within a very tight band: 16 of the sample 22 companies had P/Es between 14 and 16. Much greater differentiation among the companies showed up in derived estimates for short- and long-term growth expectations (exhibit). One implication is that benchmarking based simply on P/Es is fraught with danger. A jump in the near-term performance of a peer company following a performance dip, for example, could underlie its P/E. Since your company may have avoided that problem, the short-term rebound implicit in the peer P/E is an inappropriate comparison.

Yet another metric, the market-to-book ratio (M/B), doesn't reveal the extent of the improvement the in the company's long-term growth prospects. But the really difficult strategic challenge of generating a rising TRS is the need to surpass high performance expectations. Managers must look beyond the market's current vision—for example, by redefining the competitive arena of the company or seeking to exploit its built-in expectations by financing M&A-driven growth with equity.

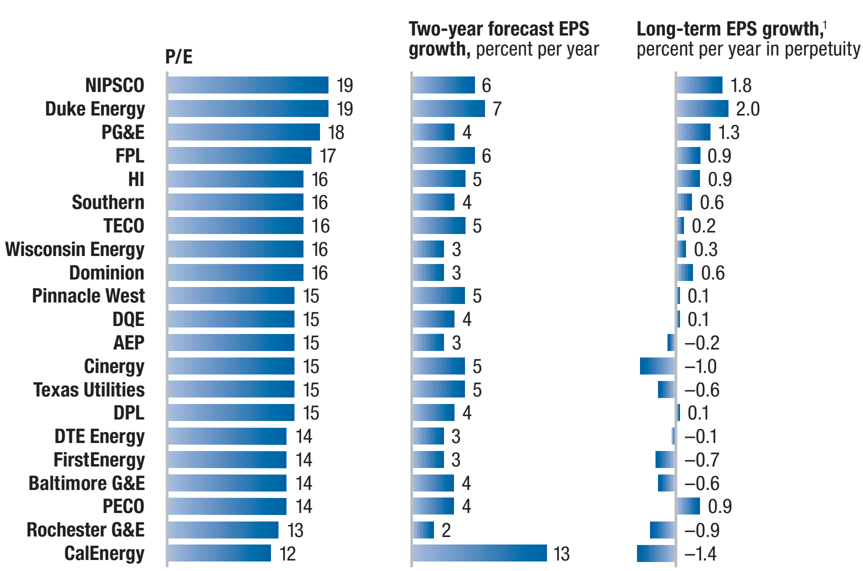
From companies in the second class, the market expects big things in the short term but relatively little down the road. These companies—the "sprinters"—are classic turnarounds in mature industries. To sustain share prices, managers must ensure that they have put in place initiatives that are sufficient to meet the market's short-term expectations. To generate the

market expects: a high M/B can reflect strong current performance rather than anticipated growth. Moreover, the M/B of a company reflects its decisions about whether to own the assets it uses or to outsource its business functions.

Finally, market value added (MVA), one more common corporate performance scorecard, represents TRS less a capital charge based on the cost of equity. But MVA does not distinguish between returns from improvements in short-term earnings and from long-term growth. Moreover, it doesn't remove the impact of financial market changes on TRS, so it cannot isolate returns resulting from changes in economic performance.

EXHIBIT

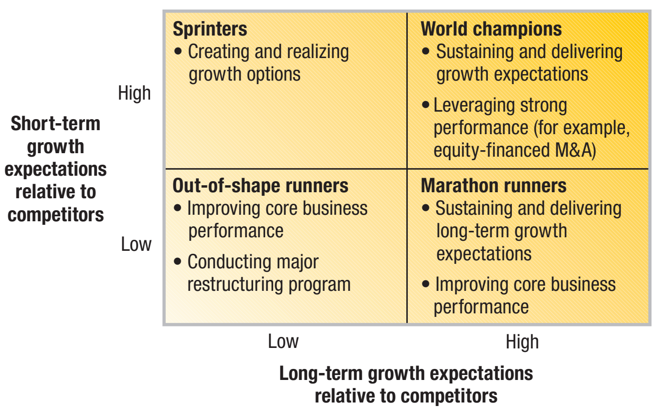
P/E vs. time-based metrics: Utilities, November 1999



[1]Assumes constant reinvestment of earnings per share (EPS) across sample companies.
Source: Compustat; Zacks Investment Research; McKinsey analysis

EXHIBIT 2

Identifying strategic challenges



required TRS, those managers must understand why the market expects better long-term performance from their competitors. Does it anticipate relatively poor long-term performance in the core business? Does it feel that the company lacks plausible growth initiatives? Management must go about building a plausible long-term growth story, perhaps by repositioning the company in sectors with more attractive prospects in the long run or by building pipelines of growth options that could raise long-term expectations.[3]

Companies in the third class—the "marathon runners"—generate small expectations in the short term but great ones over time. This third class includes many Internet companies (Exhibit 3, on the next spread), whose current valuations imply performance expectations comparable to those Microsoft has delivered on since its float in 1986. Whether the wide array of Internet stocks priced at these multiples can live up to such expectations remains to be seen.[4] Managers of companies in the third class must not only improve the performance of their core businesses to raise short-term expectations but also do whatever is possible to reinforce the market's belief in their future prospects. Those managers should also try to understand what competing companies that generate greater short-term expectations are doing, as well as identify and carefully communicate the factors underpinning their own company's expected long-term growth.

In the fourth and final class—"out-of-shape runners," such as IBM before Lou Gerstner's arrival—companies are doubly cursed: they inspire equally low short- and long-term expectations, and their share prices suffer accordingly. These companies must usually be restructured to increase the earnings of their core businesses and repositioned for long-term growth, as IBM is seeking to do with e-business, which now represents 25 percent of its revenues.[5]

[3] *See* Mehrdad Baghai, Stephen Coley, and David White, *The Alchemy of Growth*, Reading, Massachusetts: Perseus, 1999.

[4] Pfizer, too, ranked in this third class in 1997, when its short-term performance lagged, but it had a number of wonder drugs, including Viagra, in the pipeline. Since then, Pfizer has benefited from surging short-term expectations as its new drugs have come to market, and it has stormed its way into the world champion group.

[5] *Wall Street Journal*, May 13, 1999.

The foregoing discussion implies that to generate real strategic insights, you must compare the analysts' expectations for your company with their expectations for its competitors. Benchmarking of this sort neutralizes the effect of industry cycles on short- and long-term expectations and also makes it possible to avoid punishing or rewarding companies because they happen to compete in slow- or fast-growth industries.

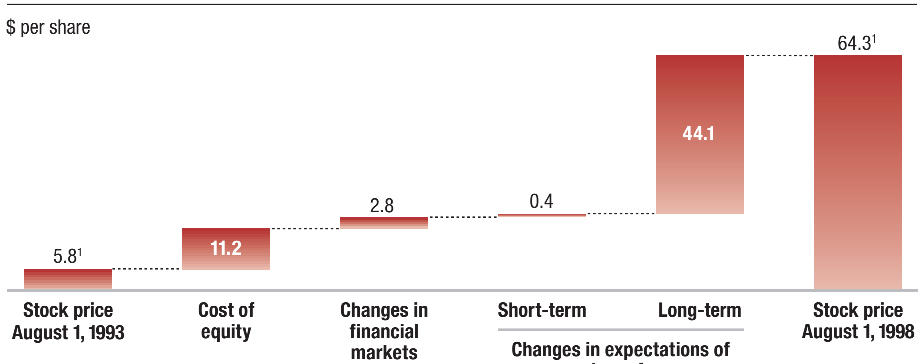
Cisco Systems: Great expectations

Long-term beliefs about a company's future can have a staggering impact, as demonstrated by the case of Cisco Systems, which makes routers and Internet access equipment. The company has generated huge long-term expectations in the market. Between 1993 and 1998, the lion's share of Cisco's total return to shareholders (TRS) came from changes in expected long-term economic performance (exhibit). During that six-year period, Cisco's market capitalization rose by $58 billion. Although Cisco does have a reputation for meeting or exceeding short-term expectations, short-term factors—earning the cost of equity, lower interest rates, and changes in short-term expectations—account for only $14 billion of that increase. After all, the five-year forecast period accounts for only 5 percent of Cisco's value. Changes in long-term expectations contributed an additional $44 billion, representing the balance of the rise in Cisco's market capitalization.

The market's expectations for Cisco imply that it will consistently enjoy earnings growth of a very robust 30 percent through 2002—the short-term forecast period. The market expects the same for the ten years thereafter, followed by growth that permanently tracks changes in the gross domestic product. On the other hand, the market could really be saying that it expects earnings beyond 2002 to grow at a rate of 11 percent in perpetuity. Is either of these scenarios plausible? If Cisco's share price is reasonable, one of those propositions would also have to be reasonable. We have found a "what-you-would-have-to-believe" analysis useful in assessing the valuation of Internet stocks as well.

EXHIBIT

Cumulative decomposition of total returns to shareholders: Cisco, 1993–98



[1]Adjusted for stock splits.
Source: Compustat

Viewing share prices through the lens of short- and long-term growth expectations makes no less sense for companies with businesses in a number of different industries, sectors, or geographies than for companies that focus on only one. But for multibusiness companies, the undertaking is more complex: you must cascade the market's aggregated expectations to the divisional or line-of-business level and compare the performance expectations for those entities with the expectations generated by corresponding units elsewhere. Often, analysts' reports provide the disaggregated information that can be used for this purpose.

Who has it right?

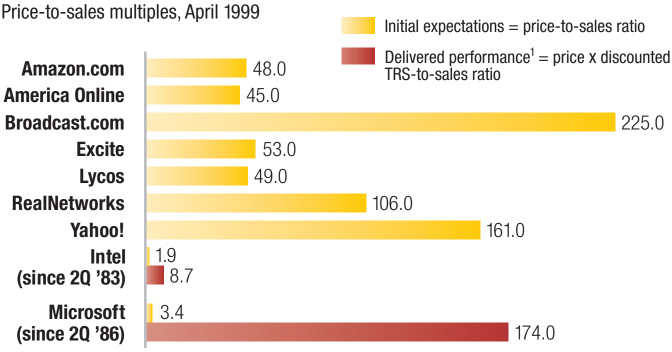
If the market expects your company to underperform its peers, either in the short or the long term, is the market right or is the company?

The market tends to overshoot or undershoot because of the information that happens to be available to it at any given time. In the early 1990s, for example, News Corporation was making bold strategic initiatives in broadcasting (by developing a fourth television network in the United States) and in pay television (in the United Kingdom). Although these moves concerned bankers and investors alike and thus led to asset sales to reduce the company's debt, Rupert Murdoch stuck to his strategy and has rewarded shareholders with a TRS of 50 percent a year since November 1990.

EXHIBIT **3**

Embedded expectations of Internet stock performance

Price-to-sales multiples, April 1999



[1]Discounted (at a rate of 19%) using average of Yahoo! and America Online risk levels.
Source: Datastream; Microsoft and Intel annual reports; Hoover's Online

You can find out whether the anticipated performance shortfalls of your company vis-a-vis its peers are real or perceived by testing its business plans against the expectations of the market. What level of investment and earnings growth do they imply? If your business plans match these expectations, you can assume that your company is fairly valued. If your expectations exceed those of the market, reexamining your company's plans and expectations will usually show who has gotten things wrong: you or the market. Should you then be confident that the plans of your company are sound, you may wish to have it buy back its stock to make the point that it is undervalued.

Managers of a company in this position should also ask themselves how well they are communicating the company's growth options or the timing and magnitude of its turnaround. One energy company, whose shares were performing less well than those of its peers, had earlier failed to deliver on explicit promises of higher earnings. In discounting its shares, the market might have seemed to be wondering if the company was in denial about its problems. But an investigation highlighted other issues. First, the market had handed the company a 20 percent share price discount when it abandoned certain growth options; investors had understood the risks they posed but knew of little else in the pipeline that could replace them. Second, this company's investor communications lacked transparency and credibility. The company responded to these discoveries by explaining its earnings and growth options more clearly, and the "expectations gap" between management and the market disappeared.

In a bull market, many companies face exactly the opposite problem: strong TRS performers have to try to keep the market from overshooting management's expectations. Indeed, attempts to dampen its enthusiasm sometimes lead to bizarre signaling rituals intended to avoid unpleasant surprises. A number of outstanding TRS performers go to great lengths to keep the market's expectations in line with their own.

Lagging TRS performers face a very different predicament: if they talk down their performance, they risk unnecessarily disappointing investors whose hopes are already low, but they cannot escape the challenge of generating more optimistic short-term expectations. The best course for such a company is to communicate its position to the market accurately—otherwise, the credibility of its management and board is at risk—and then to launch turnaround efforts involving changes in senior management and the disclosure of new growth options to raise expectations.

A rat aboard ship

No matter whose expectations you think are sound—the market's or yours—evidence clearly shows that the market's expectations matter. We examined the correlation among TRS, EPS surprises, and variables that are not related to market expectations. In most of the 12 industries we studied, EPS surprises explained the TRS performance of companies better than any other variable. In high-technology businesses, such as software and semiconductors, EPS surprises explained as much as 58 percent of all changes in the TRS of companies in the sample. During the third quarter of 1997, for instance, the revenues and earnings of Intel shot up by 20 percent, an enviable result to most people, yet its share price dropped by almost 10 percent in the three days following the announcement. Why? Analysts were expecting EPS of 91 cents, and Intel delivered only 88. Of course, since then (up to May 1999) Intel has delivered a strong TRS of 42 percent a year.

Managers know perfectly well that negative earnings surprises have a huge impact on TRS. Considering how much of a company's value is tied up in long-term expectations, it is an interesting quirk that short-term performance disappointments play a crucial role. After all, given Intel's positive medium- and long-term prospects, you would not have thought that a three-cent EPS shortfall would provoke a price drop of 10 percent. Why do EPS surprises affect TRS so profoundly? The reason is that a bad quarter, or even a quarter less good than analysts expect, is a bit like a rat on a ship: when you find one, you assume it has company. If the announcement for just a single quarter seems to prefigure more serious problems, management's credibility plummets. Conversely, stock prices can rebound from negative earnings surprises if communications with shareholders deal accurately and forthrightly with the results of the previous quarter or two.

Should questions arise over the quality of earnings, the market will respond even more swiftly and emphatically. Sunbeam's share price rose from $12.50 in July 1996 to $52 in March 1998. But a series of press articles questioned the methods used to increase the company's profits. By August 1998, after Sunbeam's announcement that it would restate its 1998, 1997, and, possibly, 1996 profits, its stock had sunk by almost 90 percent, to $5.88. Meanwhile, shareholders had filed a class action lawsuit.[6] When attempts at "earnings management" become public, they altogether destroy a company's credibility and precipitate governance and managerial changes.

In fact, the whole issue of managing expectations is fraught with ambiguity and complexity. As Arthur Levitt, the chairman of the US Securities and Exchange Commission, said last year, "Increasingly, I have become concerned that the motivation to meet Wall Street earnings expectations may be overriding commonsense business practices. Too many corporate managers, auditors, and analysts are participants in a game of nods and winks. In the zeal to satisfy consensus earnings estimates and project a smooth earnings path, wishful thinking may be winning the day over faithful representation."[7]

Still, legitimate strategic and communications issues can't be ignored. Market expectations are hard for managers to understand and even harder for them to change, but there are ways of doing both that are much more science than black magic. There had better be: the careers of executives and the success of their companies depend on doing both well.

[6] *Sunday Times* (London), June 21, 1998.

[7] "The Numbers Game," delivered at the New York University Center for Law and Business on September 28, 1998.