The Secrets of Investor Relations

...gaining value from perception and performance

Expert knowledge means success

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Note: This publication has not been updated since it was last published. Some of the hyperlinks may have changed and may need updating. In addition, some of the information in this publication may be out of date.

Introduction

Today, Investors want more than just a glossy annual report: they want information. The electronic and fast-communications age in which we live means that the information must be accurate, reliable and timely.

This publication is concerned with Investor Relations - a process by which accurate, reliable and timely information is imparted to investors and those who influence investment decision.

"Investor Relations" is defined in the Economist Pocket MBA Book as *"The growing business of keeping a company's shareholders happy, and of cultivating other potential investors who might in time become shareholders"*.

So it is that in order to communicate efficiently, companies have to speak in a single voice to all stakeholders yet at the same time address the different needs of each stakeholder. Institutions require more information from companies than in the past, and investor communications require careful planning if expensive senior management time is to be well used. Public Companies face a varied challenge to ensure that their shares are traded as advantageously as possible.

It is important for the investor relations function to be properly positioned so that essential strategic guidance - based on both market feedback and gathering of competitive intelligence - can be provided to senior management and the Board.

Why have investor relations?

It might be argued[1] that the stock market in which a company is assessed is efficient only to the extent that it has full and timely information. They have a simple operating principle - that fundamental corporate attributes and strengths must be conveyed effectively and persuasively. This is encapsulated in an investor relations philosophy summarised by the equation: PERFORMANCE + PERCEPTION = VALUE.

In Europe, Kreab, a Swedish consultancy[2] place great emphasis on what they call the "Kreab stakeholder model" - in it, every company, organisation and public authority must address the needs of at least five main target groups:

- Media - The image of a company or an organisation as it is projected in the media shapes attitudes towards what the company, management, products and services are all about.
- Policy makers - Political decisions will eventually affect the conditions under which a company operates. It's therefore of paramount importance to keep an eye on public debate and be prepared to try and influence political decisions before they become law. Companies and organisations also need to make relevant facts and information available to decision-makers, to make sure they have all the facts available when they formulate their policies.
- The financial community - Flotations, Listings, Mergers and Acquisitions, Private placements, Investments and Divestments are all events in corporate life when communication specialists are as important as financial advisors.
- Employees - A company's own staff is a key stakeholder group in all aspects of corporate communications. They must be continuously updated about what is happening in their own organisation. They, and their families, are the organisation's most important ambassadors to customers, suppliers and in the local community.
- Clients and customers - A company is dependent not only on its customers, appreciation of its products and services, but equally on its customers' perception of the company as reliable, honest and trustworthy. A company that is not seen as a responsible corporate citizen will sooner or later run into trouble.

A Case Study - and why there can be problems

When P&O had what they thought was an image problem (a liner's maiden voyage had been cancelled) they wined and dined investment analysts - all expenses paid, aboard the Grand Princess, the world's biggest cruise liner. It's said that within days of the returning to their offices, P&O shares rose strongly as buy orders flowed from clients of analysts who had been aboard[3].

Some critics may view those aboard the Grand Princess as being little more than "insiders" - questions were asked about the event, which was reported in *The Times* under the heading "SCHMOOZE LINER". The main question was: "Did everyone interested in P&O shares have the same information at the same time?"

There's no doubt that a knowledge gap has opened in the market between big and small investors. The danger is that small shareholders are getting left behind when companies give briefings, especially when it comes to the ability to ask supplementary questions. A company may do everything right to inform the market with its formal statement, but important details can often be picked up by a clever analyst in questions that follow the report.

Companies of all sizes are reaching out to investors to:

- increase individual, registered ownership;
- attract long-term investors;
- encourage more loyalty among customers and employees;
- cross-sell securities and products or services;
- create a more cost-effective way to raise capital.

Initiatives such as that described above can be mutually beneficial to a company and its shareholders. They add long-term, individual investors, which tends to reduce trading volatility. Investor programmes can attract capital from potential or current shareholders, employees, customers, suppliers or other interested individuals who are familiar with your company's products or services. Because each constituency is unique, so must be the approach to securing their participation in your investment programme.

Communication with Shareholders via the Annual Accounts

The annual accounts (as well as half-yearly or quarterly statements) provide a great opportunity to communicate with investors. Some of the informational matters that can be included in the accounts are covered here in this section.

Information can be relayed about the steps the Board taking to improve shareholder value - this ought to be music to investors' ears.

"Shareholder value" is an enticing term - but what does it mean. The fact is that it can mean different things to different people. Some investors can never get enough. If a company shows a compound growth rate of 20% for several years (well above the market) and then dips to 15% (still well above the market), some investors might be up in arms about the Board's failure to maintain momentum. Performance is therefore relative to expectation and historical results. The Board's juggling act is thus to promise little (yet enough to maintain investors' interest and support) and then to deliver more.

Investors will want to know if management believe that the company's market valuation is appropriate - the annual accounts is a good place to make a statement on that subject. Likewise, Investors will want to know if the Board is taking any actions to bring the price/earnings ratio to an "appropriate level" - yet what is an appropriate level?

Strategy disclosure is a dangerous thing to do as accounts and other circulars to shareholders can easily be read by competitors who might glean useful insights into a company's previously hidden secrets - yet investors do want to know what strategy the Board is pursuing. Getting the right balance of disclosure can be quite difficult and Boards should take professional advice as to what they should and should not say either publicly (in accounts etc) or privately (at analysts and other briefings).

Investors will scrutinise accounts to satisfy their curiousity about the company's prospects for the present year - and next year. They'll also want to know to what extent the company's gearing has changed over the past year and whether the Board is satisfied with the present level of gearing - and if not, what plans are in hand to change it.

Many investors go straight to the balance sheet to find out the company's cash position. Then they'll look in the notes to the accounts to see if there are any credit lines in place, and if not, why not. If the accounts talk about strategies on acquisitions, it may be hard to believe them if there are no funds available to finance them.

Investors also like to make comparisons - for example how does the company's return on investment compare to the rest of the industry? They also like to see that accounting policies are consistent from one year to the next, that the policies are "normal" (that is, in line with that which other companies in the same industry adopt) and that the auditors have given a clean bill of health.

There are other matters that investors and analysts look for in accounts from companies - some of these are:

- Risk management - for example, what strategy is in place on foreign exchange risk management? Is there any likely exposure in the foreseeable future? Are economic risks adequately managed? Is there a credit risk management function in place with clear independence and authority? What controls are in place to prevent fraudulent activities, trading and financial reporting? Are there controls in place to prevent exposure to excessive risk?
- Research and Development - What is the company's policy on investment in new product development? What impact will this have on cash utilisation?
- Taxation - How does the group's effective tax rate compare with other companies in the same industry? Are there any tax benefits that are not shown in the accounts?
- Strategy - How is it formulated? Is it "audited" or validated and compared with other opportunities? What is the group's policy on disposals? Are any significant activities non-core and how are core from non-core activities distinguished?
- European factors - What impact will the common European currency make on the group's prospects? Will the minimum wage legislation affect the company? Will EU legislation affect the company?
- IT - Is the company taking advantage of e-commerce? How will changes in buying patterns, particularly over the Internet, affect the company?
- External factors - Who are the company's major customers? Does the company monitor strategic direction and performance and condition of its major customers? Who are the group's major competitors? What advantages do the company's products (or the process through which it sells or markets them) have over what competitors offer?
- Corporate Governance - What is the constitution of the Board and how does it make its decisions? Are there adequate and competent non-executives and are they completely independent? How does the directors' pay compare with other comparable companies and has the Board taken independent advice on directors' pay via external advisors working through a remuneration committee comprised of non-executive directors? Has the company adopted the recommendations of Greenbury and Cadbury? Has the Board established Audit and Remuneration committees?
- Financial Reporting - Does the company follow the accounting practices and adopt similar accounting policies to those that are generally used in the industry? If alternative approaches are used, does the group explain clearly why it has adopted such alternative policies? Does the company expect its cash flow to increase or decrease in the immediate future? What procedures exist to ensure that all material contingent liabilities are identified and reported on?
- Social Responsibilities - Where, if any, is there exposure and responsibility to environmental compliance in relation to the group's manufacturing processes or material useage? Has the group any significant exposure to environmental regulation in the US? Have any significant (material) numbers of products been recalled? Are any likely to be recalled? Does the company foresee any financial implications arising from future UK, EU or US environmental legislative changes?

Legal implications[4]

The incidence of shareholder litigation has exploded in recent years so that a high growth company or one operating in a volatile industry can expect to be hit with litigation at some point in its life - this is something that's commonplace in the US.

Over the years, shareholder actions have focused more and more on the Investor Relations function in companies and they will continue to do so. On the grounds that to be forewarned is to be forearmed, it's worth talking through certain issues with management and your professional advisors now, before you get sued. On most of these, there are no 'right' answers - just trade-offs involving exposure in a securities action, credibility with the Street, and degrees of forward-looking guidance. They are merely suggestions and are presented as a checklist so that management and advisors can sit down and work through the items one by one:

- The Investor Relations (IR) Policy - Has the company reviewed its IR needs lately? Many companies implement IR practices in a fragmented, uncoordinated and piecemeal way - without any overall plan or analysis of objectives and risks. And they tend to perpetuate existing practices even when circumstances change.

  Take the example of a newly public company followed by just a few analysts, without much of a track record. It may feel compelled to provide greater guidance to the Market than a company which has been public for many years, has known risks and is covered by many analysts. Similarly, a company that normally provides guidance may enter a period in which its results are more uncertain; it may decide to reduce guidance until it returns to a more stable cycle.

  At least once a year (at annual report time, for example), your company should convene a meeting of the IR Officer (if there is one), senior management and lawyers to decide explicitly what the company's guidance practices will be for the coming year. Ad hoc reassessment will also be appropriate when a company is entering a period that will be riskier, because of product or market issues.

- Clear, Consistent and in Writing - Companies should set out their agreed IR policy in writing. This will improve the chances of doing what management has agreed that should be done. There is no good reason not to have a written policy. Once the IR policy is in place, companies need to ask themselves, at regular intervals, whether their practices are consistent with it. If there is to be consistency, the policy will have to reflect the reality of how management deals with investors.

- Talking to the Market - Companies must establish who may talk to the Market - often it is either (or both) of the Chief Executive and the Chairman of the Board. The fewer people authorised to communicate with analysts and investors, the less likely it is that your IR practices will get you into trouble. So, define the group that has IR authority to address particular topics and include this in your written policy.

  Many companies limit contact with analysts to the IRO, CEO and Chairman. To the extent that someone other than the IRO can meet with analysts, many companies require that the IRO is present - to prevent deviations from the policy, to play the 'bad cop' in refusing to discuss certain topics; and to stay current on senior management's thinking on particular issues.

- Keeping Up-to-Date - It is imperative for the IRO (or other spokesperson) to be kept fully informed, on a real-time basis, of all key corporate developments: forecasts, Merger and Acquisition activity, product developments, market trends. Ideally, the IRO will attend any senior staff meetings at which these issues are discussed. But life is rarely ideal and the reality is that the IRO is often not far enough up the corporate information ladder to be allowed to go to such meetings. The result is that IR staff may be saying things to analysts that do not reflect the latest thinking of senior management.

  At the very least, if your company provides any type of forward-looking guidance to the Market you should regularly review with senior sales and finance executives the continued validity of the guidance given in the past. One of the greatest services the IRO can perform is to ask periodically: do we need to change our guidance?

- Reviewing Draft Reports - Companies are often unsure whether they should review draft analyst reports or not. In virtually every shareholder actions, plaintiffs will allege - without having any idea if it is true - that the company reviewed draft analyst reports and commented on the revenue and earnings models in them, thereby giving rise to a duty to disclose any subsequent drop in internal projections. In practice, companies' policies on reviewing draft reports tend to vary with their age and size. A newly public company with little coverage may feel that it has no choice but to do this, whereas a larger, more established one may have the confidence to decline. In general, a company can reduce its potential investor liabilities by declining to review analyst reports.
- To Comment or Not - If your company decides that it will review reports, it should ensure that the topics on which it will comment are consistent with its guidance policies. So, for example, if your company will not comment on analysts' estimates in a meeting or phone call, it should not inadvertently deviate from that by commenting on EPS estimates in a draft report. Many companies have a practice of correcting objective factual errors in a draft report - say, an inaccurate historical figure or a wrong description of product features - but of declining to comment on forward-looking information. If that is your practice, be sure to include it in your written IR policy. Never, even in jest, respond to draft reports with comments that can later appear intended to push the analyst to a more favourable assessment. By definition, these will become an issue only when you have failed to meet the Market's expectations.
- Sending Out Analyst Reports - Companies should be cautious about sending out copies of analyst reports. Plaintiffs routinely allege that a company adopted analysts' projections by distributing copies of their reports to investors. The easiest way to avoid that issue is by not distributing them - after all, they are readily available to investors from other sources. If your company insists on providing copies, consider including a disclaimer to the effect that you are doing so as a courtesy to the investor and that the company does not necessarily agree with the content of the report, which is the independent conclusion of the analyst who wrote it. And ask yourself whether you are really passing on such reports disinterestedly, without selecting the good ones or culling the bad.

Expectations from Bankers - Plaintiffs have recently attempted to argue that companies assume the duty to update by providing projections to their Investment Bankers, who may leak them to the firm's analysts. When providing sensitive information to your Investment Bankers, Stock Exchange Sponsors or Underwriters, confirm with them that they observe an ethical wall between their corporate finance and research departments.

- Conference Calls - Most companies issue their results after the market has closed and then follow up, with a conference call with analysts to discuss the results in more detail. Such calls are clearly more efficient than individual calls to numerous market professionals. They also minimise the risk of selective disclosure to a particular analyst. But it's important to structure the call appropriately. The script for the call, along with Q&As, should be vetted by the entire management team for accuracy as well as for consistency with the company's IR policy. Companies differ on whether such calls should be tape-recorded: think this through with your advisors when you prepare your IR policy. And don't say anything on such a call that you would not be happy to see in the newspaper the next morning.
- The "Quiet" Period - Most companies stop giving guidance to the Market near the end of each trading quarter. The rationale is that information at that point contains nuances. The later in the quarter a company revises its internal projections, the more likely it is to disclose that revision by press release, not by market guidance.

If you decide to adopt a quiet period, the duration can vary. Many companies shut down guidance from the start of the third-month of the quarter until the issuance of the earnings release. Others wait until two weeks before the end of the quarter to start the quiet period.

Whatever the chosen time, you should consider stopping all communications with analysts during that period, not just those involving the quarterly results. Analysts are wily creatures: if you talk to them about anything during the quiet period, they may draw unintended inferences about the quarter from comments on other topics or even from the tone of your answers.

If you do observe a quiet period, don't tell analysts what your guidance was before it, otherwise it may be construed as suggesting that it remains viable.

Books on Investor Relations and Corporate Communications

- "The Quest for Loyalty: Creating Value through Partnership", by Frederick F. Reichheld, published October 1996 by Harvard Business School Publishing
- "New Dimensions in Investor Relations: Competing for Capital in the 21st Century", by Bruce W. Marcus, Sherwood Wallace, published July 1997 by John Wiley & Sons.
- "Investor Relations", by Michael Regester, published March 1990 by Century.
- "Investor Relations: Meeting the Analysts", by Marston, published January 1996 by Institute of Chartered Accountants of Scotland
- "Improving Investor Relations: A Business Guide", by Angus Maitland, published April 1989 by CBI.
- "Investor Relations: The professional's guide to Financial Marketing and Communications", by William F. Mahoney, published December 1990 by Prentice Hall.

London Stock Exchange promotes best practice in investor relations: "Investor Relations - A Practical Guide"

A guide from the London Stock Exchange (LSE) announced on 15 March 2010 will help companies communicate effectively with their investors.

The LSE is sending copies of a new edition of its guide to investor relations to the companies on its markets.

"Investor Relations - A Practical Guide" provides practical assistance to companies, whether quoted or considering a stock market flotation, on best practice in investor relations, examining the key principles firms should consider when developing their investor relations strategy.

The Guide collates a wealth of expertise from a series of corporate advisers, quoted companies and investors, and details the latest developments affecting investor relations, including the Companies Act 2006 provisions for electronic shareholder communication and AIM Rule 26, covering website disclosure for AIM companies.

The Guide provides insight into:

- the key stakeholders involved;
- which people, internally and externally, comprise a company's investor relations team and their responsibilities; and
- the tools and activities available to companies to effectively communicate their story to shareholders, potential investors, analysts and the media

The Guide is now available on the LSE website at: www.londonstockexchange.com/home/ir-apracticalguide.pdf

Further Information

This guide is for general interest - it is always essential to take advice on specific issues. We believe that the facts are correct as at the date of publication, but there may be certain errors and omissions for which we cannot be responsible.

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References:

[1] See Edelman Public Relations Worldwide, a consultancy based in North and Latin America, Europe and Asia Pacific at www.edelman.com/

[2] See Kreab Corporate Communication Counsellors, a Swedish (Stockholm-based consultancy) at www.kreab.se/kreab/

[3] Reported on in Australia's Business Review Weekly magazine, August 17, 1998

[4] This section has been excerpted and adapted by us from an article from Wilson Sonsini Goodrich & Rosati in Palo Alto, California at www.wsgr.com/