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The Guidance Effect: Improving Valuation

"Regardless of market environment, companies that provide guidance are more likely to preserve and enhance valuation."

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Preface

In the summer of 2009, in the wake of the greatest collapse U.S. financial markets have experienced in decades, we published a study that evaluated the impact of increased transparency on equity valuation. The investigation yielded results that supported the thesis that the practice of issuing quantitative financial guidance contributes to improved stock performance.

We found that companies that: a) provided earnings guidance, b) promptly adjusted their full-year guidance when quarterly earnings disappointed, or c) preannounced their anticipated guidance surprises delivered stock-price returns significantly better than companies that did not follow these practices.

Our conclusion in 2009 was that, given the climate of fear and uncertainty that permeated Wall Street in the first quarter of that year, investors were likely placing an exceptionally high premium on corporate financial guidance in their efforts to forecast corporate performance. For this reason, we concluded, guidance practices had an unusually pronounced impact on stock price behavior at the time.

We decided to re-visit the subject, looking at 2011 data, which reflected a changed macro-environment. Although market volatility remained high due to U.S. and sovereign debt issues, fundamental performance displayed by U.S. publicly traded companies was generally improving. Our goal was to re-test our hypothesis and potentially uncover new insights.

This White Paper summarizes our latest study results, which were generally consistent with what we found in 2009. Greater transparency once again was associated with abnormal market returns albeit with one important difference: the spreads between companies with different guidance practices were much tighter. Nonetheless, as we theorized, three years ago, there appears to be a direct relationship between the level of market uncertainty and the degree of impact that guidance exerts on stock performance.

It should be noted, however, that the more muted abnormal returns we found in our current study probably reflect not only the impact of corporate guidance practices, but also today's narrower spreads between analysts' expectations and actual corporate earnings. In 2009 nearly 40% of S&P 500 companies missed or beat consensus estimates by more than 25%, but in 2011 that number declined to 12%. The range of subsequent stock price reactions followed suit, as the average spread in market returns between the two periods decreased by approximately 30%.

Regardless, the evidence still suggests that companies providing guidance are more likely to preserve and enhance their equity valuation versus those that do not.

Regardless of market environment, companies that provide guidance are more likely to preserve and enhance valuation

Abstract

This study analyzes actual quarterly financial results reported by roughly 1,000 publicly traded companies within the S&P 500 and S&P 400 indexes for the entirety of 2011.[1] During the 30-day periods surrounding earnings events that we measured, our study found that:

- Companies that provided quantitative financial guidance with earnings announcements, whether beating or missing EPS consensus estimates, realized superior stock returns compared with companies that did not offer such forward-looking insight.
- The market placed a greater emphasis on performance above or below analyst consensus estimates than on performance versus company guidance. Wall Street marginalized results in-line with guidance unless those results amounted to a consensus beat. In those cases, the affected stocks only experienced an incremental reward. This is a new trend observed in 2011 that stands in contrast to our previous finding that guidance beats enjoy greater upside. This finding may underscore an important transition of investor psyche since 2009.
- Smaller-cap companies experienced greater volatility than larger-cap names. In both cases, however, providing updates to guidance within the context of reporting their quarterly results helped lock in price appreciation or mitigate downside depending on whether news was good or bad.

In summary, providing quantitative financial guidance positively influenced stock price performance in 2011, but to a lesser extent than in the more turbulent market environment of 2009. In both periods, companies that provided guidance were more likely to preserve valuation in the face of downside news, and enhance valuation as a result of upside news compared with companies that did not.

[1] Using the eventVestor analytics platform, we measured "abnormal stock price return" for S&P 500 and Mid-Cap S&P 400 companies in the 10 trading days before and 20 trading days after the preannouncements and earnings announcements during calendar year 2011, 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.

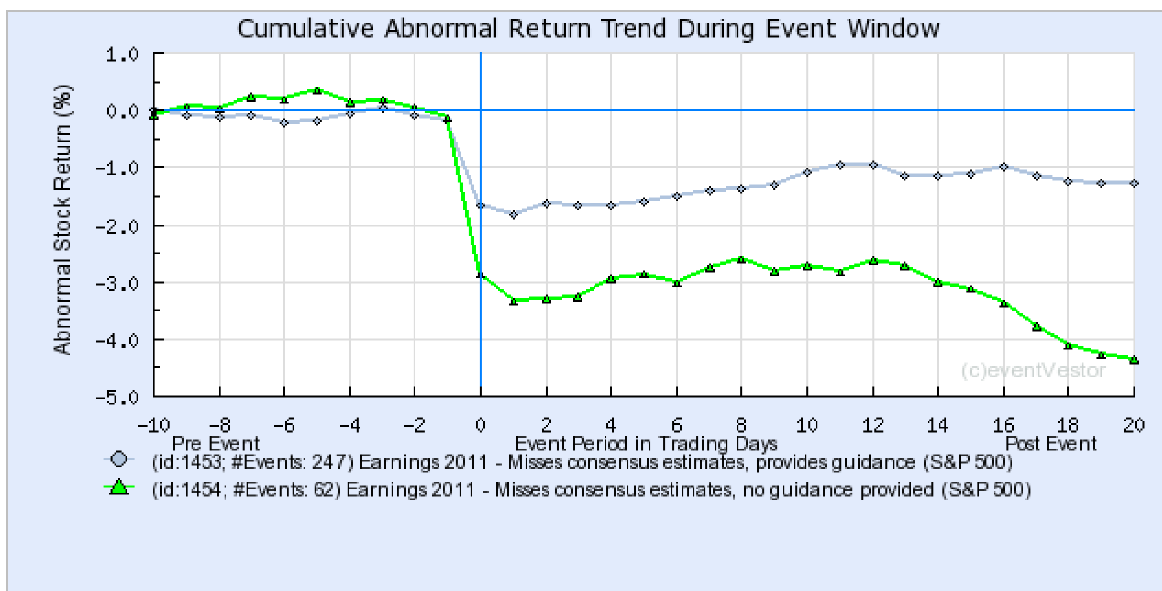
Key Findings

1. Performance versus analyst expectations dictates subsequent stock movements, but providing earnings guidance enhances performance

This study again confirmed the importance of sell-side analyst expectations in determining short-term stock price performance following earnings announcements. The relationship between reported earnings and the analyst consensus was closely correlated to abnormal market return.

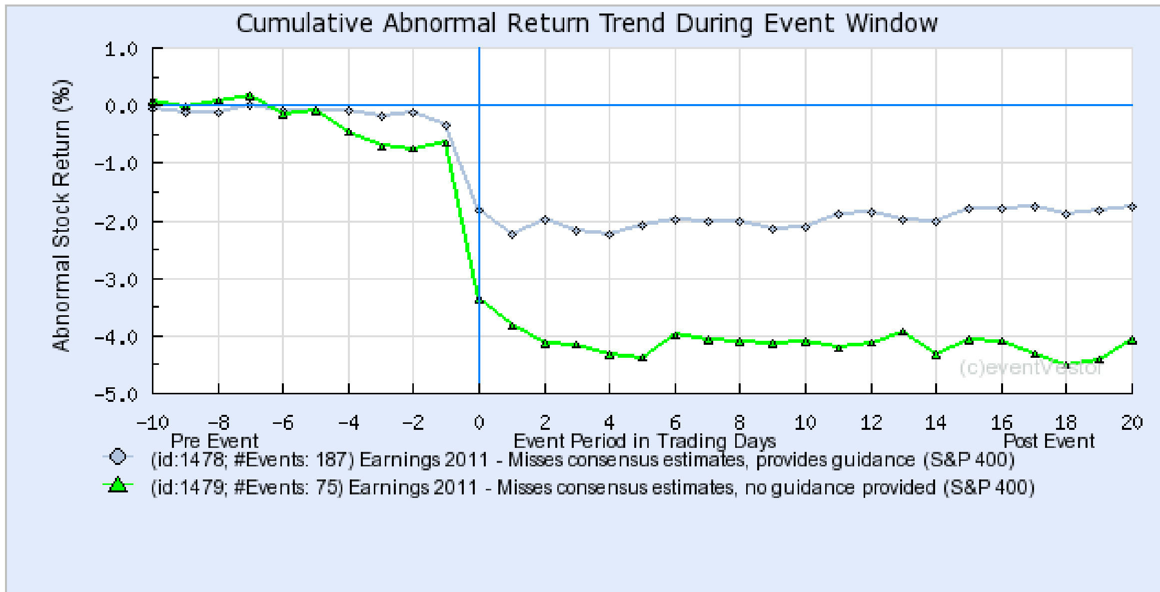
Chart 1 below illustrates that S&P 500 companies that provided earnings guidance delivered better market performance upon missing the analyst consensus than companies that missed estimates but did not provide quarterly earnings guidance. Those providing earnings guidance saw an average negative abnormal return of approximately 125 basis points (bps) relative to the market 20 days after reporting earnings compared with 10 days prior to the announcement. Companies that did not provide guidance experienced average negative abnormal returns of approximately 430 bps.

Chart 1: Impact of Providing vs. Not Providing Guidance when Missing Consensus – S&P 500



Companies within the S&P Midcap 400 index experienced similar results. Chart 2 shows that mid-cap companies that provided guidance experienced an average negative abnormal return of 175 bps after 20 days compared with 10 days prior to the announcement, versus 400 bps for companies that did not.

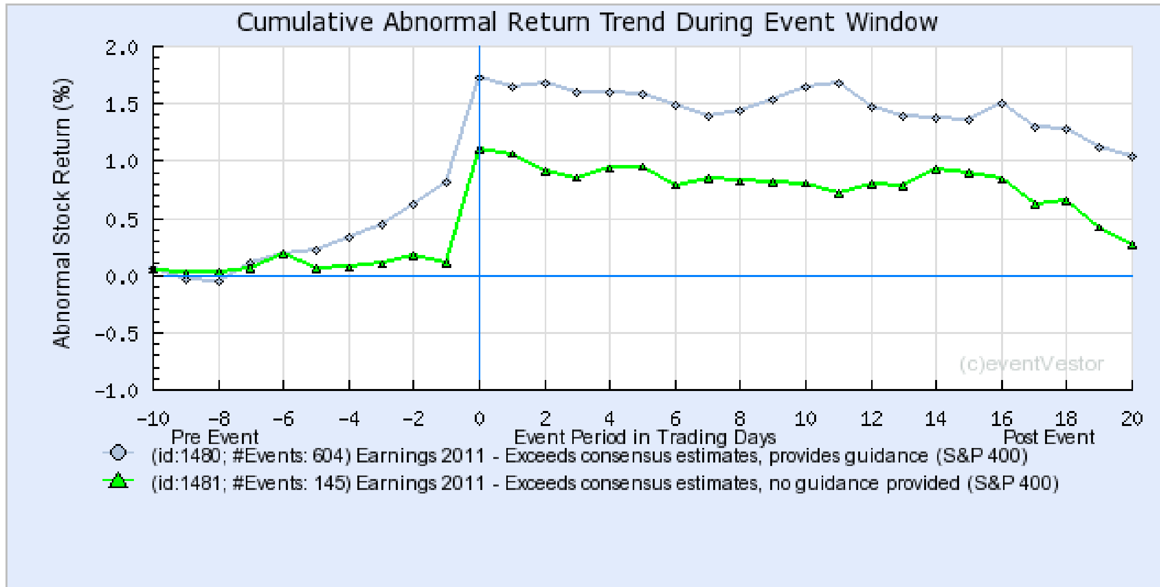
Chart 2: Impact of Providing vs. Not Providing Guidance when Missing Consensus – S&P 400



In scenarios where companies disclosed negative earnings surprises, guidance mitigated stock price declines that may have otherwise been more substantial. Charts 1 and 2 illustrate the clear impact guidance had on price performance. In both the large- and mid-cap universes, a division occurs between two otherwise congruent data sets on the day of earnings. Companies that provided guidance after missing consensus maintained a consistent degree of outperformance compared to those that did not. Large cap companies outperformed their peers by approximately 300 bps after 20 days compared with 10 days prior to the announcement. For mid-cap companies the margin was smaller; their stocks delivered positive abnormal market returns of approximately 200 bps.

With respect to beating consensus, providing guidance yielded results consistent with this trend for mid-cap companies. Chart 3 illustrates stock performance for mid-cap companies that did and did not provide guidance after exceeding consensus estimates. Companies that gave guidance outperformed those that did not by approximately 70 bps 20 days post-earnings.

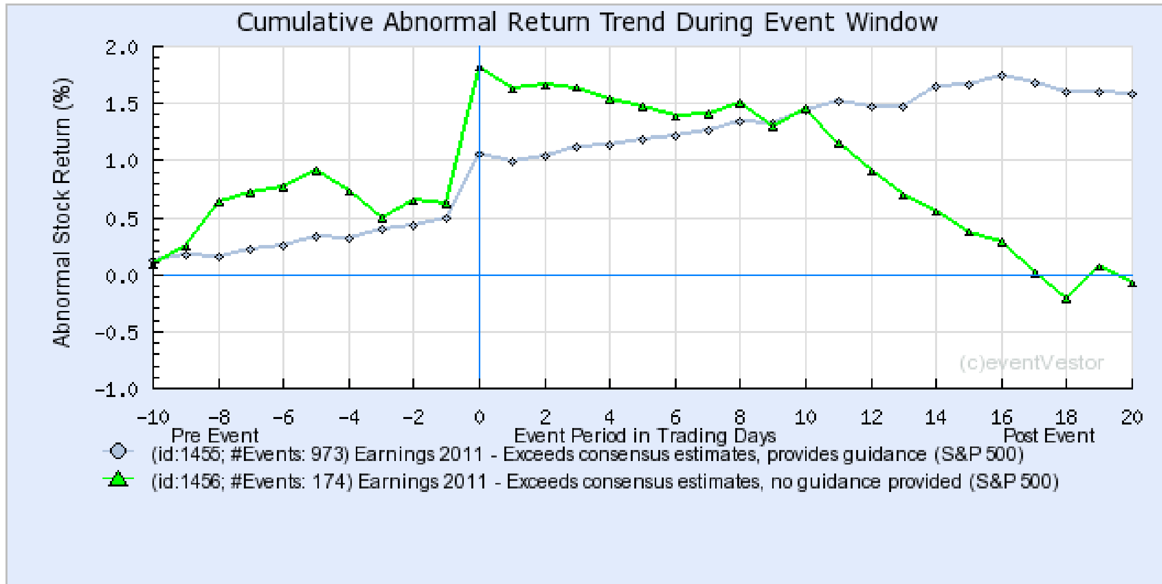
Chart 3: Impact of Providing Guidance vs. Not Providing Guidance when Beating Consensus – S&P 400



For companies within the S&P 500 index, guidance led to positive abnormal market returns in the 20 days following an earnings announcement, but an interesting trend emerged that we had not observed before. Companies that exceeded consensus estimates and did not provide guidance were rewarded with more substantial returns on the day of earnings, but in the weeks that followed those gains eventually disappeared. On the other hand, companies that exceeded consensus estimates and provided guidance experienced moderate positive abnormal price movement on the day of their earnings announcements, with continued gradual upward movement over the course of the next 20 trading days.

The net impact for the S&P 500 over the course of 2011 was an outperformance for companies that provided guidance by an average of approximately 150 bps compared to companies that did not. The inverse relationship is illustrated in Chart 4 below, and seems to indicate that investors were reluctant to buy into good news unless companies could demonstrate continued visibility through guidance.

Chart 4: Impact of Providing Guidance vs. Not Providing Guidance when Beating Consensus – S&P 500



2. Macro trends shift market focus away from corporate guidance.

Companies were not rewarded as handsomely for meeting or exceeding guidance in 2011 as they were three years prior in the 2009 study. Whereas companies in 2009 were rewarded more for beating guidance than they were for beating consensus estimates, the opposite was true in 2011.

Chart 5: Impact of Exceeding Guidance & Consensus – S&P 500

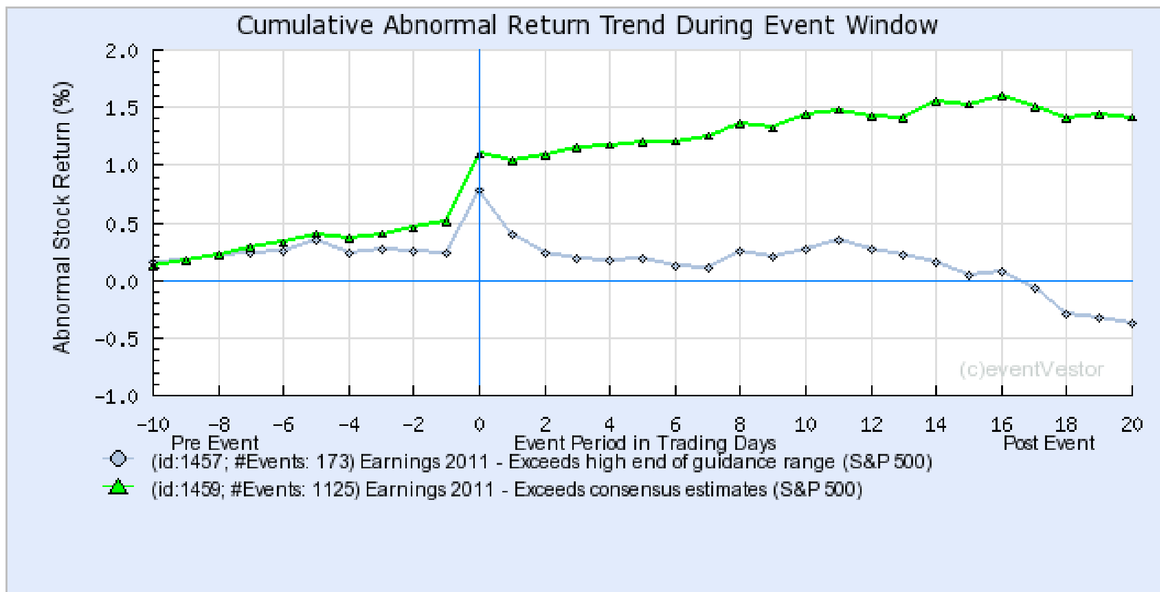
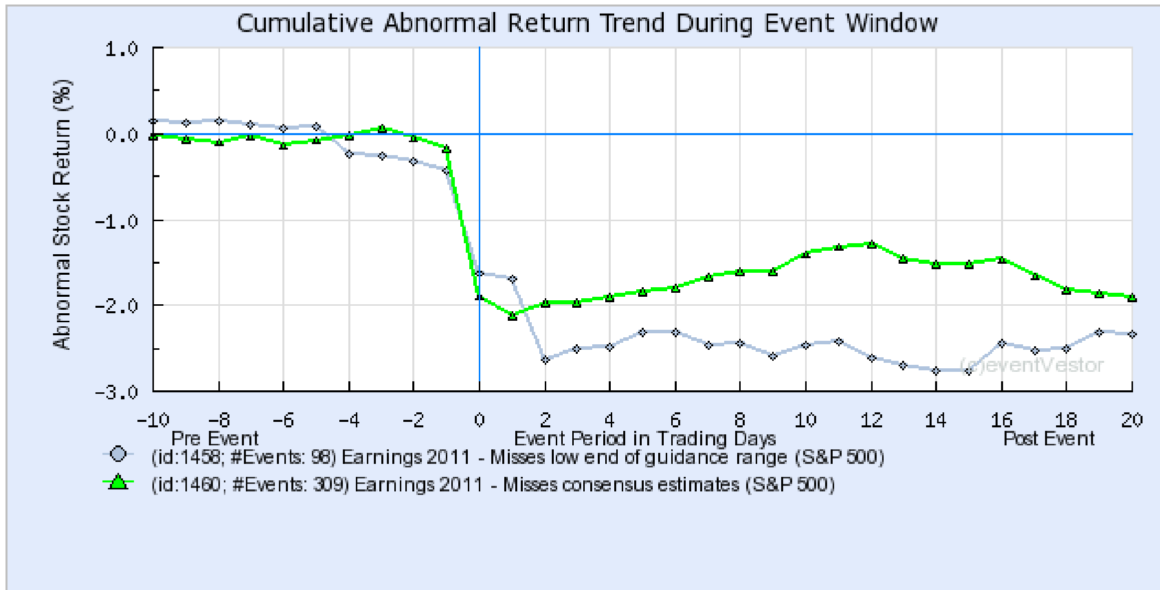


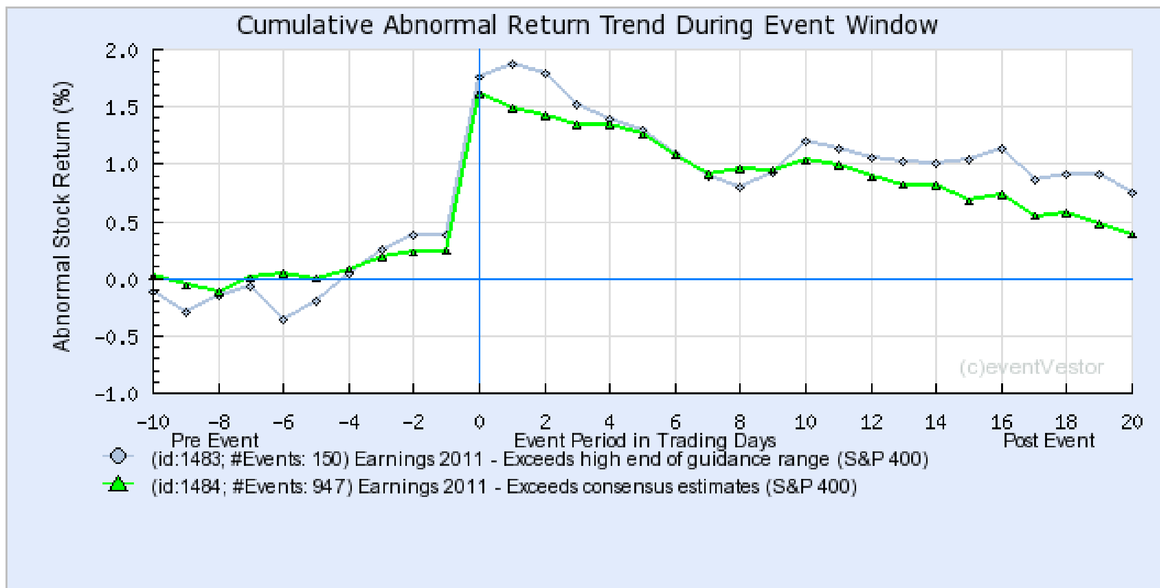
Chart 5 above illustrates the near negligible impact that upside to guidance had on stock performance for the S&P 500 during 2011. Although upside to guidance and consensus were initially rewarded similarly, the two events wound up yielding opposite results 20 days post-earnings. Companies that exceeded consensus estimates enjoyed positive abnormal market returns averaging 100 bps in the 20 days post-earnings. Upside to guidance, meanwhile, was largely ignored by Wall Street. Following the initial upside "pop" received on the day of the earnings announcement, the stocks declined approximately 65 bps in the 20 days post-announcement.

Chart 6: Impact of Missing Guidance & Consensus – S&P 500



When it came to downside, however, Chart 6 shows that S&P 500 stocks were punished with about the same severity for missing either guidance or consensus. Downside to guidance resulted in slightly greater declines in the immediate window following earnings, but after 20 days the difference in abnormal market returns between the two data sets equaled less than 50 bps.

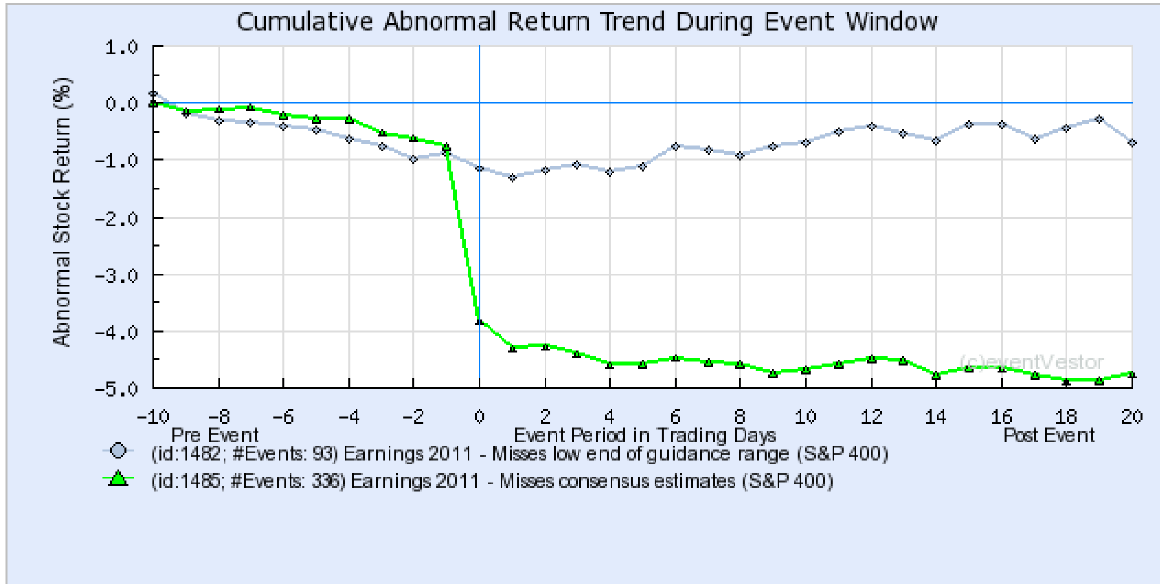
Chart 7: Impact of Exceeding Guidance & Consensus – S&P 400



For the mid-cap S&P 400 universe, a comparable trend appeared with respect to performance vs. guidance and consensus, but for these stocks the impact fell mostly on downside performance as opposed to upside performance for the S&P 500. As illustrated in Chart 7, whether exceeding guidance

or consensus, the results for the S&P 400 were nearly identical. However, this was not true for misses to guidance and consensus. As shown on Chart 8, missing guidance had nearly zero impact on average market returns within the 20 days following the earnings announcement. Misses to consensus estimates, on the other hand, were punished severely on the day of earnings, with stock prices experiencing negative abnormal returns averaging approximately 300 bps. Average market return for these companies dropped an additional 100 bps in the next 20 days post-earnings.

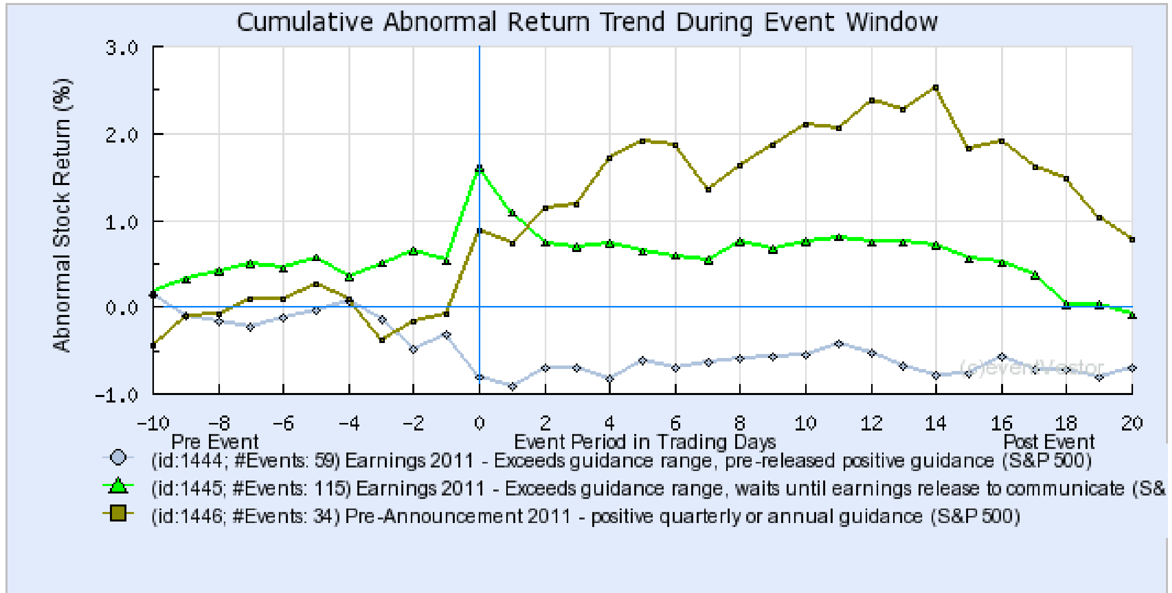
Chart 8: Impact of Missing Guidance & Consensus – S&P 400



Wall Street's de-emphasis of performance versus corporate guidance in 2011 also translated to its views on preannouncements. Our 2009 study found that companies that preannounced either upside or downside to guidance experienced significantly greater stock price returns than companies that did not. This trend was not repeated in 2011, which again we believe may be attributable to the improved market environment.

Chart 9 illustrates a net neutral impact on stock price performance for S&P 500 companies that preannounced upside to guidance. Those that did choose to preannounce positive results experienced essentially the same market returns upon preannouncing as companies that waited until earnings. Although preannouncements did generate overall higher levels of price performance -- averaging 250 bps positive abnormal return 14 days following the preannouncements – the net impact on stock price 20 days post-earnings was nearly identical to companies that did not preannounce.

Chart 9: Impact of Preannouncing Upside to Guidance – S&P 500



Although upside preannouncements were essentially ignored by the market (Chart 9), S&P 500 companies that preannounced guidance misses (Chart 10) experienced average price declines of approximately 600 bps within the 20-days following the announcement. Stocks of companies that missed guidance without preannouncing, however, declined far less dramatically. This could be because guidance misses that were preannounced tended to be more substantial than misses that were not preannounced. Further analysis supports this hypothesis (Chart 10B). For S&P 500 companies that missed guidance by more than 25%, the average negative abnormal market return for those that preannounced was approximately 320 bps. However, stocks of companies that did not preannounce but missed analyst consensus estimates by more than 25% underperformed the market by approximately -480 bps.

Chart 10: Impact of Preannouncing Downside to Guidance – S&P 500

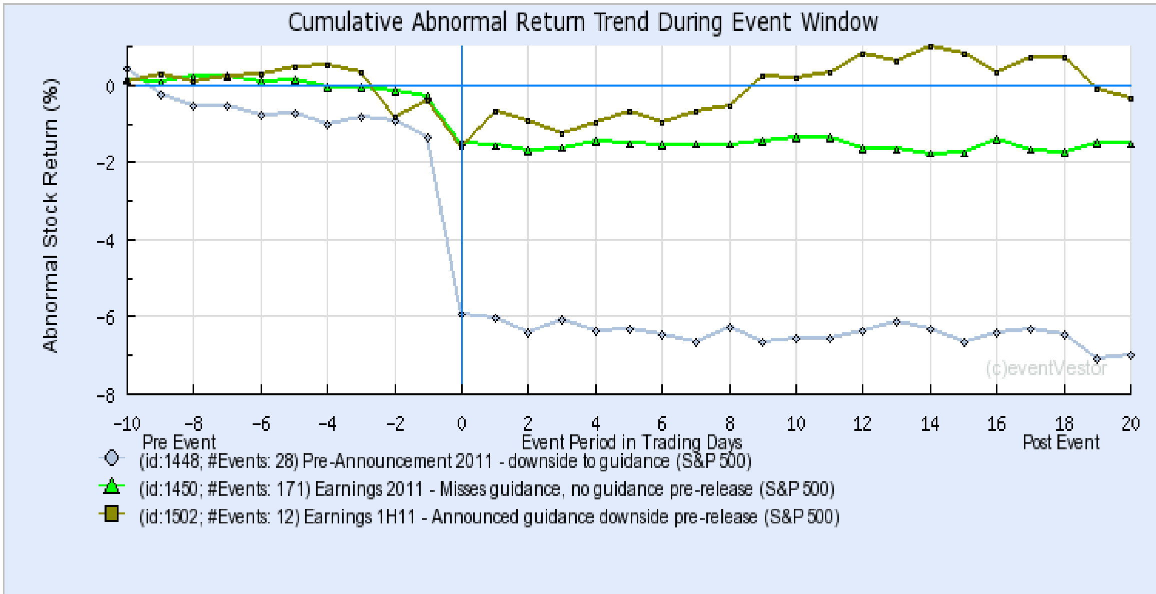
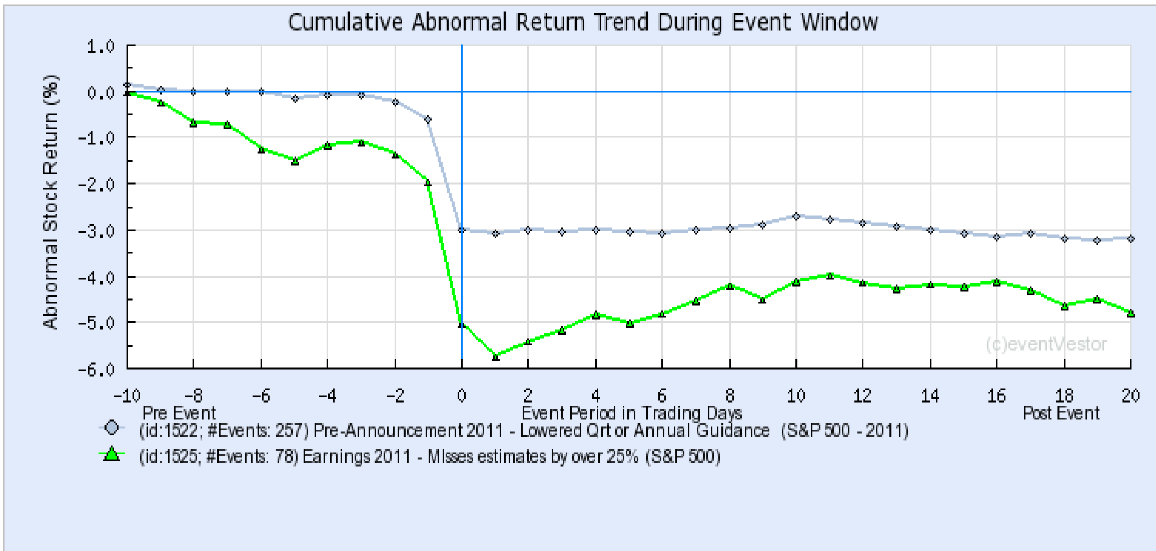


Chart 10B: Impact of Preannouncing Miss of Greater Than 25% – S&P 500



3. Smaller-Cap stocks experience sharper movements on news

Another important trend observed in 2011 was that smaller companies generally experienced sharper movements in stock performance on news than large-cap companies did. These differences were present in several of the examples highlighted previously in this document, but the charts presented in this section were selected specifically to underline the trend.

Chart 11: Impact of Exceeding vs. Missing Consensus – S&P 500

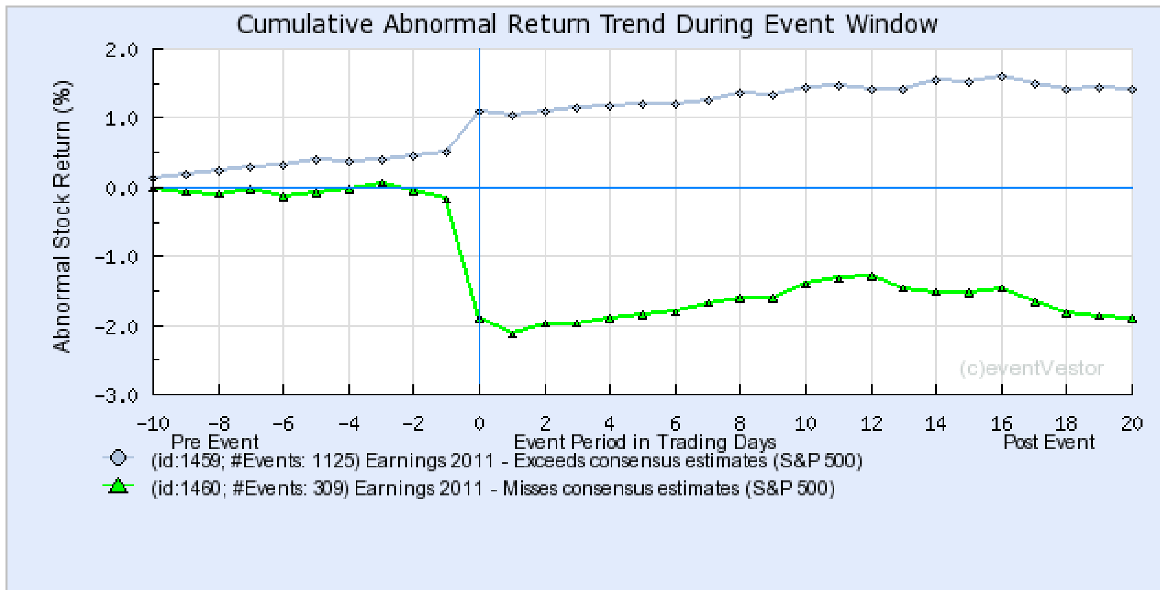


Chart 11 illustrates that for the S&P 500 universe, companies that exceeded consensus estimates in 2011 experienced approximately 50 bps positive abnormal market return on the day earnings were announced and 140 bps over the course of the 30-day period we measured. Stocks of companies that missed consensus estimates, on the other hand, experienced an average negative abnormal return of nearly 200 bps on the day earnings were announced as well as 20 days later. This represents a spread of roughly 340 bps between missing and beating consensus estimates.

Chart 12 shows that S&P 400 companies experienced wider spreads in their stock performance under the same circumstances. Those exceeding consensus estimates in 2011 enjoyed almost no benefit relative to the mid-cap universe in the 20 days following their earnings announcements, whereas mid-cap companies that missed consensus experienced an average negative abnormal return of approximately 400 bps in the 20 days following earnings. This reflects a spread between missing and beating consensus of approximately 500 bps.

Chart 12: Impact of Exceeding vs. Missing Consensus – S&P 400

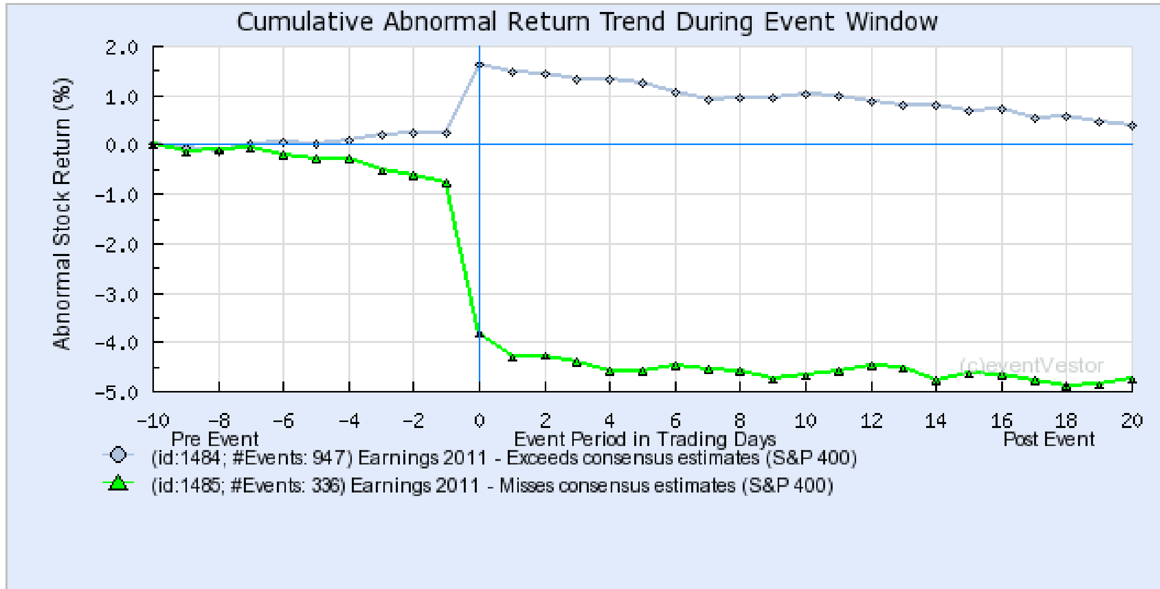


Chart 13 illustrates nearly identical stock price perfomance for S&P 500 companies that missed guidance and then issued updates to annual guidance, compared with those missing quarterly guidance and not revising annual guidance. Although lowering guidance in conjunction with the quarterly miss was punished twice as severely on the day of earnings, there was a nearly net neutral impact on average market return 20 days following the event.

Chart 13: Impact of Lowering vs. Maintaining Guidance After a Guidance Miss – S&P 500

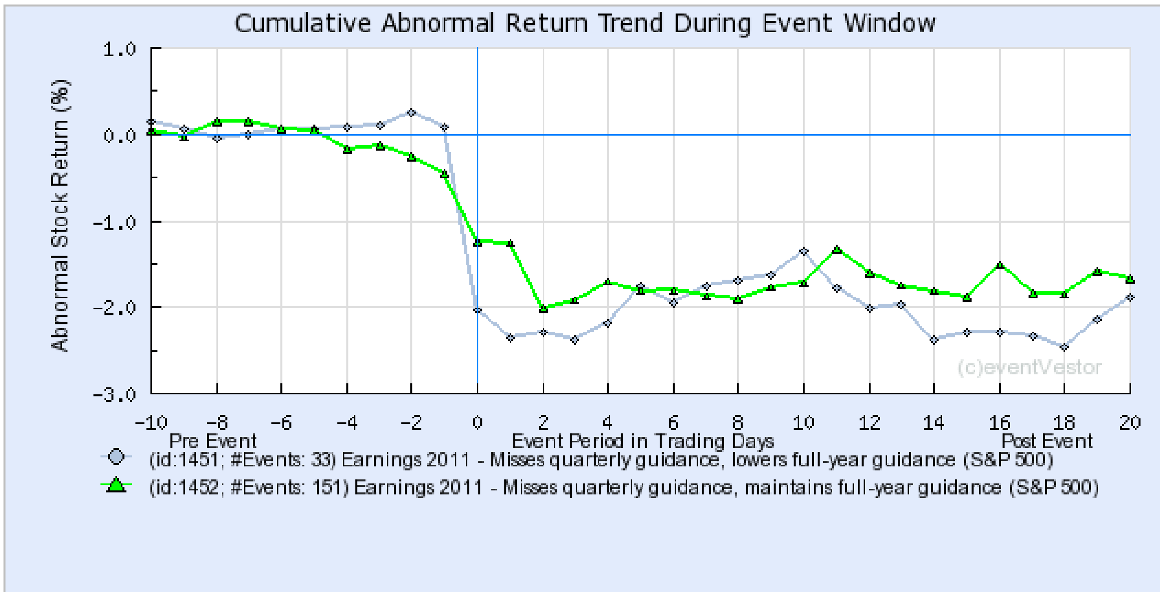
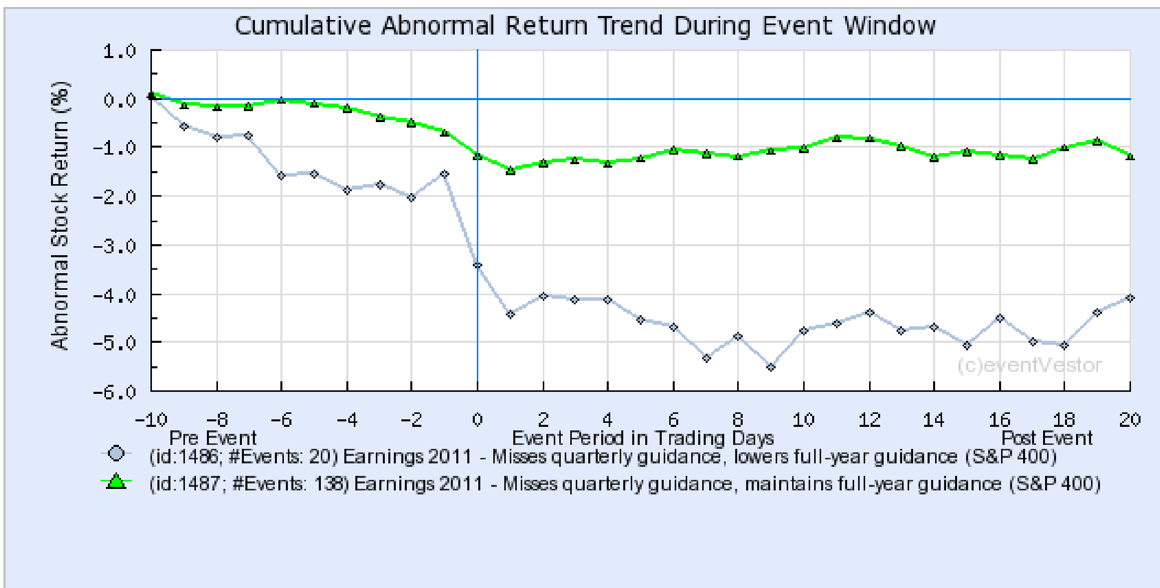


Chart 14: Impact of Lowering vs. Maintaining Guidance After a Guidance Miss – S&P 400



As illustrated in Chart 14, the results for the S&P 400 universe differ dramatically from their large-cap peers under the same circumstances. Misses to quarterly guidance were punished more severely when coupled with a subsequent downward revision to annual guidance. Mid-cap companies that maintained annual guidance after missing quarterly numbers experienced negative abnormal market returns of less than 50 bps in the 20 days following the earnings announcement. The stocks of mid-cap companies that did lower annual guidance, however, experienced negative abnormal returns of 250 bps 20 days following earnings.

Summary

Our research in 2009 supported the thesis that issuing quantitative financial guidance contributes to improved stock performance. Given the climate of fear and uncertainty that permeated Wall Street during the study period, we hypothesized that providing guidance – and thereby increasing transparency for investors – likely had an unusually pronounced affect on stock price behavior at the time.

Given the changes in the macro-environment since then, we decided to re-visit the subject and potentially uncover new insights by examining 2011 data. Although market volatility remained high in 2011, investors were generally less fearful and uncertain than they were in early 2009. As we suspected, in 2011 greater transparency once again was associated with abnormal market returns, but the effects were more subdued than in the prior study.

For investor relations professionals who are tasked with developing and implementing disclosure strategy, including guidance practices, as well as analyzing stock price performance and trading trends, our study findings suggest that:

- Corporate financial performance compared with analyst expectations is of critical importance in driving subsequent stock movements, but providing earnings guidance is likely to enhance stock returns regardless of positive or negative earnings announcements.
- Corporate guidance may have a more meaningful impact for investors in a particular company when market sentiment is unusually fearful and uncertain as it was in 2009.

Although there are no silver bullets for solving dilemmas related to communications strategy, the results of this study should serve as a useful guide for investor relations practitioners as they prepare their financial disclosures.

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