Amos Tuck School of Business at
Dartmouth College

Working Paper No. 02-01

Negotiation, Organization and Markets Unit
Harvard Business School

Working Paper No. 02-01

Just Say No To Wall Street

Joseph Fuller
The Monitor Company

Michael C. Jensen
The Monitor Company, Harvard Business School, and
Amos Tuck School at Dartmouth College

February 2002

© Monitor Company and M. C. Jensen 2002

This paper can be downloaded without charge from the
Social Science Research Network Electronic Paper Collection at:
http://papers.ssrn.com/abstract=297156

February 17, 2002
First draft September 3, 2001

© 2001 Monitor Company and M. C. Jensen
Comments welcomed

Just Say No to Wall Street

Courageous CEOs are putting a stop to the earnings game and we will all be better off for it.

Joseph Fuller

CEO, The Monitor Group
Joe_Fuller@monitor.com

Michael C. Jensen
Managing Director Organizational Strategy Practice, The Monitor Group;
Jesse Isidor Straus Professor Emeritus, Harvard Business School; and Visiting Scholar at Tuck School of Business at Dartmouth
MJensen@hbs.edu

Executive Summary

CEOs are in a difficult bind with Wall Street. Managers up and down the hierarchy work hard at putting together plans and budgets for the next year and quite often when those plans are completed top management discovers that the results fall far below what Wall Street expects. CEOs and CFOs are therefore left in a difficult situation. They can stretch to try to meet Wall Street's expectations or prepare to be punished if they fail. All too often top managers react to the situation by encouraging or mandating middle and lower level managers to redo their forecasts, plans and budgets to get them in line with external expectations. In some cases, fearing the results of missing the Street's expectations, managers start the budgeting process with the consensus expectations and mandate that internal budgets and plans be set so as to meet them. Either way this sets the firm and its managers up for failure if external expectations are, in fact, impossible for the firm to meet.

We illustrate, with the recent experience of Enron and Nortel, the dangers of conforming to market pressures for growth that are essentially impossible. We emphasize that an overvalued stock can be as damaging to the long-run health of a company as an undervalued stock, a proposition that few managers are familiar with. An overvalued stock sets in motion a variety of organizational behaviors that often end up damaging the firm. It does not have to be this way. Ending the "expectations game" requires that CEOs reclaim the initiative in terms of setting expectations and forecasts. To begin, CEOs must say no to the "earnings guidance" game and reverse recent practices in which analysts took the lead in driving industry forecasts, and companies complied. Managers must make their organizations more transparent to investors, so that stocks can trade at close to their intrinsic value. Doing so means CEOs and CFOs must inform the market when they believe the market expectations cannot be met and that the stock is, therefore, overvalued.

Forthcoming in the *Journal of Applied Corporate Finance*, Spring 2002
Excerpts of this article were published in the
Wall Street Journal "Manager's Journal" column under the title
"Dare To Keep Your Stock Price Low," December 31, 2001, and in the
Financial Times, Jan 22, 2002 under the title "End the Myth-Making and Return to True Analysis".

We thank Nancy Nichols, Pat Meredith, Jennifer Lacks Kaplan, Hardy Tey, Stephanie Mayer, and Shibanee Verma who contributed to this effort.

This paper can be downloaded without charge from the
Social Science Research Network Electronic Library at:
http://papers.ssrn.com/abstract=297156

© 2001 Monitor Company and M. C. Jensen

Just Say No to Wall Street

Courageous CEOs are putting a stop to the earnings game and we will all be better off for it.

Joseph Fuller

CEO, The Monitor Group
Joe_Fuller@monitor.com

Michael C. Jensen

Managing Director Organizational Strategy Practice, The Monitor Group and
Jesse Isidor Straus Professor Emeritus, Harvard Business School
MJensen@hbs.edu

Ending the High Stakes Game with Wall Street

Once there were whispers and informal advisories to favored analysts of what to expect in coming earnings announcements. Then the conversations became more elaborate engendering a kind of twisted logic. No longer were analysts trying to understand and analyze a company so as to predict what they might earn, rather the discussion revolved around the analysts' forecasts themselves. Will expectations be met? What will management do to ensure that? Rather than the forecasts representing a financial byproduct of the firm's strategy, the forecasts came to drive those strategies. While the process was euphemistically referred to as earnings guidance it was in fact a high stakes game with management seeking to hit the targets set by analysts—and being punished severely if they missed.

Last year, the Securities and Exchange Commission recognized that private conversations between executives and analysts had become extensive, with analysts gaining access to critical data not otherwise available to shareholders broadly. The new regulations insisting on fair disclosure addressed the mechanics of the conversation, but did little to change its underlying logic. The result, at best, has been blizzards of filings, dozens of press releases, and many more company-run conference calls.

But a few courageous CEOs have wisely decided to put an end to the gaming by simply saying no. Managing Wall Street's expectations may be a decades old game but USA Networks' Barry Diller and Gillette's CEO Jim Kilts have decided to put a stop to it. In a recent SEC filing, Diller, the chairman of USA Networks, balked at the sophisticated art form known as managing expectations, saying publicly what many have said privately for

a long time: “The process has little to do with running a business and the numbers can become distractingly and dangerously detached from fundamentals.”[1]

Witness the part that Wall Street’s rising expectations played in the demise of once high flyers such as Enron, Cisco, and Nortel, as analysts pressed these companies to reach for higher and higher growth targets, and the companies responded with actions that have generated long-term damage. To resolve these problems, managers must abandon the notion that a higher stock price is always better and recognize that an overvalued stock can be as dangerous to a company as an undervalued stock. Managing this means being willing to take the necessary actions to eliminate such an overvaluation when it occurs.

Taking advantage of the diminished power of Wall Street analysts who have been pilloried in the press and studied by congressional committees, courageous CEOs are starting to push back. Managing Wall Street’s expectations may be a decades old game but Diller and other CEOs like Jim Kilts of Gillette have decided to put a stop to it.

In his first meeting with analysts after taking over Gillette, James Kilts stood firm against the tide refusing to be forced into making predictions for his company. *The New York Times* reports that in a June 2001 meeting with analysts, Kilts stood silent even when Wall Street analysts repeatedly asked him for a more specific estimate of the company’s performance, “Mr. Kilts stood on the stage, crossed his arms and refused to give it.”[2] In moves that we believe will benefit all the players in this game, Kilts and Diller have seized an important opportunity, an obligation even, to reshape and reframe the conversation for a new era.

The Power of a Prediction

As many are aware, over the last decade companies have struggled more and more desperately to meet analysts’ expectations. Egged on by a buoyant economy and the pace of value creation set by the market’s best performers, analysts challenged the companies they covered to reach for unprecedented earnings growth. Executives often acquiesced to increasingly unrealistic projections and adopted them as a basis for setting goals for their organizations. Why? Many factors contributed to that phenomenon.

Favorable market conditions in many industries led companies to exceed historical performance levels, causing executives and analysts alike to view unsustainable levels of growth as the norm. A massive, broad-based shift in the philosophy of executive compensation contributed as well to the trend. As stock options became an increasing part of executive compensation, and managers who made great fortunes on options became the stuff of legends, the preservation or enhancement of short-term stock value became a personal (and damaging) priority for many a CEO and CFO. High share prices and earnings multiples stoked already amply endowed managerial egos; management teams proved reluctant to undermine their own stature by surrendering hard won records

[1] USA Networks. 2001. "USA Provides Internal Budget to Investment Community." *SEC Form 425.1*: October 24, 2001,

[2] Barnes, Julian E. 2001. "Gillette's Chief Is Critical of the Company's Misstep." *New York Times*, June 7, 2001. http://college2.nytimes.com/guests/articles/2001/06/07/852365.xml

of quarter over quarter earnings growth. Moreover, overvalued equity "currency" encouraged managers to make acquisitions and other investments in the desperate hope of sustaining growth, continuing to meet expectations, and buying real assets at a discount with their overvalued stock.

Parallel developments in the world of the analysts completed a vicious circle. Once, analysts were known to a handful of serious investors and coveted a spot on Institutional Investor's annual All America team. In recent times, analysts became media darlings. An endless parade appeared on an increasing array of business programming. More importantly, the views of celebrity analysts reached the same status as the opinions of leading executives. Analysts Mary Meeker and Jack Grubman were quoted in the same breath and, more importantly, credited with equivalent insight as Cisco's CEO John Chambers and Qwest's CEO Joe Nacchio. With the explosion in the markets came an explosion in analyst compensation as leading analysts shared in the bonus pools of their investment banking divisions and thereby had incentives to issue reports favorable to those deals. Analysts with big followings, a lucky record of prescience, and an ability to influence high stakes investment banking deals being sold by their firms commanded multi-million dollar salaries. Analysts had real incentives to demand high growth and steady and predictable earnings performance to justify sky-high valuations for the companies they followed, and to avoid damage to their own reputations from missed predictions. In too many instances, too many executive teams and too many analysts engaged in conversations equivalent to liar's poker.[3]

Many will say, "So, what? If overly aggressive analysts drove executives to create more shareholder value faster, what's the harm?" What they fail to recognize is that this vicious cycle can impose real, lasting costs on firms when analyst expectations become unhinged from what is feasible for firms to accomplish. As the historic bankruptcy case of Enron suggests, when companies encourage excessive expectations or scramble too hard to meet unrealistic forecasts by analysts they often take highly risky value-destroying bets. In addition, smoothing financial results to satisfy analysts' demands for quarter-to-quarter predictability frequently requires sacrificing the long-term future of the company. Because the inherent uncertainty in any business cannot be made to disappear, striving to achieve dependable period-to-period growth is a game that CEOs cannot win. Pushing the consequences of the uncertainty inherent in every industry and every company down here today and there tomorrow only causes it to pop up later somewhere else, often with catastrophic results.

More importantly, we have witnessed the implications of executives attempting vainly to record growth rates that consistently and materially exceed growth in primary demand in

---

[3] Evidence on the distortion of information provided to investors by firms and the collaboration of some financial intermediaries and analysts in this distortion have grown considerably. For an excellent compilation and analysis of this evidence see the paper by D'Avolio, Gene, Efi Gildor, and Andrei Shleifer. 2001. "Technology, Information Production, and Market Efficiency." Harvard Institute of Economic Research Discussion Paper Number 1929, September 2001. Cambridge, MA. This paper can be downloaded without charge from the the Social Science Research Network eLibrary at: http://papers.ssrn.com/abstract=286597 and at http://post.economics.harvard.edu/hier/2001papers/2001list.html

their markets. Stated simply, companies participating in markets with 4% underlying growth in demand cannot register 15% growth in earnings quarter over quarter, year over year, indefinitely. The technology and telecommunications sectors serve as examples of the consequences of sustained pressure from analysts.

In the last decade analysts' expectations consistently and vastly exceeded what companies were capable of doing. Managers collaborated in this fiction, either because they, themselves, had unrealistic expectations for their companies or, worse yet, because they used analysts' expectations to set internal corporate goals. The consequent destructive effects of overvaluation of corporate equity manifested itself in unwise actions intended to fulfill these unrealistic expectation —including value-destroying acquisitions and imprudent greenfield investments. When the fiction finally became obvious, the result was massive adjustments in the earnings and growth projections and, consequently, in equity valuations. In many cases, the very survival of the companies affected came into question. Enron is perhaps the most dramatic example.

Enron

Enron was in many ways an extraordinary company. It boasted significant global assets, true achievements, dramatic innovations, and a promising long run future. Wisely taking advantage of a rapidly deregulating market and capitalizing on its deep knowledge of the industry, Enron had seized a powerful, but probably once-in-a-corporate-lifetime opportunity to remake itself as a market maker in natural gas and energy.

Wall Street responded to this and other innovations the company made with a series of positive reports and ever-higher valuations, eventually labeling Enron one of the best companies in the economy and comparing it to Microsoft and GE.[4] However, the aggressive targets that Wall Street set for Enron's shares made the company a captive of its own success. A game Enron willingly played and yet, as its bankruptcy demonstrates, eventually and dramatically lost.

For Enron, which had captured an innovative market, its peak valuation of $68 billion in August 2001 required the company to grow its free cash flow at 91% annually for the next 6 years, and then to grow at the average rate for the economy—a pace that required it to continue to create what were, in effect, one-time-only innovations. One analyst blithely predicted that Enron would come to ". . . dominate the wholesale energy market for electricity, natural gas, coal, energy derivatives, bandwidth, and energy services on three continents."[5]

Enron, to its own detriment, took up the challenge. In seeking to meet expectations it expanded into areas in which it had no specific assets, expertise or experience—including water, broadband and even weather insurance.

---

[4] Fleischer, David N. 2001. "Enron Corp. Gas and Power Convergence." Conference Call Transcript, Goldman Sachs, July 12, 2001. New York.

[5] Tirello, Edward J., Jr. 2000. "Enron Corporation: The Industry Standard for Excellence." Analyst Report, Deutsche Banc Alex. Brown., September 15, 2000. New York.

Yet, it didn't have to be this way. Had management not met Wall Street's predictions with its own hubris the result could have been very different. As Kilts is demonstrating, managers can refuse to collude with analysts' expectations that don't fit with their strategies, the underlying characteristics of their markets, and the associated results. They can decline to bow to analysts' desires for highly predictable earnings.

If Enron's management had confronted the analysts with courage and conviction and resisted their relentless focus on outsize earnings growth, the company could have avoided questionable actions taken to please the analysts and markets. The result could well have been a lower-valued but stable and profitable company with a long-run future. And, as has happened in other companies, these questionable actions went beyond the decisions to launch unwise investments and acquisitions, and included apparent manipulation of the information it provided to Wall Street. Some of these practices are currently being investigated by the SEC including: aggressive revenue recognition practices, off balance sheet financing that reduced its apparent debt, and partnerships that allowed the company to show higher earnings.

When discovered, these practices, coupled with missed earnings expectations, first stirred Wall Street's concern and eventually caused the crisis of confidence that destroyed the company's most valuable asset—its ability to make markets in energy. Its stock price in January 2002 has fallen by more than 99% as a result. While the partnerships brought to the forefront issues of credibility for Enron and the integrity of their financial reporting, they also served to highlight the importance of Wall Street analysts and the nature of their relationship with the companies they cover.

Nortel Networks

The story of Nortel is similar. Nortel Networks' CEO, John Roth, launched a strategy in 1997 to transform the company from one dependent on its traditional strength in voice transmission into one focused on data networking. Nortel acquired 19 companies between 1997 and early 2001. And as its stock price soared (to reach a total capital value of $277 billion in July 2000), it came under pressure to do deals to satisfy the analysts' growth expectations. Ultimately, it paid over $32 billion—mostly in stock—for these companies. Most of those acquisitions have now been sold off for modest amounts or shut down and written off entirely.

The quest to transform Nortel clearly damaged this former mainstay of the telecommunication sector. Its stock has fallen by more than 91% from its peak in September of 2000. Its valuation at the end of December 2001 is $24 billion. In July 2001 it reported a record $19.4 billion second quarter loss with a more modest, but still massive, $3.6 billion loss in the third quarter. Its CEO resigned effective November 1, 2001 but remains as vice-chairman until the end of 2002. Employment has shrunk from 72,900 when Roth took over and a high of 94,500 people to a projected 45,000 by the end of this year. As of the end of 2001 Nortel's (adjusted) stock price is 44% lower than its

level of $13.16 on Oct. 1, 1997 when Roth took over as CEO.[6] Thus the decline Nortel experienced was far more than the elimination of its overvaluation, and it is this damage that can be stopped if manager's can just say no to the pressure to fulfill unrealistic market expectations.

A number of factors encouraged Nortel's managers to collaborate in this fiction including: maintenance of the value of managerial and employee stock options, a reluctance to admit that management was not as good as analysts were projecting, and in other cases an unwillingness to give up the overvalued equity currency that gave managers leeway to make unwise, value destroying investments. In summary, managerial unwillingness to bear the pain of correcting the market earlier led to even greater pain down the road.

This cycle is not without its costs for the financial community either. Analysts, too, have taken their lumps. Their integrity has been called into question in congressional hearings. The press has pilloried many of the most prominent analysts, contrasting their earnings projections with actual results. Many unhappy clients have terminated longstanding relationships. One went so far as to sue a prominent analyst in federal court.[7] Although that action proved unsuccessful, extensive coverage of the suit in the popular press reflects the depth of disillusionment. Where there is smoke from the public having been burned, political fire soon follows. If the SEC was willing to spend years and significant political capital pursuing restrictions on accounting firms providing consulting services to their statutory audit clients, will the day come soon that regulators become interested in potential conflict of interest between the investment banking and the security analysis sides of investment banks?

Restarting the Conversation

Interdicting this destructive cycle will require restarting the conversation based on a few simple rules of engagement.

- Managers must confront the capital markets with courage and conviction. Managers must not collude with analysts' expectations that don't fit with their strategies, the underlying characteristics of their markets, and the associated results. They must decline to bow to analysts' desires for highly predictable earnings. The art of analysis includes the capacity to understand phenomena like seasonality, cyclicality, and random events. Companies do not grow in a constant fashion with each quarter's results better than the last. In the long run, conforming to pressures to sacrifice value to satisfy the market's desire for impossible predictability and unwise growth leads to shortened careers, humiliation, and damaged companies.

---

[6] The breakeven share price for Nortel investors as of 12/31/2001 is $21.33 assuming a 12% cost of equity capital net of dividends. This implies the breakeven total value of Nortel at the end of 2001 was $68.5 billion. Thus investors lost a total of $44.5 billion as a result of the failed strategy.

[7] Regan, Keith. 2001. "Lawsuit Against Noted Internet Analyst Tossed." *www.EcommerceTimes.com*: August 22, 2001, http://www.newsfactor.com/perl/story/13001.html

- Managers must be forthright and promise only those results they have a legitimate prospect of delivering and be clear about the risks and uncertainties involved. They must dispel any air of unrealism that settles over their stock and highlight what they cannot do as readily as trumpet their prospects. While this can cause the stock price to fall, the associated pain is slight compared to colluding in myth-telling. This reflects more than the good conscience of a boy scout. It is, in fact, an act of self-preservation.
- Managers must recognize that an overvalued stock can be as damaging to the long run health of the company as an undervalued stock. The words of Warren Buffett in his 1988 letter to shareholders are most instructive on this point. He says, "We do not want to maximize the price at which Berkshire shares trade. We wish instead for them to trade in a narrow range centered at intrinsic business value…Charlie Munger [Buffett's long-time partner] and I are bothered as much by significant overvaluation as significant undervaluation."
- While leveling with the markets can cause the stock price to fall to a sustainable level, the associated personal and organizational pain is slight compared to that arising from colluding in myth telling.
- Managers must work to make their organizations far more transparent to investors and to the markets. Diller has chosen to provide analysts with actual business budgets broken down by business segments. At the very least, companies should state their strategies clearly, identify associated value drivers and report auditable metrics on both. That must include addressing the "unexplained" part of their firm's share price—that part not directly linked to observable cash flows—through a coherent description of the growth opportunities they foresee *and a willingness to tell the markets frankly when they see their stock price as overvalued.*
- Similarly, to limit wishful thinking, managers must reconcile their own company's projections to those of the industry and their rivals' projections. Analysts develop models about an industry's growth. If the company's expectations lie outside what is widely viewed as the industry's growth rate, its managers must be able to explain how and why they will be able to outperform their market. Some executives will be concerned or complain that making this all clear to the analysts will reveal valuable information to their competitors. To this, we have a simple response: If your strategy is based on your competitor not knowing what you are doing as opposed to not being able to do what you can do, you cannot be successful in the long run no matter who knows what.

Finally, managers would be wise to remember that analysts are not always wrong. In fact, analysts have a vital monitoring role to play in a market economy. While recent history may obscure that role, managers should not simply presume that analysts are wrong when

disagreement occurs. It is worth noting that during the 1970s and 1980s managers regularly complained that analysts were undervaluing their companies. Although this is not the place for a detailed discussion of those decades, analysts were generally correct that managers of that era were not making effective use of corporate resources. They continued to invest in industries and activities with substantial excess capacity and consequently low returns, refused to downsize and distribute free cash flow to shareholders, engaged in inefficient value destroying conglomerate mergers, and so on. And associated with all this was an active market for corporate control in which competing management teams took over and replaced managers and directors in underperforming companies and created vast new value through hostile acquisitions, LBOs, MBOs, and breakup transactions.

Contrasting the decades of the 70s and 80s with the recent era then yields an important lesson: managers and analysts must pay close attention to each other's views. Both analysts and managers bring important information and important perspectives to the conversation and both sides benefit when each does their task well.

Managers for their part must stop managing expectations and return to managing their companies. Analysts must stop making Nostradamus like predictions and instead return to their true roots—the creation of original research and analysis. The Securities Industry Association issued an excellent statement entitled "Best Practices for Research" in 2001 that lays the foundations for resolving many of the conflicts of interest on the part of analysts. We look forward to their early and widespread implementation.[8]

Stock prices are not simply abstract numbers that exist outside enterprises. Gyrations initiated by Wall Street have real effects on companies and society. The price that Wall Street puts on a company's securities and the trajectory of those prices increasingly affect the nature of the strategies firms adopt and, hence, their prospects for success. Stock prices also drive a company's cost of capital, its borrowing ability, and its ability to make acquisitions. Ultimately, the viability of the companies themselves is at stake.

A dysfunctional conversation between Wall Street and Main Street is not the esoteric stuff of business school classroom discussions. It can rob investors of savings, cost employees their jobs, erode the nest eggs of retirees, and undermine the viability of suppliers and communities. Clearly, it is time to restart the conversation on a new, stable, and enduring footing.

[8] Securities Industry Association. 2001. "Best Practices for Research. http://www.sia.com/publications/pdf/best.pdf