

In Building Premium Shareholder Value

MAKING INVESTOR RELATIONS  
A STRATEGIC WEAPON



**NO ONE LIKES  
A SURPRISE:  
What to be wary of  
to stay out of trouble**



It would appear in this post-Enron environment that the market is extremely sensitive to surprises, to the extent of even overreacting to a mere change in information. As discussed in “*Guilty Until Proven Innocent*” on page 5, the financial community is exercising caution in an environment where trust has been violated. What are some of the specific accounting tactics that are causing many analysts to be so cautious?

**“Pro Forma” Earnings —  
What you see is not  
always what you get.**

Ironically, the broad use of “pro forma” earnings often occurred as much due to the request of “Wall Street” that companies segregate their earnings, as it was used by companies to accommodate for good news and bad news. The request to segregate earnings, however, was made to better understand the quality of earnings and

their predictability. Also, since “pro forma” earnings matched the predictive models of analysts, it provided a more “true” comparison to the consensus earnings estimate. The financial media then latched on to using the “pro forma” results for headline purposes, perhaps supporting management’s belief that the market was valuing them from this perspective. In reality, it is the quality of earnings that should be

evaluated and from which future earnings power should be derived.

Most portfolio managers and analysts will evaluate the implications of the one-time or nonrecurring events leading to a “pro forma” earnings number. They will want to know how it redefines past results and how it will impact future earnings. They will also evaluate the cash implications, and turn to the cash flow statement to determine the soundness of the financial picture of the company. However, the problem with the cash flow statement is that it is usually not published until the

*continued on page 2*

**Inside This Issue**

**NO ONE LIKES  
A SURPRISE**.....page 1

**MAKING IR  
A STRATEGIC WEAPON** ...page 3

**GUILTY UNTIL  
PROVEN INNOCENT** .....page 5



## NO ONE LIKES A SURPRISE

*continued from cover*

10Q or 10K is filed, causing a significant delay as to when a better understanding can be had. What happens? When in doubt — get out. This of course leads to credibility concerns, doubt, cynicism, and eventually a fall in stock price.

### A Strong Balance Sheet — Illusion or Reality?

The core issues at Enron centered on the “independent” entities that were established “off-balance sheet.”

Harboring off-balance sheet entities, which even if done in strict compliance with GAAP, can change the investment profile of an organization when the parent bears risk. The financial community will continue to expect creativity, so long as taking on greater risk is expected to result in greater returns. Yet, not all of your

investors want to bear the greater risk to achieve those returns, because their investment portfolio is not designed for those characteristics.

Not informing your investors of off-balance sheet risks is tantamount to presenting the company as a value-oriented, cash generating

manufacturing company when in fact you are a high growth tech stock with short-lived products. Providing the information to the markets so they can assess their investment interests is critical. Have your activities changed the investment characteristics of the company? Perhaps you are no longer talking with the right investors, and it's time to target those who would find your approach more fitting to their investment style.



### Top Line Truism: Real Revenues

Although clearly defined in accounting regulations as to when a sale is a sale, booking revenues is still open to significant interpretation. This is why revenue recogni-

tion is the topic most frequently investigated by the SEC.

For example, companies can “stuff their distribution channels” or use the tactic that tech and telecom companies used not so long ago of lending money to customers strapped for cash to sell them

product. What happens? In the case of pushing product forward, eventually it catches up to you. Historically, both Gillette and R.J.

*‘When in doubt — get out.’*

Reynolds Tobacco had made attempts at this. Yet, once the market channels have more products than are needed for the current level of demand, new orders fall off, which severely impacts the future revenue stream. How do you explain this resultant fall-off in demand? Did purchasing patterns change so dramatically, or are you losing market share? These are questions you would *prefer* not to have to address.

And, it's important to note what can happen to overfilling the channels when your product has a shelf life. Stale or outdated product can severely damage a company's reputation. Stuffing the market channel is a short-term approach to meeting the expectations of the financial markets that can result in brand demolition.

As to creative financing to make the sale: GE has been effective in this arena because it acts like a financing company. It understands risk, creditworthiness and cash flow. Cisco, Lucent and Nortel all took write-offs because what they recognized was the sale.

*continued on back cover*

## MAKING IR A STRATEGIC WEAPON: *Identify and know your target*

**Y**ou probably have a very *active* investor relations program. Most likely your quarterly press releases are lengthy and thorough, you hold teleconferences that are well received by the attendees, and you regularly present at industry conferences sponsored by brokerage firms. You are probably also responsive to inquiries and have a strong rapport with the folks that tend to pay the most attention to the company. Perhaps you are fairly valued or even trade at a premium relative to peers. But have you *mastered* the discipline of IR?

If you are like most companies, you have probably mastered only the basics and may not yet have recognized the significant insight that can be gained by taking IR to the next level, nor fully realized IR's contribution to value.

By employing a variety of the basic tools of communication and being thorough in the presentation of their results, strategy and outlook, most CEOs, from their perspective, are comfortable with their investor relations efforts. It is comfortable to talk with the investors who are familiar with your story, whom you know on a first name basis, who have weathered some of your ups and downs, and have developed a confidence in management. During tough times, there's a comfort in dealing with the people we know, even if they

may not be pleased with current results.

This comfort can be deceiving, however, and may lead the CEO to believe he has accomplished an effective IR program. At this comfort level of investor relations the complete equation of communication is not being addressed. In communication, there are three major components: the *message*, the *delivery methods*, and the *audience*. This communication model exactly parallels the sales and marketing model, which is made up of: the *product or service*, the *market channel* and the *customer*. A customer-sensitive organization, which by nature is marketing-oriented, is going to have a strong understanding of the market and customers it is targeting for its products. In such a company, intensive analysis of the customer, his needs, his decision making process, and the competition, will drive product development and the marketing and sales strategy. The CEO would expect a great degree of information and analysis of the targeted markets, prospects and customers. And yet, as important as investor relations also are, many companies know little about their investors or potential investors. They have not investigated, for example, their investors' various valuation methods, analyzed their



investment processes nor learned of their purchase and buying criteria or behaviors. If you expect to be fairly valued, *your investor relations*

*strategy should be developed using the same discipline and depth you apply to your sales and marketing.*

According to a report by McKinsey and Company, "What Makes Your Stock Price Go Up and Down" (*The McKinsey Quarterly*, 2002 Number 2), a company can predict the potential direction and degree of change of its stock price given a change in information (for example the announcement of a new strategy). This is similar to forecasting your sales based on a new product introduction: which customers want the new features, which are not interested, how does the change impact their purchase decision? In order to develop your message and information delivery to meet the needs of your investors, you have to know your investors and targeted investors as well as most companies know their top customers and the markets they serve. It takes a thorough investigation to profile your investors with the same analytical approach that you use to address the customers for your products.

You need to understand investors' valuation methodologies, their resulting information needs, their perspective of your company, peers

*continued on page 4*

## MAKING IR A STRATEGIC WEAPON

*continued from page 3*

and industry, and their investment behaviors and processes, such as when they choose to buy and sell. And, not unlike the marketing arena for your product market, there are many variables to consider in your analysis. In marketing, this analysis leads to a targeted market segment – in investor relations, it leads to targeted investors, those with the most propensity to invest in your stock.

There are four parts to the “marketing study” that is needed to identify and reach those targeted investors:

**The Shareholder Profile:** Who is currently invested in your stock, what valuation method do they use, and what is their investment decision process?

**The Perception Audit:** How do current and prospective investors perceive the current value of your company? How do they perceive the future prospects of the company, its peers and the industry? How do they evaluate investment opportunities?

**The Targeted Investment Audience:** Who has the valuation interests that match the investment characteristics and opportunities of your company? What is their profile?

**Strategic Thinking:** How does this information help you with your strategic and operating decisions?

As noted in the report by McKinsey, there are two key changes a company must make in order to adopt a marketing oriented approach to investor relations: “The first is to stop viewing the market as a monolithic entity that is judging a company’s performance in an adversarial way. Second, companies will need to overhaul their investor relations units... to take on a more strategic role.”

It takes an intensive information gathering process, both internally and externally, and rigorous analysis of the results in order to derive an IR plan and program that is strategic, not administrative, in nature. At this level, IR becomes a critical component of your strategic thinking process. More importantly, the significance that IR has on the reflected value of the company can be recognized and measured.

For more on implementing a process to make IR a strategic weapon for your organization, contact Deborah Pawlowski of Kei Advisors at 716.843.3908 or email [dpawlowski@keiadvisors.com](mailto:dpawlowski@keiadvisors.com). <

## MISSION STATEMENT

KEI Advisors provides CEOs with a unique and sophisticated process, the Pinnacle Value (PV) Process, to create premium shareholder value. We accomplish this by closing the information value gap created by the market’s perception of a company’s strategy, prospects and capabilities and by enhancing management’s relations and credibility with investors, analysts and the Board of Directors.

*Our process effectively allocates resources to achieve the intrinsic value inherent in the organization and provides the metrics for evaluating progress and achievement.*

*We assist in value enhancement first by assessing the market’s perception of your company and management. We then employ our unique process to define communications and investor relations strategies, align your communications strategy with your corporate strategy, and develop creative approaches to the capital market. We also help the CEO assist the Directors with their relationships with the financial markets and in fulfilling their responsibilities to investors.*

### Deborah K. Pawlowski

President and CEO has significant corporate experience in investor relations, communications, marketing and management. Investor relations programs that she has managed have been awarded the prestigious Association for Investment Management and Research Award for Excellence in Corporate Reporting and Investor Relations.

### James J. Tanous

Executive Vice President, has over 30 years of experience with a number of publicly traded companies for whom he provides advice on financing, mergers and acquisitions, securities, antitrust and corporate governance matters.

### Raymond P. Reichert

Executive Vice President, brings strong experience in the area of federal and state taxes to the team. His experience includes transactional tax planning for large transactions, review and recommendations on corporate structures to reduce tax implications, and negotiations on behalf of corporations with the IRS and state tax departments.

### Joseph P. Kubarek

Senior Vice President, provides guidance for companies dealing with public securities offerings, private placements, public and private mergers and acquisitions, venture capital financing, takeover defenses, proxy contests, executive compensation and shareholder matters.

### Kayla E. Klos

Vice President, provides in-depth research and analytical skills in evaluating corporate strategic issues and crisis situations including proxy fights.

Kei Advisors LLC

12 Fountain Plaza, Buffalo, NY 14202

Phone: 716.843.3853 • Fax: 716.856.0432

[www.keiadvisors.com](http://www.keiadvisors.com)

## GUILTY UNTIL PROVEN INNOCENT

Even as positive economic news is being reported, there remains a definite wariness among analysts and portfolio managers. The damage wrought by Enron's alleged misleading of the financial markets and its shareholders has caused increased cynicism among those whose livelihoods are based on predicting companies' future economic performance. This increased cynicism has occurred with good reason because misinformation or incomplete



information can lead to large mistakes, which are often very costly.

"At this point, many portfolio managers will reevaluate their current holdings," suggests Greg Ramsby, Director of Small Cap Research of DePrince, Race & Zollo, Inc. of Orlando, Florida, which manages over \$2.0 billion in

assets. He commented, "I am more likely to have confidence in a management that has repeatedly demonstrated that they do what they say they will do. But that does not prevent me from reevaluating their past performance and reporting, and continuing to question reported results to establish a clear understanding of the economics of the firm."

For analysts, the predictability of economic performance is dependent upon the quality of the reported financial information, and the disclosure of the detail of which they are comprised. It is also dependent on the analyst's ability to determine the capabilities of management. An analyst will recast financial statements by adjusting for various accounting practices and disclosures of atypical events. This results in adjusted financials that provide a better basis for determining possible outcomes. If the financial statements harbor inaccuracies or masked results, then the analyst's predictive modeling is thrown for a loop. An accounting adjustment or reported error completely eradicates their past work, thereby not only throwing the analyst's opinion into question but also jeopardizing his or her reputation.

Likewise, if management provides its strategic path and framework for decision-making and then diverges from that direction, the analyst's predictive model is useless. Analysts'

*'If the financial statements harbor inaccuracies or masked results, then the analyst's predictive modeling is thrown for a loop.'*

livelihoods are based on both the financial analysis and the interpretive skills needed to integrate management's stated direction into their financial models. Applying this proven technique, it is easy to see why modeling future performance is so highly dependent upon the past decision making patterns and behaviors of management, the future direction that management provides the market, and management's credibility. A "failure" in any of those areas can cause the analyst's model to come crashing down, and with it management's credibility followed closely by the company's perceived value.

"Managing expectations is a critical responsibility of management. In order to be effective, management must clearly understand the financial model implications of the words they voice to the market," Mr. Ramsby said. "They must be credible, clear, and consistent to develop and rebuild investor confidence."

Our prediction is that it will take improved transparency and more continuous disclosure to rebuild the financial communities' belief in management credibility. The financial markets will most likely not tolerate a company "taking the fifth"; rather they will demand prompt, clear and full disclosure. Therefore, be prepared to reprove yourself – continually. <

## NO ONE LIKES A SURPRISE

continued from page 2

### Pension Funds: Another Good News-Bad News Event Just Waiting to Happen

If overly aggressive assumptions have been used for the discount rate to estimate pension costs and the expected long term return – both of which would have resulted in higher income in past years – how will the future earnings picture look? Will you be caught unaware and realize losses that will have to be amortized in the future, thereby increasing pension costs? Will you make a “one-time” adjustment to re-smooth the reported earnings? Many analysts are paying close attention to the reporting of pensions and are cautious of aggressive assumptions that overstate the current earnings picture. CEO credibility may be severely damaged if this issue comes to light at a time when market conditions no longer tolerate such aggressive tactics.

### The Cost of Options: Shareholder Dilution

The pendulum on options is beginning its inevitable swing back. During the “up market,” issuing options in

lieu of cash compensation was encouraged by shareholders as a means to put management in an “at risk” position similar to their shareholders. Also during these “good times,” managements were encouraged to “share the wealth” among more employees. However, companies that used options to pay employees in lieu of cash were in effect understating compensation expense.

There is another significant impact of options: the dilutive effect it has on the shareholders. As options are exercised, it transfers wealth to management and employees. Tech stocks are well noted for their use of options for employee compensation. Significant use of employee options is a major factor contributing to their current devaluation relative to their highs. This is due to the recognition of true compensation expense and the resulting shareholder dilution.

“Pro forma” earnings, off-balance sheet liabilities, issues with revenue recognition, aggressive assumptions for pension plans, and the dilutive effect of options: because analysts recognize these as opportunities to misrepresent

*‘Tech stocks are well noted for their use of options for employee compensation.’*

the true economics of a corporation, can you question their cynicism as they try to value a company? There are ways to overcome this cynicism, at least with those investors most likely to impact your stock price. You should start by addressing head-on the trends mentioned above. Start by helping analysts and your investors to understand the logic behind the assumptions made in your accounting processes. Provide the additional information needed for thorough valuation. And most importantly, do not resort to the “management manipulation” of earnings patterns that they are taught to watch for in their financial analysis courses.

You may need a more thorough understanding of the current perceptions held by analysts and investors in your company, their valuation approach and methodologies, and their investment behaviors. For help in developing the investor intelligence you need to better address the information needs of the market, call Deborah Pawlowski at Kei Advisors, 716.843.3908. <

Kei Advisors LLC

12 Fountain Plaza

Buffalo, NY 14202

Phone: 716.843.3853

Fax: 716.856.0432

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