The End of Guidance?

While the debate between sell-siders desperate for financial projections and corporate issuers increasingly concerned about their accuracy rages on, the reality of a rapidly changing Wall Street is beginning to overshadow this fight. Investment banks are making deep cuts in their unprofitable research arms, leaving sell-side analysts with smaller teams, a larger coverage universe, and diminishing possibility for success. Their biggest customers – the hedge funds – are lagging market returns, suffering massive redemptions, and in some cases barring investors from liquidating assets in hopes of keeping their funds alive. Given these drastic changes to the audience that public companies will address in 2009, today is an opportune time to re-assess your company's guidance policy.

The root of the issue is increasingly the poor accuracy of many sell-side models. Changes in estimates and ratings, which used to drive significant volatility and opportunity for short-term trading by hedge funds, are having a lesser impact, especially during the recent period of unprecedented market volatility. Few believe that anyone outside of management can provide true insight into a company's performance in this environment. And, sell-side analysts have lost traction by failing to reduce estimates in a timely manner, missing very significant credit issues, and generally leaving outdated or unclear ratings on many stocks. The sell-side is no longer sought out by the buy-side for clarity into a company's future earnings power, but rather the buy-side is redirecting its focus and going straight to the source, looking for transparency directly from management teams.

Before looking at guidance policy itself, take the dynamics playing out on Wall Street into consideration and engage in a constructive discussion on who is demanding guidance and how your stakeholders are using it. Ask the following questions to gain a better understanding of the perception of your company and to help set the tone for communicating guidance information in the earnings process.

- To what degree does the sell-side have influence over your investor base?
- Are particular analysts well-respected in the industry and is their research highly regarded?
- Do you operate in a highly fragmented market or industry that requires a specialty analyst to engage the buy-side?
- Do your sell-side analysts provide industry trends to compare past recessions with the current one?

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- Outside of top- and bottom-line metrics, is your current guidance policy focused on providing the sell-side with appropriate metrics to correctly model the company's operations?

Guidance in the Current Environment

Guidance in any environment should be primarily driven by management's ability to effectively communicate expectations for the company's performance. It should be driven by the business and its predictability and not by the demands of the investment community. And, if the metrics that management is using to measure the performance of the business are changing, the focus of communications around financial metrics and possibly guidance must reflect these changes.

- If your company has some level of visibility, effective guidance comes down to successfully communicating guidance within the context of a variety of factors, including the realities of the current environment, past guidance policy, current expectations for performance and peer guidance policies, among others.

- If visibility is poor and management is unable to provide reasonable expectations for the company's performance, traditional guidance is a slippery slope. It may be painful to make a change to guidance policy, but no one is getting credit for numbers that are not based on reasonable visibility. In fact, providing guidance without communicating the underlying assumptions that support a message of visibility will likely ultimately damage management and corporate reputation if the benchmark is not met.

Irrespective of whether a formal guidance policy is in place (annual, quarterly, or more qualitative), management must first determine what type of guidance makes sense and if any level of guidance is reasonable. There are several additional considerations to think about in structuring your guidance.

- **Change in metrics –** If current conditions are causing a change in the management of the business, then guidance should reflect this change. For example, if the business is now being run to maximize cash flow rather than to drive top-line growth, not only should the communications emphasis reflect this new reality, but guidance, if provided, should as well.

- **Change in timeframe –** For those companies that have traditionally provided full year guidance and now find that visibility is limited to the near-term, a change in policy to a quarterly model, at least for now, may make sense and is certainly a better than providing guidance that has no basis in the realities of the business.

- **Change in the range –** Widening the range to take into account the increased risk associated with potential pressure on results from worsening market conditions is reasonable as long as the underlying assumptions are clearly communicated.

- **Change in pre-announcement policy –** In a complete shift from traditional counsel, today, we believe, there is an increasing need for issuer pre-announcements. In this environment, the divergence between sell-side estimates and buy-side sentiment and expectations requires heightened leadership from management teams. If this means updating guidance via a well communicated pre-announcement, so be it. More than ever, Wall Street is looking to management teams to set the bar and waiting for a formal earnings call to reset expectations or make a restructuring announcement may not be enough. In fact, it may even damage management and corporate reputation to wait on news that the market expects.

Whether or not the decision is made to provide formal guidance, the level of disclosure provided by management teams will be an important consideration for the buy-side as they consider their portfolio holdings and potential investments. Transparency does not necessarily mean quantitative, traditional guidance around revenues, profitability, and earnings. Rather, many are looking for increased granularity on the qualitative drivers of business performance and operational guidance to provide additional clarity on the company's ability to navigate the current environment. The buy-side needs to believe in the company's ability to withstand recessionary pressures and continue to execute on its strategic plan.

To address current and future operating performance, consider incorporating and emphasizing non-traditional elements into the discussion of results and provide directional guidance on these elements when appropriate and possible. The ability to demonstrate effective management of liquidity, cash flow, expenses, capital deployment and working capital, and other operating metrics has heightened importance in this environment where top-line growth prospects can be so uncertain.

Maintaining credibility and ensuring a level of confidence in management's ability to operate in a changing environment is top-of-mind in the buy-side community. Guidance has been and will continue to be an important tool for achieving improved valuation. However, it may not be the best tool in the current environment. If the way you are managing your business today looks different than it did one year ago, so should the way you manage the Street's expectations.