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The Earnings Call:

When Investor Relations Officers Prove Their Worth

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INTRODUCTION

> "Costco shares slumped about 2 percent in early trading, but as [CFO Richard] Galanti started spinning his chicken stories around 10:00 a.m., the stock climbed all the way back." – "Costco Stands Behind Its Cheap Rotisserie Chicken Strategy," *Bloomberg Business* (October 9, 2013)

It happened on an earnings call four years ago, but it's still talked about today. Costco had put up a bad quarter and the analysts on the October call smelled blood. As their questioning of company leaders turned aggressive, Costco's stock began to wilt. That's when CFO Richard Galanti stepped in with the perfect data point: a folksy anecdote about the superstore's rotisserie chickens. Costco's willingness to sell them cheap (and earn customer goodwill in return), Galanti said, reflected its determination to play the long game. The stock recovered as he was talking.

No law requires public companies to conduct quarterly earnings calls, much less to reveal any particular information in them. And as late as the 1980s, earnings calls were unheard of. But today, earnings calls—while often less dramatic than the Costco example—have become a ubiquitous feature of the corporate landscape. Their emergence over the past several decades has been paralleled by the rising profile of the executive responsible for supervising them: the Investment Relations Officer.

First created by General Electric in 1953, investor relations departments were once responsible mostly for disseminating annual reports and other printed materials. They now have much greater influence and respect, due in part to their role in the quarterly earnings call, which has become the single most important point of contact between a public company and the market. In those calls, companies face tough questions, and having the right data point on hand to answer can make all the difference. Costco's CFO had one at the ready, but folksy wisdom won't always do it. And today, it's the IRO who is responsible for making sure that leadership is prepared to answer any questions that come their way.

This paper will first discuss the background of the modern earnings call, and then identify special topics of concern to IROs preparing for them in 2017.

EARNINGS CALL BACKGROUND

History of the Earnings Call

> "They believe in us. They believe we will get this fixed." -- Oscar Munoz, CEO of United Continental Holdings Inc., referring to corporate customers on a 2016 fourth-quarter earnings call, a week after the forced removal of a paying passenger from a United Airlines flight.

No single event is more responsible for the swift and universal adoption of the quarterly earnings call than "Regulation Fair Disclosure," a rule issued by the U.S. Securities and Exchange Commission in 2000. It prohibits public companies from making disclosures to certain audiences (such as a favored institutional investor) and not others, and thus encourages companies to speak to the entire market at once. The quarterly conference call is a very effective way to do that. Likewise, Regulation Fair Disclose discouraged companies from conducting private conversations with market participants (in which they could accidentally or intentionally make a selective disclosure). As a result, earnings calls are often the *only* setting in which a company interacts directly with investors.

Process

> "Steve Jobs stole the show on the call, trashing competitors like RIM and Google, and suggesting that the iPad and iPhone will win against rivals because they are better products at great prices." -- "Steve Jobs Steals the Show on Apple's Earnings Call," *Business Insider* (Oct. 18, 2010)

A small handful of CEOs enjoy such exalted status that their presence is neither required nor expected on quarterly earnings calls. The late Steve Jobs dropped in on calls only once every so often, while the current CEOs of Amazon, Google, and IBM can and do get away with skipping their calls. It's a testament to the importance of earnings calls, however, that beyond this very select group, virtually all public company CEOs participate in them. They, along with Chief Financial Officers, are the most frequent participants.

Earnings calls typically last 45-60 minutes, and most follow a familiar, four-part structure:

- **The Introduction**: In the kick-off to the call, frequently handled by the IRO, the company will address any housekeeping matters and read a safe harbor statement which, pursuant to the Private Securities Litigation Reform Act of 1995, limits the company's liability in the event that its actual results don't live up to statements made on the call.

- **Overview:** Usually delivered by the CEO, this portion of the call is sometimes called "the commercial." It covers the company's strategic vision and major developments like product launches. Special guests, such as division heads, sometimes speak during this part of the call. It sets the tone for the entire presentation.
- **Discussion of details:** The CFO then delivers the financial results, going into income statements and balance sheets, among other facts and figures.
- **Question & Answer:** In the Q&A portion, analysts and investors pitch questions that may relate to topics already discussed, but can also deal with new subjects. The Q&A portion usually takes up at least half the running time of an earnings call.

Most companies tightly control the high-pressure Q&A portion of their calls, and many accept questions only from sell-side analysts. That may be changing, along with other aspects of the now-standard earnings call format. In recent years, Zillow broke ground when it became the first company to use questions submitted via Twitter and Facebook during its earnings call. Yahoo!, meanwhile, amped up the production value of its calls significantly under former CEO Marissa Mayer, broadcasting via high-quality streaming video and a using a set with the feel of a broadcast news program. Another innovator, Netflix, has also broadcast its earnings call via live-streamed video, and replaced the standard Q&A. Netflix experimented with a discussion moderated by a member of the financial press and a sell-side analyst. In contrast to Zillow's approach, Netflix's was perceived as being less open and democratic than that standard Q&A session, and accordingly generated a certain amount of controversy in the investment community.

Earnings Call Participants

> "Our parents are fighting and its awkward." -- Laurent Potdevin, CEO of LuluLemon Athletica Inc., on tensions between company founder Chip Wilson and the board of directors, on the company's 2014 first-quarter earnings call.

Sitting at the intersection of finance, communications and marketing, IROs take center stage in the earnings call process. From helping to craft messaging used in the pre-call earnings release and public filings to writing the call script to prepping the CEO and CFO for the Q&A session, it is in many ways their show.

Other figures of course play a role, beginning with the speakers. The CEO has the ultimate authority over the content of the call, and should be expected to weigh in on big issues such as the extent to which the company wants to project future performance. Regardless, the earnings call is a major event for a CEO—one the market will use to assess the quality of his or her leadership.

Other internal personnel involved include CFOs, public relations, and legal departments (to review forward-looking statements, among other things). Others may be involved as necessary—for instance, marketing and sales executives to review comments about a product launch.

The external audience invited to join the earnings calls varies, but buy- and sell-side analysts are regular participants. Portfolio managers are frequently invited, and even individual investors are also allowed to listen to the call. Members of the press can access the call like any other member of the public, and some companies will schedule a separate press conference call. Other companies prefer to field press inquiries on an individual basis.

Challenges

> "[Nordic American Tankers CEO Herbjorn] Hansson was virtually chased off the most recent call last week by annoyed NAT investors after struggling to answer their more probing questions about a covenant breach, his ageing fleet and the stock's poor performance in recent years." "'Investor Darling' Hansson Under Fire from Investors and Analysts," *TradeWinds* (June 21, 2017)

Many challenges face the IROs tasks in orchestrating the quarterly earnings call, which seems to offer danger at every turn. This is an event that is often criticized for being too boring, while it simultaneously has been shown to have a measurable impact on the market perception of a company.

For IROs, the biggest challenge lies in the information they must master in order to adequately prepare for an earnings call. Their greatest concern is ensuring that neither the CEO nor CFO are unprepared to answer questions being lobbed at them by analysts. To prevent a scenario like the one that happened on the NAT call this summer, they need to absorb news, public filings, releases, and call transcripts not only for the company in question, but for its competitors. That is only the start of work of IROs, who will also want to inform themselves about recent lines of question by the analysts likely to appear—and possibly pose questions—on the upcoming earnings call. Additionally, IROs will want to tag and index their most relevant pieces of information so that they are available to themselves and the call speakers at a moment's notice.

As the below indicates, the topics on which they may have to speak are far-ranging indeed.

HOT TOPICS FOR EARNINGS CALLS

Executive Compensation Disclosures

Executive compensation has come under intense scrutiny by Washington regulators and investors alike, giving IROs ample reason to have answers at the ready on this hot-button issue. Regulatory uncertainty surrounds at least three current compensation-related issues:

- **CEO pay ratio:** In 2015, the SEC adopted a rule implementing the Dodd-Frank Act's requirement that public companies disclose three compensation-related data points: (i) the annual compensation of their

CEO, (ii) the median compensation for all employees (excluding the CEO), and (iii) the ratio between the two. Assuming this Dodd-Frank provision stays in place, these disclosures would be made beginning January 1, 2018. Of course, that's a significant assumption. The Financial Choice Act of 2017, which is through the House (but not, as of this writing, the Senate) would fully repeal Dodd Frank's CEO pay-ratio provision. The SEC could also repeal its own rule on the subject, but cannot do so with just two of its five commissioner seats currently filled.

- **Pay versus performance:** The Dodd-Frank Act contains a provision requiring companies to disclose the relationship between the compensation actually paid to the CEO and other "named executive officers" and the financial performance of the company, as reflected in its "total shareholder return." Pay-versus-performance disclosure requirements were proposed in 2015, and the provision is not affected by the Financial Choice Act.
- **Say on pay:** Under current rules, public companies must give their shareholders an advisory vote on the compensation of top executives at least once every three years. Although the vote is non-binding, a "no" vote from shareholders on a CEO's compensation can be a stinging rebuke. Only a handful of companies have suffered losing votes on executive pay, but in 2017 the shareholders of both FleetCor Technologies and EpiPen maker Mylan voiced their displeasure with large pay packages for their company's executive leaders. The Financial CHOICE Act would require companies to hold votes on compensation only in years in which "there has been a material change to the compensation of executives of an issuer from the previous year." The practical impact of any legislative change is uncertain, given that most companies now give shareholders a "say on pay" every year.

Regardless of what public companies are legal required to disclose on these issues, they are on the minds of information-hungry institutional investors. When the Securities and Exchange Commission indicated that it may delay implementation of the CEO pay ratio rule, for instance, more than 100 institutional investors—including CalPERS and the AFL-CIO—joined together to push back against the proposed delay. These are issues, then, that IROs must be fully informed on and prepared to address.

M&A and Transactional Events

The volume of global mergers and acquisitions dipped slightly in 2016, but that was coming off record levels in 2015. And while the number of transactions fell, the revenue associated with those deals decreased only two percent—meaning that the deals got larger in size. The trend towards megadeals has continued in 2017, with the value of deals targeting the U.S. rising 21 percent in the first quarter.

M&A transactions are transformative events for the corporations undertaking them—all the more so in the case of the colossal deals happening with more frequency. Investor relations teams, which contribute to the messaging around these transactions, have a significant role to play given that institutional investors, buy-side analysts, and portfolio managers are frequently skeptical of M&A as a vehicle for corporate growth. IROs will be asked to champion any M&A transactions that a company makes; specifically, they will be called on to explain the strategy behind the transaction, and to outline plans to integrate the purchased entity into its new owner. Even for companies that are not going through M&A events, their IROs should be prepared to assure audiences that management is seeking out opportunities.

Managing Extraordinary Events

As the responsibilities of IROs increase, their jobs touch more and more events that impact their companies. Cybersecurity and data breaches offer a prime example of this phenomenon. While IROs of decades past would not have been concerned with cybersecurity, the role of the IRO has advanced to the point where IROs must be prepared to address any event that can damage the company's brand or market value, which definitely includes cybersecurity incidents. Shareholders may want to know, for instance, if the company has:

- Inventoried its critical digital assets and put plans in place to protect them;
- Created data breach response plans to mitigate the damage of a successful attack, and apply with all relevant law; or
- Established policies and procedures to mitigate the cyber-risk posed y third-party vendors and other external relationships.

On the cybersecurity front, the IRO has more to do than answer these questions. The investor relations team may well be an integral part of a cybersecurity response plan, fulfilling any duties a company has to inform its investors of a security breach. The IRO should also be actively involved in protecting sensitive financial information from unauthorized release. If IROs were not already attuned to the potential for misuse of the information they trade in, they should have been after hackers recently gained access to thousands of financial press releases and executed trades on the news contained within them.

Beyond cybersecurity, IROs should be prepared to address any global news events with the potential to have a material impact on the business. From Brexit to Congressional action on healthcare, IROs should be ready to disclose how important news events could affect the business, and to discuss how the company has prepared to address the global events with the greatest impact on its operations.

Bringing the Board Into Focus

One focus of increasing investor activism is board representation, making it another area that IROs should be ready to proactively address. Boards and their audit committees are now asked to be fluent not only in cybersecurity, but also the Foreign Corrupt Practices Act, whistleblower claims, and other matters that require a sophisticated understanding of technological and legal matters.

Shareholders may demand to know whether board members—and in particular, members of the audit committee most likely to be dealing with some of the more challenging matters—have the appropriate experience to handle them.

One area of particular attention recently is the diversity of corporate boards. To give just one example, the largest asset manager in Britain recently vowed to start voting against directors at U.S. companies with no women on their boards. And although shareholders rejected the proposal, it's worth noting that two large investors in Apple recently pushed the tech giant to increase the diversity of its board.

The British investor, Legal & General Investment Management, initiated a campaign against all-male boards at British companies two years ago, and it is credited with achieving the appointment of female board members at Jimmy Choo and other companies. Beyond that specific issue, there are signs that "ESG" (environmental, social, and governance) issues are becoming ever more important to investors. Shareholder resolutions on ESG matters increased from 370 in 2016 to 430 thus far in 2017, according to ProxyPreview. And according to Harvard University research, ESG issues account for 40 percent of all shareholder proposals for companies in the Russell 3000. ESG factors are clearly on the minds of investors and, accordingly, should be top of mind for IROs as well.

There is no doubt that the modern IRO has many subjects to master in preparation for the quarterly earnings call. It could be said that having such broad responsibility is the price for being counted among a public companies most important executives. Regardless, there is no reason to believe that a corporation's interactions with its investors will ever diminish in importance; to the contrary, if history is guide, the IRO will only continue to gain recognition for playing such a vital corporate role.