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Maintaining market confidence through an earnings downgrade

"Day one is always ugly – and the six months following might be too. But they'll get over it, you've just got to go for it." – Fund manager

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Introduction

The effective communication of an earnings downgrade can be complicated. The stakes are high and getting the delivery wrong will contribute to the discount that the market places on the credibility of the company and its management.

As the market continues to review and price in a flood of future earnings downgrades in 2020, some companies will also be coming to market needing to raise capital. In this environment, early, open and upfront communication will have a significant influence on the outcomes.

This paper captures the opinions and insights of a leading group of New Zealand fund managers and research analysts, a Sydney-based specialist small cap fund manager and two NZX-listed entities with previous experience – to create a practical communications guideline for companies preparing to downgrade.

The interviews took place between January and February this year and focused on the following two areas:

1. The factors that listed entities need to focus on most when planning for and preparing to communicate a downgrade.

2. Factors material to maintaining or rebuilding trust and confidence.

In response to COVID-19 and the unfolding economic impacts, the fundamental factors identified in this paper are more relevant now than ever.

All but one of the managers and analysts we interviewed felt too many listed entities were not communicating downgrades effectively. A recurring irritation was that downgrades often aren't "one-offs"; they're followed by other downgrade announcements in relatively short order. In certain cases this comes down to a lack of genuine introspection of the issues and the causes.

Further, the factors that rapidly erode confidence are a lack of genuine ownership, overly optimistic assessments of the fix and, most of all, any sign of spin.

The guideline is presented in three short and simple chapters. Skip to chapter two for the most practical elements if your company's planning is already underway.

Chapter one: you need capital on call in the Bank of Reputation

Establishing a baseline of goodwill ahead of an earnings downgrade will influence what happens at the outset and along the road to recovery. Think of it as having a solid cash reserve for times like now – without it the road ahead will be uncertain and painful.

Importantly, market participants we spoke with understood that an earnings downgrade is an expected part of a business cycle.

Therefore, building your company's reputation through an effective programme of communication should focus on areas including establishing a healthy baseline understanding of the company's earnings profile and its people, competitive position and overarching strategy.

For insights on drivers of effective reputation management, read SenateSHJ's recently published Reputation Reality report.

Chapter two: leave no stone unturned

During an earnings downgrade cycle the market will demand clear, concise and carefully considered communication.

Management credibility and pricing risk are the two big things the market is looking for. The market will discount the stock price if it thinks management isn't credible. This perception will be driven by two key factors: it thinks there are potentially more downgrades to come; and it may be questioning whether management has the capability to pull the company out of the situation.

The market will be looking, and listening, to understand whether a downgrade is cyclical or structural.

A cyclical downgrade is relatively straightforward from an announcement perspective. Changes occur. Often these are temporary, and as long as management has a clear and robust plan to address them, the market will be fairly understanding.

A structural downgrade often carries a fundamental underlying performance risk, which makes maintaining trust and confidence more complex.

As one fund manager commented: *"We appreciate that from a management team perspective if you start with a structural issue and believe the board and management can self-help their way out of it, it is important not to go overboard at the outset. What we will be looking to assess is the strength of the fix-it plan, and whether we have confidence that the right team and resourcing are in place to manage their way through this.*

"We value frankness and we'll listen and look carefully to understand how open and upfront management are about the problem.

"We understand the challenges of being in business; all companies go through pain at times. What we worry about are the companies where everything's too rosy. While no one likes to present bad news in detail, it generally pays off in the end."

Another perspective came through consistently: *"Companies should not be afraid to knock the trust thing on the head early by being frank when the shit hits the fan. And back your team to show its capability over the long run."*

Building the narrative – what the market expects to hear

There will be an expectation of a certain level of self-reflection at the announcement – particularly when it involves a structural downgrade. Therefore, stop and consider:

- What commentary has been provided previously that may relate to the downgrade?
- What indication, if any, has been given of a possible earnings headwind?
- While the market doesn't like surprises, it does understand forecasting can be difficult. However, if you haven't accounted for events that have been emerging for a while – such as slow-moving regulatory reforms – patience will be tested.
- If the narrative until now has included promises of new contracts and growth that are no longer materialising, the market will be looking for a sacrifice(s). The greater the downgrade, the greater the potential sacrifice expected.

Next, start writing down and testing internally within your team:

- What went wrong? And why?
- What's the rationale behind the new forecast?
    - Stress-test the new numbers to establish what a best-case versus worst-case scenario looks and feels like.
    - Be conservative when landing on the new number. Having to go back to the market a second or third time may be the start of a death by a thousand cuts.
- Set out in bullet-point form the rationale for the new numbers.
    - Challenge this from all angles as you frame up a workable message set that can hold water.
    - Again, challenge whether the company is ready and able to provide a new set of numbers. If there's too much uncertainty and the objective is to rebuild confidence, be open and upfront about where the company is at, and focus on the roadmap to presenting a new set of numbers.

This simple exercise will force your team to think about the new numbers in a way that might help avoid a second or third downgrade.

Roadmap to recovery

The remediation plan needs to strike the right balance between the extent of the downgrade and the actions required to restore confidence.

Companies needing to raise capital and starting from a low reputational baseline may need to demonstrate significant sacrifices to provide the market with the confidence it requires for them to stay in the game.

Companies need to be prepared to adopt tough measures from the outset. The market participants we spoke with pointed to a broad range of initiatives, including:

- Capital management initiatives that include a commitment to go further if required.
- Possible changes at board and/or management level.
- Reviewing and possibly freezing dividend payments.
- A commitment from key people to acquire stock as a sign of confidence in the company's long-term fortune.

Announcing the downgrade

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Key points to factor in:

- Don't attempt to wing it.
    - Have you rehearsed as a team? Even if one team member is a confident presenter, you're only as strong as the weakest link.
    - Allow the time and space to go through your paces together.
    - Have clearly defined speaking roles and responsibilities.
- Have someone outside the team sense-check and stress-test your announcement plan.
    - This is particularly relevant for small and medium-sized listed entities, which may have few internal resources and little expertise and/or experience.
- Focus on telling it all, and telling it once.
    - The market participants we spoke with raised concerns about companies briefing groups in an ad-hoc and inconsistent manner. This can lead to some parties ending up with more information than others.
    - Hold a single briefing for all to participate in, and ensure there's an audio recording filed with NZX that day for those who can't.

- Factor in enough time to brief key media.
    - Don't expect them to have an existing knowledge and understanding of the company's strategy – particularly when you haven't invested the time to engage with them.
    - Ensure media spokespeople are well briefed and rehearsed.

Chapter three: under-promise and over-deliver

The overarching principle must be to under-promise and over-deliver. This is not new; however, a common point emphasised throughout our interviews was that companies that have got it wrong and continue to do so have failed to meet this basic hurdle.

Good market communications will be planned and built on ensuring transparency, visibility and delivering tangible results that relate to milestones set out in the roadmap to recovery.

Be mindful that updates are only valuable at key milestones, and actually help the market to form a genuine view of the recovery.

Steer clear of light and fluffy updates that don't contain material news. They can have the opposite effect when trying to rebuild confidence.

This paper is not intended as an exhaustive communication guideline. For further assistance with your communication planning, contact:

Hugo Shanahan: hugo@senateshj.co.nz / +64 275 111 561

Kate Walsh: kate@senateshj.co.nz / +64 21 858 619

Neil Green: neil@senateshj.co.nz / +64 21 660 872

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