THE CONSENSUS ESTIMATE CONUNDRUM

With time and patience, you can help ensure your company's consensus estimates are accurate and up-to-date.

By Margo Vanover Porter

When consensus earnings estimates for your company are released by third-party organizations, do they accurately reflect your internal projections?

Do these consensus estimates agree with the earnings models analysts use to calculate their projections?

These are among the tough questions that investor relations professionals must wrestle with on a regular basis.

As long as the news media and the investment community focus on whether or not a company meets or beats expectations, you must ensure that the company's consensus numbers are spot-on, insists Ellen J. Roberts, former vice president of investor relations, Wilmington Trust Corporation. Otherwise, your company's reputation could suffer.

"The headline risk is terrible," she says. "The headline is always really big when you miss. The headline is much smaller when you meet or exceed, unless you exceed by a great amount. Generally, conventional wisdom says it doesn't matter whether you beat or exceed, the point is if you miss either way, there is an inference that your ability to project is lacking."

So how can IROs ensure consensus estimates — and the analyst estimates on which they are based — are accurate and up-to-date? IROs agree that, like it or not, you must routinely double-check the outside world's numbers against your own internal projections.

Although it occasionally gives him heartburn, Mark Namaroff every few weeks asks his stock surveillance analyst to provide the

numbers from third-party vendors, such as Thomson Reuters, Bloomberg, and FactSet. "I compare them against the models," says the director of investor relations and corporate marketing for Analogic Corporation. "I do this every couple of weeks to keep track of the changes."

He routinely finds what he considers to be inconsistencies across-the-board. "Right off the top, the estimates that are published by these services don't agree with the models," he says. "This requires an IR person like myself to get in touch with the analysts to have them resubmit their models or call those services to correct them or to get in touch with the service providers to make sure they understand the discrepancy. It can be a vicious cycle."

He recalls reading a report on a recent quarterly earnings call indicating that Analogic beat consensus on non-GAAP earnings per share, which he deemed a good news/bad news situation. "Our internal analysis indicated we fell short of consensus," he says. "It was a good problem, but it wasn't correct. We just met consensus. A lot of analysts reported very favorable results for us. In actuality, it wasn't the case. Usually these problems are discovered after they are published. Then you're saddled with trying to manage Street expectations."

He worries that just the opposite could also happen — a transposition of a number or data entry error could cause a vendor to erroneously publish a consensus estimate indicating the company fell short of its intended mark. "If there is a report out about us missing consensus, where in actuality I met consensus, it could cause the stock to trade in a negative way. I'm very concerned about investor perception of us and how we are performing on a quarterly basis."

GAAP and non-GAAP results also pose a problem. "That's another headache for us. I check to make sure our analysts are reporting GAAP and non-GAAP numbers correctly based on what we give them from quarterly results. The service providers sometimes mix up the GAAP and non-GAAP or sometimes they publish the same number for both. We haven't yet figured out why they do that."

What's the Problem?

In addition to an occasional data-entry mistake, a hazard in any office environment, IROs encounter what they classify as inconsistencies in and confusion about what should be included in — and excluded from — the consensus estimates.

"This is a communication issue," Roberts emphasizes. "It's not a matter of vendors reporting the wrong number. They're just plugging numbers into a calculation. Now, occasionally there is a typo or data-entry error, but the issue is much larger and has predominately to do with the fact that no two sell-side analysts build their financial models in the same way. Some base their estimates on operating results; some base their estimates on GAAP results. Some include certain items; some exclude other items. You're not playing on a level field to begin with."

She believes service vendors should draw attention to analyst estimates that are out-of-pattern. "If four or five modeled their estimates on a GAAP basis but one modeled on a non-GAAP basis, that estimate ought to be asterisked or noted that it's not an apples-to-apples comparison," she says. "It would be irresponsible for a reporter to say, 'Consensus was X' if that calculation was a mishmash of operating and GAAP estimates and only includes a small portion of the analysts. If I have nine or 10 analysts and only half of my coverage is represented, I don't think that's consensus. That doesn't meet the spirit of the definition."

In her opinion, fact-filled footnotes might help investors understand the methodology behind measuring a company's value in 90-day slices. "Just in the same way that all of us who are making financial disclosures that are footnoted out the wazoo, the vendors should be required to notate whether analyst X is using a different methodology than analyst Y. Specifically, I would make the point of whether it's a GAAP-based estimate or a non-GAAP or operating estimate. I think the vendors should also be required to disclose whether their number considers all of the sell-side analysts' estimates that are available."

She suggests an explanation could read something like, "Our consensus estimate includes five, but 10 analysts follow this company."

Sorry, Your Estimate Doesn't Count

When asked how his company formulates consensus estimates, John Butters, senior earnings analyst, explained the procedure at FactSet Research Systems. "Basically, we have an agreement with analysts that we will use their data in the mean estimate," he says. "In exchange, we have access to their research notes. We have a back-end group that goes through the notes and pulls out relevant data on EPS estimates, target prices, and so forth and then goes into the database, which eventually results in the mean estimates."

To keep an apples-to-apples comparison, FactSet excludes from the consensus estimate analysts who fall outside-of-pattern. However, to avoid confusion, estimates from all contributing analysts, whether or not their estimates are part of the market EPS, are published and visible to clients.

For example, when they click on a market EPS estimate of Bank of America to access the contributing individual broker estimates, clients will see a list of analysts/estimates that are included in the market EPS; a list of analysts/estimates that are excluded from the market EPS; a list of analysts/estimates that are included in the alternate/minority basis (GAAP or Non-GAAP) EPS; and a list of analysts/estimates that are excluded from the alternate/minority basis EPS.

Joy Gillis, principal, Hanover Square Investor Relations, doesn't like it when service vendors ask out-of-pattern analysts to conform with the majority of their peers. "Post what the analysts have come up with, and let us sort it out," she asserts. "I've talked to them [third-party providers] repeatedly and their approach is 'We are going to take the majority and try to force the other analysts to come into line.' We've gone round and round about it."

Eliminating even one estimate can significantly alter the outcome for companies with a limited analyst following, Namaroff points out. "For us at Analogic, if you exclude one out of the five, it has a huge effect on the average," he says. "For a company with 20 analysts, it may not be a big issue."

Develop a Road Map

To ensure her client's data stays up-to-date and accurate, Gillis subscribes to a third-party service, checking it every day. "My client companies depend on me to provide them with what's going on in the market. So as soon as I see a discrepancy, I get it resolved by building a really good relationship with the customer support team. They know me well. Every time I call in, they make notes. They have been excellent in responding to any issue I have. If there is something that is not right and I know the rest of the market world is looking at it, I get all over it until it gets fixed."

With 22 analysts writing research and publishing financial models on his company, Robert Borchert devotes considerable time to monitoring the estimates. "We do not subscribe to any of the primary services," explains the senior vice president of investor and corporate communications for MedAssets Inc. "We don't have direct access to those databases so we need to reach out directly to the earnings estimates analysts at each of those firms to try to validate on a quarterly basis their consensus estimates. The challenge is 'What's the best way to validate that information?' For small capitalization companies, like MedAssets, where the investor relations department is three people — me, myself, and I — you have to prioritize and find ways to streamline the process."

He has settled on a system where every quarter he borrows the services of a financial planning and analysis associate from another department. Together, they update the company's internal consensus model and then examine, line by line, 22 analyst models by segment revenue, consolidated revenue, adjusted EBITDA, GAAP EPS, and so forth.

"This provides the road map to reach out to third-party consensus vendors," he says. "If we identify a significant variance, we dig into each analyst estimate to find the inaccuracy. In many cases, we can send the vendor a screen shot of our consensus estimates by firm Excel page so the vendor can compare it to the data in [its] system. It is a hand-holding exercise every single quarter."

For example, Borchert explains that he recently contacted a third-party vendor to identify his new contact — his previous contact had left the firm — and try to establish a relationship. After explaining that his goal was to keep the estimates as accurate as possible, he asked the new contact to examine his company's estimates. Two were wrong.

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—Ellen J. Roberts

"Both were adjusted EBITDA estimates from two of our largest sell-side firms. One estimate, which was four months old and after we had revised our financial guidance for 2011, was $15 million higher than most of the other estimates, therefore skewing the consensus higher. At the same time, the second EBITDA estimate should have been excluded from consensus because they are one of the firms that do not add back stock compensation expense. Therefore, the estimate was $12 million lower."

Wanted: Magic Wand

On such a complex issue, IROs agree there are no easy answers. "If there's a magic wand you could wave to fix this, I certainly don't know what it is," Roberts claims. "But I think that education is probably in order for both the vendors and the reporters."

Meanwhile, Borchert encourages you to keep checking those estimates. "It's the investor relations officer's responsibility to work through these challenges, to track the consensus estimates on a continuous basis, and to resolve any issues in a timely manner. You cannot blame a third party because these are your analyst estimates. You need to take steps every quarter to make sure those estimates are as accurate as possible."

"We'll never be 100 percent," he adds. IRU

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