Using Investor Relations to Maximize Equity Valuation
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Using Investor Relations to Maximize Equity Valuation

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# Contents

## PREFACE

**A Brave New World of Investor Relations**  ix

## INTRODUCTION

**A New Approach and Why It's Important**  xiii

## PART ONE

**Capital Markets and Their Players: A Brief Primer**  1

**CHAPTER 1**

The Capital Markets and IR  3

**CHAPTER 2**

The Sell-Side Disclosed: Who They Are and What They Do  13

**CHAPTER 3**

The Buy-Side: Institutional and Retail Investors  21

**CHAPTER 4**

Employees, Suppliers, Customers  25

**CHAPTER 5**

The Media  29

## PART TWO

**Post-Bubble Communications: Events in the Markets and the New World of IR**  33
CHAPTER 6  
Greed Is Good, ‘90s Style  

CHAPTER 7  
Of Rules and Regulations  

CHAPTER 8  
Post-Bubble Reality  

CHAPTER 9  
Of Reason, Renewal, and Honesty  

PART THREE  
Investor Relations—The Fundamentals: Traditional IR and the Need for Change  

CHAPTER 10  
Traditional IR: What It Is, and Why It’s Not Enough  

CHAPTER 11  
Staffing and Sourcing the New IR  

CHAPTER 12  
Grasping the IR Evolution  

PART FOUR  
Investor Relations—Maximizing Equity Value  

CHAPTER 13  
Positioning IR to Succeed  

PART FIVE  
Definition  

CHAPTER 14  
The IR Audit
CHAPTER 15
Excavating Value Post-Audit

PART SIX
Delivery

CHAPTER 16
To Guide or Not to Guide: That Is the Question

CHAPTER 17
Targeting the Audience

CHAPTER 18
Integrating with PR

CHAPTER 19
Infrastructure/Disclosure Check

CHAPTER 20
Delivering the Goods

PART SEVEN
Dialogue

CHAPTER 21
From Delivery to Dialogue

CHAPTER 22
Maintaining and Building Relationships

CHAPTER 23
Meeting The Street

CHAPTER 24
Event Management

CHAPTER 25
The Banker Mentality
## CONTENTS

CONCLUSION  
   A Call for Change  

APPENDIX A  
   Two Press Releases  

APPENDIX B  
   The Conference Call Script  

APPENDIX C  
   Velocity Inc. 2004 Investor Relations Plan  

INDEX  

245  
249  
255  
261  
267
Preface
A Brave New World
of Investor Relations

If a chief executive officer or chief financial officer wanted to hire an outside agency to help management more effectively interact with sell-side analysts, investment bankers, and portfolio managers, it would seem obvious that the best person to hire, especially if the shareholder implication of the decision were really thought through, would be someone who had senior-level, first-hand experience as a sell-side analyst, an investment banker, or portfolio manager. At least that’s our view, one that seemed obvious. Yet, almost every day, corporate America’s best management teams make the decision to put investor relations in the hands of professionals who don’t have the appropriate background.

Choosing the wrong investor relations support can add risk to the already risky business of dealing with Wall Street. After almost a decade of seeing corporate communication blunders that lose shareholders billions of dollars in value, we became convinced of the tremendous need for a more professional, strategic, and capable approach to IR.

Along with John Flanagan, our lawyer and founding partner, we started Integrated Corporate Relations in 1998 in a small office above an antiques store in Westport, Connecticut. We’d both been senior-level equity analysts on Wall Street and covered exciting industries while enjoying the opportunity to become experts on specific companies and industry sectors. Similar to most equity research analysts during the 1990s, we worked long hours under stressful conditions to be the go-to guys who knew the companies, the management teams, and the underlying fundamentals that would presumably move our stocks.

As analysts, our job was to take information, both distributed by the company and that which we uncovered, and conduct in-depth analyses of these businesses and their earnings potential. During that process, however, we often found a costly communications disconnect that invariably penal-
ized the companies (in terms of valuation and cost of capital) and investors (in terms of declining share price).

The culprit? The problem was nothing more than a general lack of expertise on the part of management teams with regard to dealing with The Street and managing the nuances of the stock market. All too often, there was unnecessary confusion, uncertainty, and caution, leading to an arbitrage between reality and perception.

During that process we frequently witnessed management teams struggle with interacting and communicating with The Street, and we realized that if we were privy to the details of any given situation, we could really make a difference. That’s why we crossed the capital markets divide, so that we could help transform not only the perception of investor relations, but also its importance to a company’s long-term success.

As former analysts, we saw the complicated relationship between corporations and the investment community and realized we were probably the best-qualified third party to give counsel on strategic IR issues. This type of advice was certainly not the job of legal counsel, who most likely never had spoken to an analyst or portfolio manager as part of his or her job. Nor was it the task of the big accounting firms that advised CFOs on other important reporting issues. Most importantly, we strongly believed that it wasn’t the job of a third-party public relations firm, staffed in all likelihood with PR experts and communications majors. While these professionals may be at the top of their game in many communications-oriented situations, they simply don’t have the background to advise management teams on complex capital markets–based, strategic IR issues. Nonetheless, this type of firm was dominant in the business of investor relations although there is no guarantee that the landscape will remain that way.

We came to IR because we believe that former sell-side analysts and portfolio managers have the unique experience to advise CEOs and CFOs on how to deal with the markets. As analysts, we understand how research, investment banking, and sales and trading coexist and interlock to drive profits at investment banks. Understanding this point is critical to positioning a company and advising management on how best to approach any sell-side firm. We also understand exactly what portfolio managers are looking for, and how it can change from quarter to quarter. In essence, we package the product for the sell-side and the buy-side (the buyers) because we’ve sat in those seats.

Currently, many CEOs and CFOs dismiss IR as too costly or unnecessary. That’s a precarious stance on a communications function that, at its best, can lower a company’s cost of capital and, at its worst, can destroy management’s credibility, as well as hundreds of millions of dollars in share-
holder value. The new world of corporate affairs must position IR at the tip of the spear, leading the communications strategy to preserve and enhance corporate value.

We created our company to improve the IR equation. In the past six years, we’ve gathered an exceptional team of Wall Street sell-side and buy-side professionals, including our president Don Duffy, a former portfolio manager, and James Palczynski, a former sell-side analyst. We like to think that we’re redefining investor relations, and despite a mixed market over the last few years, our business has flourished. Why? We believe it’s a direct result of the value proposition a group of former capital markets professionals can bring to the IR process.

We have also taken a fresh look at the practice of corporate communications in general and launched a PR group run by Mike Fox and John Flanagan. We’ve challenged the established practices of many of today’s largest corporate communications firms that see IR on a lower rung of the corporate communications ladder. We strongly believe in shaking up that mind-set. Our view of the world is that IR strategy, focused on long-term equity value, should be a force in all corporate communications decisions, providing a check and balance to PR issues that, if not handled properly, could erase market capitalization, and raise a company’s cost of capital.

All of our senior professionals come from Wall Street. We understand the science and the art of the stock market, and we help corporate executives better direct their time and money to optimize performance, increase profitability, and spur growth. In our view, the transformation is beginning to take hold and was accelerated by the bear market in 2000, 2001, and 2002; corporate malfeasance; stepped-up government regulation; and a renewed commitment by many to fix the system.

This book is about our approach. We believe that every company executive and investor relations officer must understand certain basic communications essentials in order to facilitate efficient capital markets understanding and optimal equity valuation. IR can also play a decisive role in the competitive performance of private companies. We have helped many private companies find a voice on Wall Street without sacrificing the privileges

“Our view of the world is that IR strategy, focused on long-term equity value, should be a force in all corporate communications decisions.”
of being private. Any private company that does not utilize IR in its strategy is missing out on an opportunity to affect its competitor’s cost of capital and bolster its reputation with investment banks that could eventually take it public.

In the following pages we relay the tools we employ to help our clients maximize equity value. We call it “capital markets advisory,” but in reality it’s what investor relations ought to be. It starts with definition. In order to help a company reach its best possible level of performance, one must have a thorough understanding of what adds value to, and what detracts value from, a stock. It continues with delivery. Corporations must understand how sales and trading, research, and investment banking work together, and how they can take advantage of this understanding to best benefit shareholders, employees, and the company as a whole. Dialogue rounds out the process. This book is for the corporate executives, investor relations officers, analysts, bankers, and investors who want a better understanding of the process.

As we see it, management needs to gather advice from very experienced analysts and portfolio managers when trying to navigate the choppy waters of Wall Street. IR practices at larger agencies have become exposed for what they are: namely a commodity service frequently incapable of providing solutions for complex capital markets issues. We believe that we’ve come up with a better mousetrap for IR, and we’re pleased to share our thoughts with you. We hope you enjoy the book.

Tom Ryan and Chad Jacobs

Westport, Connecticut
May 2004
Introduction
A New Approach and Why
It’s Important

Earnings are coming in low, the CEO’s about to resign, inventory is up, and the cost of new equipment just doubled. It’s a sure thing where the stock price is headed, right?

Not necessarily. When it comes to the stock market, Adam Smith’s invisible hand has been known to get a gentle tug from a variety of constituencies. There’s the company itself and the information it provides. There’s the equity research analysts who offer their intelligence and opinions on the company and the industry. There’s the media and the stories they present. Rounding out the mix are all of the stakeholders, such as employees and strategic partners, and the long arms of their actions and opinions.

All of these constituencies influence those most affected by the tug, the investors. From sophisticated institutions to ordinary individuals, investors depend on reasonable information upon which they can make sound decisions. The company’s responsibility is to seed the substance and direct the form of this information, and IR is at the core of this responsibility.

Though the long-term value of a company’s stock correlates reliably to a company’s long-term financial performance, the short-term price is vital to keeping cost of capital low and maintaining a competitive advantage. We believe stock price or equity value, is the tangible consequence of an obvious, but often mismanaged, equation:

Equity value = Financial performance + How that performance is interpreted by a variety of constituents

A company’s underlying fundamentals and industry outlook are important. The company must understand its strengths and weaknesses in the context of its competitive environment to attract the investors and investment banks that present the best fit to come along for the long-term journey. How
that story is told is critical. Packaging the information for each audience must be done in the same way that gifted executives package and sell their products. The bottom line is that public companies are in a sense products to Wall Street, and Wall Street is the market for public companies. Let the commerce begin.

Information alone does not determine stock price; it’s also the interpretation and perception of that information. Recent stories from The Wall Street Journal’s What’s News, Business and Finance column read something like this:

- An apparel company said its net income was overstated and that its third quarter results were lower than reported. Stock slips in a sell-off.
- A technology company’s shares fell 10 percent on worries about more disclosures of accounting irregularities. Finance chief quits.
- An entertainment company’s distribution deals are the subject of a grand jury probe into potential conflicts of interest. Stock price slightly up on low volume.
- An Internet company’s earnings jumped 69 percent and sales surged 84 percent, beating forecasts. But its shares fell in after-hours trading on high volume.

These examples are certainly a mixed bag with some counterintuitive market reactions. The most likely reason that the entertainment company’s stock didn’t move on bad news is the result of a consistent and clear IR strategy and how that strategy managed expectations leading up to the event. Chances are that the entertainment company’s stock was already down and that new management dealt with the problem transparently and quickly. Although there may be no catalyst for the stock (as evidenced by the low volume), the worst is likely over. The news was likely compatible with shareholder understanding of management’s assumptions regarding future performance, and that’s exactly the situation that company wanted to be in given the circumstances.

How about the Internet company? In all likelihood, the company had been growing quickly and ignored IR while earnings were accelerating, a common mistake. Without the proper strategy to control the sell-side, estimates and expectations increased, leaving 69 percent earnings growth as a disappointment. Too bad for the tech company’s management team that was on the verge of an all-stock takeover of a rival company. Their stock just plunged, and that acquisition just became materially more expensive or out of the question altogether.
The thrust of traditional investor relations has included necessary disclosures, such as annual reports and 10-Qs, as well as communications, such as press releases and conference calls. As most IR professionals and Wall Street experts know, this approach is not enough. Companies that are increasingly aware of this fact look at IR more strategically than administratively. This strategy shift must include proactive counsel that understands the capital markets, positions the company properly, and cultivates interest and investor confidence. The goal is to heighten management credibility, generate third-party validation, and improve the company’s exposure to potential investors, all to maximize equity value.

IR helps a company devise a strategy and present its story based on quantitative and qualitative attributes, competitive issues, the industry situation, and most importantly, the current valuation. In order to do this well, IR must have the capacity to act as a peer or confidant to the CEO, CFO, and the board of directors. Additionally, IR must advise on a variety of issues from union relations to project development to dividend yields to crisis management. IR must be able to solve problems and communicate issues in the context of shareholder value, and do it quickly. This is the language of the CEO, and it’s the basis on which he or she is compensated and judged. And IR can’t talk the CEO’s language unless IR understands valuation and capital markets. Period.

Part One of this book provides a quick overview of the capital markets, the arena, its players, and how IR works with all of these areas.

Part Two covers the current environment, including what happened during the boom and bust, the rules that surfaced, and the regulatory environment.

Part Three looks at the basics of IR, including administrative and strategic tasks, internal and external communications, and the changes we see coming.

Part Four presents IR with dimension and reveals the practices that marry IR, corporate communications, corporate strategy, and ultimately equity value. In this section we answer:

What goes on in the day of an analyst?
What are the portfolio managers looking for?
How can a company uncover value?
Why is guidance so important?
When is the best time to release earnings announcements?
Why and when should a company ever pre-announce?
How can a teach-in boost a company’s visibility?
Why are Wall Street’s morning meetings key to IR strategy?
What are the landmines that CEOs can set off with just one wrong word?
What is the most effective time for insiders to buy or sell stock?
How can a company best deal with short sellers?
What is plan B if a company can’t get coverage?
How do mid, small, and micro-caps stand out in a crowded field?
When are private companies missing out if they don’t have IR?
How can a company prevent the whisper number?
When is bad news better than no news?
Who’s not being honest, and how can a CEO get real feedback?

IR should be the tip of the spear of any financial communications strategy and help management define the tangible and intangibles of valuation, deliver a company story, and navigate the nuances of the capital markets dialogue to maximize equity value.

In addition, the caliber of a company’s IR and the ability to untangle complex communications problems must be upgraded and handled by people with applicable experience. To us, it seems like common sense. A company that is going to hire a third party to navigate its course on Wall Street should retain someone with senior-level Wall Street experience. But then again, common sense isn’t always so common.
This portion of the book provides a very basic overview of the capital markets: the arena, its players, and how IR works with all of these areas. The IR skills and tools necessary to manage this arena are only briefly presented here, and then discussed in-depth in Part IV.
CHAPTER 1

The Capital Markets and IR

No public company operates in a vacuum. In fact, many people, including regulators and competitors, generate opinions that can affect a company’s position in the capital markets. Every decision a company makes, whether financial, strategic, or operational, ripples into the capital markets and affects the stock price, the competitive position, or the public’s perception. Anticipating and assessing the impact of corporate actions on the capital markets, whether from an acquisition, a change in dividend policy, or a new product introduction, is the function of investor relations (IR).

The underlying premise of the capital markets is to connect those who have money with those who need money. However, this match must be made in a mutually beneficial manner. To that end, the sell-side, the middlemen and -women, must bring quality companies that need capital to Wall Street to sell equity or debt to the buy-side, managers of trillions of dollars in capital. What about companies that already have money and want to grow? They seek out the sell-side, who can help them acquire or divest of businesses or divisions. These transactions too must be beneficial to the buy-side, and to ensure that value is created, shareholders must approve these actions.

So who are the sell-side and the buy-side? The sell-side is made up of firms like Goldman Sachs, Bank of America Securities, S.G. Cowen, Wachovia, RBC Securities, Merrill Lynch, and Piper Jaffrey, to name a few. They are known as investment banks or brokerage firms, and they employ bankers, institutional salespeople, traders, and research analysts. The buy-side is composed of investors. The majority of these are institutional or professional investors, like Fidelity, T. Rowe Price, and Wellington Management, and they control huge amounts of money, usually from funds, endowments, or pensions. Simply put, they are true professionals who invest
on behalf of their clients. Other investors include individuals who put their own money into the capital markets pot.

Generally speaking, companies that need money can get it in one of two ways. They can take it in exchange for a piece of the company—that is, they can sell equity or ownership, by giving the investor shares of stock in the company. Or they can borrow the money, and pay it back to the investor with interest, selling the investor debt—for example, bonds. On the other side of the equation, those who want to invest their money can do so, again generally speaking, in either stocks or bonds, and there are usually specialists in each area. (Of course, hybrid financing vehicles, like convertible bonds, are an option, but this discussion focuses just on equity and debt.)

Equity shares can be traded publicly on either the New York Stock Exchange or The American Stock Exchange, which are open auction floors, or the NASDAQ and Over-The-Counter exchanges, which are buyer-to-seller negotiated systems. Debt trades publicly on the bond or fixed income markets. A company that has equity or debt that trades publicly is subject to the rules and regulations, significantly augmented and expanded in recent years, of the Securities and Exchange Commission.

INVESTOR RELATIONS, TAKE 1

Publicly traded companies are required to provide certain information to current and potential investors. This information includes mandated SEC disclosure documents, such as annual reports, 10-K filings, proxy statements, quarterly 10-Q filings, and 8-Ks that announce unscheduled decisions and actions. Additionally, there are the day-to-day goings-on of the company, marketing strategies, operational decisions, acquisitions, and general business fluctuations that, if deemed to be material, can be shared with investors.

All of these communications are supported by other vehicles such as

Though the SEC does not have a specific definition for material information, the term is generally interpreted to mean anything that would affect the understanding and decision making of an investor—i.e. anything that would cause a rational investor to act.
press releases, conference calls, and management presentations, whether live or Web cast.

In most cases, the packaging and distribution of this information is the responsibility of investor relations, as IR is the filter through which all financial communications come out of the company. (See Figure 1.1.)

Companies have either an IR department or an executive designated with IR responsibilities, and many companies supplement the IR function with outside IR counsel. IR counsel, either internal or external, not only administers disclosure responsibilities but, in a perfect world, works to preserve or enhance the company’s equity value. IR counsel steeped in capital markets know-how and industry-specific knowledge understands the cause and effect of stock movements and incorporates that knowledge into all strategic communications plans.

**STOCK PRICES**

Stock price, or equity value per share, moves up and down on company-specific financial results, macro- and micro-economic influences, and investor perception of the company. Digging deeper, however, stocks move for two main reasons: performance, both past (actual) and future (expected), and the way that performance is communicated and perceived.

A buoyant stock price is critical for any company because it can create opportunity in the form of a second currency beyond just cash to buy other companies. It can also attract the best employees and vendors and improve the morale of the entire organization. Many institutional investors only invest in stocks with large market capitalizations—that is, greater than $1 bil-
lion, and sometimes $5 billion. Many investors focus only on large caps because they view them as having less risk, less volatility, and more liquidity, which allows big investors to buy and sell rapidly without moving the market. Correspondingly, companies want institutional investors to buy stocks because they usually buy large amounts, increasing liquidity and modifying volatility.

Companies with fewer shares outstanding often have to fight for exposure and awareness and work hard to support the continued buying and selling of their shares. Standing out among thousands of publicly traded companies and increase trading volume should be one of the aims of IR. Exposing the company to a wider range of shareholders can also attract the sell-side, which, from an investment banking perspective, views a high equity price as an opportunity to acquire assets for stock rather than cash or sell more equity to the public to raise cash for operations or debt reduction. All of these options or opportunities derive from a high stock price and are examples of a low-cost transactions that benefit shareholders.

**COST OF CAPITAL**

Though *the long-term value of a company’s stock correlates 100 percent to financial performance*, a company’s daily, monthly, or yearly stock price is important because it determines a company’s cost of capital, and cost of capital is real money. As everyone knows, it costs money to get money—usually in the form of interest payments, or selling a piece of the pie. The cost of debt, or borrowing, is interest paid, and the lower the interest, the lower the cost of capital. The cost of equity is the price that investors are willing to pay for each share. In this case, the higher the price per share, for a constant earnings number, the lower a company’s cost of capital, because the company will have to issue fewer shares to raise the same amount of money.

These relatively simple concepts can have a significant impact on the capacity of companies to generate profits and remain competitive. Keeping cost of capital low should be a major concern to CEOs and CFOs in running the business and creating shareholder wealth. It’s a fiduciary obligation.
The Virtuous Cycle of a High Stock Price

If the cost of capital is determined by a company’s equity value, it’s pretty important to maximize that value at any given time. Beyond financial returns, it energizes employees, partners, and vendors; supports important strategic activities; influences the media; and creates a superior return on investment to that of one’s competitors. This becomes a virtuous cycle. (See Figure 1.2.)

Strategic and consistent communication and outreach can have a significant and positive influence on share price, and therefore the price-to-earnings ratio or any other valuation method. This is because one multiple point on a company’s market value can be worth tens, or even hundreds, of millions of dollars. For example, if a company’s stock price is $60 and its earnings are $6 a share, they’re trading at a P/E of 10. If they have 200 million shares outstanding, the total market capitalization is $12 billion. If the multiple goes up just one point, to 11, the stock trades at $66 a share, and the market cap is $13.2 billion, a $1.2 billion increase in value from one multiple point. Strategic positioning and outreach can accomplish that expansion.

Valuation—The Obvious and The Not-So-Obvious

There are many different types of investors with many different objectives. Some want growth and look for stocks with high returns and earnings momentum. Others seek value and purchase stocks they feel are undervalued.
and underfollowed by Wall Street. Another type of investor wants *income*, like stocks with a dividend.

Regardless of the differences, most investors take the information they are given and run it through quantitative models. Then they compare the results to other companies in the same industry and make an investment decision based on these relative quantitative indicators. This is basic information easily culled from a company’s financials, which must be disclosed on its income statements, cash flow statements, and balance sheets. Anyone can get these and do their modeling.

Then there are the *intangibles*, which is where IR needs to be at the top of its game. The intangibles are the nuances of value, the managing of expectations and perception, and the ability to *define, deliver,* and create a *dialogue* about a company’s financial performance and position in its industry. In fact, intangibles are an important component of maximizing value. Anywhere from 20 to 40 percent of a company’s valuation is linked directly to these items. That’s a big piece of the valuation pie, and the job of IR is to help management maximize it and investors understand it. (See Figure 1.3.)

**AIR TIME FOR THE PRIVATE COMPANY**

Regardless of whether a company is traded publicly, or its stock is held by private investors unable to sell the shares on public exchanges, having a voice in the capital markets is important. Many private companies wait until
they are considering going public—that is, offering their shares to the public via an initial public offering—before they incorporate IR into their strategy. This is a missed opportunity for private companies to build relationships with Wall Street and, more importantly, to create a distinct advantage and gain a competitive edge in their industries.

The opinions of capital markets professionals, particularly analysts but sometimes portfolio managers, are often quoted by the media, and the media is an integral force in shaping public perception and forming a company’s reputation. Therefore, in order for private companies to have equal representation in the public eye, they have to be at least a twinkle in the eye of the capital markets. They have to get their message and mission across so that it is well-understood and incorporated into the points of view of The Street. An IR strategy is of great value to the private company in putting the message out there.

A private company has the best of both worlds. Privates can talk to the world, make predictions about themselves and the industry, and potentially affect their competition’s perception and cost of capital, yet never be held to the regulatory accountability that comes with life as a public company.

INVESTOR RELATIONS, TAKE 2

Providing the necessary disclosures and information is one thing. Knowing what Wall Street expects from a company and its management team is some-
thing else entirely. The best IR professionals are inside the brains of their investors, and think like analysts and portfolio managers. By understanding valuation they can approach analysts and money managers as peers and work hard to build trust.

IR can directly improve the 20 to 40 percent of a company’s valuation linked to factors outside of financial performance and bolster market capitalizations while increasing exposure and obtaining valuable third-party validation. There is a science to valuation, but there is also an art.

Two companies of similar size in a similar industry are growing earnings at 20 percent annually, yet one trades inexpensively at a 10x P/E multiple while the other garners a 20x P/E multiple. The former, in all likelihood, has credibility issues or problems understanding the investment community. The latter most likely understands the nuances of communication, how to be economic to investment banks, and how to preserve credibility in tough times. That’s the art of the stock market and that’s what affects equity value.

Though the uninitiated may believe that investing is a game of chance, few intelligent investors act with this understanding. Professionals on the buy-side have too much responsibility for too much money to invest aggressively with management teams that don’t understand Wall Street. Investors need to believe that they will get good and relevant information clearly communicated by the company, and that the CEO and CFO understand the capital markets and how to properly circumvent issues that could be detrimental to equity value in the short and the long term.

Premium valuation results from not only strong performance, but also because of a belief in management, which reduces uncertainty. Lower risk perception means higher value, and IR can be a key factor in this equation. CEOs and CFOs should seek to establish this credibility and trust with all communicated events. It’s an insurance policy on shareholders’ personal wealth and management’s reputation.

**GLOBAL IR**

Companies are expanding their communications to foreign sources of capital, and investors are culling a global range of investment opportunities. In
this arena of global exchange, specific investor relations expertise distinguishes itself.

IR professionals with extensive relationships and a wide range of capital markets know-how can extend the reach to find the right investor well beyond the company’s home shores.

- When is the time to think about marketing to overseas investors?
- How will you know if overseas investors will even care?
- Will the story translate?

Roam from Home

Investing can be precarious and risky from the outset. Add an ocean, a different language, a distinct currency, and cultural idiosyncrasies, and the uninitiated might consider it speculative. Generating interest from international funds that invest in U.S. equities requires knowledge of the funds’ investment guidelines. Many international funds, similar to those in the United States, publish their investment outlines on their Web sites, and this information is also available from institutional investor databases, such as Thompson Financial and Big Dough.

Once a pool of potential investors is identified, IR must think through the issues that an international portfolio manager or analyst will have to address to complete adequate due diligence. Additionally, if the investment idea comes from a voice they feel they can trust—someone with whom they have a relationship or who has experience in the overseas markets—international marketing can be efficient. Companies should consider marketing with a brokerage firm that has institutional salespeople who cover that region. Thankfully, the investment bank consolidation of the 1990s created many such banks with strong overseas presence, including Credit Suisse First Boston, Deutsche Bank (formerly BT Alex. Brown), and CIBC Oppenheimer.

Experience has taught us that investment opportunities tend to travel better when a product or service of the company is already international. Companies listed on U.S. exchanges that do a substantial amount of business overseas have a much easier task translating their business, and thus their investment merits, to foreign investors.

Many large branded companies, like Starbucks and Wal-Mart, have had significant international business success and have also captured the attention of foreign investors. Some emerging companies have also done the same.