

BETWEEN THE LINES

October 20, 2017

Even the All-Stars Need to Work on Their Game

Introduction

Another *Institutional Investor* All-America Research Team ranking has come out. This ranking identifies the analysts *Institutional Investor* believes are the best and the brightest on the sell side. No doubt, these top-ranked analysts are first rate when it comes to fundamental analysis and stock picking. However, our expertise—and that on which we coach and advise our clients—is interviewing executives and determining the completeness, accuracy and reliability of the information provided using our proprietary Tactical Behavioral Assessment® (TBA™) methodology. We thought we'd take a look at how some of these analysts ask questions and compare their approach with the techniques we advocate. In this edition of *Between the Lines*, we break down both good and bad questions from a randomly selected sample of last year's top analysts to show how BIA's recommended question types could have helped them gain more insight from management.

You Can Lead a Horse to Water...

"And then just real quick on some of the regional color. Asia Pac saw a little bit of a deceleration in cabinets added, and then I think even in the U.S., excluding—if you kicked out the LinkedIn churn, there was a slight deceleration there as well. Anything going on there that is worth pointing out?"

- Jonathan Atkin, RBC Capital Markets, Company: Equinix Inc., Event: Q1 2017 Earnings Call

This is an example of a leading question. Rather than requiring management to come up with a response, Mr. Atkin signals that he will accept the response that there are no factors "worth" pointing out. This type of question lowers the respondent's psychological barrier to simply stating "no" by presenting it as a possible—even default—response. Moreover, by asking for what is worth pointing out, versus what the factors are, Mr. Atkin gives management significant leeway in what constitutes a "worthy" factor. Altogether, this question puts no pressure on management to either provide a response or expand on their thought process if they choose to avoid discussing the topic. It would be better to phrase the question in a way that puts the burden on management to come up with an answer, or requires an explanation that would paint a more complete picture.

How management exploits this poorly phrased question:

In responding to Mr. Atkin's question, management does not directly answer the question. They take advantage of the way the question is phrased and do not address the individual regions. They also take advantage of the "out" that Mr. Atkin provides, stating that nothing is "really" going on outside of timing, which qualifies the extent to which other factors are or are not at play.

How BIA would rephrase this question:

- What factors drove deceleration in cabinets added in Asia Pac? In the US? What else?
- Which factors are the most challenging for you to address?
- How long will this deceleration in cabinets added persist?

Seeing Double

"Yes, balls and also I'm sure you're seeing some player -- well, particularly Nike was present obviously in the hard goods side as well. So just who's exiting? Where do you see market share opportunities? And is there still product out there from those OEMs that are exiting?"

- Kimberly Greenberger, Morgan Stanley, Company: Acushnet Holdings Corp., Event: Q1 2017 Earnings Call

Ms. Greenberger asks several questions at once. This allows management to pick and choose which questions to answer, enabling them to avoid questions that might reveal unfavorable information, which could leave Ms. Greenberger with an inaccurate or incomplete impression. To elicit a better response, BIA recommends asking questions one at a time to put pressure on management to respond specifically to each individual question. This will also allow you to evaluate each response individually.

How management exploits this poorly phrased question:

Management takes advantage of Ms. Greenberger's use of multiple questions. They avoid talking about excess inventory in the market from the OEMs that have exited the market, and instead only discuss excess Nike inventory.

How BIA would rephrase this question:

- Which OEMs are exiting the market?
- Where do you see the greatest opportunity to increase market share?
- How much excess inventory from exiting OEMs is still in the market?

Good Question/Bad Question

"On the M&A front, what is the largest deal you would consider doing?"

- Toni Sacconaghi, Bernstein, Company: HP Inc., Event: Sanford C Bernstein Strategic Decisions Conference

"Okay. Now, how do we think about the impact on financial services? Obviously a lot of outsourcing deals have a heavy commitment from financial services. So what is the impact on that business, and how should investors think about that?"

- Toni Sacconaghi, Bernstein, Company: Hewlett Packard Enterprise Co., Event: Sanford C Bernstein Strategic Decisions Conference

In these two examples, Mr. Sacconaghi demonstrates what BIA would characterize as one effective and one ineffective question. When trying to elicit information about M&A, he asks a direct question that presumes M&A of some magnitude will take place. This question smoothly moves past whether or not there is a deal in the works, a topic that many management teams will not (or cannot) address, and asks about the size of M&A under consideration. He also frames the question hypothetically, asking about the largest they "would" consider, rather than what they "are" considering, enabling management to talk about the issue without directly committing to a plan of action. This gives them psychological leeway to provide insight without revealing legitimately sensitive information.

In contrast, when asking about the impact of recent developments in the financial services segment, Mr. Sacconaghi is less direct. Not only is it unclear exactly what information he is seeking—making it harder for management to be responsive—he also phrases the question in a way that enables management to respond any way they choose. Mr. Sacconaghi is literally asking "how investors should think" about the impact of trends in financial services, not what the actual impact is. This phrasing actively invites a less transparent response if management chooses to avoid providing certain information. BIA advocates asking clear, direct questions with a single meaning to ensure that management's responses address exactly what you want to know.

How management exploits this poorly phrased question:

In the first example, Mr. Sacconaghi's presumptive question proves to be effective, as management details the limits of their interest in M&A. In the second example, management sidesteps the question, giving no specific details. The contrasting degree of insight provided in these two responses underscores the importance of asking clear and direct questions.

How BIA would rephrase this question:

- What is the most that financial services could be affected? What is the least?
- To what extent will financial services revenue be reduced?
- In what specific ways could financial services be affected operationally?

Beating Around the Bush

"Okay. And obviously -- I think you mentioned in the prepared remarks but also in the press release, some modest pressure on labor. And I know you got a lot of thing -- higher salaries and contract labor dragging EBITDA year-to-year by about \$11 million and \$4.9 million, sequentially. I know there's some step-up occasionally in higher payroll taxes, et cetera, et cetera, in the first quarter. That may be part of what's going on. It did seem like some of the other companies went into a little bit of relief in the first quarter. How would you describe the situation you're seeing?"

- AJ Rice, UBS, Company: Quorum Health Corp., Event: Q1 2017 Earnings Call

Mr. Rice describes his observations in a long prologue before posing his question. BIA advocates using prologues when broaching difficult issues (in fact, we provide specific training on how to formulate effective question prologues), but Mr. Rice's execution in this example creates some problems. His lead-in to the question is not well-crafted, making the question confusing instead of clear. Moreover, in his eventual question, Mr. Rice cites "the situation," but it is unclear from his prologue what situation he is referring to, which gives management a great deal of latitude around what topics they ultimately discuss. An effective prologue makes management more receptive to a challenging question by framing it in a way that reduces the psychological barriers to providing responsive information, often by conveying the question in the context provided by management or projecting empathy and non-judgment. A well-crafted prologue provides a smooth transition to the question, while presenting the question in a less threatening manner. To be effective, however, it is key to follow a prologue with a well-crafted, clear and direct question.

How management exploits this poorly phrased question:

Half of management's response is spent confirming the assertions Mr. Rice makes in his prologue; the other half addresses the topic, but is qualified and offers only a minimal level of insight. By capitalizing on the loosely connected prologue and the unclear question, management is able to sidestep the intended question and avoid fully disclosing information.

How BIA would rephrase this question:

- Given the variety of factors mentioned in your prepared remarks and press release, it is understandable that there is a drag on earnings. And clearly you are not the only company that has been affected by similar dynamics. What are the most significant pressures currently affecting EBITDA?
- Other than salary and pressure on labor, what are the most significant headwinds to EBITDA growth? What else?
- How much has labor pressure increased/decreased in the quarter?
- How are payroll taxes impacting EBITDA?

There's No Right Answer to a Statement

"Hi. If it is okay I'm going to dive back into North American tapes decline. I just don't quite get how the minus 13.5% organic services decline in North American tapes has to do with a large project from a year ago. The decline in that business is 7 points worse than the first quarter decline, but the comp year over year is only 4 points, let's call it, less easy. So, when I see this 13.5% decline versus a year ago, minus 1.7%, it just doesn't seem like the year-over-year comparison explains it all."

- Andrew Steinerman, JPMorgan, Company: Iron Mountain, Event: Q2 2016 Earnings Call

In the above example, Mr. Steinerman never actually asks a question. It is therefore difficult for management to determine what he wants to know. A topical statement, rather than a direct question, allows management to respond in any way they choose, revealing information they want investors to hear and avoiding information they don't want to reveal while maintaining a veneer of transparency. It also sets up even the most responsive executives to provide an inadequate answer. An effective question must be fair, allowing forthcoming management teams to answer readily, while putting pressure on reticent management teams to respond.

How management exploits this poorly phrased question:

Although management generally discusses the topic in question, they offer little additional insight, and what insight they do offer is qualified. The lack of a clear question puts them in control of their answer, eliminating any impetus to reveal important or unfavorable information.

How BIA would rephrase this question:

- How is this large project from 2015 driving the organic services decline in North American tapes in the present quarter?
- Outside of the impact of the large project from 2015, what are the most significant factors driving the organic services decline in North American tapes?
- What is the most that the large 2015 project contributed to your comps?

About this Report:

This report represents the application of BIA's Tactical Behavior Assessment® methodology and reflects BIA's assessment of the completeness and responsiveness of statements made during earnings conference calls, television interviews and other presentations. In each case, our assessment represents the opinion of BIA applying the Tactical Behavior Assessment® methodology and does not purport to indicate that any individual is in any specific instance being truthful or deceptive. BIA does not make stock recommendations. Under no circumstances is BIA's analysis intended to be a recommendation to buy or sell the securities of the company which is the subject of this report.

About BIA:

Business Intelligence Advisors (BIA) is the leading Intelligence Solutions research and advisory firm. Founded in 2001 on the principle that Intelligence techniques originally developed for the national intelligence community could be powerfully applied to the private sector, BIA has developed a ground-breaking suite of service offerings to provide clients with an edge in collecting and evaluating information critical to their success – whether that means making a more informed investment decision, identifying hidden risks, or enhancing due diligence efforts. BIA's services, which include proprietary Behavioral Intelligence Research, Expert Advisory, Investment Intelligence, and Learning & Development Solutions, are delivered by a team of in-house experts from the national intelligence and finance fields.

www.biadvisors.com