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A New Investor Relations Paradigm

**Remarks by Gary A. Kraut to
the Investor Relations Association**

**These remarks formed the basis for a subsequent article,
“The Coming IR Paradigm”
which appeared in the June 2001 edition
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*Although this speech is somewhat dated,
the thoughts expressed are not.*

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“Globalization and technology have made the world a lot messier and less structured than before. Change can bite companies a lot quicker these days.”

Today's seasoned investor relations professionals are at the top of their game. They represent their companies before some of the smartest people around, and frankly, do it very well. But the level of play may be shifting as CEOs recognize the true power of IR and in turn, look to their IR executives to leverage that power.

Fueled by globalization, or at least spurred by it, this emerging paradigm shift will present IROs an extraordinary opportunity to enhance the value they bring to their top management team. But if they don't respond, they could find themselves passed by.

There is no clinical data to back this up, just a gut feel. But having worked with European investors since 1972, three years after G.A. Kraut Company began, and as the first Western IR firm to open its doors in Asia in 1980, I've had a front row seat watching the world change.

Back in the 70's and 80's, there were huge gaps in information and culture between investors in different countries and on different continents. IR was an isolated practice, occasionally looking overseas, but mostly U.S. focused. That difference has now vanished, or will very shortly.

Today, Bloomberg terminals are everywhere. American and Asian CNBC are on view aboard cruise ships going down the Straits of Malacca. There are no buy side firms of any consequence on earth that are not overrun with sell siders offering their wares.

As a result, international investor relations doesn't exist anymore. It's just IR -- with investors in different geographical markets on the same planet.

Orchard Road in Singapore looks different than Madison Avenue in New York, Newbury Street in Boston or Oxford Street in London, but the shops and merchandise are often the same. Similarly, there are different investment styles from Zurich to Edinburgh. But they are not that much different than the difference between growth-oriented Denver and value-oriented Philadelphia.

Do European and Asian investors tend to be longer-term holders? Sure, but not that much longer anymore. Performance culture is now a global phenomenon. Are sell siders in many industries now looking at global versus just national peers? Yes. Is the competition for capital intensifying because of cross-border exchange listings, financings and merger and acquisition activity? You bet.

So, what does this mean for IR? Can IR be practiced in 2005 much as it was in 1990, only with more up-to-date tools? Sure, if IR remains a mechanical function.

But that won't work anymore. Today, CEOs and CFOs now know too much about how IR can add huge value to name a mechanic to run investor relations. As I talk and work with 30 or 40 CEOs each year, I see that they have a great interest in serving their shareholder constituency. Some CEOs are overly eager to make investors happy. I see much the same attitude among CFOs worldwide.

What I don't see enough of is IROs empowering themselves to contribute more to this goal. This is surprising because some of the smartest and most capable people in the company are now responsible for IR. Most are well plugged into senior officers, the board, and of course, the owners of the company.

CEOs recognize this. In the CEO's mind, IR is no longer a backwater. It's a driver of value. But IR is often so limited and entrenched, especially in the U.S., that IROs are reluctant to take the wheel CEOs and CFOs want them to steer.

I'm not accusing IROs of behaving like civil service automatons. On the contrary, most are terrific at what they do. Fifteen years ago, IT directors sat at metal desks in the basement. They were good at what they did. Today, they are embedded in mahogany row. Management recognized their importance. Now management is recognizing the importance of IR. But IR has not sufficiently seized its mandate.

CEOs want IR to think and act broadly. They don't come out and say it, but they do. Many IROs seem content to focus on daily dealings with investors or doing what their predecessors did or their peers do. IROs are uncomfortable pushing the envelope.

But just as investors and markets have changed, so have CEOs. By and large, they understand the capital markets or at least understand their importance. They are certainly internationalists. They usually hold the importance of IR in high regard.

The 80's takeover phenomenon woke American CEOs up to IR. American boards became far more shareholder responsive. In the 90's, it was non-U.S. CEOs and boards that awakened to the power of IR. Globalization propelled cross-border financing, M&A, and listing on the Big Board and NASDAQ. Something like 1,000 non-U.S. companies raised capital in the U.S. in the '90s. Because CEOs of non-U.S. companies are newer to IR, they appear to be looking at it with a cleaner slate. They are more open to new IR ideas. They don't have IR as pigeonholed. As a result, I give Europe a shot at becoming the leader in global IR later in this decade. Yes, Americans may lose their supremacy in a practice invented here.

The reason, however, is not CEOs. It's American IROs who don't grasp or seize the opportunities CEOs want them to capture. It's IROs who don't want their role to grow -- for fear of shaking the tree, losing their job, being uncomfortable -- whatever. I don't know a single IRO, for example, who has asked for an R&D budget to explore what more value the function could provide.

Globalization and technology have made the world a lot messier and less structured than before. Change can bite companies a lot quicker these days. Something like 42 of the Fortune 100 of 1990 do not exist in the same form they did a decade ago.

So, to protect and enhance shareholder value, IR has to think and act differently and beyond the investor orbit. It must pay more attention to what's going on all over our great planet. It should push the borders of out-of-the-box thinking. It needs to capture, analyze and employ insights as well as information from wide ranging intelligence networks.

The IR intelligence network must pay broader attention. For example, I wonder if IROs in California recognized last year that deregulation could lead to insufficient power or water? Not likely.

Should they? Is this an area for IR? I say yes, if our goal is to enhance shareholder value. The function should be a lot broader than keeping on top of the competitive landscape, interpreting who bought or sold today, or whether an institution is correctly targeted as a GARP or growth investor.

Now let's go way out. Should IR be a center of domestic and global geopolitical risk analysis? I say yes, again based on IR's role of protecting and enhancing share value. Here's one way of doing it, starting with a macro perspective.

What is the largest global threat in the world to your company and way of life? Is it Islamic instability? Is it lack of water? Is it an armed conflict in the Middle East or between China and Taiwan? Is it innovation or lack of innovation? Is it cheap labor elsewhere? If one of your "could happen" scenarios played out, how would it impact your company or your industry? Is anyone in the company looking at such issues?

Should anyone be focused on potential global crises or mega trends? If so, why not IR? IROs spend a good portion of most days talking to astute observers of their company and industry. IROs are incredibly plugged into a network that can provide information and insight.

For example, how much do most IROs know about the Near East? Should they care? It holds a surprising amount of the world's proven oil and natural gas reserves. In *Eastward to Tartary*, author Robert Kaplan says deposits in the Near East could be a source of great conflict in the years ahead because all the governments that lie above it are less than stable -- Hungary, Romania, Bulgaria, Turkey, the Balkans, and Central Asia. What about the ongoing turmoil in Indonesia -- the fragile fourth largest nation in the world? Should companies care about what's going on there? My read says you better believe it.

Events in these areas could impact the value of a company. For example, the Kurds want independence from Turkey. Turkey is a rare Moslem democracy. So what if Kurds get their independence? Well, most of the hydrocarbons that would flow to Europe and the West have to travel in pipelines under Kurdish Turkey to get there. Should IROs start to now obsess about the Kurdish situation, the Mideast or Indonesia? No. Should IROs be asking what they can do to help interpret how macro geopolitical events could affect business decisions and valuation to senior management and the board? Maybe.

The U.S., according to a recent study, is only the 14th most globalized country in the world. Smaller nations, like Finland, Holland and Singapore, have been dependent on other nations far more and longer than we have. They had to globalize faster than we did.

But now, nearly one-third of the revenues of S&P 500 companies are from outside the U.S. In some industries, for example, computers and oil service, it's much higher. Twenty-eight percent of the world's gross national product now comes from North Asia.

As a result, investment research is going global because assets are increasingly invested globally. How can an auto analyst look at Ford and GM without understanding Daimler Chrysler, Peugeot, Toyota and Honda? Look at telecom, pharmaceuticals and oil. Same thing.

Global valuations will come together. Analysts and PMs will employ global peripheral vision. So must IR.

Am I suggesting that IROs become micro-Henry Kissingers? Yes. IROs have the ability and skills to focus and interpret macro tides in the distance that could wash up on their shores.

Furthermore, who is more able to lead a competitive intelligence effort than an IRO?

Is this far out? Sure it is. But is it more important to focus on the latest web casting innovation? Maybe. How about both?

Another emerging development catching fire worldwide is the equity value of intangibles. The most obvious of these is a company's reputation. The better the overall corporate reputation, the greater the likelihood the company's equity will price at its optimum value -- all things being equal.

I believe IR should focus on the global importance of intangibles. I have lost no respect for financial metrics. I've just gained respect for the power of intangibles.

E&Y recently concluded in a study entitled *Metrics That Matter* that up to 65 percent of an institutional investor's decision-making on valuation can be based on non-financial [or intangible] performance indicators depending on a company's sector. As little as 35 percent is, therefore, based on financial metrics. Of the intangibles, 30 percent has to do with brand and corporate image and 35 percent with other intangibles such as quality of management.

E&Y concluded that investors reward companies for good communication of intangibles in the industries they studied, with a two to six percent market improvement short-term and as much as 12 percent long-term.

Whether you agree with their findings or discount them sharply, intangibles count big across all constituencies. And all constituencies play a role in protecting or adding value, the central role of IR.

Here are the 10 most important non-financial criteria, according to E&Y. Keep in mind the actual intangibles for any particular company and industry may be somewhat different, and they may change over time. That's why managing intangibles for optimum valuation is no cookie-cutter exercise. It requires systematic planning, communication, measuring and tracking, which can readily be done by IR.

1. Brand/corporate image.
2. Strategy execution.
3. Alliances/M&A activity.
4. Value of human capital/employees.
5. Quality of management.
6. Innovativeness.
7. Reach and strength of distribution.
8. Quality of strategic vision.
9. Effective use of technology.
10. CRM -- customer relationship management.

I believe a number of other areas will play a greater part in IR because they have a big role in making the right impression on investors, customers, employees -- anyone who matters.

First, corporate governance. Quality of governance is an intangible. Soon, companies and nations around the world will be rated on corporate governance much as S&P rates bonds or *Good Housekeeping* rates consumer products.

Why? Because there is significant evidence that good corporate governance translates into a lasting premium on equity valuation. Shareholder activists are heading a parade marching to the tune of "better corporate governance leads to better returns." McKinsey recently joined the parade after surveying 200 institutional investors with \$3.25 trillion in assets. McKinsey found that institutions around the world take corporate governance into account when making investment decisions and appear willing to pay more for the shares of a well-governed company.

The U.S. and the U.K. are leading the world on governance standards. But other nations will catch up and thereby increase global competition for investment. To give an idea how fast the corporate governance ball is rolling, there were 17 corporate governance-related conferences in the world last February alone, according to the leading governance newsletter, *Global Proxy Watch*. Four are in the U.S. Others are in spots that range from Accra, Ghana; Windhoek, Namibia; Lausanne, Switzerland and Mumbai, India.

Pfizer has become the first company I know of to centralize in one department corporate communications, media, IR, the corporate secretary and fulltime corporate governance officers. What does this tell you? How about: get involved.

Continuing, investors know that good management drives shareholder worth. But what drives good management? The board.

And the board is going to get more shareholder scrutiny.

Here are the areas where I expect boards will be publicly measured alongside their peers.

Board Accountability -- Do they have sufficient numbers of independent directors to exert influence? The board should see its duties as including the pursuit of shareholder value. The board should regularly evaluate itself. The board should review corporate strategy and internal controls.

Disclosure -- Is the MD&A comprehensive? Is the audit committee equipped to apply rigorous oversight to the external audit?

Shareholder Rights -- Shareholders should have the right to convene a special shareholders meeting and introduce dissident resolutions.

Remuneration -- Board compensation should be aligned with shareholders'.

Control -- There should be no structured takeover defenses (voting limitations, poison pills.)

Shareholder Base -- Major owners should be disclosed so that investors can weigh those ownership interests against minority shareowner protection.

Also, be prepared for investors to increasingly ask for meetings with individual board members.

Another area that IR needs to pay attention to is the press. The press is important because it is a barometer and creator of the corporate brand and reputation. Do IROs know what's on reporters' minds about their company and industry? Who are their sources among investors about a company? Here's where I think IROs should work hand-in-glove with their counterpart in PR or corporate affairs. They need not fear the press anymore than PR people need to fear investors.

There is a lot of disintermediation going on in the media. Day traders often read messages boards instead of *The Wall Street Journal*. Institutional trading desks have CNBC on all day.

Analysts are a source for reporters. But they have less insight under Regulation FD and less credibility for many reasons. Still, they love to be quoted and featured.

Grasp what the press is saying globally and locally. An IR director in California threatened by an electricity shortage needs to know what the local media is telling local employees, what the Sacramento media is saying about developments in the legislative branch and Governor's office, what the economic/financial media is saying about demand and what the global media is saying about OPEC.

It's no longer enough to focus entirely on analysts and money managers. The IR function needs to be more extroverted.

Another area impacting value is branding. This is yet another intangible that IR folks need to dive into in order to optimize share value over time.

Citing McKinsey, "brands should be a company's most significant intangible asset... companies with strong brands consistently earn two-to-five percentage points higher total returns to shareholders than their industry counterparts." Another study showed that firms with the largest gains in brand equity over a set period experienced stock returns of 30 percent, while companies with losses of brand equity over the same period saw their share average move a negative 10 percent.

In other words, share value can be enhanced by explaining clearly how a brand is levered into new product areas, businesses and geographies.

There's an old definition of brand as everything a company communicates about itself.

Does an IRO know the image their company is projecting around the world and to various stakeholder groups? If so, are they marketing their brand as a competitive advantage in analyst presentations, on their website and elsewhere?

How important is this? Microsoft last June had total assets of \$37 billion. At the same time, the bust-up value was \$370 billion. A big part of the \$333 billion difference is the Microsoft brand.

Want to try a test? Ask your CEO and CFO what your company stands for. Will they give you the same answer? Volvo, for example, stands for safety.

Here's a big difference between Adidas and Nike. Adidas performs through technology, has an understated personality and focuses on team not individual sports. Nike also advocates performance through technology but focuses on individuals and conveys a winner-takes-all personality and a big attitude.

What's the point of all this? Rethink IR from a broad, global point of view. That's usually the CEO's perspective. Extend the definition of IR to embrace other disciplines that reveal and create value.

IR can be a cannon rather than a pistol.

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