

What Makes a Great CFO? Does CFO Quality Impact Valuation?

Eleven Investment Professionals
Provide Their Insights

g.a.kraut company inc.

Introduction

“Does the stock market reward companies for having a great CFO?” A client recently asked us that intriguing question. So, to find out, we had lengthy conversations with 11 buy side and sell side analysts, asking them what defines a great CFO and if having one makes a difference in market value.

The analysts were passionate and opinionated when characterizing a great CFO. However, while they suggest great CFOs often lead to greater investor confidence, *there was no consensus among them that trust translated into enhanced share value.*

But along the road these investors provided wonderful insights into what characteristics great CFOs have in common.

This study says great CFOs see themselves as teachers. They have a deep understanding of the business. They think like investors. They are viewed as key players strategically as well as operationally. They take charge of their relationships with investors. They are confident but not arrogant. There is no spin to how they present the company. And they are hallmarks of trust.

Inadequate CFOs were characterized as myopic and disinterested, if not in over their heads. Arrogance was another common trait, as was a lack of strategic insight. Analysts were especially critical of CFOs who mislead them, as well as of those who fail to understand how investors assess and measure performance. Investors discount the value of CFOs they view as numbers mechanics.

We think you will find the following interviews compelling.

The views expressed in these interviews are those of individual investors and do not necessarily represent the views or opinions of G.A. Kraut Company. Copyright © 2008 G.A. Kraut Company. All rights reserved. May not be copied, quoted, reprinted or redistributed without permission.

Interview one

For over 38 years, G.A. Kraut Company's investor relations team has specialized in helping public companies reveal and build value. This is our only business. The firm is focused on providing investor relations strategy, research, investor communications and implementation services.

Our strategic thinking can make companies more attractive to investors. Our research fosters smarter decisions. Our communications expertise enables companies to position investor messages crisply and convincingly. Our implementation skills enable executives to focus on what counts.

G.A. Kraut Company is employed by some of the world's largest businesses. We also work with IPOs, non-U.S. companies, small- and mid-caps.

To me, the best CFOs are almost more than CFOs. They have a strong command of the financials or the numbers; that goes without saying. But the better CFOs also convey a strong understanding of the operations and the strategic direction of the business, and are able to tie it all together. There are some CFOs who I'd say are really good at being a "CFO," but there are other guys who I feel are much more integrated into operations and strategies. Those are the guys that I really feel have a lot of control and a lot more credibility, and I can have a lot more confidence in. I'm not sure if that makes sense, but it's more than just having a handle on the numbers. In fact, that's the minimum requirement. If the CFO can add value on the operating side or the strategic side, that's when you see the CEO and CFO are running the company together. That at least gives you the idea that the person is very competent and very much has his finger on the pulse of the operations that drive the numbers. Anybody can make a budget, and anybody can say operations didn't come in the way they said they were going to; but the guy who has his finger on the pulse of the operations and has a hand in the strategic direction of the company should, theoretically, have a better budget and a better idea of where things are going.

“ There are some CFOs who I'd say are really good at being a 'CFO,' but there are other guys who I feel are much more integrated into operations and strategies ”

There are a few CFOs that jump to mind as being top CFOs. Within the hospital business, there have been two guys over the years that have stood out. The current CFO at Community Health Systems [Larry Cash] is definitely one of the better CFOs.

The old CFO at Universal Health, [Kirk Gorman], who has since moved to a not-for-profit hospital system, was also highly regarded by most people. This is actually an interesting question because I'm going through the list in my head and thinking, that person is mediocre or this person is mediocre. Going through the list of companies I cover, it's hard to pick out the really good CFOs. There are a lot of guys in there that I'd say are okay, but there are not a lot of guys where I'd say they're great.

“ This CFO understands how the money is made, not just how much the company makes ”

What makes the two CFOs I mentioned great to me goes back to what I was just saying. I was thinking of them when I was describing to you what I picture. A lot of the other CFOs have a handle on the numbers, but you don't necessarily get the feeling they've got in-depth knowledge of the operations, or that they have a significant vote in the strategic direction. In contrast, the CFOs I mentioned clearly have an in-depth understanding of the business, and played a major role in shaping the strategic and operational focus of the companies. They also have a very close rela-

relationship with the CEOs. You could almost look at them in some ways as a CFO who has significant influence with the CEO and COO. He's almost the type of guy where if, God forbid, the CEO died tomorrow, you'd probably say he could do just as good a job, and he's got a better understanding of the numbers than the CEO does.

“ It definitely helps that people take away an element of confidence through the presentation skills of a CEO or CFO ”

The CFOs who are clearly a key part of the senior management team, as opposed to the ones who are just keeping track of the numbers, do a better job of understanding the numbers if they're that involved with the company. On top of that, it will increase investor confidence, as well as improve how you talk about the business and your confidence level in the business.

A great CFO is about two things when you talk about the stock. One, he is the guy who is probably better positioned to have a handle on the numbers. Two, he probably presents better and will have more detailed answers than the guy who is just in charge of the numbers, and he'll probably come across as much more confident and comfortable. In other words, this type of CFO understands how the money is made, not just how much the company makes.

The investment community is mixed on how much a CFO stands out. A strong CFO does enhance investor confidence, and that could play a part in the multiple. Obviously, there are a lot of other things that come into play, so it's just not that simple.

It's not necessarily somebody who is really salesy or slick that attracts investors, but it definitely helps that people take away an element of confidence through the presentation skills of a CEO or CFO. On the other hand, I know of one CFO, who is pretty strong, but she just doesn't present that well. She has a dry personality, so most investors just don't talk to her on an in-depth basis that frequently. They sort of come away feeling, blah. But if you have an in-depth conversation with her, you come away very impressed with her knowledge and her grasp of the numbers. On the other hand, I know some CFOs who are extremely smooth, almost too smooth. I don't think that makes investors feel any better either, because even if they're competent, you almost have the impression they're just telling you what you want to hear. The two CFOs I mentioned earlier — and this may be a bit of a personality thing — are clearly straightforward, down-to-earth, sort of guys.

They are straight shooters, which is a term that you'd probably get from a lot of investors, and that adds to your confidence level a little bit in terms of what they're telling you. Even if the business is doing poorly, if a guy comes across as a straight shooter, he will at least get a little bit more credibility. Even if the investors don't

“ It's being able to explain what's going on and why the numbers become what they become, and are they going to be what you think they're going to be ”

come away excited about the business, at least they appreciate that the guy is telling the truth. In turn, when the business gets better, you're going to be more credible.

Another element comes down to how the CFO gives guidance and talks about expectations. You can't ridiculously under-promise and over-deliver because eventually people will just expect that magnitude of upside. The CFO who is perceived to be on the conservative side rather than the aggressive side, though not ridiculously so, is someone who is also well appreciated. It also depends on how big a company you're talking about. The CFO can also change a bit depending on the size of the company. With some of the bigger companies I cover, you don't have as frequent interaction with the CFO as you do with some smaller companies, where the CFO actually is the IR person.

Not to dodge the question of how a CFO makes his mark, but that's a hard question to answer without knowing the situation. You really don't know where the opportunity is for that person to make an impact. You don't know what the company is, you don't know how well they're doing, and you don't know who that CFO replaced. Just talking about my little neck of the woods and the companies I cover, if a new CFO comes in, the answer might be a little different.

The characteristics we discussed earlier are how you'd want to portray yourself as a new CFO — being well integrated into the business, and not just a numbers guy. It's being able to explain what's going on and why the numbers become what they become, and are they going to be what you think they're going to be. It's conveying yourself as a straight shooter, and also erring on the side of conservatism over time. Beyond basic characteristics like that, it's got to be a fairly specific situation as to where somebody could have an impact.

“ A lot of the worst CFOs have some things in common ”

A lot of the worst CFOs have some things in common. Typically, they're the opposite of what I'm describing. They don't tend to give very concrete answers to questions because they don't have the concrete understanding and the background, or maybe they just don't want to tell you. They don't come across as being that straight; they come across as being canned or even incomplete. Unlike a good CFO, they don't fully understand the questions and the perspective that the investor is coming from. I've seen CFOs that are just so out of touch with the investment community when answering a question, that you sit there saying, "That's not at all what the guy was really asking!" The really bad CFOs don't even get the gist of it. The smart investor asks a question, but really has another question in mind, and the smart CFOs get it. This may be because they understand the business so well, so they understand where the investor is really going with the question. Some of the worst CFOs don't give you good answers. They don't really even understand why you're asking that question at the end of the day. They don't give you the sense that they're really that in touch with the guys on the Street.

Interview two

Probably the most remarkable comment I'd ever had a CFO make to me was a long time ago in the nursing home industry when there was some major reimbursement changes going on. They had admitted it was a difficult situation because they had to respond to the changes in Medicare. Then the CFO actually said to us, the right plans are there, if these damn employees would only execute. You sort of walked away saying, oh man, how out of touch is this guy? That's an extreme example, but the bad CFOs just don't give you a sense of being integrated into what's actually going on in the company.

Some of the CFOs that I mentioned before, particularly the one at Universal Health, who is no longer there, get it. He knew where you were coming from every time, whether it was a big group or a small group. If nothing else, at least it gives the investor the sense that this guy was really on top of something. For the guy who doesn't even understand the question, you walk away concerned that he doesn't even know what's going on. That may not be the right impression, but it doesn't help the perception.

“How can investors have confidence in what he says? It's knowing the business or not”

Talking about guidance and expectations could obviously make or break a CFO pretty quickly, even if they're good at what they're doing. Perception is the reality. The CFO at Merrill Lynch was quoted last summer saying, the Company's exposure to the sub-prime market is appropriate and manageable. Then a month later, Merrill took a charge, so this guy was obviously out in right field somewhere.

Merrill got a new CEO [John Thain] and immediately thereafter a new CFO. The CEO came in with a lot of praise, and most investors I talked with who knew him said this is a good guy for Merrill to get. But then he brought his CFO over with him from the NYSE and based on the guy's background and conversations with investors who knew him, the feedback was they weren't really impressed. The stock exchange is about price and volume, and he seemed good enough to do that business. But then he becomes the CFO of a global investment bank with 50 different divisions, and you're not sure this guy knows a lot about a lot of these businesses, so how is he going to be the CFO of Merrill? How can investors have confidence in what he says? It's knowing the business or not. Now maybe the guy will do a couple of meetings and he'll knock the socks off of people by showing that he really does understand the intricacies of these businesses. But from the investor focus, there is a question as to whether this guy really understands the business. I don't talk to a lot of investors who cover financials, but it was echoing the one key thing that people hone in on: does the CFO really know the business or not? This guy wasn't in the job for two days, and that was one of the comments I got.

The most important thing that the CFO needs to know, and that I as an investor need to know, is that he or she has the full trust of the CEO. It's very important that the Street understand the relationship between the two because it's an important piece of the Street having confidence in the CFO.

From a purely practical standpoint, having cyclical experience is important. These days we may be having cycles that are elongated or truncated or stalled but we are also having shocks of different kinds. Knowing what a cycle is like — knowing what you do and where you are in one — is very important in order for a CFO to present a confident face to investors.

A good CFO has to be relatively outspoken. Investors have to know what positions the CFO is taking on behalf of the company and where they stand. For many investors, understanding the CFO's positions today will be helpful in predicting how the CFO will behave in the future. It can't be a black box.

It's important for the CFO to reconcile the accounting with the economics of the business for investors. Whether the accounting is reflective of the underlying economics of the business or not, accounting doesn't always explain how the world works. The CFO needs to be able to actively position the company and describe how the company views both the accounting and the economics.

Finally I would say that there are two other qualities of CFOs that should be mentioned: those that don't get their companies or themselves into trouble as CFOs and those CFOs that can get their companies out of trouble. Each type of situation requires somewhat different skill sets, but each has its own value.

I've been reading a book lately which is very interesting and I would recommend it to any CFO. It's called *The Black Swan: The Impact of the Highly Improbable*, by Nassim Nicholas Taleb, which deals with the statistics of events. That brought home to me another point: a good CFO has to understand numbers and statistics in a way that I don't think many do. That's going to be more important going forward as companies and investors cope with increasingly complex and complicated situations.

“Two other qualities of CFOs that should be mentioned: those that don't get their companies or themselves into trouble as CFOs, and those CFOs that can get their companies out of trouble”

When I think about the CFOs I've known over the years, there are a few that come to mind as standouts. I guess the first would be Kriss Cloninger at AFLAC. He has taken on the role of CFO and now President. He understands the nature and strategy of their business. Investors have a great deal of confidence in him. He

knows what he's there for and what he is to do. His CEO seems to have a lot of respect for him and gives him a lot of credit for their successes.

There was another CFO. I forget his first name but he worked for both Citibank and for Salomon Brothers. He was a CFO that was very good in both damage control and protecting a company from itself in the future by providing liquidity backup. He

had this quote he always used that exemplified what a CFO should do at a financial-type company in particular. He used to say, "You don't need capital in the brokerage business if they trust you. You can't have enough capital if they don't." He did a superb job in a difficult position during a challenging time, and understood the underlying nature of the role of the CFO.

“ In essence, he took the information and made it more digestible for investors ”

I've heard the CFO at Morgan Stanley say a number of times that the CFO's role is to make decisions on the debt side of the balance sheet, and the CEO makes decisions about the equity side of the balance sheet. That makes a lot of sense to me in those kinds of companies.

Another great CFO is Al de Molina who is now with Cerberus Capital. He was very good at explaining risk and whether Bank of America and the banking industry was getting credit for it. Almost a year and half ago he was telling people things weren't right. He has a very good sense of financial matters and he has a great skill at making people outside the industry understand them.

I would also include Frank Newman as another great example. He came out of the old Bank of America operation and came in as CFO after the S&L crisis. He took a company that had lost the trust of the securities market, simplified the business and made it very transparent and in essence recreated the trust of shareholders. He tried that again at Banker's Trust where he became CEO.

The next person who resembled Frank but has gone on to be more successful in the banking area would be Bob Kelly. He is now with Bank of NY/ Mellon. He came from a Canadian bank to be CFO of Wachovia and was instrumental in developing investor trust. He took the financial statements, which are set up to be regulatory driven, and put them in a more logical business framework and laid things out so you could see progressions and concepts. In essence he took the information and made it more digestible for investors. The financial services industry has a wealth of data but it is portrayed in a virtually undecipherable way. The CFOs that understand their responsibility to inform the investment public are better CFOs. Their ability to communicate the information is a sign of how well they understand the business internally. As an investor, that gives me confidence in how they make decisions behind closed doors.

Jamie Dimon, Chairman and CEO of JP Morgan Chase, is an example of a CEO who is also a great CFO. He's never actually had a CFO. He's very unusual. There are few CEOs that know the numbers down to the granular the way he does. Frankly some

CFOs don't seem to know their numbers as well as he knows his. Dimon appears to know it all — where the money is made, who is valuable, who is not. Dimon is a great CFO without being one. One could learn a lot by understanding his history, his behavior. He may not really understand how to grow businesses as someone who has always been in the business of acquiring businesses. He does his own IR. He makes the message, delivers the message and makes sure the message gets heard.

The investment community recognizes and rewards high performing CFOs. In the case of both Bob Kelly and Frank Newman, the companies were highly rewarded. All of the CFOs I named have been highly rewarded personally as have their shareholders. Dimon has a very high level of trust and respect from investors. I would have to say that, yes, I believe a company is likely to be more highly valued with a great CFO than if they have a run-of-the-mill CFO. I think it is really tied into being at the right place at the right time.

If I was offering advice to a new CFO, I guess my first point would be to demonstrate to the Street that you have the confidence of the CEO. Be open and be detail oriented and demonstrate that you understand everything about the business from the inside out.

“ At the end of the day, it really comes down to trust and belief ”

The worst CFOs that I've encountered are simply in over their heads or so arrogant that they messed up even though they had a good business behind them.

I can think of two poor CFOs. Both came from companies that had underlying good businesses but they simply didn't follow accounting rules. Those CFOs had no excuse for not properly accounting for their businesses and each of them independently of the other refused to account for the businesses properly. They were just plain stupid – while protesting their innocence, honesty and everything else. The amount of time, energy and money they had to spend to recreate their financials and fix this fiasco is unbelievable. There is just no excuse for the inability of those CFOs to get their accountants to follow the accounting rules.

I guess I would just say in closing, never underestimate the importance of the public role and visibility of the CFO. At the end of the day, it really comes down to trust and belief.

Interview three

A great CFO is worth their weight in gold. The CFO is the one that has to be able to translate operations into the financial numbers. Numbers are just another language very similar to French or English or Italian. It has to be interpreted. The CFO needs to explain why capital is sitting in the balance sheet, or [why] the income statement or the cash flow statement is the way it is. They need to be able to intelligently communicate what they mean and also about the success or failure of the organization as it tries to achieve its goals. That ability is what is so critical about being a good or great CFO.

The other thing a great CFO should do is to drive the understanding of the financial metrics through the organization and through to the investment community. It's not enough to sit there and tabulate the numbers and say, "This is what we did." How are they improving profitability? What drives decision-making within the organization? The CFO is the one who can determine, even more than the CEO or in conjunction with a good CEO, what kind of metrics they want the entire organization to pay attention to. Are they improving rates of return on invested capital? Is it revenue growth? That's where the CFO has a tremendous amount of influence.

A really good CFO is also going to understand that the investor relations function is a two-way street as well. The CFO probably shouldn't be the primary contact for the Street. They ought to get somebody as an IR person who is not only very good at communicating the company's story to investors — and I mean investors, not sell-siders or hedge funds — but also someone who can interpret the information they learn from investors for the CFO and the CEO. A great CFO can make a huge amount of difference for a company and is frequently more memorable to investors than a CEO.

“A great CFO can make a huge amount of difference for a company and is frequently more memorable to investors than a CEO”

When you ask me who the best CFOs are I've encountered, I immediately think of Enrique Falla and Pedro Reinhard at Dow Chemical. These two were there at a time when Dow was willing to give their CFOs a tremendous amount of influence both internally and externally. When we used to go there, we always started off with a dinner with either the CEO or the CFO, then go through the whole following day of presentations, and last finish off with whoever you hadn't seen the night before.

That showed a tremendous amount of confidence in the organization that you are basically going to get the same message from both. But it also means that there is a certain amount of independence of the CFO relative to the CEO.

“Numbers are just another language, very similar to French or English or Italian. It has to be interpreted”

Dow Chemical used to almost de facto separate the CEO and the CFO. The Board of Directors really should hear separately from the CEO and CFO because one is more about operations and one is more about finance. To protect the integrity of the operation, the Board can get operational updates but they really need to see the finance, too. They need to be independent.

Terry Crews at Monsanto is phenomenal. In the background he has been able to make a tremendous amount of change at Monsanto, though you'd never know it. He's not a guy to talk about what he's done. He's very quiet, very principled. The investors who pay close attention recognize and appreciate those skills but that's probably a very small percentage of investors. Truthfully, how many investors care about anything other than the stock buyback and an earnings surprise?

We own AbitibiBowater where there are a lot of problems right now. One of the reasons we bought the stock was because of Bill Harvey, the CFO. I think he is a very strong CFO who has dealt with a very difficult situation in a very quiet way. Anyone that has really gotten to know him recognizes him for what he is, which is a very strong, very influential CFO who understands not only his role but how it plays in the broader organization on an operational basis.

The problem is that most people who invest money today don't really care about companies. They only know them as flashing lights on the screen. The investment timeframe they work off of is maybe three months. When Steve Cohen of SAC Capital can talk in The New York Times about how he is going to become an investor and might even hold a position for six months that shows you how badly warped the perceptions of investors are.

Most people on the buy side are so intimidated by corporate management that they are afraid to ask a question. Whenever you go and see a company give a presentation, even if the room is filled with a hundred investors, at the end of the meeting most of the time you might get only ten people who will go up and talk to the CEO and CFO. It's not because they are uninterested, it's because they are intimidated. That feeling of intimidation has been created by the sell side, which sees their primary job as disintermediating investors from their companies and companies from their investors. The sell side's job is to get in between the two and siphon off as much of the cash flow as they possibly can. That's why we have no more pre-emptive rights which wind up with rights issues. That's why the dividend has fallen by the wayside. That's why stock buybacks have come to the fore. There's no fee in a dividend. There's a fee in a stock buyback.

“The problem is that most people who invest money today don't really care about companies”

“The sell side is disappearing so fast, and their incentives are so warped, that we don't even talk to them anymore”

Interview four

These investment bankers have the gall to go to the CEOs and CFOs and say, "Stock buybacks are what your investors want." Yet in all my days in this business, I have never once fielded a call from a banker asking me what we thought about what we held. It's very difficult for a CFO to work around the sell side.

The CFO needs to get an investor relations operation that actually reaches out and talks to the people who own the shares. He needs to choose who they want to own their stock and he needs to do it in an intelligent manner. They need to talk to the long-term intelligent investors and make sure they are talking to the right people at those firms. That's what the focus of their investor relations function has to be. I recognize that they still have to talk to the sell side but frankly the sell side is disappearing so fast, and their incentives are so warped, that we don't even talk to them anymore. It's not worth it. The sell side is too conflicted. The company needs to figure out how to get a hold of the investors who actually own their shares.

The worst behavior that I've seen from a CFO is the person who sees their job as obfuscating and hiding and uses the numbers as a shield. That's the person who points to the 10Q and says, "That's what the number is in the book". They're abdicating their function of interpreting the numbers for the investment community.

“ The worst ... is the person who sees their job as obfuscating and hiding and to use the numbers as a shield ”

The worst CFOs are the ones who are enamored with Wall Street. Good investors work to try and benefit from the growth in the cash flow that comes from the corporation. That's how you build wealth, that's why you buy equity. When you own equity, the tradition is that as earnings grow the dividend grows, and that as the cash flow grows, if you discount it back in time at a growing rate, it becomes worth more if the company executes appropriately. When a company gets enamored of

a banker, what that banker is trying to do is to get a fee for taking away from the cash flow of the corporation and giving it to the banker. A lot of CFOs today are pretty sophisticated and they see the bankers as a necessary evil. The problem is they still spend more time talking to bankers than they do talking to their investors.

Over the last thirty years, the amount of assets under management has grown so much that they had to figure out clever ways and attract people to sit atop those assets as portfolio managers. But the number of people who have clear perceptions about how to invest hasn't really increased, especially as a percentage of the total number of people investing. There is a dearth of folks who are stubborn about focusing on companies for the right reasons and with long-term horizons.

Our whole approach towards the CFO is that we want to understand how they understand the business and figure out what they can do to influence a financially educated point of view as deep into the organization as possible.

A CFO, from an investor's perspective, has to think like an investor. That is most important. I've heard too many CFOs on conference calls who don't sit back and think, "What are the salient issues that an investor needs to know, and how do I explain them clearly to the lowest common denominator of the people listening to this presentation?" That's the biggest thing that most CFOs blow. Really good communication skills combined with thinking like an investor is to me most important.

The other thing is a CFO has to understand how his company makes money and be able to impart that to investors. On Wall Street right now, with the CDO write-offs, I honestly think they all got bagged because they didn't understand the product. Understanding how your products make money is really the most important thing to impart to investors and it's something CFOs have to educate themselves on. I don't think the CFO at Merrill Lynch, for example, really knew how CDOs made money. The critical issue is what sets your company apart. It might be a great business but how does it make money in that great business?

“ He understood what made his company financially attractive and how they managed towards that goal ”

The first name that comes to my mind as a great CFO was a fellow named Gary Cypres. He hasn't been the CFO of a public company now for probably 15 years, but he was the CFO of a company called Wheelabrator-Frye. What differentiated him was that he understood accounting backwards and forwards. He actually was a professor of accounting and he understood his profession. Because he had the skill of being a teacher, he knew how to impart the technicalities of what he was doing in very simple terms. The other thing was that he understood what made his company financially attractive and how they managed towards that goal. In other words, they had a bunch of mature businesses but they managed the company for cash, for cash flow and how to raise cash.

“ The worst CFOs I encountered were the ones who tried to keep things deliberately vague ”

He was very good at explaining why that was the goal and how they wanted to achieve it. His value as a CFO was definitely recognized at the time. Forbes, Fortune and others used to have "CFOs of the Year" and he was elected to those a few times. I can't remember specifically if the stock got rewarded for it or not.

Good CFOs communicate well, which prevents volatility in the stock. They prevent misinformation or misinterpretation taking control of a stock, even if it's only for a fleeting basis. It may not show up in a long term chart but investors don't like volatility and they don't like surprises. A good CFO can articulate what's going on

consistently and leave no room for judgment errors or false conclusions. I've got to believe that helps the stock price. With the increasing preponderance of investors with short investment horizons, that's even more important now.

There is also a dearth of corporate knowledge and experience amongst brokerage analysts, which is a real problem. That goes back to the communication issue. If a CFO is dealing with less experienced people, he just has to be careful that people understand what he is saying. CFOs have to be careful about not focusing their presentations on the half dozen people who follow the company closely. It's a common problem: a company gets trapped into responding to the interests of a handful of sell side analysts. The worst CFOs I encountered were the people who tried to keep things deliberately vague. There wasn't transparency to what they were saying and doing. I don't think it was a case of not understanding what was going on; they wanted to obfuscate the issues.

“ A good CFO should always talk strategically and long-term in his communications with the investment community ”

If I was giving advice to a newly appointed CFO, I would tell him to be consistent. For example, if he chooses to provide forecasts, he has now trapped himself into always providing forecasts because the first time that he deviates from that norm, people are going to suspect that there is something wrong. Before you do something for the first time, just remember you are married to this policy because once you change it, the inference that everyone is going to draw will be negative.

My second piece of advice relates to the involvement with analysts – going out on road shows with them. If I were the CFO of a public company, I would do it myself or with an independent IR company rather than going around with analysts. Going around with the analysts is always a no-win situation for a CFO. There always seems to be bias because companies tend to travel with the analysts that are positive on them. Unfortunately, the only way an analyst can get paid these days is through access to management because they can't get paid through investment banking anymore.

The other piece of advice I would offer is that the CFO should try to be as inclusive and responsive to people, irrespective of their opinion. In fact, I would try to err on the side of being more responsive to the people that are negative than to the people that are positive. When they were writing Sarbanes-Oxley five years ago, I talked to the members of the Senate Finance Committee about what was really wrong with Wall Street research. I said the problem was not investment banking but the vindictiveness of corporations towards analysts that did not have positive opinions on their stocks. I still think there is going to be a blowup on that someday.

I don't believe the markets make a big distinction between a company that has a great CFO and one that has a run-of-the-mill CFO. I would say that the best CEOs tend to be people who surround themselves with strong people. My sense is that a great CFO would be working for a company that has a very highly regarded management. So it is kind of a chicken and egg thing. It would result in a higher valuation but I think the higher valuation would be the result of the entire management team, not just the CFO, though the CFO would be a big piece of the package.

A good CFO should always talk strategically and long-term in his communications with the investment community. This is one of the problems with Wall Street today. Everybody is interested in the next quarter. All analysts today want their models plugged in for them. I don't think a good CFO should get caught in that trap. The quarter has always got to be reviewed within the context of the longer-term strategy: keep investors focused on the strategy while giving them the information they need quarter-by-quarter. It's a tough balancing act but it's one of the reasons why a lot of CEOs don't talk to the investment community anymore. They are trying to manage for the next three to five years when everybody on Wall Street is wondering about the next three months. That short-term narrow focus on models is one of the things that drives companies crazy. It's one of the problems of the inexperience on Wall Street.

Interview five

First and foremost, a CFO has to have an astute understanding of finance. People assume that CFOs have that, but I would say it's not in all cases. It's also being capital market savvy, so in addition to the oversight of operations, which obviously the controllers are responsible for, it's also being someone who is communicating the fundamental strengths of the company well.

A good CFO is someone who actually might construct equity valuation models for their own company. That is very important because what happens is, when someone does that, they in turn are able to provide supplementary data that is more useful to someone like me, who is essentially trying to come up with a valuation. Concise disclosure is

incredibly important. There are actually some financial supplements of some companies that I go through where it's just very impressive. They literally walk you through all the data that you need in order to model their company. They give you a lot of

“ Concise disclosure is incredibly important ”

the answers, and this puts you in a position where you don't have to make a lot of assumptions, or at least they are very clear in the way they communicate the information so that they actually distinguish between what is art and what is science. Essentially, you can then look at their assumptions and stack them up against your own. Obviously if you agree or disagree with their assumptions, then you can go ahead and do that, but the information is there.

I'd say the best CFOs I've encountered are Steve Sterrett of Simon Property Group and Mike Pappagallo of Kimco Realty Corporation. I also like Bruce Johnson at Regency Centers Corporation. I might not agree with what Bruce Johnson says, but he can definitely engage in some great dialogue.

The first two CFOs stand out in my mind because they run like Swiss watches. They have very sound ways of fielding questions, and a very sound way of understanding what I'm trying to do. When we get into a discussion, they know the answers I'm trying to get to. They are intuitive that way. They have a vast amount of experience speaking with analysts and portfolio managers, so they're very helpful. You can couple that with the fact that since I'm in my early 30s, I also look for people who can actually serve as a mentor. I'm obviously buying securities, and I don't have any experience in operations, so a CFO who can actually teach me about the business, in addition to answering my questions in a thoughtful manner, is invaluable.

“ When we get into a discussion, they know the answers I'm trying to get to. They are intuitive that way ”

I personally feel that an investor has to have intellectual curiosity. If they don't, they can't possibly take advantage of the resources out there. The men and women who run these companies on the financial side have been in the trenches for a long time. They can really add a lot of value with regard to how decisions are made. We're trying to field so much information so quickly, so if we actually have a pretty good idea of how certain management teams are going to react to whatever, that's going to influence how you trade or invest in the stock.

“ A CFO who can actually teach me about the business ... is invaluable ”

If you go back to the issue of disclosure, there are two things. One is, if the company is a strong company, and also discloses well, then the information is there. I do believe that the market is going to offer that company an information premium, only because of the fact that it's available. They have access to it, so they don't assign as much of a risk premium to a name, because of the fact that they lack information. In addition to that, a good CFO has pure decision-making skills. Right now, we're dealing with the credit crunch. CFOs are responsible for, or at least in part responsible for, how they use capital and how they raise capital. The balance sheet risks out there right now are obviously concerning. One CFO may sit there and be a little bit more lax or get steamrolled by the CEO. Or maybe both of them aren't thinking straight and they levered up a year and a half ago because maybe that was a good idea at the time. Now, all of a sudden you have people who are actually talking about solvency risks. But others who were disciplined and patient and held off for a while will have access to a lot of capital, and can take advantage of those parties out there that made mistakes. I think that's probably the right thing to do at this point in time. I think it's a combination of disclosure and just pure decision making.

I would tell a newly appointed CFO they should talk to the investment community at length as much as possible, where he or she should be ready to explain for example, why he or she isn't providing information a competitor provides to the market. I'd say they should also structure information in such a way so that people can figure it out pretty quickly and easily. A good CFO is also candid and is willing to learn about the job I'm doing.

Obviously I need to spend some time thinking about their job, so they should figure out what kind of job I'm doing. If they do that, then the momentum will be there, and the velocity of the value added, at least on the capital markets front, will be at a pretty healthy clip. Stepping into the investor's shoes is something that a CFO should do.

“ In addition to that, a good CFO has pure decision-making skills ”

A bad CFO is someone who has trouble being confident, because lack of confidence definitely translates in a lot of people's minds to uncertainty. I mean confidence in both the information they receive and the way they present the information. The

Interview six

worst CFOs do things like give guidance when they don't really have all the facts or understand it and then change it without really giving investors much of a good explanation. Another real complaint of mine is those CFOs where I'm just left with the feeling that they aren't being forthright. They just don't give complete information. I don't want to have to play Twenty Questions with a CFO to try and figure out what is really going on at the company.

The other type of CFO that really bothers me is the one that seems more like a marketing person for the company. Everything they're telling me might be true but when they are too rah-rah, it just feels like I'm getting snowed and I'll get even more suspicious.

What makes a great CFO is the ability to act in an extremely sophisticated financial manner, while at the same time explaining sophisticated financial maneuverings to the investment community in a way they understand. Basically we want someone who, by their actions, shows us a deep understanding of how to not only manage the company's balance sheet and cash flows, but also invest for the future, using all the available tools, and not just necessarily issuing bonds when interest rates are attractive, or issuing stock when the stock is attractive.

I've spent God knows how many hours since August on conference calls and in meetings with CFOs of finance companies, given what's been going on. At the end of the day, the ones that you feel the most comfortable with are the ones who can explain their balance sheet to you in English, while at the same time functioning at a highly complex level. This is pretty basic. It isn't rocket science to ask for something like that, but you would be appalled by how many guys can either talk inside baseball or outside baseball, but can't do both.

“ It can be absolutely damaging if people don't understand what a company is actually doing ”

It can be absolutely damaging if people don't understand what a company is actually doing, and that's obvious even with a lot of the big companies. I'll give you a good example.

There is a company called JER Investors Trust. They held a conference call in August, when things were falling apart, that was essentially a primer on structured finance investing. They talked for over an hour, and they did their best to make sure that all the investors could follow, from top to bottom, their balance sheet. They wanted us to see why, in their opinion, that while they were having problems, they were going to make it. I have told a number of clients who held the stock and who were questioning why we still owned it, listen to the playback of the conference call.

You will understand by the end of the conference call, if you followed along, why we still think it makes sense to own the stock. The ability to talk to people and to present these very complex instrument and strategies in English is extremely important.

“ A good CFO is a good teacher ”

Beyond that, from an external point of view, nobody wants cheerleaders. Everyone knows too much to fall for cheerleaders. A good CFO is a good teacher because that's what they're doing. The CEO and CFO and the COO are out there teaching everyone else about their company, and why their company makes more sense from an investment standpoint than someone else's.

I can't say who the best CFOs are I have encountered. The guys at Danaher Corporation have been very good because they focus on finding what works in their company and allocating capital to that. They figure out what doesn't work in their company, and take the capital away. They go out and look at what works in other companies and either buy those companies or buy parts of those companies for bolt-on acquisitions. When we visited Danaher, there just seemed to be no real ego. They were very focused on doing the right things and executing as best as they can. Whereas in a lot of other companies, the egos of the CEO, especially, and the CFOs cloud the stories. But with Danaher, they just seemed, top to bottom, to be very, very focused. On the other hand, the senior management at CapitalSource have huge egos, but they are very good at what they do. It's not always a net-net negative to have the big egos.

“You know pretty quickly when someone is just sticking to the script and cheerleading”

Whether the investment community rewards the really good CFOs is too discrete a question in the current environment where there are just so many inputs. There are so many things that go into buying and selling, so I don't think you can really lock that down. Perhaps the good CFOs get more benefit of the doubt when they have that "trust me" conference call that every company has to go through at some point when things aren't going so well. I don't know, but perhaps the CFOs that the Street trusts are not going to get downgraded as much, or the plans questioned as much, but I don't think one can really answer that.

I have a really good "bullshit" meter. I've been doing this for 10 years, so you know pretty quickly when someone is just sticking to the script and cheerleading. Who knows what's going on in the CFO's head? But given the public disclosures they have to make to the SEC, unless they want to go to jail, it's pretty easy to figure whether they're spinning too much when they're telling their story. I'd say they just have to play it straight as much as they possibly can. With our clients, you only have one time to screw up before your reputation is ruined, especially if you come across as insincere or dishonest. It's pretty much the same way with the CFO.

“What you want the CFO to do instead is admit the obvious and say, 'Yes, it is hurting us'”

The worst characteristic in a CFO is the one whistling in the wind, the one who on their August or September conference call was saying, "You know, we haven't really seen any pull backs in our market, and the credit crunch isn't going to affect us all that much." That's just patently ridiculous.

What you want the CFO to do instead is admit the obvious and say, "Yes, it is hurting us, and this is how it's hurting us, and this is how it could potentially hurt us; but also

this is how we can potentially benefit from it if we position ourselves this way. If we position ourselves this way to take advantage of it, we might have to dilute you a little bit because we're going to do a convertible offering, or we're going to raise capital somehow. It may hurt for three to six months, but we're not running the company for three to six months, and I would imagine you're not in the company for three to six months. If you're in it for the long term, we're going to take advantage of this market volatility. It's going to hurt us over the short term, but over the long term, it should help us in this way." Compare that answer to, "Well we're just kind of plugging along here, and doing okay. The markets that we're participating in are doing okay. Our competitors are dropping left and right, but since we're so brilliant, we're just doing great." That's just bullshit. You want them to acknowledge the obvious, because if not, they come across as insincere, which is not good.

CFOs need to respect the intelligence of the people they're talking to. We may not know all the nuances of the company, but we know enough when you look at all the companies in the industry, to know exactly what is affecting that company, and what could affect that company. It's not really a question of respect; it's a question of giving credit where credit is due, and just being honest. All it comes down to is just being honest and straightforward. They have to recognize the realities of the situation, not just internally, but externally.

Interview seven

The characteristics of a CFO I see as being most important are honesty, integrity, deep financial accounting acumen, and a good knowledge base of the company, as well as a focus on shareholder value.

It's tough to answer who are the best CFOs I've encountered. I'm not sure I'm really comfortable answering that. I think Don Blair over at Nike is pretty good. His name comes to mind because he's done a good job contributing to shareholder value by communicating with shareholders on how they prorate capital structures and such. I

think Tom Steinbauer over at Ameristar is pretty decent, too. So these are guys that would come to mind. Another really good CFO I should also mention is Jim Murren over at MGM. Part of it is the role they play for the market in terms of communicating the story and where they fit in with their markets. A lot of those guys have a lot of the characteristics we talked about.

“ In some cases, the market does reward strong CFOs ”

In some cases, the market does reward strong CFOs, but in some cases, no. In the case of MGM and Ameristar, probably not. In terms of why or why not, that's a good question, but I don't necessarily know the answer. In most cases where they did, those people were pretty charismatic and really effective in telling their story. In the case where they didn't, the person involved in that situation was a little less charismatic, but probably no less capable.

In general, I think a company with a great CFO should be more highly valued by investors because I think a CFO is very important. It probably depends on how strong are the other members of the management team. If the company has a great CEO and mediocre CFO, the stock could be as highly valued as someone with a good CEO and a good CFO. I think there are probably too many variables to give you an exact answer, but I'd say a good CFO should provide an important role in the company. If everything were held equal, I would imagine the market does reward them, but probably not to the extent that they should.

“ A new CFO should focus on how they allocate capital ”

I would tell a new CFO first and foremost that they should know their business and the financials and accounting of it backwards and forwards. That's key. Honesty and transparency are also important. Another thing I always find important is that they need to have those qualities and accessibility both in good times and in bad times. When your company is performing well, or when your company isn't performing well, you need to be in front of investors just as much. No hiding.

The worst CFOs I've met were arrogant and not as well versed in the financials as they should be. In situations when things get bad, you can't get a hold of them, and you can't get straight answers. They disregard the metrics that they used to pay attention to and change the scoring system that they hold themselves accountable to.

A new CFO should focus on how they allocate capital. First and foremost, it's going to be that stuff. I would much rather have a CFO who is excellent at those things, even if he never talks to me. At the end of the day, that's what these guys are paid to do, not necessarily to talk to the Street or to people like me. If you have both, that would be great, but proficiency and doing a good job and thinking about capital structure and allocations on the short- and long-term basis would be the biggest focus of a successful CFO.

Interview eight

The first few qualities that come to mind regarding a good CFO are integrity, a sense that the individual is looking out for the best interest of the company, including all its constituencies, clients, employees, shareholders, etc., and whether or not the CFO has a solid grasp of his company's business fundamentals. I have met a range of individuals where I didn't sense that they knew that. They didn't really have a good command of their own business. Sometimes, it's trying to judge business situations correctly, specifically in an industry with increasing competitive dynamics, and how do they think about the trade off between growth and returns, or how do they think about factors that would create value in terms of the company's stock price over time.

A lot of CFOs that I have met truly don't understand free cash flow and the importance of that, and why that drives value creation. There are also a number of CFOs I've met who were just downright arrogant, and that's always a big turn-off.

Common sense and a level-headed grounding around how they handle themselves are critical to the position. I have met some CFOs who are just over-confident in their abilities. But as I said, the first quality is integrity because I've seen a number of individuals who I felt were either intentionally misleading, or didn't quite tell you the whole story. They would be selective in their disclosure and I felt we were just not getting the full story.

David Moffett at U.S. Bancorp was a good CFO, but he's no longer there. He really understood free cash flow and how to create value for the company. He really understood all the drivers of the business and took a lot of steps to de-risk the company. David Viniar at Goldman Sachs also exemplifies a lot of those characteristics. He's a

very thoughtful business leader, and he is extremely knowledgeable about all the different areas of the company. They both have done a good job constantly finding ways to share new information with the investment community in conferences, and there is a forthright candor when they talk about the company. David Moffett has done a number of things there that have constant-

ly kept U.S. Bancorp at the forefront around risk management. He is not the current CFO, though the current CFO is also very good. David had tons of integrity, and it always felt like he had the right things in mind in terms of how to run the bank. He had good use of excess capital, and was just a very bright banking executive and a really strong CFO. Good CFOs all have the same kind of stature. They might be in different businesses, but they all focus on similar kinds of attributes.

“ Good CFOs all have the same kind of stature ”

“ A lot of CFOs that I have met truly don't understand free cash flow and the importance of that, and why that drives value creation ”

“ Over time, a company with a great CFO is more likely to be valued by investors ”

For the most part, investors probably recognize the skills those CFOs have, though in some cases more so than others. Gary Perlin at Capital One is a really strong CFO. A lot of it tends to be time dependent. For example, if you ask most people today, they'd tell you Goldman Sachs has been a great stock recently, and therefore David Viniar is a great CFO. But if you ask people that question at \$65 instead of \$100, you might not get the same answer, although he is a great CFO independent of where the stock price is. Today, if you ask people what they think of Gary Perlin at Capital One, you might get a very mixed response. For example, it's been a very challenging stock, but I actually think his strengths have been highlighted even more because of the challenges, and over time, the stock will recover. Now you might not get that same response from other people. Five years ago, if you asked people what they thought of David Moffett at U.S. Bancorp when the stock was at \$16, they would probably have said he's not that strong. Today, the stock is at \$32, and he has recently left as CFO. I would definitely take a closer look at a company where David Moffett was the new CFO. My guess is that is what will ultimately wind up happening at Capital One.

Another example is Gary Crittenden, who was the CFO at American Express, where Gary did an excellent job. He has left and gone to Citigroup, and I think he's going to do an excellent job there as well. I have no desire, however, right now to own the stock. Gary is one great executive, but Citigroup is one enormous company. My point is, while Gary is going to do a lot of really positive things, it still gets back to what price do I have to pay to own the stock. When Gary got there, I think the stock was still into the \$40s, and I had no desire to own it. Now, it's at \$24, and I'm still in a "wait and see" mode. With that said, I still think Gary did an excellent job at American Express.

Over time, a company with a great CFO is more likely to be valued more highly by investors, not because of the person, but because if he or she is truly good at their job, they're going to be focused on the right kinds of things. Those things will manifest themselves in the fundamentals of the company, and the financial characteristics of the company. But this will also depend on the time horizon. Some people didn't like some of the acquisitions U.S. Bancorp did years ago, and that was why you might not get as high of an endorsement from other folks. Those acquisitions changed the financial characteristics of the company, and ultimately improved free cash flow and the risks. All those things led to a higher stock price.

“ If the CFO is really strong, that's probably going to show itself in the financial discipline of the company ”

Interview nine

If the CFO is really strong, that's probably going to show itself in the financial discipline of the company. It's probably going to show itself in use of excess capital, and it's probably going to show itself in terms of risk management and other factors that, if managed well, will create value for shareholders. I just don't see how the idea that people just like a CFO over any time horizon will lead to out-performance in the stock. There are some businesses where the CFO is not that important, for example, where there is more of a product cycle. In a financial services company, the CFO is really important. In other sectors, I don't know that it is as important.

I would advise a new CFO not to make an abundance of investor presentations. Give enough of them, but don't go overboard with it. There are some companies where they're at every single conference, and you just wonder who is running the company. Depending on the industry, I would err on the side of giving less guidance, not more, and I would err on the side that you would give guidance that is very direct and conservative, and not egregious. At the end of the day, good financial systems and good risk management are going to show themselves in the business. Whether or not you gave guidance is going to matter less. Goldman Sachs doesn't give long-term guidance, and they don't give near-term guidance, which speaks volumes.

I've worked directly for a CFO, so I have a little bit of perspective. As an investor, first of all, what I look for in a CFO is one who has a good handle on his business. They need to understand the moving parts, and be able to communicate and show confidence about what the numbers are.

The absolute death mark for a CFO is that investors think that they don't know what's going on in their company. If you ask a CFO questions and he says, I'm not sure or I have to get back to you, or if there seems like there is some uncertainty, that's not good. Having familiarity with their company and understanding it are key, as well as being able to communicate that confidently.

They also have to be trustworthy. Nobody wants a CFO who puts a lot of spin on things. Another thing I'd say that separates bad CFOs from good CFOs are when the latter understands what the investor community does and wants. When you talk to a good CFO, they are really able to help investors with models, talk about estimates, and understand the process. There are some CFOs who manage their business well, but they should probably do that for a private company, not a public company. For a public company CFO, it's very helpful when they understand what investors are looking for.

The best CFOs are really co-CEOs in some ways, where they help with the strategic decisions and deal with investors. Lockheed Martin is a very big company and their former CFO was really the guy that most people saw. They didn't really even see the CEO that frequently, but that was fine, because Chris Kubasik, the CFO, was so good.

“The best CFOs are really co-CEOs in some ways, where they help with the strategic decisions and deal with investors”

Chris Kubasik was good because he could tell the story, he was out there, and he was able to convey a vision of the company. He also provided investors a good understanding of what was going on day-to-day. There was no real need to get the CEO's opinion on things because investors knew it was in sync with the CFO's. They knew that Chris could communicate, and was trustworthy. He could put himself in the shoes of the investors.

Another example of a good CFO is Dan Comas, the CFO of Danaher Corp. Larry Culp is the CEO, and everybody understands that, but if I call up and ask Dan a question, I know I don't have to call back and ask Larry the same question. I get one answer, and it's the right answer. There is no difference of opinion between the two.

I don't know about the all-time best CFO, but one person who comes to mind as a good CFO is John Bartholdson at Triumph Group, which is a mid-cap public company. He retired last year, but I'd put him up there as a good CFO. Chris Kubasik, at Lockheed Martin was a great CFO. Dan Comas at Danaher is great, as is Patrick Allen at Rockwell Collins.

A great CFO not only understands the story, he's got a strategic vision. He doesn't make the decisions because that's what the CEO does, but I can ask him questions if I can't get ahold of the CEO, and he understands what I'm asking for. In some ways, I want to know if a CFO can take some of the workload off the CEO. It is frankly sometimes hard for investors like myself to just call up and ask for a meeting with the CEO. Sometimes it happens, but sometimes it doesn't. More often than not, I am likely to get an audience with the CFO.

The CFOs that I think are good are the ones who I can talk to and get what I need. For other companies I might say, "This guy doesn't get it, and I'm concerned that he is not privy to all the CEO's thinking so, therefore, I need to talk to the CEO, too."

It's not necessarily more comfortable talking to the CFOs of larger companies. The worst CFO out there works for a large company and just has no confidence. On conference calls, he puts investors to sleep and he's been confrontational. I just don't have confidence that he is as plugged into the CEO as I would expect. So, larger companies don't always have better CFOs. Then there's Keith Sherin, the CFO of GE. I'm sure he is extremely capable as a manager and organizer, but he's not the front man for GE. It may not be his fault, but he has not been given the opportunity, so I can't say how he's doing one way or the other.

Having a good CFO certainly helps the way the investment community rewards the companies they work for. Management is one of those things you can never put your finger on and say how

much value it adds. It's one of the things I look for, and I don't mind paying higher valuation for a number of factors, one of which is management. You can say you're paying up for it, but you're getting a Cadillac, so it's okay. If you were to ask me what the management is worth, I don't know how I'd describe it or give it a specific number.

Whether a company gets rewarded for having a good CFO depends. Part of it depends on the CEO. There are a couple of companies, like GE, where when you've got a very good CEO, sometimes you don't need that CFO. I don't know if you could say any one company is rewarded by the CFO. There are some companies where you say the CFO is great, but I also like the CEO because he's the front man, so no harm, no foul. Companies where the CFO and CEO are both great do get a bit of a

“ A great CFO not only understands the story, he's got a strategic vision ”

“ So while I don't know if a company really gets rewarded by the CFO, they can get penalized if the CFO is bad ”

value added. In a case where the CEO is okay, but most people think the CFO is terrible, that can penalize the company. So while I don't know if a company really gets rewarded by the CFO, they can get penalized if the CFO is bad.

Another example is Gardner Denver, which is a mid-sized company. I personally am not a huge fan of the CEO, but the CFO is a woman I think of very highly. I don't own the stock anymore, but when we did, we did up our valuation to reflect her. If she left, we would sell the stock because we thought that highly of her. I would also definitely take a closer look at any company she moved to because I have such respect for her. I would think she will become a CEO someday. She is someone we identified as a very good leader. With ITT, I think very highly of the CEO, and less so of the CFO. That was a case where I was willing to overlook the CFO. If they had a bad CEO as well, that would have worried me.

I'd tell a new CFO that before you go out on the road to talk to investors, it's going to take six months to learn the company inside and out. Before you go talk to anybody, make sure you've got a 100% grasp of the company. If you start off on the wrong foot, it's very hard to recover. I would err on the side of taking time to get prepared. A smart, new CFO should also ask us what we're looking for, as well as ask us to give them a report card on what kind of things we want.

“ Before you go talk to anybody, make sure you've got a 100% grasp of the company ”

When I look at bad CFOs, the ones that really fall flat on their face are those who just don't understand what the investment community is looking for. For example, they will miss earnings results, and then they'll say they don't understand what the big deal is. Then they ask why investors took their stock down 15%. They need to understand that that's what we look for on the investment side. That frustrates investors, and I know it frustrates me personally because it demonstrates a lack of concern for shareholder value. Not only did this management miss estimates, but they also don't understand what they're doing wrong, and that's a little troubling. I think bad CFOs also don't understand that investors are willing to take a leap of faith because that's what we do every day, but they need to guide us along. Some CFOs earn the trust of the community, but it's not automatically granted to them.

The qualities that are important for a good CFO depends on who the CEO of the company is, and who is in front of the Street more often. The ones who are more active and present the story very well are good. The best CFOs are the ones that embrace the tough questions. Instead of trying to duck around them, they take them head-on and anticipate what people are going to ask. Another good quality is seeing how they treat the cash flows of the business, whether how tight it's run or how loosely it is run.

They need to have a comfort level when presenting the story to the Street, and they need to know the business issues, not just the numbers. Even if they're not the ones setting the strategy, they need to understand the strategy and convey it.

There are a couple of CFOs I really like. I like Barry McCarthy from Netflix. He tackles the tough questions head-on. The stock is heavily shorted, yet he takes all the questions head-on. In fact, I think he enjoys that. I also like Daniel Wu from Focus Media for the same reasons. He anticipates investors' questions. He's not really the strategy guy there, he's the numbers guy, but he can at least anticipate the questions people are going to ask. He can read between the lines and understand what people are trying to get at. He has an answer regarding issues people might pick up on.

The investment community does recognize and reward companies for the abilities of their CFOs. Obviously we like the better CFOs more than the weaker CFOs. A lot depends on the make-up of the company and how active the CEO is with the Street.

If the CEO is more active with the Street and is the front person, a good CFO is less important. The less active the CEO is in investor relations, the more the CFO becomes very important.

How the company itself is doing is a critical part of the dynamic when we look at the CFO. You see companies where the CFO doesn't really give you that much confidence about their capital budgeting and similar things. They may want to go off and execute a strategy that doesn't make economic sense, and there is a tie there.

There was one company where the CFO was asked what returns the company wanted for new projects, and his answer was, "The CEO says it's in the ballpark with the rest of the industry." There wasn't really any analytics behind what he said and I don't think the company had any real analytics to start with. Not surprisingly, that CFO didn't seem that capable.

“ They need to know the business issues, not just the numbers. Even if they're not the ones setting the strategy, they need to understand the strategy and convey it ”

The market definitely distinguishes between the CFO like that and a CFO who is really doing a great job. Then there was the CFO who was asked what the share count of the company was, but he couldn't answer the question. This is a basic thing that he should have known, and it's the kind of thing that drives confidence among the investors. It's also how you run the balance sheet.

I would tell a new CFO that he should anticipate and embrace the tough questions. The more people shy away from that, the more you worry about them. Anticipating questions is actually pretty big. I personally like the CFOs who are non-spin. They're more up front and tell us what's really going on, or at least as much as they can say.

“ I would tell a new CFO that he should anticipate and embrace the tough questions ”

If they come back and say they'll have to get back to me regarding an answer, that would give me more comfort than the one who ducks the question, but it depends on the type of question. If it's a question about basic fundamentals like returns, they should know what kind of returns they want for their projects. If they're going to build a new factory, you have to know what kind of return you want on it.

A CFO should promise what they deliver, not over-promise and under-deliver.

Interview eleven

When I think about a CFO, I think their most important job is to be a governor or regulator on the application of capital. Ultimately, the Board has to make these decisions, but it's the CFO's job to pretty much channel through what information they see. To make these decisions intelligently, a CFO has to be able to get data and be on top of what the metrics are to manage the business. Ultimately, this flows down to return on capital and cash flow, which go hand-in-hand.

You can have lots of free cash flow, but if you invest a bazillion dollars to get that free cash flow, then that was a bad decision because the return on capital is low. It's understanding how to allocate capital, understanding the drivers in the business, and where to put capital. In order to make these decisions, you need to have the data to make intelligent decisions. It's not only being a gatekeeper, it's having influence in terms of how the capital should be allocated.

I don't put high on my list that CFOs should deal with strategy. I do think it's great if they can help to develop strategy, but in my view, that's not what their primary role or function should be. It is measuring the business, understanding the metrics, understanding the current capital, and how to reinvest that capital. For example, if there are no reinvestment opportunities, then the decision is how to get the capital back to shareholders. Is it in the form of a dividend, in the form of a buy back, in the form of a one-time dividend, or in the form of a one-time debt tender? It's understanding return on capital. If the stock price is really high, it doesn't make sense to buy it back. They should be issuing stock, not buying it back.

It all comes down to having the right data and tools to make the decisions. The CFO's job is to make sure that they are getting that, and keep getting it. Doing that on a divisional basis is part of that. Execution is how you organize the business along function lines, regional lines, and product lines.

When I think about the best CFOs, Chris Liddell at Microsoft is very good. He's done things that showed smart allocation of capital. He has the data to make decisions. He is helping to evaluate where they are investing capital. They're losing money in a lot of places, yet they continue to invest. There is no other household name that comes to mind regarding the best CFOs. I would categorize the majority of the CFOs as being mediocre because they aren't good allocators of capital.

Ultimately it's not their decision, but they do have a significant influence over the decision. Acquisitions would be another area where there could be allocation of capital. Most of them are mediocre because they allow things like bad acquisitions to happen all the time, where basically it's their job to kill an acquisition. Good CFOs should have sufficient influence on their Board because it should come down to data,

“ It's understanding how to allocate capital, understanding the drivers in the business, and where to put capital ”

information, and understanding the risk and rewards. It is their job to lay out the case whether these are smart allocations of capital or not. It's their job to make the case, yes or no.

The investment community doesn't really reward companies that have a good CFO. The company gets rewarded because it's hitting the numbers. A good CFO could help with that, but it's not going to make a difference necessarily. Not to disparage the CFO of Google, but a lot of people could be their CFO. I'm sure he is very talented because Google hires very talented people, but the stock price reflects more about the company and growing earnings, than it does about the CFO.

“ Good CFOs should have sufficient influence on their Board ”

Most likely, a good company has a good CFO because a good company has a Board that is smart and hires good people. There are bad companies with good CFOs, but that is not going to make a difference. One person even that high up can't make the difference at a crummy business model.

It may not be that the model is broken, but it may be that the wrong decisions are being made, there's bad execution, or it's a turn-around. Can a good CFO make a difference on a turnaround? Yes, he absolutely can, but a good CFO alone may not be able to do it. They also need a good CEO as well. If I had a choice between having a better CEO or better CFO on a turnaround, I'd want a better CEO for the strategy and execution. Turnarounds are really execution issues. It may also be there are data or reporting issues, and they might not have the facts to evaluate return on capital. If a company makes 10,000 units of computers, and the CFO comes in and says we have to figure out how much we make on each part, and it turns out we're losing money on 80% of the parts, then that CFO can make a difference. But he is still number two to the CEO.

The worst kind of CFOs are the ones who lie. They absolutely lie. I don't know if they lie because they are dishonest people, but I think they lie because they are delusional. They aren't accepting reality, and they are afraid to tell the truth because they'll suffer in the near term. But you know what? They are buying time. They think maybe they can work their way out of the problem, but it never happens that way. The truth comes out and they get nailed harder for not being upfront. They have to be upfront and they have to set expectations low and to be realistic to give themselves some leeway.

“ When you think about the worst CFOs, it's the outside work they do in the investment community, not the inside work they do ”

What's interesting is, when you think about the worst CFOs, it's the outside work they do in the investment community, not the inside work they do. But if their inside work sucks, it doesn't really matter how good they are on the outside. If they don't have the day-to-day information to make the decisions, then the business is going to suffer anyway. If they are on top of the stuff internally, then they are a good inside CFO.

Acknowledgements

Whether they are good outside CFOs depends upon how upfront they are, how realistic they are in setting expectations, and if they set them low. I've had plenty of CFOs lie to me.

The word "lying" has a lot of emotional context around it because plenty of people have been burned when companies miss their numbers for whatever reason.

“I've had plenty of CFOs lie to me”

Sometimes it is out of the control of the CFO, and other times it's not. Sometimes the CFO is not realistic and didn't set expectations low enough. A part of that is a battle with the CEO, for sure, but a good CFO will be assertive and be able to control that process. This happens to big companies and small ones, though it's less typical with the smaller companies.

I would tell a new CFO to divide their brain along two tracks; the inside work and the outside work. With the inside work, you have to have the talent to be on top of your numbers and understand how to manage the business from a reporting standpoint so you can evaluate and then make the intelligent capital allocation decisions, or at least get the information to make those decisions. The outside CFO is the one communicating with the Street, and has to be upfront, consistent, and realistic in setting expectations. That latter one can be tricky because of the sell side analysts, where you're not supposed to tell them to take their numbers down. But that's bullshit because you can, with code words, manage them down and point them in the right direction.

On the one hand, I've been in situations where I heard a company say I don't care what the Street says, I'm managing my business. I'm not giving guidance and let them figure it out. But you have to give enough information and data and metrics so that people can figure it out. Black box and no transparency suck, so they have to provide the metrics. People have to understand the metrics and how they are relevant to the business. Assuming it's not too complicated, you can probably get the metrics down for any business to four numbers and get a rough approximation on where things shake out. Part of me says, one school of management doesn't care what the Street says, but the other school understands you've got to think about what the Street says because they're helping to set expectations. When I do my work, I will not buy the stock of any company where the Street is higher than my numbers. I'm not going to do it.

Another important thing is for the CFO figuring out when and how to raise capital most efficiently. Some CFOs don't do that very well. They should raise money when they can, not when they have to. When it comes to equity, you get better valuations if you do all those other things I mentioned right. The internal and external things done right will yield a better stock price because the CFO is pretty much managing the Street relationships. They are providing consistent information and credibility. A good CFO sets expectations low.

We would like to thank the sell side and buy side analysts from these firms for participating in this study:

- Balyasny Asset Management
- Harris Associates
- Harris Private Bank
- Brookfield Redding
- Lord Abbett & Company
- PNC Capital Advisors
- Merrill Lynch Global Securities
- Putnam Investment Management
- TCS Capital Management
- Zirkin-Cutler Investments

g.a.kraut company inc.

275 Madison Avenue ● New York, NY 10016 ● 212-696-5600 ● www.gakraut.com