INVESTING IN AN EFFECTIVE ANNUAL REPORT

By Lynn Casteel
EXECUTIVE VICE PRESIDENT, TRAVERS COLLINS & COMPANY

Thousands of public companies go significantly beyond the SEC requirement of producing an annual report on Form 10K, and provide investors with a four-color positioning brochure intended to communicate value and potential growth. The annual report is a targeted communication piece offering public companies the opportunity to showcase the value of products, services, employees, management strategies and markets. With nearly 15,000 public companies competing for investors, they can't afford to have an annual report that misses the mark.

What's the first step to producing a better and more effective annual report? Accepting the premise that the annual report is a marketing document and probably the most important piece produced by a public company during any one year. It's difficult to understand how some companies can put less thought and planning into their annual report than they would a sales brochure, but many do. The annual report is a company's flagship sales brochure for investors.

Annual Report Project Objectives

- To introduce or create interest in your business among investors
- To provide an understanding of the factors that drive value
- To produce a valuable longer-term reference document

The annual report doesn't have to be expensive to be effective, but it does have to be well thought out. Why go to the expense and effort of creating an attractive four-color report if it's not focused on increasing investor understanding of the factors that drive company value?

DESIGN AND SUBSTANCE

One of the primary obstacles to producing an effective annual report is deciding on an appropriate style and level of design. It's not always easy to arrive at a visual theme and treatment that is consistent with financial results, traditional industry practices and the communication style of senior management.

A good annual report design will create interest and invite the reader inside. But an annual report is not about the design, it's about increasing comprehension of the content. A really good design won't call attention to itself, but will make it easy for investors to find the information that's intended to differentiate the company and highlight the factors that create value. Page after page of uninterrupted text and large 4-color photographs are unlikely to get the job done. Readability enhancements on inside pages improve the probability that potential investors will spend additional time to grasp important information related to the company's future prospects.

ARs: What's Included

Photographs	82%
Charts/Graphs	75%
Mission Statement	60%
Market size/share data	35%
Margin call-outs	34%

Annual Report Survey
2002 National Investor Relations Institute (NIRI)
Top 5 Survey Responses

Due to the size of an annual report – normally 30 to 50 pages – few investors will take the time to read it cover-to-cover. The use of bold headlines, highlight boxes, attention grabbing – but relevant – photography, informative captions, charts, graphs, tables and other enhancements get the reader's attention and establish the value of the annual as an information resource on the company. These visual content-oriented enhancements are an effective way to focus an investor's attention on the unique aspects of a company – including non-financial factors – that communicate strategy and demonstrate value or the potential for growth in value.

For companies with more than a single line of business, we recommend the use of a business summary spread that outlines products, targeted markets, distribution channels, competitive advantages, growth drivers and financial information related to each segment. Client feedback has indicated that business summary spreads have been well received by analysts and institutional investors because it provides a faster and easier way to develop an understanding of the company's various businesses.

Each year a number of companies choose to produce a 10-K wrap, an annual report without graphic elements, design enhancements or photography, which are so visually uninteresting that they provide no incentive to read them. For many of the companies in this category the decision is based on economic necessity related to poor financial performance over an extended time or perhaps a bankruptcy filing. But for others, the decision seems to be based solely on a desire not to invest in communicating to shareholders and potential investors.

For companies weighing this approach, it's important to consider the downside of making investors struggle to understand or learn more about their business and growth potential. Also, it's a significant strategic mistake for a company to create the perception that it belongs in a category typically associated with financially distressed companies, or that management is not committed to open and proactive communication with investors.

SELECTING THE RIGHT CONTENT

One study determined that the average public company turns over approximately 35 percent of its shareholders annually. The average company will see a significant change in its shareholder base every year and should refine and reinforce its key investor messages each year. It simply isn't a good idea to assume that readers of an annual report have any significant base of prior company knowledge.

In fact, this approach should guide the development of content for the entire report. Key messages should be repeated throughout the various sections of the report to increase exposure and reader comprehension.

More than numbers

There is no wrong time for a company to talk about its business strategy, plans for growth and how it will meet the challenges of industry and the broader economy. Over time strategy and execution drive a business – not short-term financial performance. The results from the National Investor Relations Institute's (NIRI) 2002 annual report survey support this view, as 65% of the respondents indicated that strategic direction was their primary narrative theme.

Investors aren't paying for the results of last year or even last quarter, they're buying the future potential and anticipated performance of the company. Past financial performance is one indicator of the company's future potential providing a benchmark starting point, and an indication of management's ability to manage for growth. It provides investors with a measure of credibility, and therefore should always be an element in a company's investment story, but shouldn't be the primary message of its annual report.

Although we believe the annual report is the best vehicle to define what a company is, it sometimes becomes necessary to use the report to define what the company is *not*. Examples of this include organizations that are transitioning from one business to another and companies that seek to differentiate their business from others within an industry that is out-of–favor with investors. This makes sense when a company has successfully taken steps to focus its business in areas with stronger margins or it has a stronger competitive position and less operational volatility than peers.

Primary Development Themes

Strategic Direction	65%
Products and Markets	44%
Financial Performance	30%
Future Plans	26%
Maintaining/Increasing Shareholder Value	30%

Annual Report Survey 2002

National Investor Relations Institute (NIRI)
Top 5 Survey Responses

The primary communication advantage of the annual report is the flexibility it offers in presenting information. Important messages can, and should, be communicated throughout the report since different investors will focus on different sections of the report. By presenting information in a variety of ways a company can ensure that its key messages reach the widest possible audience. Short, declarative sentences work best. Because the primary objective of the annual report is to make investors feel comfortable about owning a company's stock, why would anyone want to make their business difficult to understand?

Communicate consistently

As long as annual reports are produced, many companies will find it necessary to share negative news with investors. A direct and forthright approach works best. Attempting to ignore or bury bad news in the annual report sacrifices the best opportunity to communicate planned solutions and often results in damaged credibility. There are few companies that can avoid cycling through difficult periods that challenge the skill of the management team, and necessitate changes to strategic plans and operating activities. Attempts to gloss over or ignore negative events or disappointing results will do damage to management's credibility with investors, which typically takes a very long time to repair.

Even during periods of down performance, companies should still communicate their competitive strengths, operational advantages and the longer-term strategies that will drive future growth and profitability. It's important to be candid about the challenges or problems that a company faces, but it is not a good strategy to ignore the competitive and performance factors and strengths that will enable the company to weather difficult periods and return to a growth mode.

FOCUS ON THE AUDIENCE

Any good communication piece is developed with an understanding of, and focus on, the primary target audiences. Although the annual report has utility for a number of groups, it's important to understand the primary audience – investors – and develop messages and provide information tailored to their needs. Even among investors it's important to recognize that information needs vary related to the significant differences in financial sophistication.

A majority of the companies recently surveyed by NIRI indicate that institutional investors receive the greatest consideration during the drafting of the annual report. This is a result of the power of institutions – with control of 50% of the market's capital – to influence valuations as they move in, or out, of an investment position in a company.

Primary Target Audiences

Institutional shareholders	88%
Individual shareholders	77%
Financial analysts	74%
Employees	58%
Customers	54%

Annual Report Survey 2002

National Investor Relations Institute (NIRI)
Top 5 Survey Responses

In research commissioned by Potlatch Corporation, 4 out of 5 portfolio managers indicated that the annual report was an important tool for their investment decision. For smaller cap companies with limited institutional ownership, the ability to attract the attention of this segment of the market is pivotal to improving valuations. It's also an important element in limiting the share price volatility that can result when an institution with a sizable position decides to move its investment elsewhere.

ADDING VALUE

The composition of most annual reports falls within a relatively narrow range of options. Few companies stray far from the accepted practices that have evolved over the last 20 years. But even within this relatively limited range of options, the opportunity exists to find creative ways to position a company in relation to peers or competitors and focus attention on characteristics and opportunities that drive value.

The shareholder letter is the forum used frequently to address the most important issue for investors – the future direction and potential performance of the company. There are many ways to approach this issue, but we strongly recommend that the letter be used to frame the strategic direction of the company and address major issues that could potentially impact the execution of significant initiatives.

Regardless of company size, or the effect of external factors on an industry, investors want to be confident in the leadership and quality of management. An effective letter will clearly communicate the company's strategic direction by describing competitive initiatives, tactics and goals for future growth.

With the current intense focus on corporate governance issues, we also recommend that this be addressed in the letter, in addition to the minimum disclosure that will likely be required by proposed SEC guidelines.

The operations review section provides the greatest latitude for customizing content and building a case for value. It's surprising that some companies choose to put little or no effort into this section of their annual report. The following are examples of content that we believe can provide strong value for review section readers.

- Key Industry Factors (competitive position, competitors, key products/services, market share, economic impact, consolidation trends)
- Customers (purchase motivation, consumption and penetration rates, distribution channels)
- Market Growth Drivers (new opportunities, geographic expansion, size and saturation)
- New Product Opportunity (developments, sales from new products, investment in R&D)
- Intellectual Property and Human Capital (patents, trademarks, brands, competencies, training)

- Strategic Plan Detail (key market opportunities, diversification, acquisition and divestiture strategy, new technologies)
- International Business (issues, opportunities, performance)
- Margin Contribution (cost-reduction initiatives, pricing strategies)

Many companies mistakenly assume that investors already possess an in-depth understanding of their business and the many factors that could affect or enhance performance. It takes continuous effort to educate existing and potential investors on the characteristics that drive value and make a company a good potential investment. We recommend investing enough effort in the annual report to ensure that it effectively performs this task.

SETTING THE RIGHT BUDGET

Many companies, and particularly smaller ones, struggle with establishing a budget for the annual report. Justifying a million-dollar advertising budget seems easy in comparison to committing $50,000 to $100,000 for producing the investor-marketing piece that will define the company for the next 12 months. A large budget doesn't guarantee an effective annual report, but a reluctance to establish a workable project budget makes it difficult to plan and execute a worthwhile finished product.

NIRI's 2002 survey determined that small-cap companies (market capitalization <$500 million) had average budgets approximating $75,000, and were producing around 17,000 reports that averaged 40 pages in length.

Companies with tighter budgets can make the money go much further by avoiding unusual formats, shapes, sizes and expensive design treatments, all of which add to production costs which are approximately 40 percent of the typical annual report budget. Unless a company is involved in an unusual business that would benefit from being showcased in a unique format, the significant increase to production costs isn't justified.

Photography costs can be better controlled by anticipating annual report needs, and combining report photography with marketing or product photo shoots and budgets whenever possible.

MANAGING THE PROCESS

Like any significant project, the annual report will benefit from having a project manager that understands the time constraints and is familiar with the different elements within the production process.

Unlike many projects, the annual report process is built around a specific mailing date four to six months in the future. The necessity of providing investors with an annual report during the annual meeting proxy solicitation establishes a high level of importance to keeping to the schedule.

The need to successfully meet the proxy mailing date and SEC filing requirements, without paying extra to accelerate the process, can be significantly increased by starting the project three or more months before the end of the fiscal year and by developing a detailed production schedule with specific deliverable dates. It's also important to limit the project team to three or four key individuals who have an understanding of the schedule constraints and how to source the necessary information from other individuals within the company.

SUMMARY

Institutional investors continue to grow in importance as a percentage of the market, and a recent survey of sell-side analysts indicates that finding or holding onto research coverage will become more challenging for small-cap companies.

Both of these trends make it more important for small-cap companies to effectively communicate their investment stories directly to investors. The annual report will remain the primary document for making the case to potential investors. Now is the time to think about how you produce your annual report and what you can do to make it better.

Travers Collins & Company's Investor Relations (IR) Group is a full-service IR consulting practice focused primarily on supporting small-cap companies. Its four professionals have over 30 years of IR experience with significant exposure to the financial services industry. The Travers Collins & Company IR Group has produced approximately 50 annual reports since 1995, winning a number of national awards.

Lynn Casteel, Managing Director of the Travers Collins & Company IR group, is an experienced IR professional with both corporate and agency experience and exposure to a broad range of industries and situations adding to his value as a senior level counselor and strategist.

716 842 2222 ◦ traverscollins.com

Travers Collins & Company
INVESTOR RELATIONS