The Eighty Minute Forecast[6]

INTRODUCTION

There is a wealth of information available on the internet about any publicly traded company. Government statistics about the industry, articles in the financial press, and the company's own disclosures are just a few of the sources you can access to learn more about the company. The purpose of this case is to access as many sources as you can in one class session and then weave the discovered facts into a coherent forecast of the upcoming quarter's earnings per share. Refer to the end of chapter two for a list of websites to get you started.

To get the most amount of information collected in the least amount of time, we will divide the class into groups and make each group responsible for one part of the forecast (as described below). On the 75th minute, the instructor will ask for the inputs, type them into the simplified *eVal* model included with the case, and just like that, we will have a forecast!

Before we can get started, we need to pick a company. The steps below can apply to any company, but you might want to pick one that everyone has heard of, has relatively homogeneous goods or services, and is easy to understand. Retail firms often work well. For the purpose of this case, make sure the company didn't recently undergo some crazy transaction – you want a "business as usual" year. It is also a good idea to pick a company where their basic earnings per share is the same as their diluted earnings per share, so that the share computations in the denominator do not get unduly complex (unless, or course, you like this kind of thing).

Case Materials

Most of the materials for this case are generated in class. However, all groups will need some basic financial statements from the most recent historical quarter, and preferably from many past quarters. If you selected the company prior to class, the instructor may start you off with a basic excel file with this data. How rich your initial data is depends on what source you have. You can export five quarters of data into excel from http://www.morningstar.com (enter your ticker, hit the "Financials" link, change the settings to be quarterly, and hit the "export" button). For more history, you will need a subscription service, such as CapitalIQ, Bloomberg, or Thomson Analytics. Any business school library will have one of these sources.
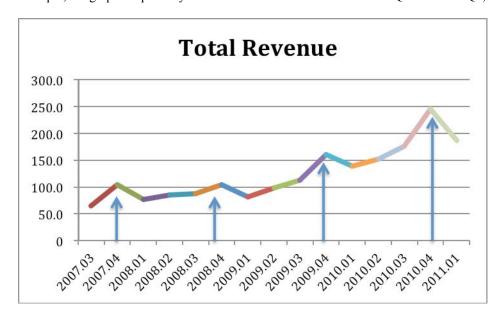
The case materials at www.lundholmandsloan.com are data from Lululemon Athletica (ticker LULU on the NASDAQ or LLL.TO on the TSX). They sell clothes for women who love yoga, and for the men who love them. But this is just an example – pick any company you like. The case materials also include the simplified version of *eVal* that handles quarterly data and is tailored to this case. It is currently loaded with Lululemon data, but you can copy over that with your company.

NOTE TO INSTRUCTORS: You will need to provide the students with the simplified *eVal* file loaded with the relevant data before class, or be really fast at typing in the data while class is in session, because at the end, you need to be ready to receive their inputs. You can cut-and-paste a yellow block of data into the simplified *eVal* file provided with the case, just be sure it is the past five *quarters* of data, not the past five years. Access whatever source of standardized data you use and then use datamaker.xls to get *eVal*-ready data (datamaker.xls is available at our website). Alternatively, cut and paste from any financial website.
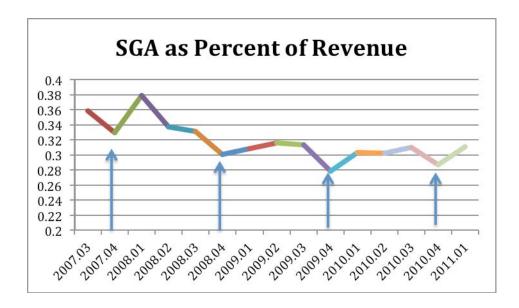
Seasonality

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[6] This case was prepared by Professor Russell Lundholm as the basis for class discussion, rather than to illustrate either effective or ineffective handling of a business situation. Copyright ©2010 by Russell Lundholm.

Every group will have to consider the seasonal pattern in the input they are trying to forecast. Consider, for example, the graph of quarterly revenue for Lululemon between 2007:Q3 and 2011:Q1, as shown below:

Total Revenue

No big surprise – retail firms do the biggest share of their business during the holiday season in the fourth quarter. In general, the two most relevant quarters from the past are the same quarter a year ago and the most recent quarter.

And costs can also be seasonal. Maybe there is a big advertising promotion that coincides with holiday sales. Or maybe the cost of air conditioning in the summer is a major expense for your firm. Turning again to Lululemon, the graph below shows their selling, general and administrative expenses as a percent of revenue between 2007:Q3 and 2011:Q1. It would appear that SG&A expenses fall in the fourth quarter. Or, could it be that they remain constant in dollar terms, and the pattern is simply induced by the pattern of revenue in the denominator? You will need to think about this for your particular company.

SGA as Percent of Revenue

The Group Tasks

Divide the class into four groups. Each group is responsible for the input in some of the yellow cells on the simplified *eVal* file. Here are their specific tasks.

Sales Forecasting Team

Your task is easy to say but hard to do: figure out what will total revenue be in the next quarter. Prepare your answer as a percentage of growth from the previous quarter (for easy *eVal* input). Besides the seasonal pattern we just discussed, what other factors drive revenue for your company? What guidance has the company given on this issue? Have other firms in their industry already reported their results? There is a wealth of information to consider, but only 80 minutes to arrive at an answer.

Major Cost Forecasting Team

Your task is to forecast Cost of Good Sold, SG&A expense, and R&D expense. Express your forecasts as a percent of revenue. Note that you are going to take the sales forecasting team's work as given; don't duplicate their work. If you are forecasting some fixed costs then you will need to do some quick calculations after the Sales Forecasting Team reports, but be ready with your formula and calculator. Besides the seasonal component of expense that we have discussed, you should think about what else drives these expenses at your firm. Did they disclose a budget for their R&D? Have they initiated cost cutting measures? Will they pay themselves fat bonuses? Inquiring minds want to know, and the clock is ticking.

Miscellaneous Forecasting Team

Not the most glamorous team title, but your task is vitally important. Often the company will give guidance on the big ticket items listed above, so everybody gets these right, and what separates the clever analysts from the dullards is their ability to nail all the other little details. Your task is to forecast all the rest of the income statement inputs on the simplified *eVal* spreadsheet. Many of these items are driven by the balance sheet, not revenue. The default forecasts in the *eVal* spreadsheet maintain the asset turnover ratios and leverage ratios; only change these if you have a specific reason to do so. Listed below are your specific line items from the Forecasting Assumptions sheet. Hopefully your firm has zeros for some of these items; otherwise, manage your time wisely because on the 79th minute, the instructor will demand your answers.

Income Statement Item	input as
Depreciation and Amortization	percent of average PP&E plus Intangibles
Interest Expense	percent of average Debt
Non-Operating Income	percent of Sales
Tax Expense	percent of pre-tax income
Minority Interest Expense	percent of after-tax income
Other after-tax Income	percent of Sales
Preferred Dividends	percent of average preferred stock

Market Surveillance Team

You have one small, specific task, and one large ill-defined task. The large task is to search the web for analyst reports, company announcements, and other juicy facts that you think the other groups should be aware of. When you find something good, shout it out! Or write it on the board at the front of the room. The other groups have to figure out how to use the facts you find, your task is to find as many facts as possible. At a minimum, you should find other analyst forecasts of the earnings per share that the class is trying to forecast.

Your smaller, but still important, task is to forecast the number of shares to be used in the denominator of the earnings per share forecast. To be precise, we are looking for the weighted average number of shares outstanding. So, for instance, if the firm had 100 million shares outstanding at the start of the quarter, and at the beginning of the third month issued 20 million more, then the weighted average would be $(2/3)*100 + (1/3)*120 = 106.67$. The *really big mistake* your group could make would be to miss a stock split during the quarter. The earnings per share forecast would be twice as big as it should be, and *it would be all your fault*. So go to finance.yahoo.com, enter the ticker, hit "key statistics," and make sure the number of shares outstanding isn't twice the amount you were expecting.