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Decoding the underlying **impact of earnings surprise** on stock prices

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2023 was a sub-par year for the Indian IT sector, long known for its ability to offer investors robust returns. Owing to the fears of the US and other western economies going into a slowdown, the industry witnessed subdued revenue expansion and therefore, offered limited returns. In the third quarter of FY 2024, the sector depicted an upswing, with its earnings data beating the low expectations and indicating strong margin performance, low attrition rates, and steady deal wins. The positive earnings surprise bolstered the benchmark Nifty index while also offering some much-needed vigour to the prices of IT stocks.

This is a classic case of an earnings surprise. An earnings surprise occurs when a company's reported earnings significantly deviate from the consensus estimates of financial analysts. The impact of such surprises on the stock price, at the time of the earnings date, can be significant and is contingent upon whether the surprise is positive or negative – potentially driving the price towards notable upswings or downturns.

Positive earnings surprises – **boosting investor confidence**

Positive earnings surprises often elicit a favourable response in the stock market as investors and traders tend to perceive robust earnings as indicative of a well-managed and financially healthy company. This positive sentiment can trigger increased buying activity as investors adjust their expectations and recognise the company as an outperformer. Consequently, this positive sentiment may stimulate demand for the stock, leading to an uptick in its price. An excellent example here involves IT major Infosys, which witnessed an over 6% rally in its share price after reporting a positive earnings surprise in the Oct-Dec quarter of FY2024. This was the stock's biggest single-day gain since July 2020, indicating the enormous impact of the positive earnings surprise on stock prices.

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Negative earnings surprises – **triggering investor concerns**

If a company reports earnings below expectations, it can have a detrimental effect on the stock price, with investors likely to interpret lower-than-expected earnings as a signal of financial distress or operational challenges, prompting a sell-off. Negative surprises have the potential to induce panic selling as investors reevaluate their positions and revise their expectations for the company's future performance, leading to a drop in stock prices. For instance, when India's largest private lender HDFC Bank shared its earnings report for the quarter ending December 2023, the stock plummeted by over 10% in the initial days post earnings. Despite the bank's announcement of a 34% increase in net profit, investors were dismayed by the higher provisions reported on a year-on-year basis, in addition to indicating concern regarding the outlook on loan growth and margins. The blue-chip bank's stocks are yet to resume their pre-earnings levels, depicting the enormous impact of a negative earnings surprise on stock prices.

Analysing **earnings surprises** and **price movements**

Multi-Act has conducted an in-depth study to assess the possibility of strategic investments based on earnings surprises. The study compared earnings surprises on the date of the earnings release with subsequent changes in price over the following 5 trading days. This analysis focused on companies which are listed in the US and were a part of the S&P 500 index during the second half of 2023. Based on the study, the following observations stand out:

The correlation between Delta (change in stock price nearly after the earnings release) and Surprise was found to be -0.4%. Given the proximity of the correlation to zero, it suggests that earnings surprise lacks strong predictive power in forecasting changes in price.

Instance with same directional movement, i.e., where a positive surprise led to a positive price movement and negative surprise resulted in a negative price movement, were surprisingly low at 49.5%. In the remaining instances (50.5%), the price movement exhibited an inverse relationship to the surprise, implying negative price movement in the case of a positive surprise and positive price movement in the case of a negative surprise.

Median Delta/Surprise - Company Wise	Count	%
Less than 0%	0	0%
0-20%	251	29%
20-40%	73	8%
40-60%	43	5%
60-80%	37	4%
80-100%	31	4%
More than 100%	439	50%
Total	**874**	**100%**

Upon further examination of instances with the same directional movement (49.5%), it was observed that in merely 8% of these instances, the price movement was about 60-100% of the earnings surprise. Instances with more than 100% price movement as compared to earnings surprise largely depicts cases with miniscule earning earnings surprise with no/low correlation with price movement.

Examining Median Delta/Surprise ratio on individual company basis reveals that price movement fall within the range of 60-100% of the earnings surprise for 13% of the companies only.

Further comparison of earnings surprise with change in price (Delta) shows low correlation between the two. Following table indicates that median Delta ranges between -2% to 2% irrespective of level of surprise.

Median Delta/Surprise - Company Wise	Count	%
Less than 0%	**0**	**0%**
0-20%	**68**	**20%**
20-40%	**30**	**9%**
40-60%	**16**	**5%**
60-80%	**25**	**7%**
80-100%	**14**	**4%**
More than 100%	**181**	**54%**
Total	**334**	**100%**

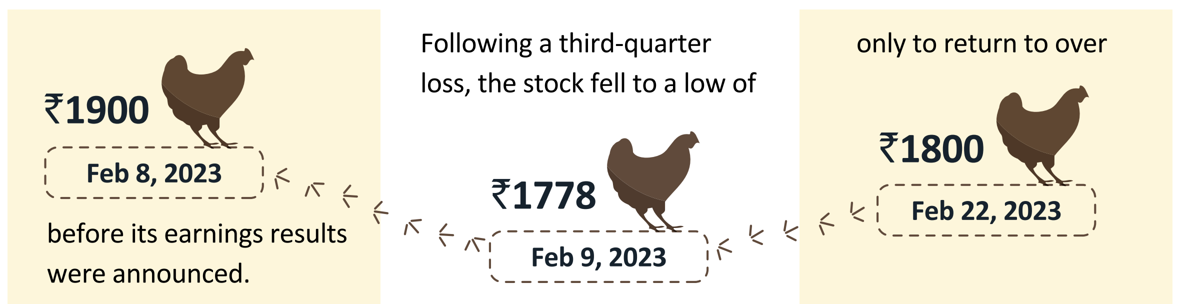
Suprise Range	Delta
Upto 5%	**0.5%**
5-20%	**0.4%**
20-30%	**1.3%**
30-50%	**1.8%**
50-80%	**-0.9%**
80-100%	**-1.4%**
More than 100%	**0.7%**

Influencers beyond **earnings surprises**

Based on the study's findings, it can be concluded that an earnings surprise is not the sole factor influencing changes in stock prices. In addition to the actual earnings figures, market attention is often directed towards the company's guidance and management commentary during the earnings call, with positive guidance having the potential to undermine the negative impact of an earnings miss, whereas cautious or negative guidance can minimise the impact of a positive surprise. Similarly, broader market conditions and investor sentiment can contribute to the overall impact – in a bull market, positive surprises may be more favourably received, while in a bear market, positive surprises might not prevent a decline in stock prices.

Therefore, it is crucial to recognise that market reactions are unpredictable, and multiple factors, including market expectations, the overall economic environment, and geopolitical events, can influence stock prices on earnings dates. Additionally, responses to earnings news can be transient, and the market may recalibrate its evaluation over time.

For instance, Venky's (India) Ltd, a leader in the domestic chicken industry, was trading at over



This clearly exemplifies the transient nature of earnings news and the subsequent market calibration.

On the other hand, it is evident that earnings surprises, whether positive or negative, significantly impact investor behaviour, thereby influencing stock prices. However, empirical analysis also suggests that earnings surprises alone do not reliably predict subsequent price movements, underscoring the importance of considering broader market conditions, management guidance, and investor sentiment. **Understanding these dynamics is vital for investors navigating the unpredictable terrain of stock price reactions to earnings disclosures.**