JANUARY 2019 DATA UPDATE 6: PROFITS, GROWTH AND VALUE

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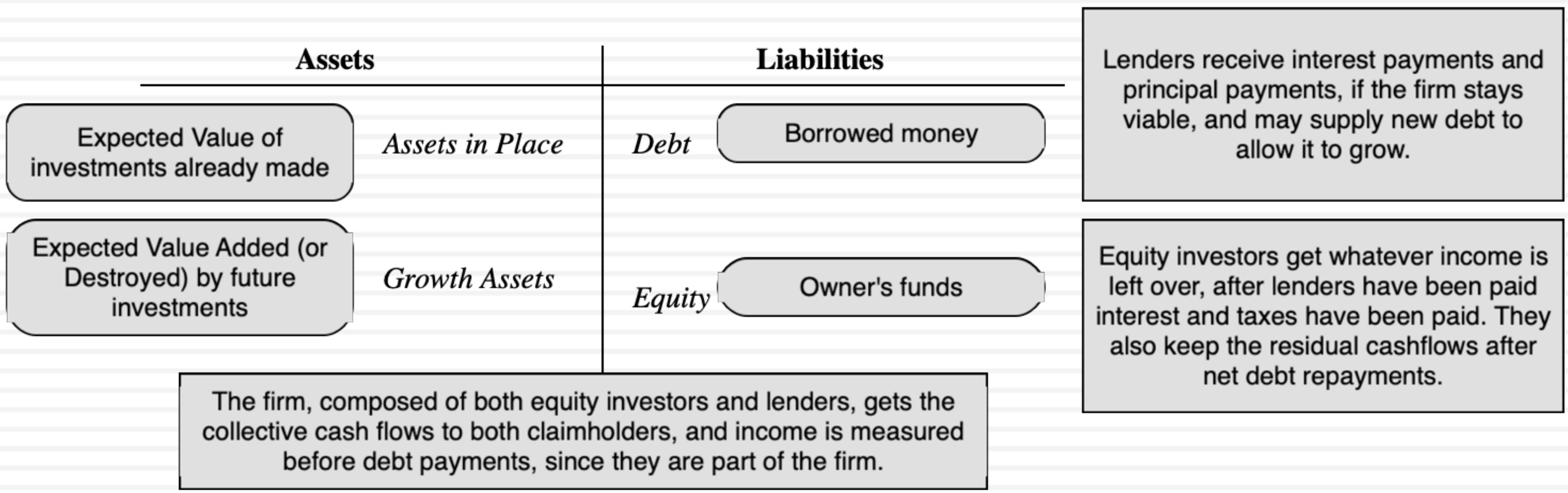
Measuring financial success

- Many companies measure success using lower thresholds, with some arguing that making money (having positive profits) is good enough and others positing that being more profitable than competitors in the same business makes you a good company.
- In this post, I will look at all three measures of success, starting with the minimal (making money), moving on to relative judgments (and how best to compare profitability across companies of different scales) and ending with the most rigorous one of value generation.

1. Profit Measures

Profitability and Returns: A Balance Sheet Perspective



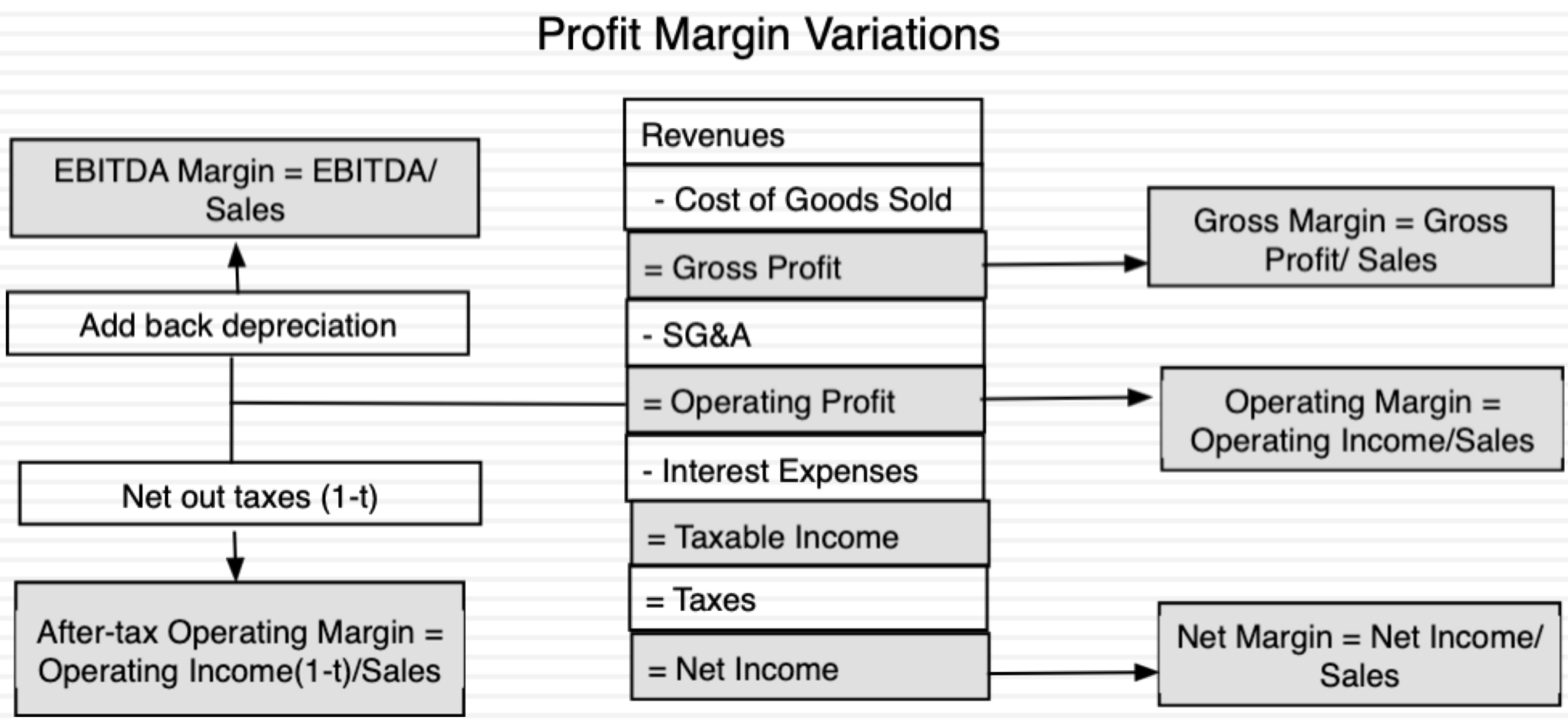
Through whose eyes?

Claimholder	*Accounting Income*	*Profit Margin*	*Accounting Return*	*Cash Flow*	*Hurdle Rate*
Equity	Net Income	Net Margin = Net Income/Sales	ROE = Net Income/ Book Value of Equity	CF to Equity = Cash flows after debt cash flows (interest and net debt repaid)	Cost of Equity
Firm (Equity & Debt)	Operating Income after taxes	Operating Margin = Operating Income/Sales	ROIC = Operating Income/ (BV of Equity + BV of Debt – Cash)	CF to Firm = Cash flows before debt cash flows	Cost of Capital

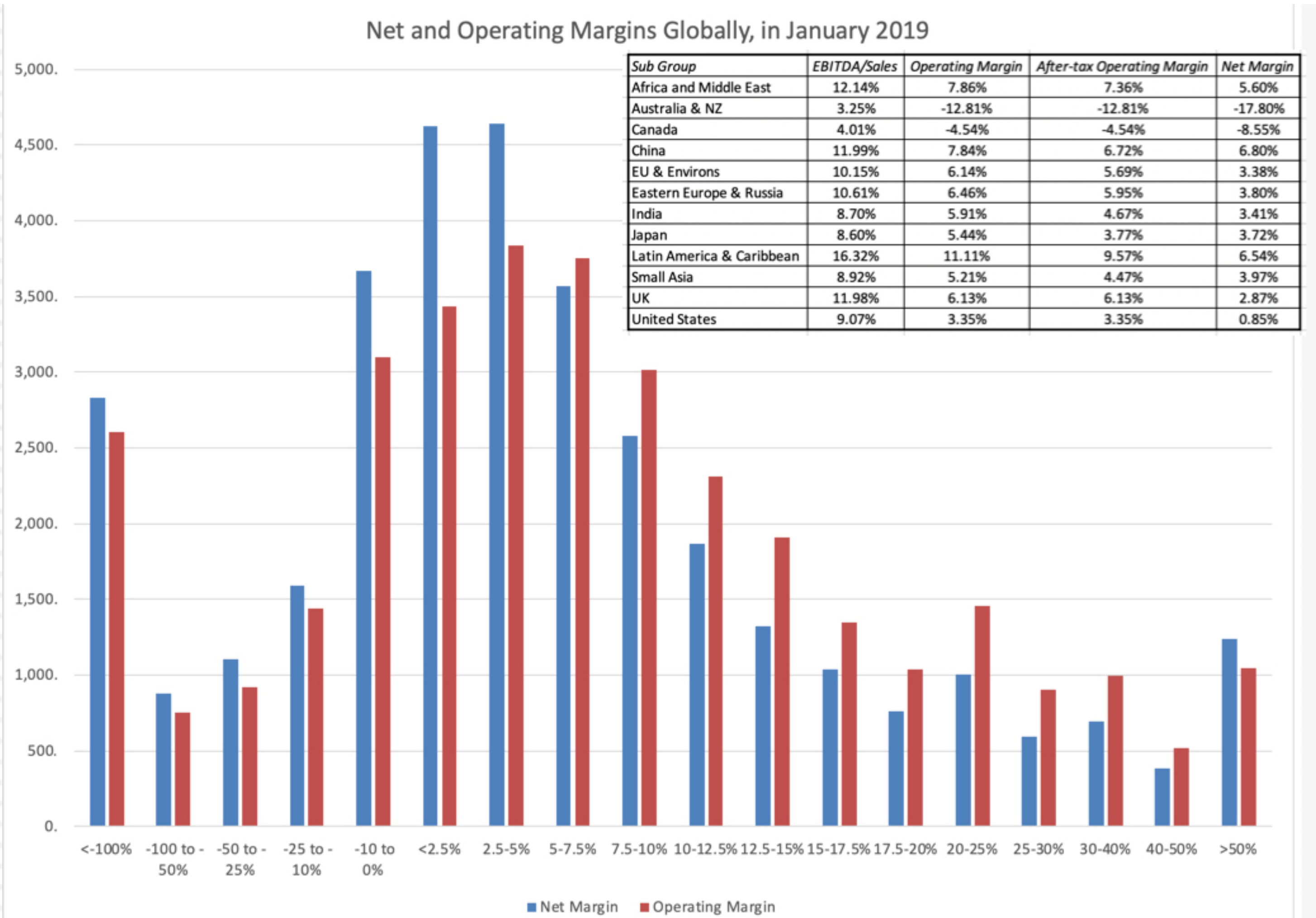
1. The Minimalist Test

	Africa and Middle East	Australia & NZ	Canada	China	EU & Environs	Eastern Europe & Russia	India	Japan	Latin America & Caribbean	Small Asia	UK	United States	Global
% Positive Operating Income	75.00%	38.59%	24.16%	80.68%	71.23%	77.52%	74.94%	90.39%	78.81%	74.79%	64.21%	55.26%	71.24%
% Positive Net Income	74.46%	36.56%	24.35%	80.23%	66.59%	77.56%	73.66%	88.80%	75.18%	73.34%	59.55%	54.70%	69.60%

2. Profit Margins – A Relative Test



Global Margins



Sub Group	*EBITDA/Sales*	*Operating Margin*	*After-tax Operating Margin*	*Net Margin*
Africa and Middle East	12.14%	7.86%	7.36%	5.60%
Australia & NZ	3.25%	-12.81%	-12.81%	-17.80%
Canada	4.01%	-4.54%	-4.54%	-8.55%
China	11.99%	7.84%	6.72%	6.80%
EU & Environs	10.15%	6.14%	5.69%	3.38%
Eastern Europe & Russia	10.61%	6.46%	5.95%	3.80%
India	8.70%	5.91%	4.67%	3.41%
Japan	8.60%	5.44%	3.77%	3.72%
Latin America & Caribbean	16.32%	11.11%	9.57%	6.54%
Small Asia	8.92%	5.21%	4.47%	3.97%
UK	11.98%	6.13%	6.13%	2.87%
United States	9.07%	3.35%	3.35%	0.85%

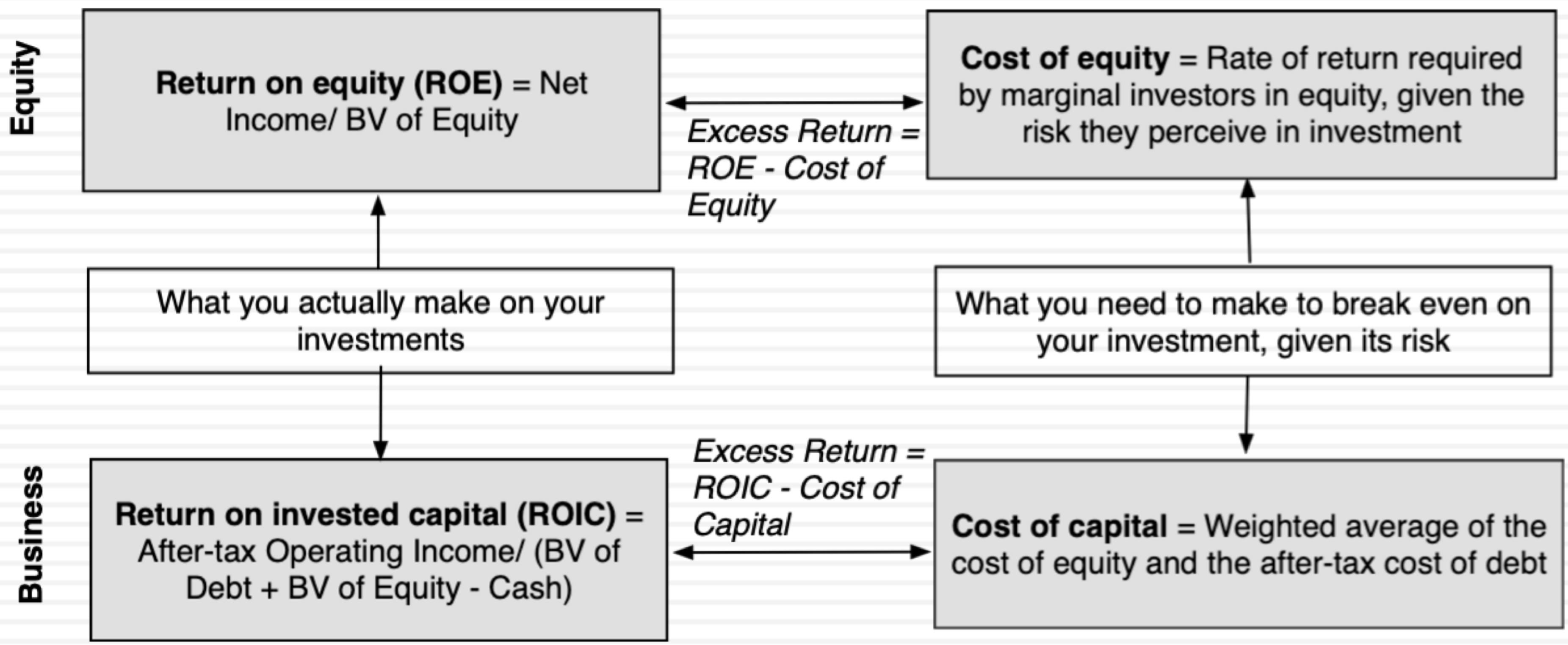
3. The Value Test

- As a business, making money is easier than creating value, since to create value, you have to not just make money, but more money than you could have if you had invested your capital elsewhere.
  - Profits: How much do you expect to generate as profits and cash flows from existing projects?
  - Invested Capital: How much capital is invested in existing assets/projects?
  - Opportunity Cost: Given the risk of the investment, what return do you need to make to break even?

In a perfect world, here is what you would do..

- For profits: You would use expected earnings and cash flows in future years to measure profits to both equity investors and the business.
- For invested capital: You would have an inflation-adjusted estimate of how much capital is invested in existing assets or equity.
- For hurdle rates: You would have costs of equity and capital that reflected
  - The mix of businesses that a firm operates in
  - The current debt to equity ratio for the firm, with all financial commitments treated as debt
  - The mix of countries that the firm does business in

Different Perspectives



Return on Equity

Return on Equity

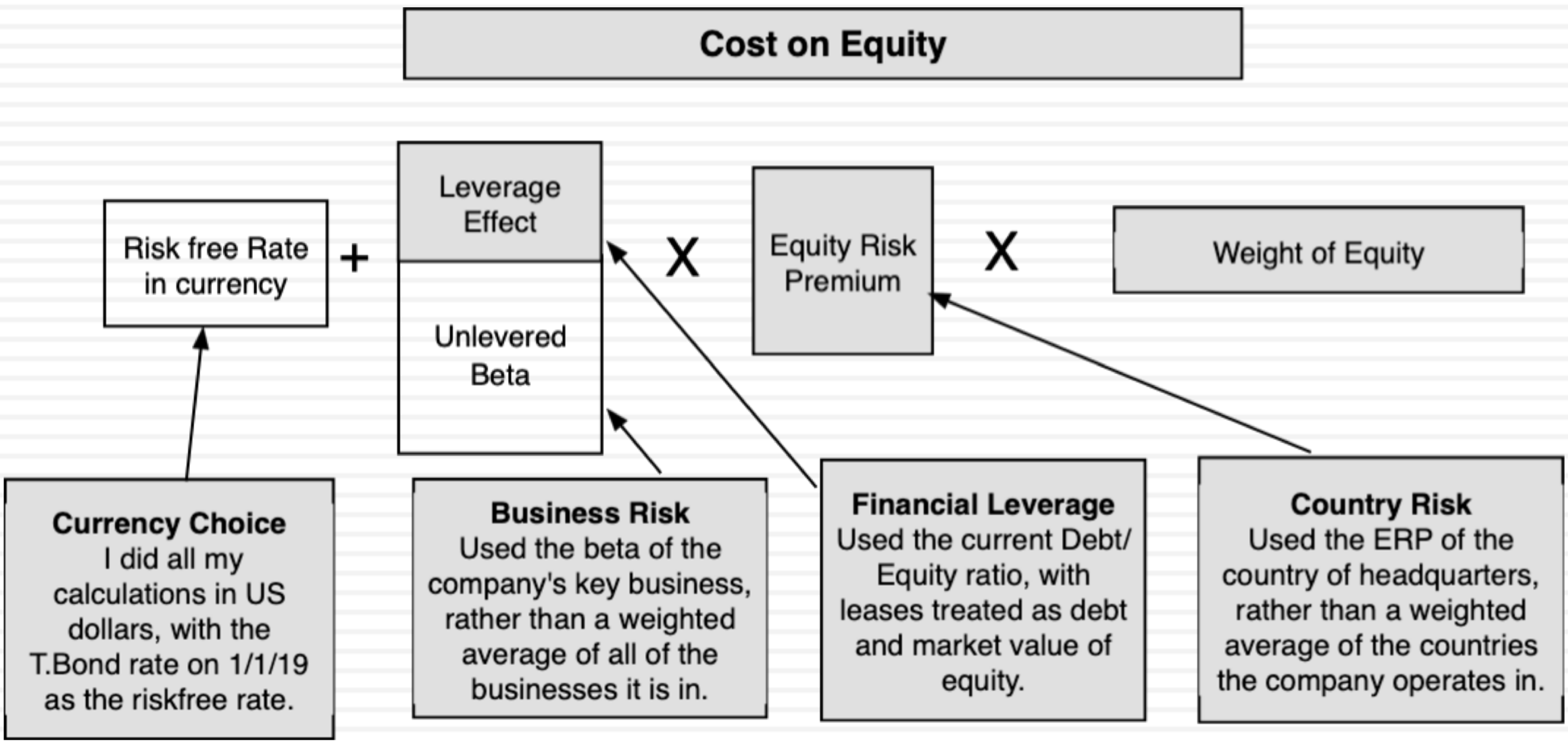
Net income in most recent twelve months.

Equity Income

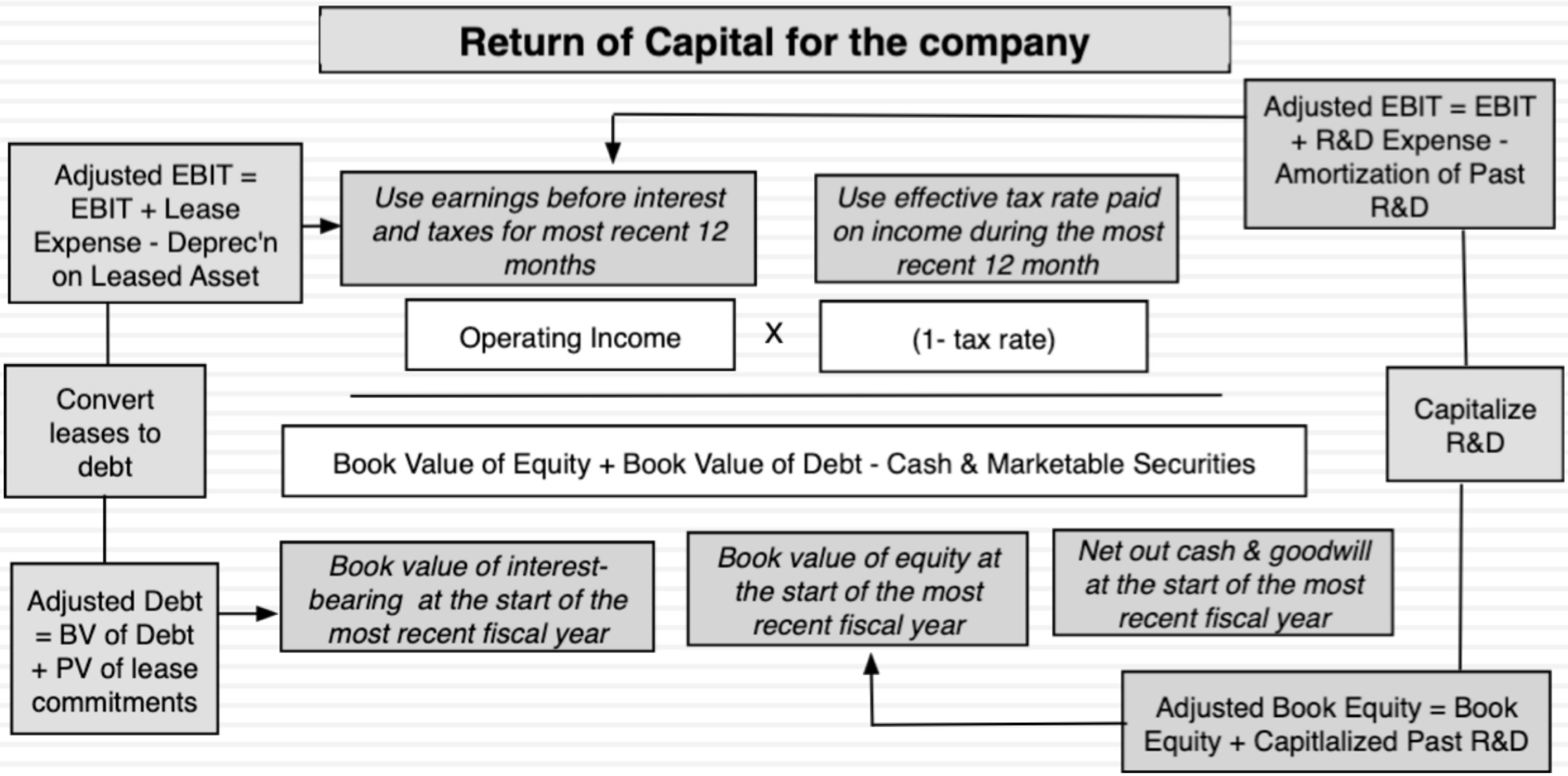
Equity Capital Invested

Book Value of Equity at the start of the fiscal year.

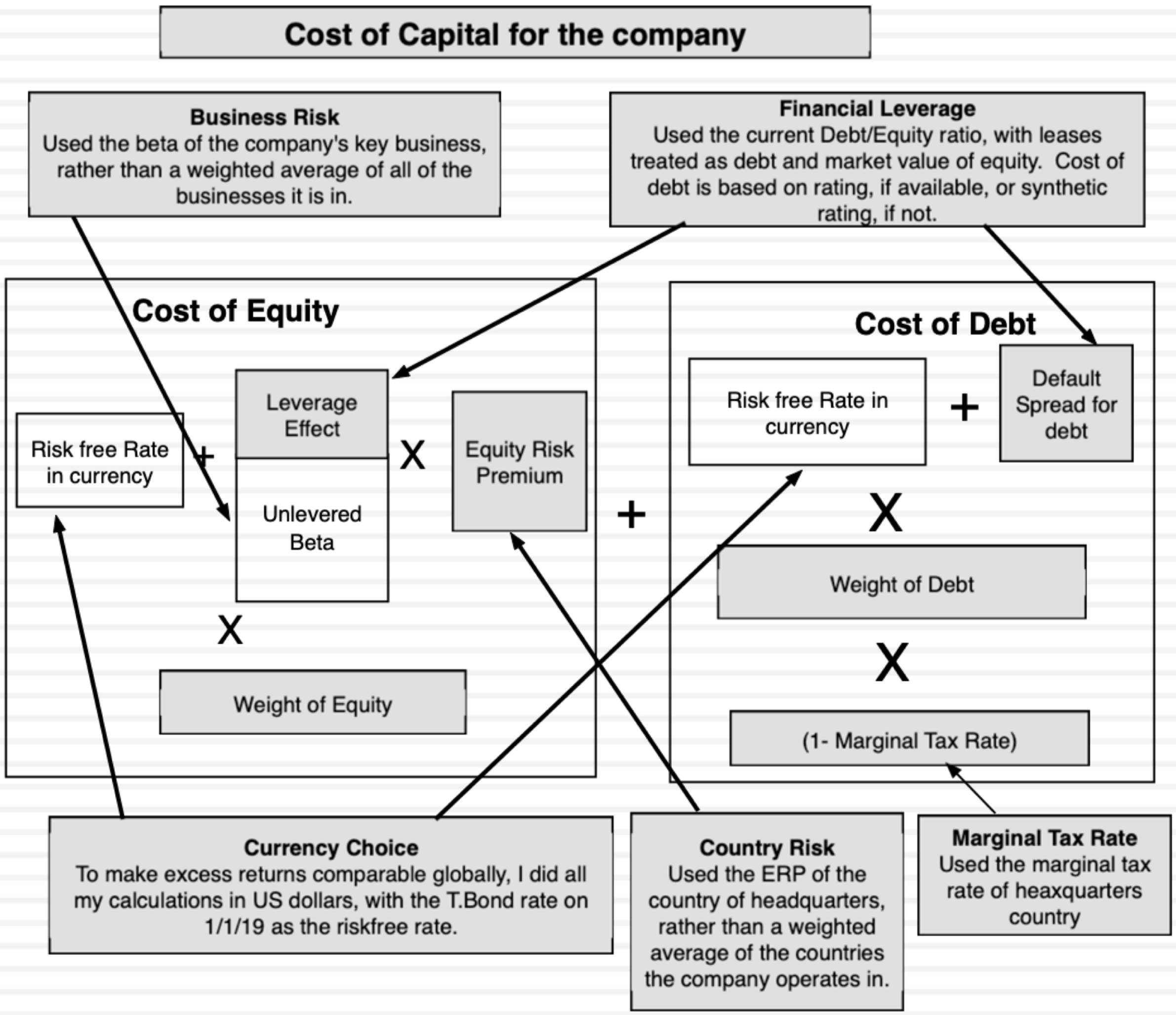
Cost of Equity



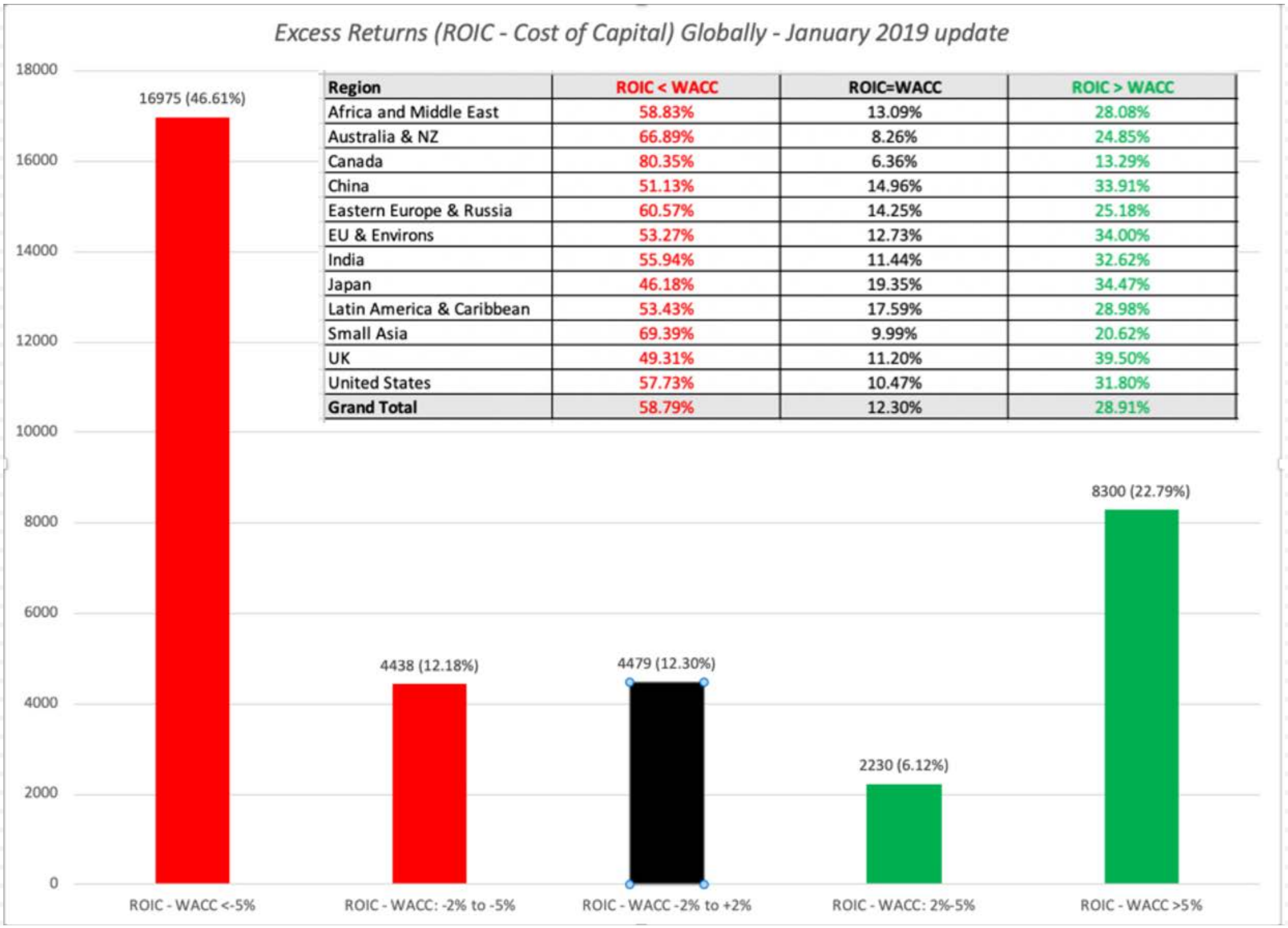
Measuring Excess Returns: Estimation Choices for Return on Capital



Measuring Excess Returns: Estimation Choices for Cost of Capital



And the results



Region	ROIC < WACC	ROIC=WACC	ROIC > WACC
Africa and Middle East	58.83%	13.09%	28.08%
Australia & NZ	66.89%	8.26%	24.85%
Canada	80.35%	6.36%	13.29%
China	51.13%	14.96%	33.91%
Eastern Europe & Russia	60.57%	14.25%	25.18%
EU & Environs	53.27%	12.73%	34.00%
India	55.94%	11.44%	32.62%
Japan	46.18%	19.35%	34.47%
Latin America & Caribbean	53.43%	17.59%	28.98%
Small Asia	69.39%	9.99%	20.62%
UK	49.31%	11.20%	39.50%
United States	57.73%	10.47%	31.80%
Grand Total	58.79%	12.30%	28.91%

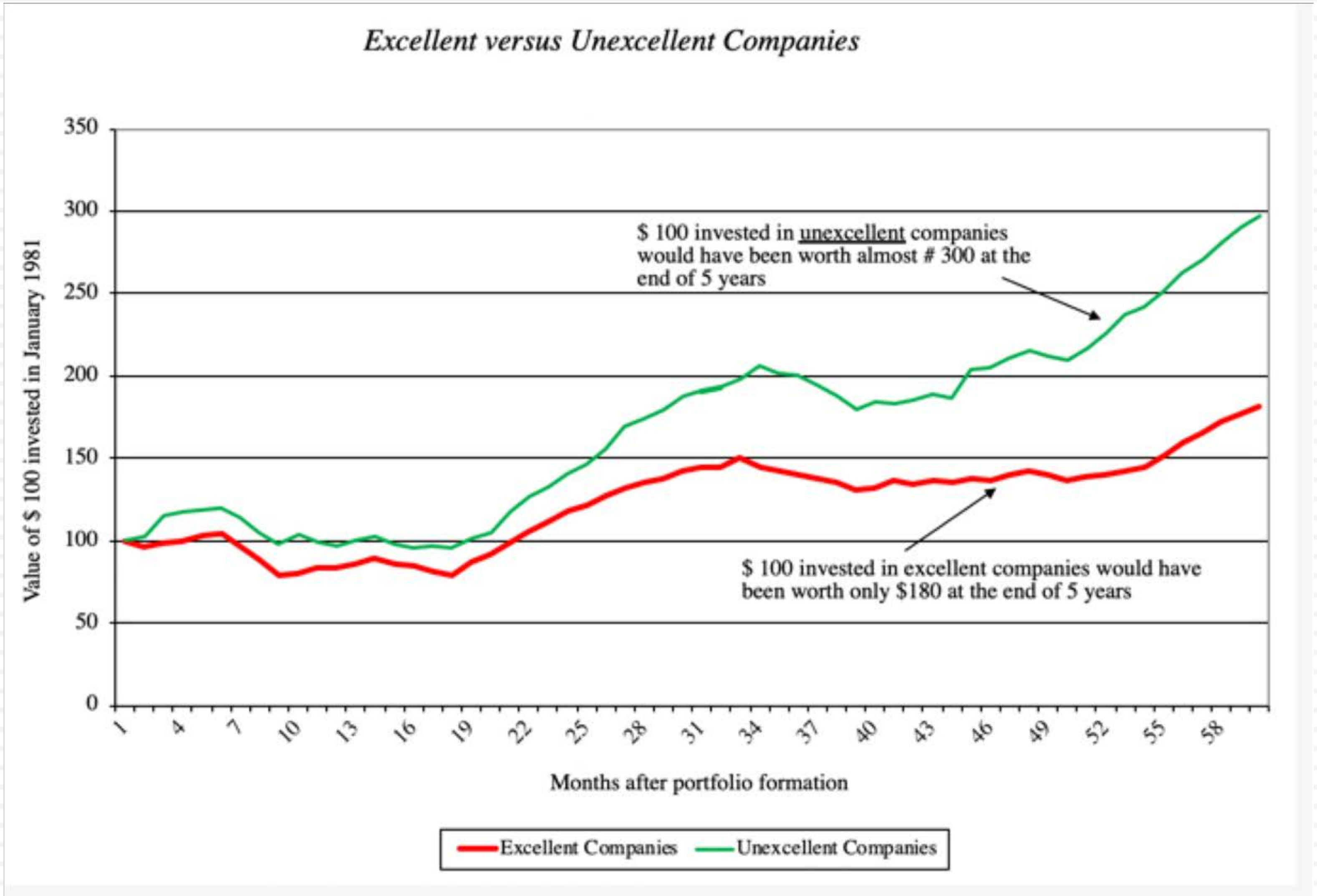
Corporate Finance Implications

- Growth is a mixed bag: In 60% of companies, it looks like it destroys value, does not add to it.
- Good and Bad companies: There are lots of bad companies, if bad is defined as not making your hurdle rate.
  - In some companies, it is bad management that is responsible.
  - In others, the entire business has turned bad and there is little that the company can do to reverse the process.

Implications for Investors

- If equities are value driven, the stock price for a company will reflect its investment choices, and companies that invest their money badly will be priced lower than companies that invest their money well.
- The returns you will make on these companies, though, will depend upon whether the excess returns that they deliver in the future are greater or lower than expectations.
  - Thus, a company that earns a return on capital of 5%, much lower than its cost of capital of 10%, which is priced to continue doing the same will see if its stock price increase if it can improve its return on capital to 7%, still lower than the cost of capital, but higher than expected.
  - A company that earns a return on capital of 25%, well above its cost of capital of 10%, and priced on the assumption that it can continue on its value generating path, will see its stock price drop, if the returns it generates on capital drop to 20%, well above the cost of capital, but still below expectations.

Which explains findings like this one..



Final Thoughts on Corporate Governance

- Check box corporate finance: Corporate governance laws and measures have focused on check boxes on director independence and corporate rules, rather than the end game of better managed companies.
- Real corporate governance: Corporate governance should give stockholders a chance to change the way companies are run, and if corporate governance works well, you should see more management turnover at companies that don't earn what they need to on capital.
- A Cynical afterthought: The fact that six in ten companies across the globe earned well below their cost of capital in 2018, added to the reality that many of these companies have been under performing for years, and are still run by the same management, makes me wonder whether the push towards better corporate governance is more talk than action.