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How Good, Old-Fashioned Sales Growth Drives Value

Far too many companies stress near-term profit and cash flow rather than investing in the business.

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During every holiday season, business and investment news seems to revolve around retail sales figures. To get the scoop on where sales are heading, journalists probe securities analysts, economists, customers, and industry insiders to collect valuable insights on store traffic, sales conversions, volumes, and pricing. From this, they draw broad inferences about the health of individual companies, industries, and, indeed, the overall economy — without ever talking about earnings, cash flow, or rates of return on capital.

Are sales-growth trends really this informative? How important is sales growth to the creation of shareholder value? Does this apply to other industries outside retail?

As we enter 2012, many companies are preparing, scrutinizing, and approving their strategic plans and operating budgets. They must decide how much emphasis to place on current-year earnings or returns versus giving up some return to fund both capitalized and expensed investment opportunities. These investments may drive growth over the next few years, but are they worth sacrificing returns now?

To provide insights on this growth-versus-return trade-off, we studied the 500 largest U.S. nonfinancial companies with full data for the period starting in 2006 and ending in the middle of 2011.

Let's look at a basic premise of corporate finance theory: value is created when an investment earns a return that's more than the weighted average cost of the debt and equity capital used to finance the investment. So perhaps it's no surprise that when we split companies into high,

medium, and low groups based on their level of return on capital, the companies with higher returns on capital delivered higher total shareholder return (TSR), in the form of dividends plus share-price appreciation.

The median cumulative TSRs over the five-and-a-half-year period for the high, medium, and low return on capital groups were 60%, 54%, and 38%, respectively. That represents a difference of 22% from the high group to the low group in favor of those with higher returns on capital.

This happens because investments in a high-return company are typically more efficient and deliver more profit per dollar of investment — a measure that's highly valued by shareholders. Within companies, this principle should direct executives to invest more in their businesses with high returns on capital.

How important is sales growth in explaining differences in TSR? Very important. The median TSRs of the high, medium, and low sales-growth companies were 74%, 52%, and 28%, respectively. That's a 46% difference between the high and low groups, revealing that sales growth is a larger differentiator of TSR than return on capital. Despite all the focus on measures of profit and return, delivering good old-fashioned sales growth is a very important driver of value.

How do sales growth and return on capital interact and influence share-price performance? To test this, we examined companies based on both growth and returns simultaneously. As expected, the best TSRs came from companies in the top bracket on both growth and return, and the worst TSRs came from companies low on both.

The key strategic decisions faced by many companies involve trade-offs between growth and return. Many lower-return companies should cut back on growth investments, at least for a time, while they improve their rate of return.

In particular, when returns are below the cost of capital, growth may not add much value at all. This is true even if earnings per share rises, as the low-return investments may cause the P/E ratio to fall, offsetting the EPS improvement. Returns might need to be improved simply to "earn the right to grow" in the eyes of investors.

On the other hand, many very high-return companies should consider investing more aggressively in growth opportunities despite the resulting drag on returns. A good case example is Oracle. During the first half of the last decade, Oracle's return on capital hovered at lofty levels — between 33% and 36% — while growth averaged only 3%.

During this period, Oracle's TSR underperformed the Nasdaq. During the second half of the decade, Oracle invested heavily, acquiring PeopleSoft, BEA Systems, Siebel, and Hyperion. Growth surged to an average of 18%, while return on capital collapsed to the 15% to 25% range. The company's investment in growth delighted investors, and its TSR outpaced the Nasdaq by 73%.

Sales growth has been an important driver of shareholder value during the difficult times we have endured since 2006 and is likely to be even more important as the economic cycle plays out and the U.S. economy improves going forward.

In recent years, far too many companies seemed to overly stress near-term profit and cash flow rather than investing in the business. To be sure, current 2011 estimated earnings before interest, taxes, depreciation, and amortization (EBITDA) for the S&P 500 is 22% above the level achieved in 2007. For many companies, the EBITDA increase may be coming at the expense of underinvestment in longer-term growth, and they may be ill-prepared as the economy comes back.

Growth investments need to earn an adequate return. But is now the time to spend more on research and development, advertising, capital expenditures, or acquisitions to fuel future growth? Are investments in staff required to be able to handle enhanced growth investments? If you wait until the economic cycle has peaked, it may be too late: the investments could come on board just in time for the next downturn.

For many companies, now may be the time for a call to action on investing in growth. As we enter 2012, executives face an important opportunity to pursue strategic priorities that drive a better balance between top-line growth and return on capital.

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