Cash Flow | March 14, 2013 | CFO.com | US

Are Your Growth Investments Effective?

Performance scorecards that include a company's reinvestment rate and reinvestment effectiveness can complement profit and return measures for CFOs.

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Alongside all the hoopla about the Dow Jones Industrial Average breaking through the 2007 peak last week is the worry that we may be approaching another peak (and subsequently another fall). How are America's companies performing and how are they being valued?

Brokerage analysts expect about three out of four companies in the S&P 500 to have higher net income in 2013 than in 2007 and they forecast aggregate net income to be 50% higher. However, 71% of these companies have lower price to earnings (P/E) multiples today than they did when the market peaked in 2007. Earnings are reaching records but valuations are still down.

While it probably is rational for valuation multiples to be lower at the top of the cycle and higher at the bottom, the stock market often demonstrates the opposite. When earnings drop in a downturn, the stock market often suffers a bigger decline and multiples fall as they did in 2008. And when earnings recover, as they have recently, the market often advances more – as if to suggest that economic cyclicality has vanished and the rise in earnings can be repeated forever.

But interestingly this has not happened so far. Earnings are hitting records yet multiples have stayed below the last peak. Maybe investors will eventually be irrationally exuberant but they are simply waiting for earnings to hit a higher peak. Or maybe there is something else at work.

ANALYSIS

Valuation multiples tend to be higher when a company is growing on both top and bottom line, which tends to happen when a company's products or services are differentiated and viewed as having sustainable competitive advantages. This differentiation often requires investment in product and service features, brand strength, productive operating know how and effective logistics. And continual reinvestment into a business is indeed crucial to its success.

Not surprisingly, the reinvestment rate, which quantifies the percentage of cash flow reinvested into the business (see "Are You Reinvesting Enough?"), has been shown to be an important driver of total shareholder return (TSR includes dividends and share price appreciation) over time. Hence, the reinvestment rate should always be a prominent and deliberate strategic discussion point for CFOs amd other corporate executives.

During the current recovery, however, the reinvestment rate hasn't distinguished strong versus weak share price performance. This may be because just any reinvestment isn't necessarily good reinvestment. To distinguish between good and bad reinvestment, we need a second measure, reinvestment effectiveness.

Measuring Reinvestment Effectiveness

Some CFOs have expressed reasonable concern that tasking their business leaders with raising their company's reinvestment rate might lead to more expenditure without any more growth. To complement the reinvestment rate, the effectiveness of reinvestment can be measured to reflect the degree to which reinvestment leads to actual growth.

How would you do this? Simply divide the increase in revenue over the period by the amount of total investment, which should include capital expenditures, R&D, working capital increases, net acquisitions, etc. Because reinvestment can be variable and revenue generation delayed, reinvestment effectiveness is best measured on a rolling three or five year basis.

It would be logical to include brand building marketing as an investment as well but this can't be done with public data as most companies don't report marketing expenditures and those that do don't follow consistent standards like those applied to R&D. Nonetheless, marketing expense can be considered an investment for internal measurement if material.

Consider Amazon. Over the last five years, Amazon has reinvested $13.8 billion in capital expenditures ($7.3 billion), R&D ($11.5 billion) and acquisitions ($2.3 billion), net of the "funding" generated by their increasingly negative operating net working capital (-$7.3 billion). Amazon's $13.8 billion in reinvestment from 2008 through 2012 represents a 75% reinvestment rate on the cash they have generated, which is essentially their earnings before interest, tax, depreciation, amortization and R&D (or, EBITDAR) less tax.

Note that Amazon actually invested $21.1 billion but had 35% of it funded by structuring their operating working capital policies such that current liabilities are increasingly higher than current assets. They receive payments before they make their own payments, which helps fund their growth investments.

Amazon's reinvestment rate is approximately equal to the median rate for the S&P 500 over this period but to see how well Amazon has performed we must look at reinvestment effectiveness. During this period, their revenue increased by $46.3 billion which, when divided by the investment of $13.8 billion, implies reinvestment effectiveness of 335%.

Amazon's reinvestment effectiveness is more than eleven times the S&P 500 median of 29% - a figure which is less than half of what it was five years ago. This drop in overall reinvestment effectiveness by the companies comprising the S&P 500 is to be expected during a downturn but nevertheless it is one of the important reasons why valuation multiples have declined and TSR has generally lagged most other five year periods.

Amazon delivered TSR of 171% over this period which far exceeds the median S&P 500 company that delivered 35%, which isn't surprising given Amazon's high reinvestment effectiveness. In fact, the companies of the S&P 500 with reinvestment effectiveness above the index's median delivered double the median TSR of those with below median reinvestment effectiveness.

Performance Scorecards

These new metrics of the reinvestment rate and reinvestment effectiveness should be an important part of the performance scorecard utilized when managing a business. Of course it's important to manage margins, returns on capital and residual income measures like economic profit. But improving these period efficiency metrics is worth more when it can be done while investing in the future rather than at the expense of it.

Many managers today are imbalanced toward short-term thinking, profit and cash flow "squeezing" and underinvestment. By including the reinvestment rate and reinvestment effectiveness on an equal footing with margins and returns, managers are encouraged to manage for both the short and long term. If everyone manages this way, perhaps valuation multiples will rise back to historical levels.

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