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Why Some Stocks Perform Better Than Others

High returns, growth, and low leverage are common criteria. But capital intensity is also an important factor.

Gregory V. Milano

Did you ever wonder why investors aren't more interested in buying your stock or are more interested in the stock of another company in your industry, even though you are a "better" company? The answers lie deeper than just looking at earnings per share (EPS), the typical place to start. Indeed, how capital-intense a company is could make the difference between a buy and a sell.

Typical managers who are focused on EPS growth get frustrated when their company's share price doesn't perform well. But our research shows that EPS tells us little about valuation and stock-price performance.

It seems reasonable that investors aren't blindly wowed by EPS growth, since companies can manufacture such growth without really creating much value for investors at all. For example, when companies repurchase stock, EPS grows regardless of whether the shares are undervalued or overvalued at the time. We find that those who deliver more EPS growth from buybacks tend to suffer declining price-to-earnings multiples that diminish much of the expected benefit.

Those who agree that EPS growth may be a deceptive performance indicator often use profit margin and other measures of operational efficiency to explain their thinking. But this too can be misleading, since some weak businesses have high margins and some strong businesses have low margins.

For example, consider two businesses with vastly different profit margins. The first needs $600 million of capital to deliver $200 million of sales, and its 12% profit margin yields $24 million of profit (12% of $200 million). That is merely a 4% return on capital ($24 / $600), and equity investors aren't very attracted to 4% returns on their money.

ANALYSIS

The second business has only a 6% margin on $400 million in sales, which is, again, $24 million in profit. But the similarity stops there, since the second company has employed a scarce amount of capital. With a small amount of receivables and fixed assets, its capital employed totals just $50 million, which translates into a whopping 48% return on capital ($24 / $50). Investors would likely find that high return alluring.

The problem with profit margin is magnified when these businesses are divisions of the same company: the focus on profit margins makes the first company seem successful, even though the second earns 12 times the return. A focus on margins can lead to inefficient capital-allocation decisions. For capital- intense businesses, a higher margin is needed to earn an adequate return. But for capital-light businesses, lower margins can be more than adequate.

Still, returns alone still tell an incomplete story. That's because the true benefit of higher returns only really materializes when combined with strong growth. After all, if there's no growth, then the two companies in our example both deliver a constant $24 million profit. The difference in return on capital is merely of historical significance, since the amount of capital employed is really just an unvarying sunk cost: the companies might be valued similarly.

Indeed, it is the potential high return on *new growth investments* that attracts stockholders to the opportunity to take part in fresh value creation. If the two companies above each invested $10 million to grow their business at the existing rate of return on capital, the first would deliver $0.4 million of new profits while the second would deliver $4.8 million. Twelve times more profit growth for the same investment sounds like it would be pretty interesting to investors.

Besides these operating value drivers, capital structure matters, too. Companies delivering strong growth at high returns should be careful to not take on too much debt, since the capital of highly leveraged companies becomes more constrained during downturns. That can impede the ability to continue to make high-return investments through up and down business cycles. Although leverage often reduces the weighted average cost of capital, our research shows that companies with above-average leverage tend to deliver below-average share-price performance over time, and this seems to stem from constrained growth.

To attract investors, is it enough to deliver high returns with strong growth while maintaining low financial leverage? Unfortunately, the answer is no. Those characteristics may be adequate to define a "good company," but to be a "good stock" you must also be at an attractive valuation. It is important for management to understand how its valuation relates to its current and future expected performance so it aims high enough when developing strategic plans and performance goals.

My colleagues and I combined a variety of measures of returns, growth, financial leverage, and valuation to develop an algorithm that identifies "good stocks." To prove out this algorithm, we back-tested how it would have performed as a stock-picking tool over the past 10 years. Across two mutually exclusive samples of U.S. stocks, the model outperformed the relevant index by double-digit shareholder returns per year. On average, companies with such characteristics do very well for shareholders.

To be a good stock, the message to company executives is clear. Drive high returns while investing in growth. Do so with modest leverage so you can keep investing in growth through the next cyclical downturn. And recognize that when valuation is high, you may have to wait for performance to catch up before investors view your company as a good stock.

Gregory V. Milano, a regular CFO *columnist, is the co-founder and chief executive officer of Fortuna Advisors LLC, a value-based strategic advisory firm.*