Increasing the value of your business

Newsletter
Spring 2012

Avondale Analysis:
Current *and* Future Profits Drive Your Company's Valuation

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Avondale Analysis:
Current and *Future Profits Drive Your Company's Valuation*

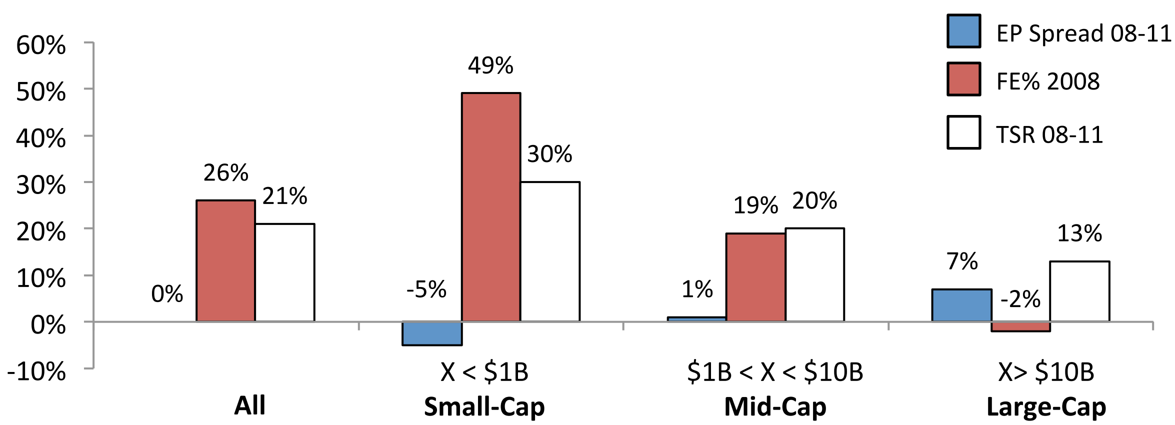
Maximizing near-term profits at the expense of value-creating investments does not lead to superior shareholder returns

The last three years represent one of the more anomalous periods in U.S. stock market history, with valuations and shareholder returns rebounding strongly from the depths of the recession. We wondered how closely actual and expected profitability were connected to those returns.

To answer this question, Avondale analyzed the economic profitability and stock performance of more than 1,600 companies in 124 industries over the past three years. Despite the unique circumstances of the period, results confirm our long-held belief that in order to generate superior shareholder returns, leadership teams must balance the delivery of current financial performance with building future expectations through value-creating investments.

Our analysis of three key metrics – current profitability, expected profitability, and total shareholder returns (TSR) – shows that:

- Despite generating significantly higher profitability over the past three years, the largest companies (>$10 billion market cap) lagged the rest of the market in TSR by a wide margin.
- Smaller companies, by comparison, were less profitable, but began and ended the three-year period with substantially higher expectations for future profitability (FE%) and generated higher TSR.



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Takeaways for Your Business

Our analysis confirms common wisdom. First, smaller companies are investing to grow and become more competitive. It follows that a larger proportion of their value is represented by expectations for future profit. The primary challenge for small companies is to convert those expectations into actual profit.

Second, larger companies are more competitive and profitable, and a larger proportion of their value is represented by current financial performance. The primary challenge for mature companies is to create new expectations for future profit growth.

It's crucial to understand where your company - or different businesses within your company - stands in relation to current and expected profitability. Delivering maximum profit this year will not generate superior TSR without simultaneously investing to grow expectations for future profit, and high expectations for future profit are not sustainable without someday converting those expectations into current profit. The best companies, large or small, find a way to do both.

Methodology

TSR is driven both by growth in current profits and by changes in expectations for future profits. To measure current profits, we looked at the spread between return on equity and the cost of equity for each company in our sample; we call this the EP Spread. A positive EP Spread indicates positive economic profit (EP).

A company's total EP Spread is driven by the overall profitability of the industry in which the company competes (Market Economics, or ME), and the competitiveness of the company in its industry, measured by its relative profitability (Competitive Position, or CP, equal to EP Spread minus ME).

We also calculated what each company would be worth if it continued performing at its current level of profit forever; this is its Current Performance Value (CPV). Subtracting CPV from the company's Total Market Value (TMV) gives us Future Expectations Value (FEV), or the amount of its TMV accounted for by expectations for future profit.

We compare the relative profit growth expectations among companies by measuring the proportion of each company's TMV accounted for by Future Expectations Value; this is the company's Future Expectations percent or FE %.

By looking at EP Spread over the past three years, FE% at the beginning and end of the three-year period, and annualized TSR over the same timeframe, we are able to infer the relative importance of current and expected future profitability on value creation.

Summary of Results

We analyzed 1,675 companies collectively and also broke them into three subsets based on 2008 market capitalization: large (greater than $10 billion); mid-sized (between $1 billion and $10 billion); and small (less than $1 billion). The following are a few of the most salient observations from our study.

Large Companies: In Search of Growth Opportunities

Among the largest companies we analyzed, those that generated positive EP Spread not only began the three-year period with the lowest expectations for future profits (FE%), their FE% also grew the least during the same three year period. This suggests that large companies were well-positioned to restore profitability in the aftermath of the recession, but remain challenged to create credible new growth opportunities.

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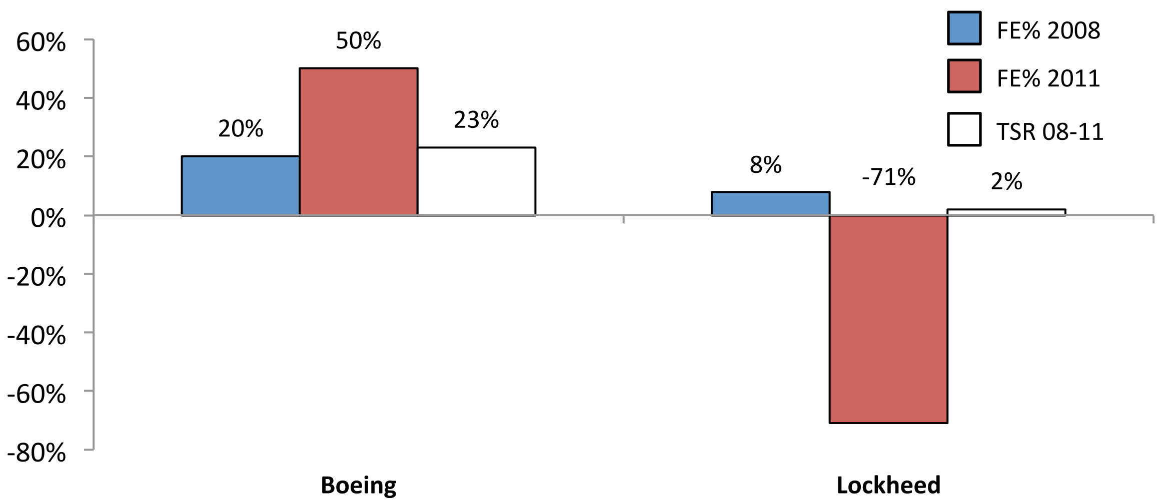
A good example is Lockheed Martin. One of the most profitable companies in our sample over the past three years (EP Spread = 76%), Lockheed nonetheless produced TSR of only 2%, below even the already low median for the largest companies. The aerospace market was profitable the past three years (ME = 10%), and Lockheed strongly outperformed its peers (CP = 66%). But Lockheed remains exposed to declining prospects for defense contractors, and saw its FE% fall to -71% in 2011 from 8% in 2008.

By contrast, Boeing also outperformed the aerospace market (182%), but its relatively higher exposure to the recovering commercial airline sector drove its FE% to expand from 20% in 2008 to 50% in 2011. Not surprisingly, Boeing also achieved above-median TSR of 23%.



Current Profitability Is Not Enough

Large companies often struggle to allocate human and financial capital to smaller business units, products or customers with growth potential because management focuses more on protecting mature and currently profitable activities in the company. Investments in mature parts of the business typically have shorter payback and much less uncertainty, making it more difficult to justify riskier investments in new business ideas.

But the three-year results of the largest, most profitable companies confirm that generating current profit is not enough to drive superior TSR. These companies must continually generate and invest behind credible strategies to participate in more profitable markets and/or increase competitiveness in order to grow expectations for future profit (FE%). In the long run, the risk of not doing so dwarfs the specific project risks of new ventures.

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Mid-sized and Smaller Companies: Better Overall Balance

Mid-size companies in our research (those with market caps between $1 billion and $10 billion) appeared to better balance current profitability with the growth of future expectations. The median profitability, 2008 FE%, change in FE%, and TSR of these companies was similar to the overall market.

Lululemon Athletica, Inc. is an example of a mid-size company that generated positive profit over the past three years (total EP Spread of 14%), while growing its FE% well above the overall market and generating exceptional TSR of 127% over the same period.

The higher median TSR of the smallest companies (<$1 billion market cap) was most likely skewed by survivorship bias: some smaller companies with negative TSRs in 2008 went out of business by 2011, and therefore are not represented in the sample. Including these companies would have reduced the median TSR of this group by an indeterminate amount.

Nonetheless, among the survivors in this group, EP Spread is much lower and FE% is much higher than the rest of the market. These companies have more of their history in front of them, and must validate their high expectations by converting them into economic profit.

Two Paths to Current Profit and Future Expectations

It is important to note that companies participating in unprofitable markets are not doomed to poor performance, nor are companies in profitable markets assured of success. Our analysis demonstrates how companies with strong competitive advantages in unprofitable markets can be more profitable than uncompetitive companies in profitable markets, as well as the converse.

For example, the cable and satellite industry generated negative market economics of -4% over the past three years. But DirecTV significantly outperformed its peers during this period, thereby generating a total EP Spread of 56% and TSR of 23%.

Conversely, Career Education Corp., competing in an education services market that generated positive market economics of 15%, underperformed its competitors and produced a total EP spread of only 2%. Career Ed's TSR was a value-destroying -24%.

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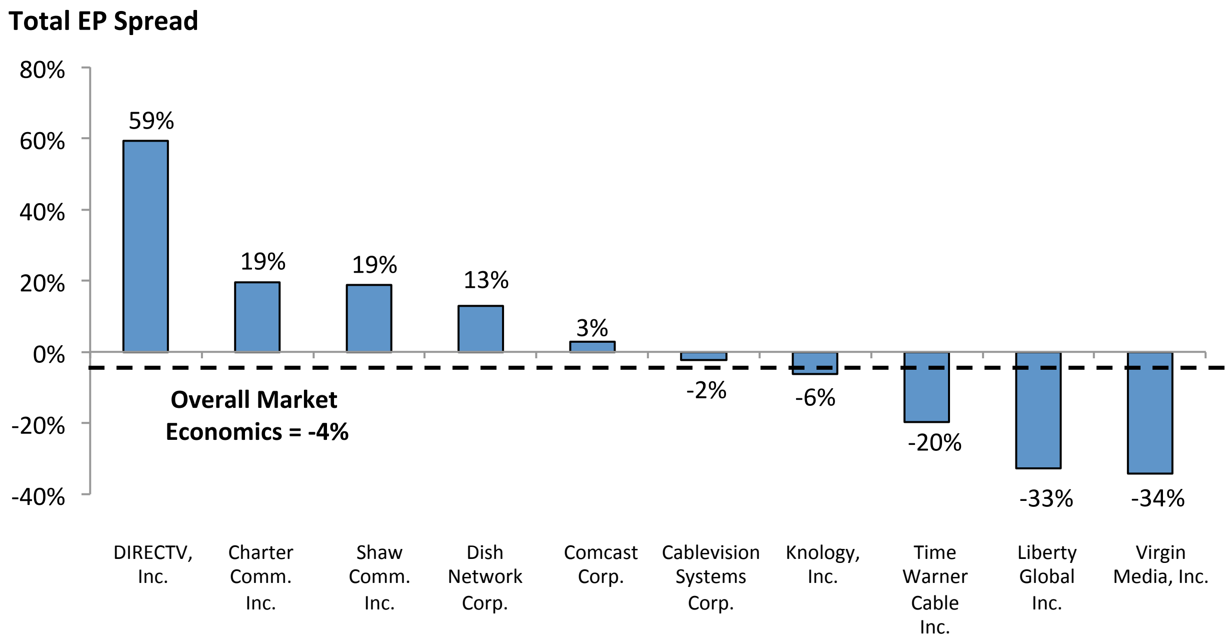

Companies can grow future profit expectations with investment strategies to grow in new, more attractive markets, and/or with investment strategies to become more competitive in existing markets.

Our analysis reinforces the need for leadership teams to find the right balance between managing for current financial performance while investing in future growth. Keep these takeaways in mind:

Regardless of company size, it's important to understand where your business stands in relation to current and expected profitability.

As smaller companies invest in growth, they must find ways to convert future expectations into actual profit.

Larger companies, which are more inclined to measure value by current financial performance, must continually look to create new expectations for future profit growth, by building credible strategies to participate in more profitable markets and/or increase competitiveness.

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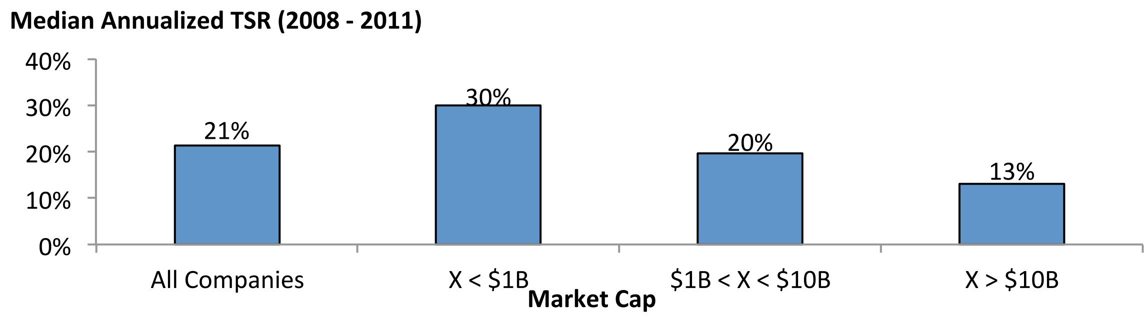
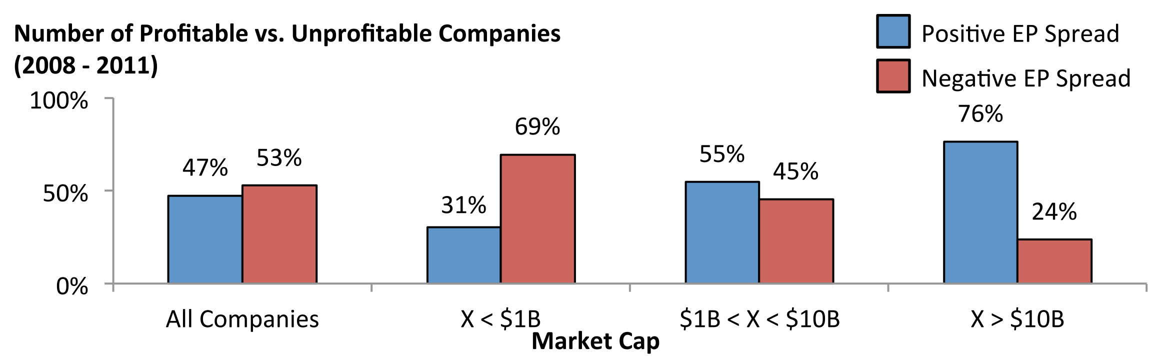
Following are more findings from our study:

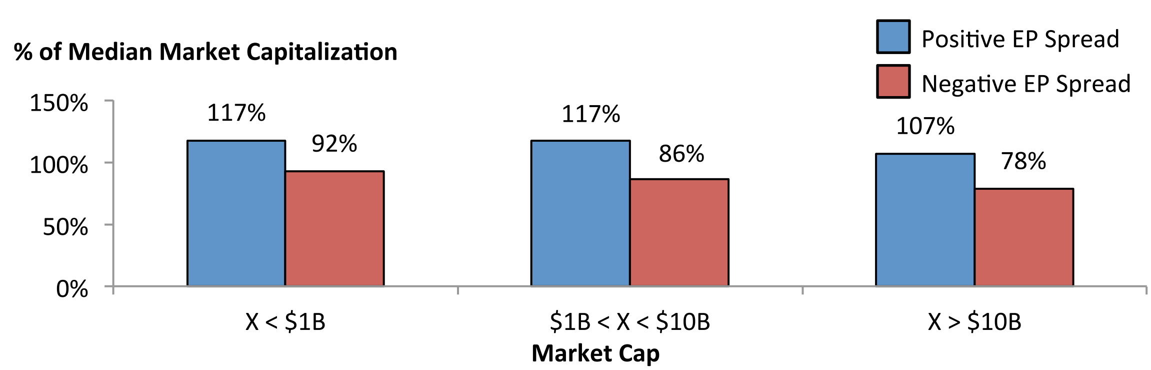
The median TSR of the 220 companies in our sample with market capitalizations greater than $10 billion in 2008 was well below the median TSR of the entire sample, while the median TSR of the smallest 707 companies (market capitalization below $1 billion in 2008) was well above the overall median. (The relative TSR performance of the smallest companies is likely skewed upward by survivorship bias, as discussed above.)



Overall, just under half of the 1,675 companies achieved a positive EP Spread from 2008 to 2011, although size mattered. 76% of the largest companies were EP positive, while only 31% of the smallest companies were profitable.



Size also mattered within groups. Positive EP companies ranged from 103% to 117% of median market cap, while negative EP companies ranged from 78% to 98% of median market cap within each size group.



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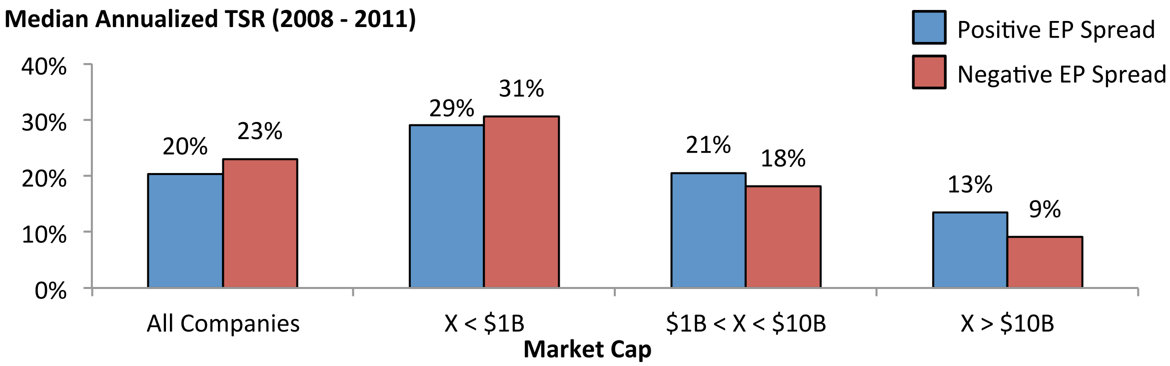
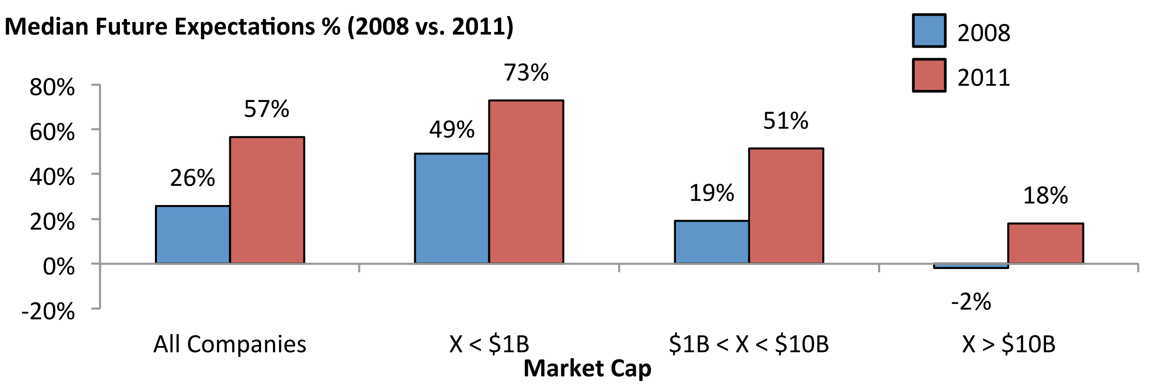
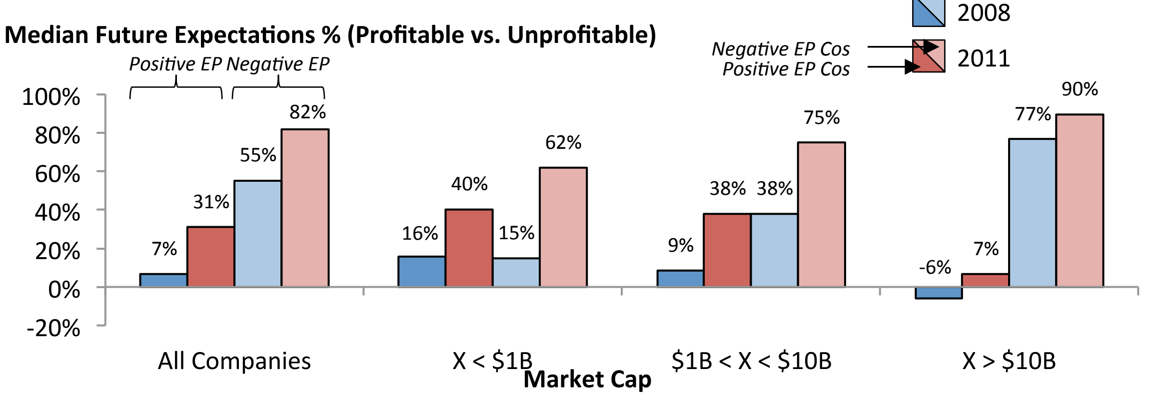
The median TSR among all companies was 21%, and was actually higher among negative EP companies (23%, likely affected by the small company survivorship bias). However, among companies with market capitalization greater than $1 billion in 2008, median TSRs were higher among positive EP companies.



Overall, the median percent of total market capitalization represented by expectations for growth of future EP (FE%) grew from 26% in 2008 to 57% in 2011, reflecting the more positive economic environment today. Median FE% ranged from -2% for the largest companies to 49% for the smallest companies in 2008, growing to 18% and 73%, respectively, in 2011



Overall and in each size category, median FE% was much higher among negative EP companies in both 2008 and 2011.



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About Avondale

Avondale is a strategic advisory firm that identifies and executes initiatives to drive sustainable value growth. Avondale's strategic and financial advice helps companies create value in their business and focus investment around the most profitable growth opportunities. We partner with management teams and investors to increase value through organic growth, M&A growth and core business performance improvement.

The company was formed in 2004 by Bill Stewart and Karl Stark following successful careers at other top-tier strategic advisory firms. Since then, the company has grown to more than 20 professionals with deep experience across multiple disciplines: from principal investing to senior executive leadership.

Avondale partners with clients across three areas:

- Strategic Advisory
- M&A Advisory
- Principal Investing

Avondale was recently named one of the fastest growing companies in America by Inc. Magazine
Avondale is the top ranked strategic advisory firm and the fourth ranked Chicago business on the 2011 Inc 500 list.

Karl Stark and Bill Stewart also co-author the "Herding Gazelles" column on Inc.com, which can be found at: http://www.inc.com/author/karl-stark-and-bill-stewart

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