

SEPTEMBER 2013

# Learning from stock return leaders and laggards

Insights on the paths to value creation



## 1. Learning from Stock Return Leaders and Laggards

Few topics generate more passionate debates at the board level than stock performance.<sup>1</sup> Stock returns are paramount because they are the culmination of many corporate decisions and the channel through which shareholders are ultimately rewarded. To some extent, stock performance is affected by macro events that are beyond the control of senior decision makers. **Executives can, however, differentiate themselves through their preparations for and responses to such events.** For instance, some managers adapted better to the rising tide environment of the post-crisis period and significantly outperformed their sector peers. Do the recent outperformers have special attributes? Were these attributes unique to the post-crisis period or are they traits that will continue to drive shareholder value in the coming years, regardless of the underlying economic and political environments?

The strong rebound in equity markets over the last few years has divided companies into Leaders and Laggards.<sup>2</sup> Analyzing the characteristics of each group provides key insights to decision makers regarding strategic, operational and financial policy. In this report, we discuss the most successful strategies of recent years and highlight the ones that we expect to persist in the future and others that may abate or even reverse. Key insights from post-crisis stock returns include:

### The rising tide lifted all industries

Annualized returns for median performers were positive across all industries and typically above 10% since 2010.

### Leaders and Laggards are found across all industries

The difference between the annualized returns of top and bottom performers was above 20 percentage points in most industries.

### Growth is where it all starts

Outperformance was achieved through strong top- and bottom-line growth. Leaders grew the top line almost twice as quickly as Laggards. The growth difference was significantly more pronounced down the income statement as Leaders grew cash flows three times as quickly as Laggards and earnings per share over five times as quickly.

### Leaders used their entire corporate arsenal to generate outsized returns

Leaders were more proactive in making strategic decisions, improving operational efficiency and adopting more shareholder-friendly financial policies.

<sup>1</sup> In this report, stock performance relates to total shareholder returns (including dividends)

<sup>2</sup> Leaders are defined as those firms in the top third of S&P 500 non-financial firms in terms of total shareholder returns (including dividends) relative to the industry; Laggards comprise the bottom third of the S&P 500 based on the same measure

Figure 1

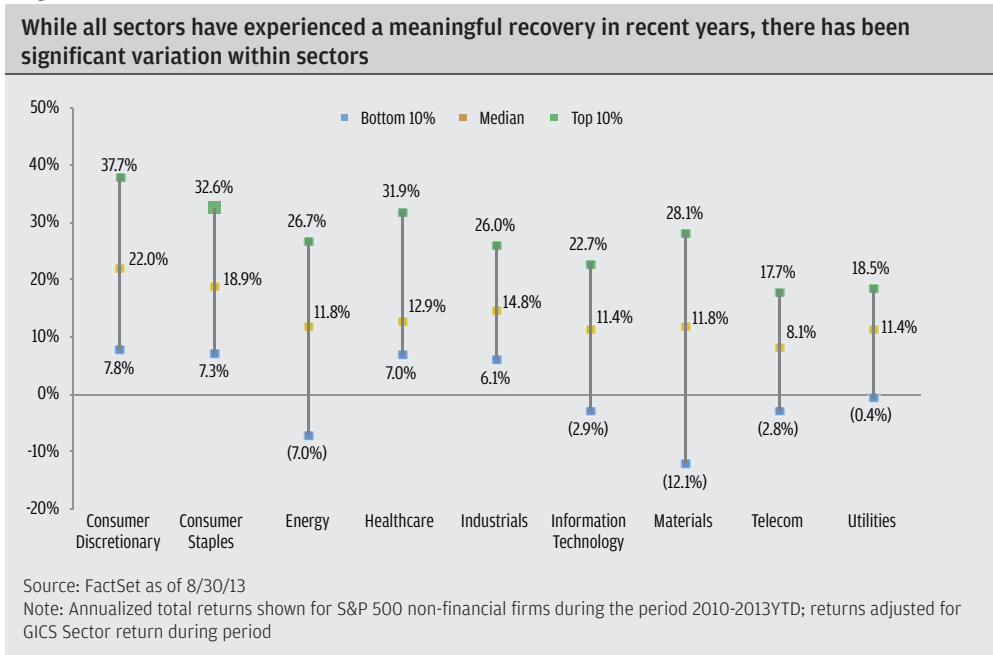
**Firms must adapt to the always changing market environment to outperform**

Factors driving stock return outperformance		2010-2013	2014 and beyond
Strategy (top line)	International exposure	↓	↑↑
	Strategic acquisitions	↑↑	↑
	Disciplined capital expenditure	↑	↑
Operations (margins)	Employee productivity	↑	↔
	Working capital effectiveness	↑	↑
	Operational efficiency	↑	↔
Financial policy (bottom line)	Dividends	↑↑	↑
	Stock buybacks	↑↑	↑
	Leverage/financial flexibility	↑↑	↑

## 2. Post-crisis returns—the rising tide lifted all industries but not all firms

Major U.S. equity indices have rebounded from post-crisis lows and are trading at new highs. The rising tide led to double-digit median annualized returns across most industries. There has, however, been **significant dispersion in the performance of firms within industries**. The range of annualized returns between firms at the 10th and 90th stock return percentile, since 2010, is at least 20 percentage points in most industries.

Figure 2



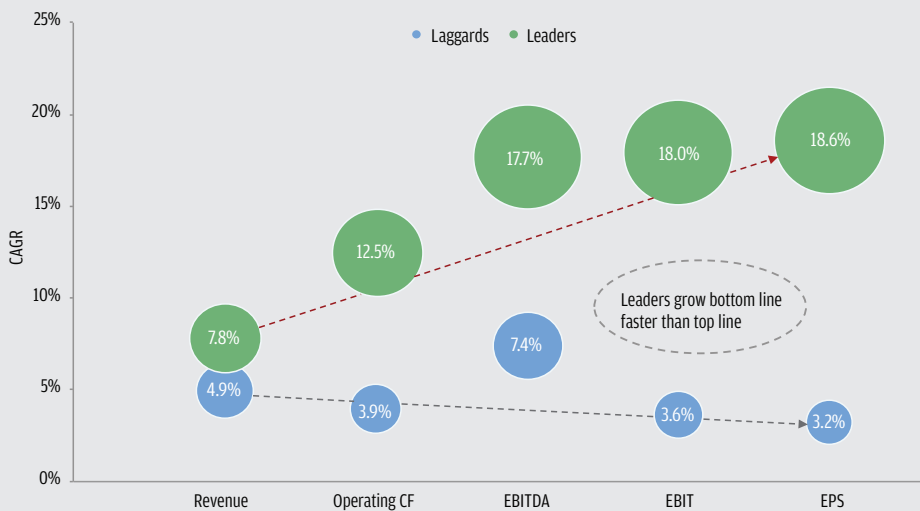
The wide variation in returns, even within sectors, leads to a natural stratification of firms. We categorize firms based on their total return performance relative to their sector as **value-creation Leaders (top third)** and **value-creation Laggards (bottom third)**. Less obvious are the strategic, operational and financial determinants of the differences between the Leaders and Laggards.

### Growth is where it all starts:

A closer look at the Leaders shows that they have not only benefitted from stronger top-line growth, but also accelerated conversion of the top line into profits (Figure 3). Leaders grew the top line at 7.8% annually, versus 4.9% for the Laggards. The difference between Leaders and Laggards expands significantly as one moves down the income and cash flow statements. For example, Leaders grew operating cash flows at 12.5% versus 3.9% for Laggards. The separation between the top and bottom third stock return performers in each industry is also remarkable for EBIT and EPS. EPS growth is more than five times higher for Leaders than for Laggards, suggesting that top-line growth difference is certainly not the only driver of return differentiation.

Figure 3

#### The growth separation between industry Leaders and Laggards expands dramatically toward the bottom line



Source: FactSet as of 8/30/13

Note: CAGR represents growth from 12/31/09 to 8/30/13 (or, if LTM data not available, as of 12/31/12)

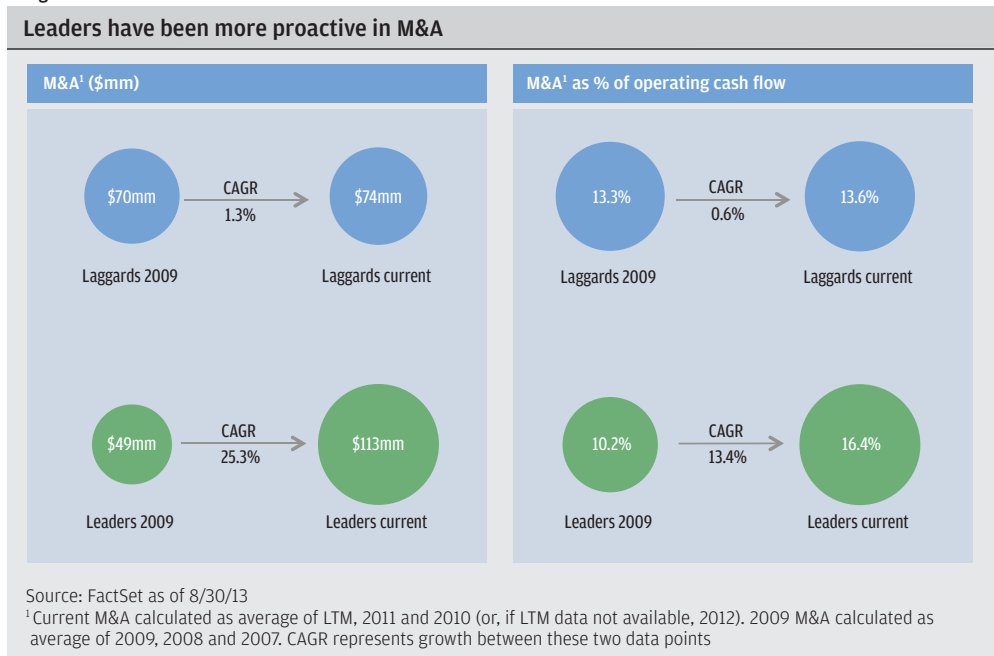
#### EXECUTIVE TAKEAWAY

The rising economic tide in the post-crisis period has not lifted all firms equally, leading to value-creation Leaders and Laggards. Leaders have generated incremental shareholder value through both superior top-line growth and accelerated bottom-line conversion.

### 3. Top-line growth driven by strategic acquisitions and U.S. exposure

The sluggish economic environment has increased the challenges of achieving organic top-line growth. **Leaders drove top-line growth by allocating greater capital to strategic acquisitions.** In Figure 4, we show how Leaders ramped up their spending on acquisitions (relative to operating cash flow generation) more quickly than Laggards (13.4% and 0.6% CAGRs, respectively). This difference is particularly significant given that Leaders also grew operating cash flows more quickly than Laggards (12.5% versus 3.9%, as shown in Figure 3).

Figure 4



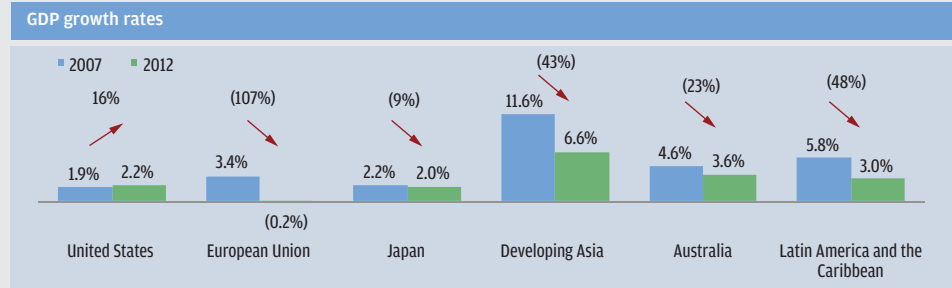
Leaders' top-line growth has also benefitted from higher exposure to the comparatively healthy U.S. economy. The United States was the first among major economies to be affected by the financial crisis. Swift and decisive moves by the Federal Reserve helped the **U.S. recover more quickly**. As a result, the U.S. stands out as the only major region in which the economic growth rate has surpassed its pre-crisis levels. This unexpected rise in domestic growth—relative to faltering global expansion—coupled with a strengthening U.S. dollar—relative to emerging market currencies—has fueled the stock returns of firms with greater revenue exposure to the U.S. in recent years (Figure 5).

In the mid 2000s, robust internal economic activity—along with foreign capital inflows—propelled much of the growth overseas, particularly in emerging economies. The financial crisis derailed this growth trajectory and pushed investors toward the safety of developed economies, particularly the U.S. This has led to a generally **strong U.S. dollar environment that has impacted firms through both direct and indirect channels**. As a result, firms with greater international revenue exposure have tended to underperform in recent years.<sup>3</sup>

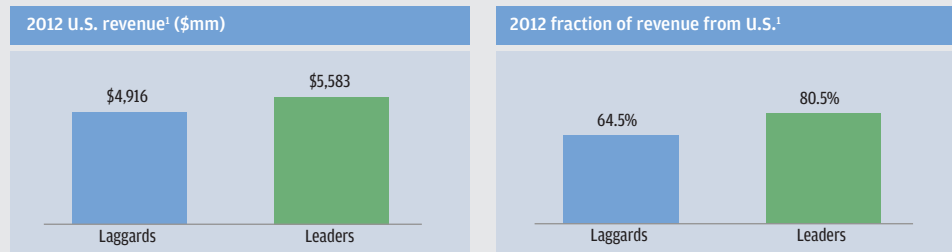
<sup>3</sup> For further reading on recent shifts in the foreign exchange environment, please see our July 2013 report, "Foreign exchange curveballs: Capitalizing on paradigm currency shifts" at [jpmorgan.com/directdoc/JPMorgan\\_CorporateFinanceAdvisory\\_Foreign-ExchangeCurveballs.pdf](http://jpmorgan.com/directdoc/JPMorgan_CorporateFinanceAdvisory_Foreign-ExchangeCurveballs.pdf)

Figure 5

### Leaders' top-line growth was driven by greater U.S. revenue and greater exposure to the relatively healthy U.S. economy



Source: International Monetary Fund



Source: FactSet

Note: CAGR represents growth from 2007 to 2012

<sup>1</sup> Based on median revenues; used North America or Americas revenue when U.S. was unavailable

Looking ahead, emerging markets continue to grow more quickly than the U.S. despite their recent slowdown. Further, the growth rates for many of these markets may be poised to revert to pre-crisis levels in the coming years. This suggests that firms should not abandon strategic opportunities in international growth markets. In fact, it may be prudent to take advantage of current and future Euro-zone or emerging markets' weaknesses to expand or solidify the exposure to growth markets.

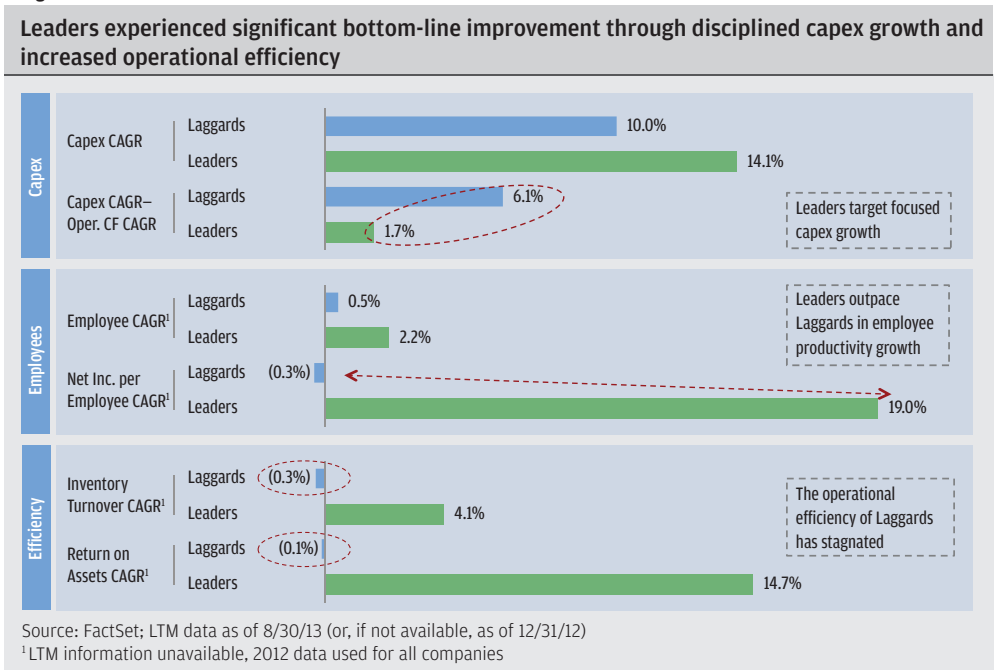
#### EXECUTIVE TAKEAWAY

Leaders have achieved incremental top-line growth through strategic acquisitions and greater U.S. exposure. Looking ahead, inorganic growth continues to remain an attractive option and a global rebound may re-tilt the growth balance toward non-U.S. markets.

## 4. Leaders have complemented top-line growth with even faster bottom-line growth

The chasm between Leaders and Laggards is magnified by the unequal conversion rate of sales to profits. Leaders increased sales roughly twice as quickly as Laggards, but increased EPS five times more quickly than Laggards. Figure 6 shows that Leaders not only increased capex and hired employees at a faster pace than Laggards, but also increased productivity of capital expenditures, labor and working capital relative to Laggards.

Figure 6



### Disciplined capital investments...

The difference in growth rates between capex and operating cash flow was lower for Leaders, suggesting that they took a focused approach to investments.

### ...and increased labor productivity...

Leaders grew headcount 2 percentage points faster than Laggards but increased employee contribution to the bottom line nearly 20 percentage points faster than Laggards.

### ...generate operational enhancements.

Common operational metrics indicate that Leaders grew their bottom lines and executed more M&A without sacrificing operational efficiency.

#### EXECUTIVE TAKEAWAY

Leaders outpaced Laggards in the conversion of sales to profits through increased capital discipline and operational efficiency. As productivity improvements reach their limits, firms need to turn toward strategic investments to generate growth and superior stock returns.



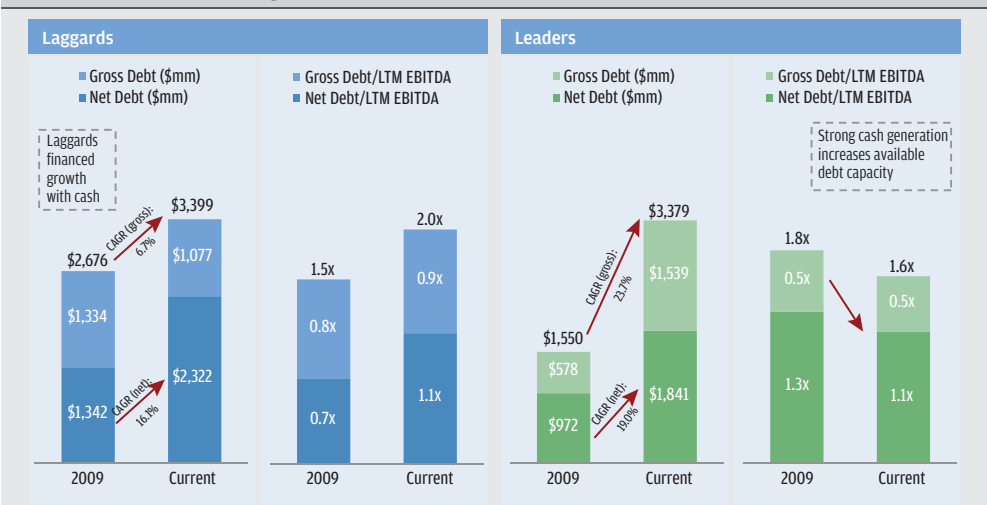
## 5. Growth has been partially funded with cheap debt

Not only must firms strive to grow in today's competitive environment, but must also optimize the financing of their growth endeavors. Today's historically low costs of debt should direct firms toward increased leverage. Yet cash depletion appears to be driving the growth initiatives of Laggards (Figure 7). Leaders, on the other hand, seem to have funded much of their post-crisis growth through new debt. They have **taken advantage of the historic-low cost of debt financing** to increase their absolute debt level at an annual pace of over 20%. EBITDA growth in excess of debt growth has, however, decreased the gross and net leverage ratios of Leaders. Interestingly, this now leaves **Leaders with increased financial flexibility** and dry powder to capitalize on future opportunities relative to Laggards (their gross debt to EBITDA ratio dropped from 1.8x to 1.6x versus an increase from 1.5x to 2.0x for Laggards).

Time could be running out, however, as interest rates and borrowing costs are projected to rise in coming years.<sup>4</sup>

Figure 7

### Leaders partially funded growth with debt, but not at the expense of financial flexibility



#### EXECUTIVE TAKEAWAY

Despite funding growth with debt, Leaders have actually strengthened their financial flexibility due to robust cash flow generation. Leaders are therefore well positioned to capitalize on the cheap debt environment (but should consider exercising this option before a potential rise in rates).

<sup>4</sup> For further reading on the implications of a rate spike, please see our May 2013 report, "When rates take off...Corporate finance implications of rapidly rising rates" at [jpmorgan.com/directdoc/JPMorgan\\_CorporateFinanceAdvisory\\_WhenRatesTakeOff.pdf](http://jpmorgan.com/directdoc/JPMorgan_CorporateFinanceAdvisory_WhenRatesTakeOff.pdf)

## 6. Taking advantage of shareholders’ thirst for distributions

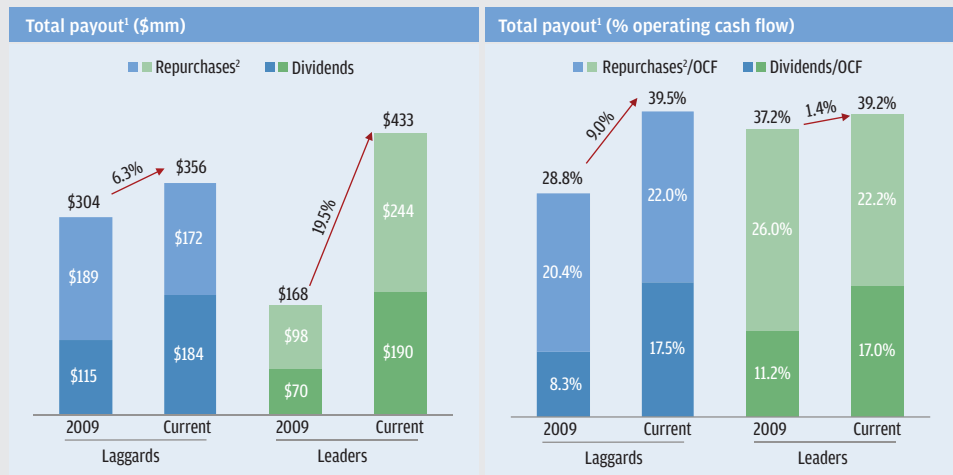
Historically low treasury rates have significantly pushed down the cost of debt, even as the cost of equity remained rather stable and P/E ratios remained low. As a result, the EPS accretion from, and therefore general attractiveness of, debt-financed share repurchases reached new highs over the last few years. Further, the low interest rate environment also ratcheted up investor demand for high-yielding securities.

**Both Leaders and Laggards have increased their level of total shareholder distributions.** However, Leaders have capitalized on these factors more aggressively, not by raising their already high payout ratios, but through their stronger bottom-line growth (Figure 8). For Laggards who were trying to satisfy investor pressures for more returns, this came at the expense of a payout ratio that increased by about one-third.

This comparison underscores the notion that, as in the case of Leaders, enhanced **distributions must be accompanied by meaningful growth initiatives**, such as strategic acquisitions, organic growth or enhancing operational efficiency, to be able to fuel future distribution growth. **Note that the composition of shareholder payouts has an increased dividend component and is remarkably similar for Leaders and Laggards.**

Figure 8

**Leaders grew absolute levels of shareholder distributions more quickly than Laggards but saw their payout ratio growth rate tempered by robust cash flow generation**



Source: FactSet

Note: CAGR represents growth from 12/31/09 to 8/30/13 (or, if LTM data not available, as of 12/31/12)

<sup>1</sup> Total payout calculated as the sum of the medians of dividends and repurchases for each period

<sup>2</sup> Repurchases calculated as the average of the previous three years

### EXECUTIVE TAKEAWAY

Supported by stronger cash flow growth, Leaders grew absolute levels of shareholder distributions more quickly than Laggards. This suggests that steadily rising shareholder payouts, supported by robust cash flow generation, efficiency and growth initiatives, can create long-term value.

## 7. Key takeaways for 2014 and beyond

Today's macroeconomic and corporate finance environments are rapidly evolving. This requires Leaders to constantly reevaluate their strategies and provides Laggards with an opportunity to make up lost ground. Senior decision makers must be aware of current market trends and the **potential need to update their strategic, operational and financial policies.**

### Strategy:

- **Leaders have executed more cash-financed M&A than Laggards.** This is consistent with the strong positive response of equity investors to acquirers announcing synergistic transactions.<sup>5</sup> This positive reception to M&A should continue as long as M&A can drive top- and bottom-line growth and financial flexibility is plentiful. As equity multiples continue to expand and the cost of debt increases, we will likely see a shift in acquisition currency from cash to equity
- **Return Leaders have been U.S. focused.** In the land of the blind, the one-eyed man is king. Firms with more exposure to U.S. and less exposure to the decelerating growth and weak currencies of the emerging and Euro-zone markets have outperformed. This trend is expected to reverse as global economic growth rebounds

### Operations:

- While both Leaders and Laggards have grown capital expenditures, **Leaders have been significantly more efficient in converting those investments to cash flows.** Capital allocation discipline is a key organizational skill that is of paramount importance in low- and high-growth environments alike
- **Leaders have increased both headcount and employee productivity at a greater rate than Laggards.** Improving workforce efficiency should continue to pay, but there may be limits to these types of efficiency gains in a higher growth environment
- Leaders' acceleration from top-line growth to bottom-line growth derives partly from **more efficient inventory management and improved return on assets.** Many of these levers, such as effectively managing working capital, are expected to continue to drive future returns

### Financial policy:

- Leaders took advantage of the low interest rate environment by adding more debt than Laggards. They **maintained their leverage ratios and financial flexibility, however, since their EBITDA increased more quickly than their debt levels.** Leaders also used leverage to fund EPS-accretive share repurchases. These benefits from the historically low cost of debt are still meaningful, but should decline if interest rates continue to rise and valuation multiples increase
- **Leaders exploited investors' thirst for yield by rapidly growing their dividends.** These increasing payouts from Leaders were marginally greater than the attendant increase in their earnings. And though the dividend premium has been declining recently with rising rates, firms that consistently grow their dividends should continue to benefit from the baby boomers' need for cash returns as they continue on their path to retirement

<sup>5</sup> Historically, target shareholders responded well to M&A, but shareholders of the acquirers did not. However, this historical performance has changed over the last three years, when investors have rewarded acquirers that announced synergistic transactions. See our December 2012 report, "Uncorking M&A: The 2013 Vintage" at [jpmorgan.com/directdoc/JPMorgan\\_CorporateFinanceAdvisory\\_MA.pdf](http://jpmorgan.com/directdoc/JPMorgan_CorporateFinanceAdvisory_MA.pdf)









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