

Earnings Momentum & Economic Profitability: Where Are We Now?

Executive Summary

This paper summarizes our current reading on the state of the economy, corporate earnings and profitability. Our opinion is briefly summarized as follows:

- Earnings momentum and economic profitability deteriorated significantly from 2006 to the first quarter of 2009, and the stock market followed suit.
- The rally that began after the March 9, 2009 low was accompanied by a significant improvement in earnings momentum. So far, this improvement is only a deceleration of *negative* earnings growth and not a return to *positive* earnings growth.
- An analysis of publicly traded US stocks indicates that companies remain near unprecedented lows in economic profitability, significantly lower than other recent recessions.
- While cost-cutting may speed the recovery somewhat, we expect a slow recovery in economic profitability. We see only modest improvement in 2009 and 2010.

Shenandoah employs multiple models when analyzing stocks and portfolios, including an earnings momentum model and a discounted cash flow model. Viewing these models in the context of one another is a primary underpinning of our stock selection process. Additionally, analyzing these models in aggregate (across all US stocks or a subset) offers insight as to where we are in the current economic cycle.

Highlights:

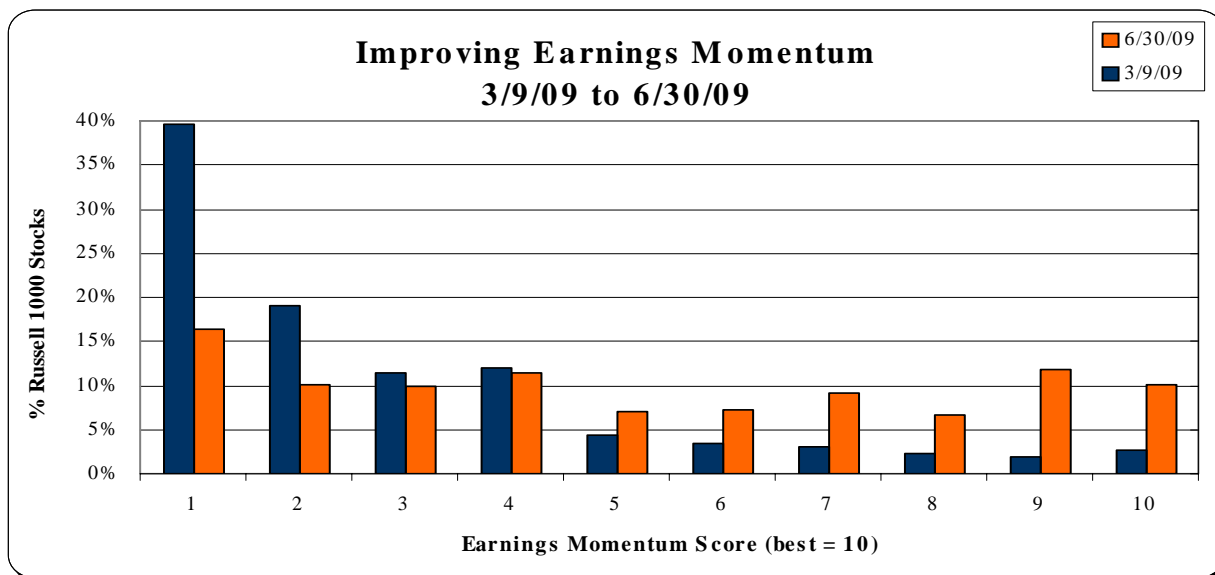
- **Earnings momentum** is the rate of change of earnings growth, not the actual earnings growth per se. Positive earnings momentum occurs when earnings growth is accelerating, or when earnings declines are decelerating. Earnings momentum has improved dramatically in recent months, but it is an improvement of the latter kind. In other words, earnings are not getting worse but have not yet begun to improve.
- The rally that began after the market lows set on March 9, 2009 was likely driven by short-covering and investor rotation toward more risky stocks, i.e. those stocks that suffered most in the market decline (Financial and Consumer Discretionary stocks, especially). The “low quality” nature of the rally is illustrated by the fact that the stocks that exhibited the worst earnings momentum (most negative earnings surprises and estimate revisions by Wall Street analysts) prior to March 9 generated the highest subsequent returns (through June 30.)
- Earnings momentum improved across the board since March 9. All economic sectors showed substantial gains, but real earnings growth is still on the horizon.
- We define **economic profitability** in the context of individual companies’ Economic Margins (source: Applied Finance Group—AFG). AFG defines the Economic Margin as follows:

$$\text{Economic Margin} = \frac{\text{Operating Cash Flow less Capital Charge}}{\text{Inflation Adjusted Invested Capital}}$$

- ◇ *Positive Economic Margins create wealth for the shareholders;*
- ◇ *Negative Economic Margins destroy wealth for the shareholders;*
- ◇ *Zero Economic Margins: operating cash flow equals total cost of capital.*

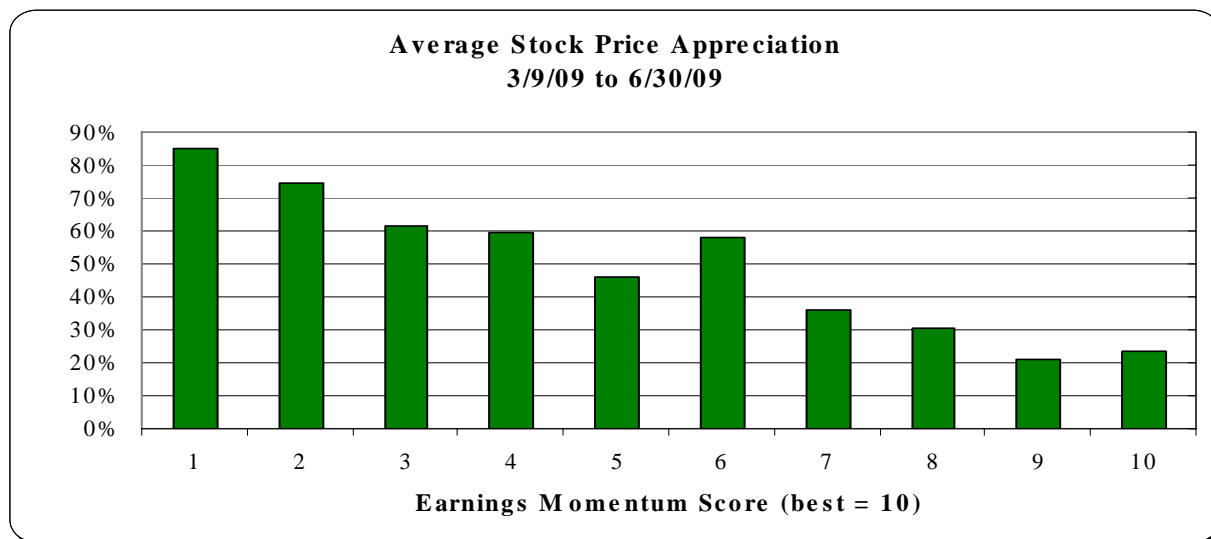
- As of June 30, 2009, we estimate that only 35% of our investable universe (approximately the Russell 1000) will achieve economic profitability this year (positive economic margins). This is a dramatic decrease from 2005 and 2006 when approximately two-thirds of those companies were economically profitable (had positive economic margins). To put this in context, it is useful to note that economic profitability bottomed at 58% from 2000-2002 in the wake of the bursting tech bubble before moving higher in 2003.
- **Current forecasts indicate some improvement in 2010, when we expect approximately 42% of stocks in our universe to be economically profitable. While the stock market may lead (move higher), we expect true economic recovery to be a prolonged process.**

Corporate earnings momentum has improved considerably since the beginning of March. We define earnings momentum on a scale of 1-10 based on historical earnings surprises and the recent movement of earnings estimates by Wall Street analysts (estimate revisions). Currently, 22% of companies are ranked most positive (scores of 9-10, i.e. those companies with the most positive estimate revisions and earnings surprises), up from only 4% at 3/9/09, the date of the current market low. The number of companies with weakening earnings characteristics (negative surprises and estimate revisions, model scores of 1 or 2) now stands at just 26%, down from 59% at 3/9/09. This shift is illustrated in the graph below.



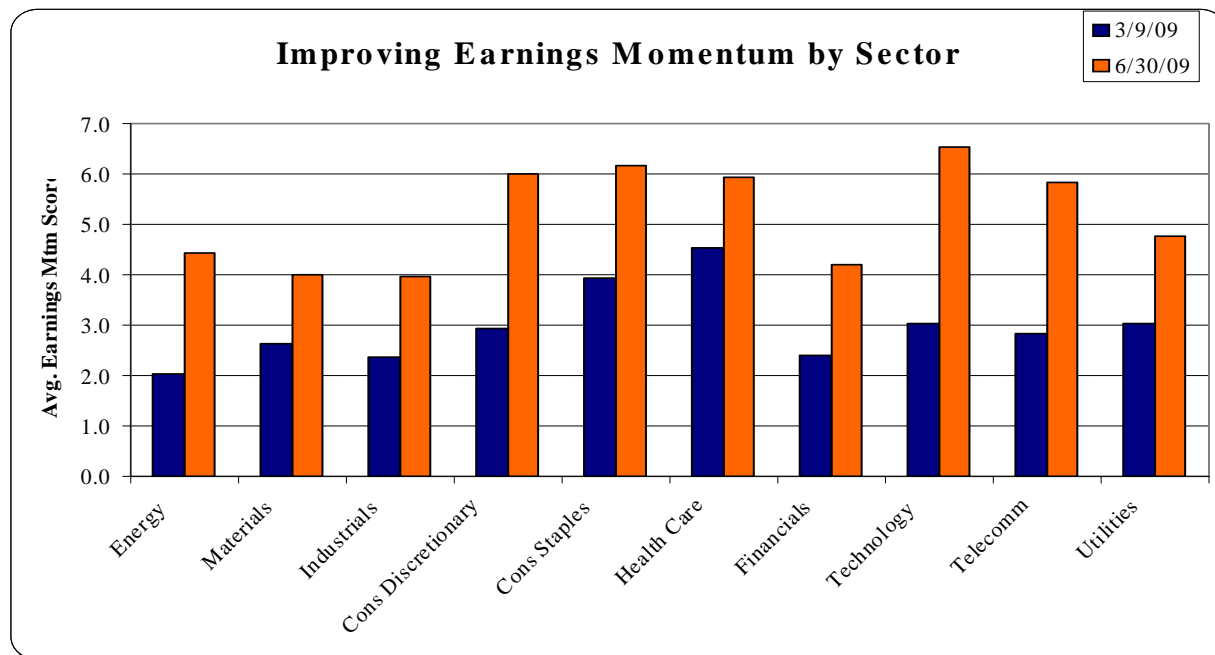
Source: Raw earnings momentum data is provided by Market Profile Theorems (MPT).

Earnings momentum has indeed improved, but earnings momentum is not the same as earnings growth. Earnings momentum is the rate of change in earnings growth, so positive earnings momentum may be due to accelerating earnings growth *or* decelerating earnings declines. So far, the current recovery falls in the latter category; earnings have stopped deteriorating but have not yet begun to actually improve. Reported earnings for the first and second quarters (so far) have been better than expectations, but we contend that this is primarily due to extremely low, possibly overly pessimistic, estimates. A rebound in real earnings growth is not anticipated to begin until late 2009 and gain further traction in 2010. Still, the concept of earnings stabilization sparked a huge rally after the 3/9/09 lows that continued throughout the second quarter. It is not surprising that this rally was led by those stocks that ranked most poorly prior to the rally, as the following chart illustrates.



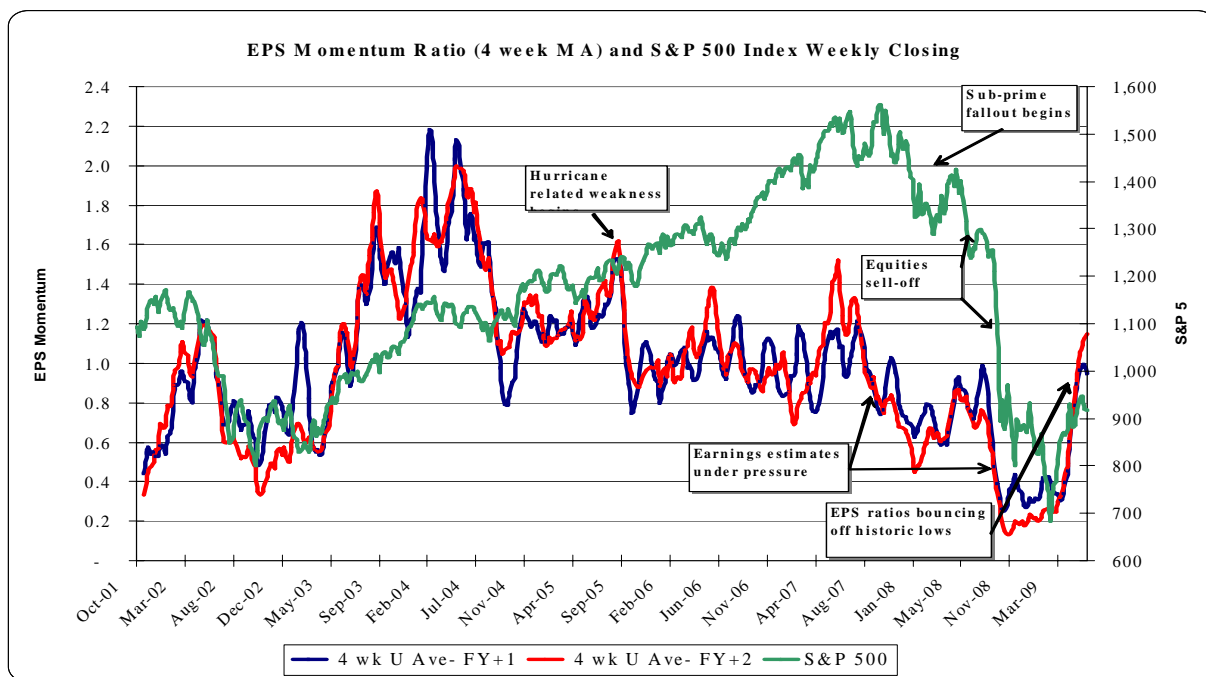
The worst ranked stocks posted an astounding average return of over 80% during the rally, almost four times the return of the stocks that were ranked best (10) at 3/9/09. This low-quality rally was similar to the several “low quality” rallies in 2001-2002, before economic recovery finally took hold in 2003.

By now we know that the rally was driven by beaten down stocks in the **Financial, Consumer Discretionary and Technology** sectors. It is really interesting to note the broad-based improvement in earnings momentum; every sector participated, not just the three listed previously.



Source: Raw earnings momentum data is provided by Market Profile Theorems (MPT).

But, again, earnings momentum is not earnings growth! The chart below depicts the performance of the S&P 500 index (green line) in the context of analysts' estimate revisions (next fiscal year earnings ratio in blue; estimates for year after next in red). Estimate trend lines are defined as the ratio of rising estimates to falling estimates. After falling to lows around 0.2 (i.e. five falling estimates for each rising estimate), the ratio has risen to approximately 1.0. This means there is one estimate being lowered for each rising estimate. This indicates stabilization but is not sufficient to actually call a bottom in the economy or predict a rebound.



Source: Analysts' Estimate data is provided by Applied Financial Group (AFG) and Zacks.

In order to get a better picture of where we are in the economic cycle, we analyze corporate profitability in the next section.

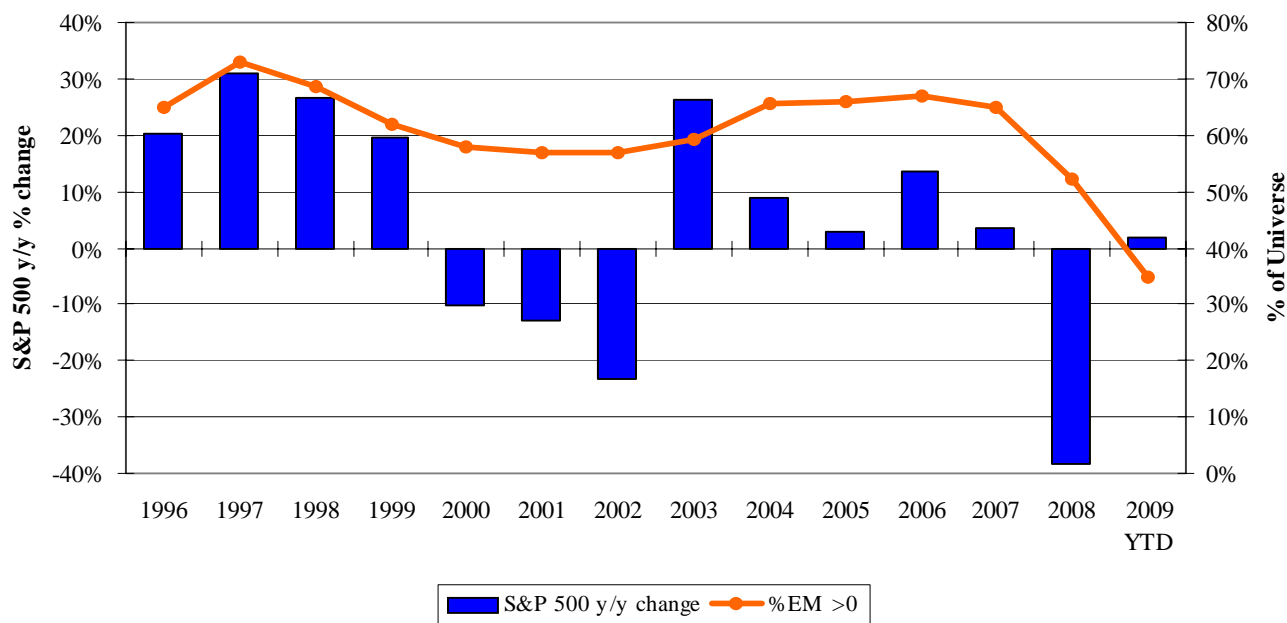
Economic Margin (EM) is a measure of a economic profitability that can be compared across time, companies, sectors and industries.

$$\text{Economic Margin} = \frac{(\text{Operating Cash Flow less Capital Charge})}{\text{Inflation Adjusted Invested Capital}}$$

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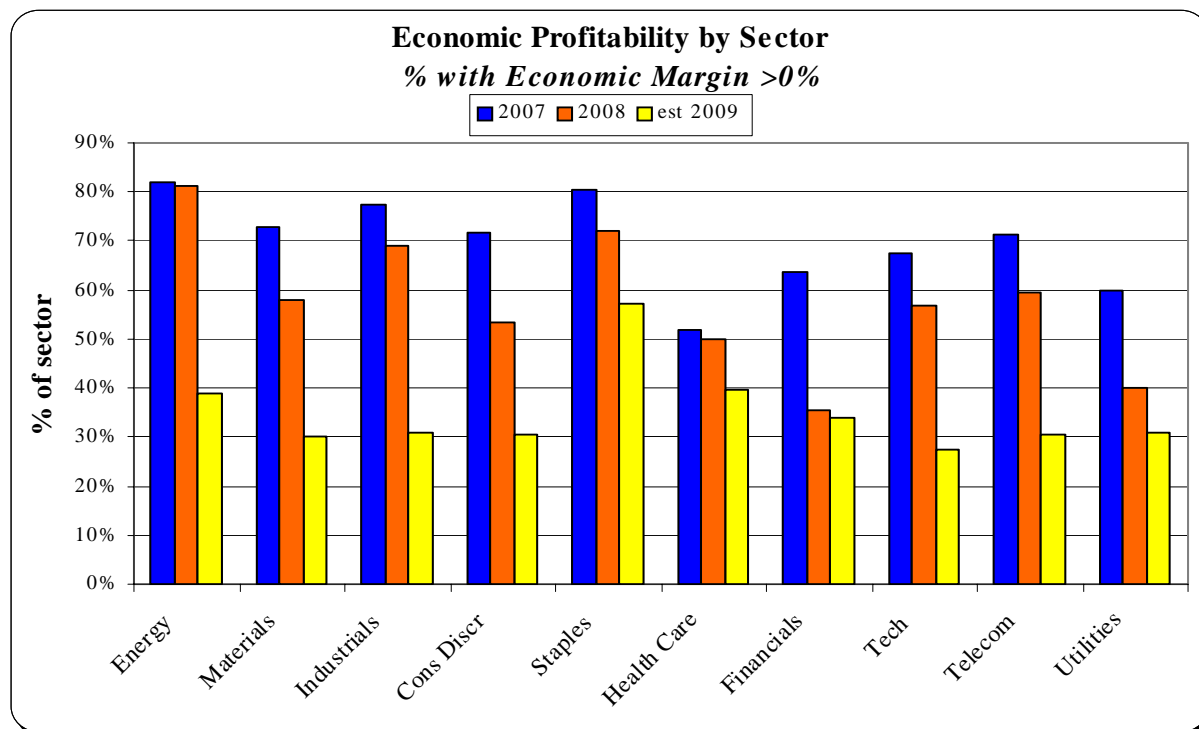
Economic profitability (measured as the percentage of companies in our broad universe with an economic margin greater than zero) **peaked in 1997 (72%)** 3 to 4 years ahead of the bursting of the “technology bubble” and moved steadily lower until it **bottomed in 2000 (57%)** where it stayed through 2002. Equity performance was negative during this three year period as companies struggled to adapt their operations to the less robust economic environment. Due to improving economic conditions and leaner corporate operations, economic profitability began to move higher in 2003 and continued to do so through **2006** when it reached a **level of 67%**. However, by 2007, while earnings continued to move higher, economic profitability and equity market performance both began to show signs of fatigue. As they say, “the rest is history.”

Breadth of Economic Profitability vs. Y/Y % change in the S&P 500 (price only)

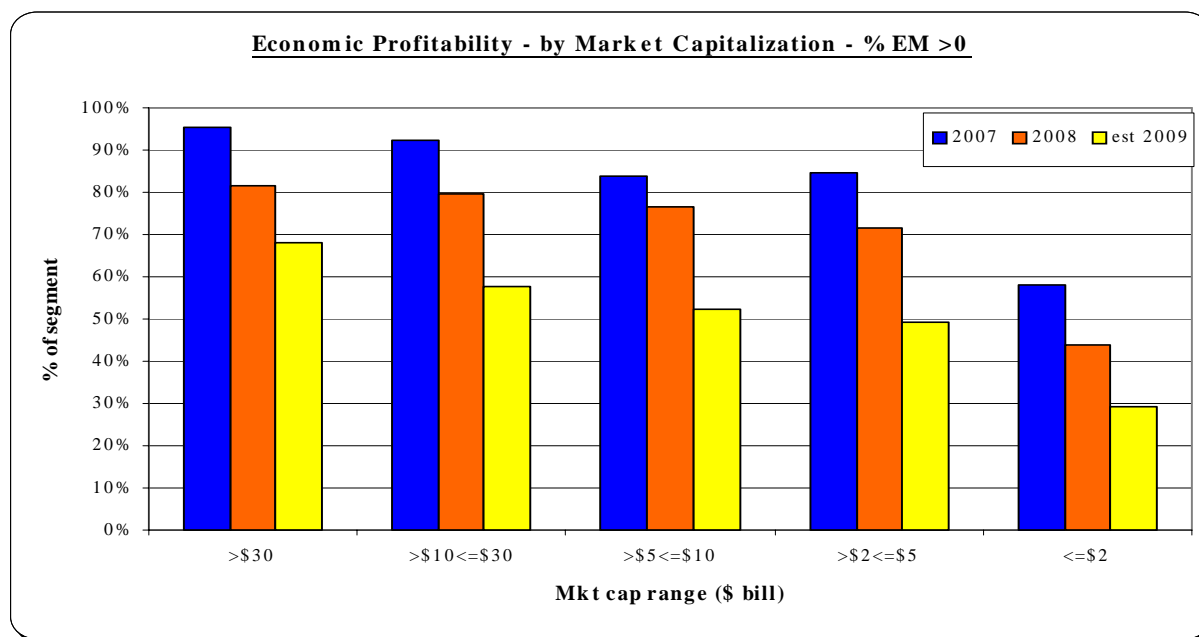


Based on current forecasts, only **35%** of the companies that comprise our broad universe will achieve economic profitability in 2009, down from 51% in 2008, 64% in 2007 and 67% in 2006 (peak in the most recent profitability cycle). It is not surprising that the most recent financial and economic weakness has resulted in a significant reduction of profitability. However, the severity of the drop in profitability is indicative of the swiftness with which the twin disasters impacted companies. With little time for preemptive cost cutting or asset reductions, 2008 corporate profitability fell well below the 2000—2002 levels and is expected to fall considerably lower in 2009. Some improvement in profitability is forecast for 2010 (42% of companies), however; it will remain well below the historical average. The current low level of economic profitability is an indication that there is a considerable amount of “deadwood” still to be removed from corporate income statement and balance sheets. The extent of improvement in corporate profitability will be aided/hindered by the speed of the global economic recovery.

The Financial sector took the hardest hit to economic profitability in 2008. However, as we have noticed in our Earnings Momentum research, the non-financial sectors are now playing catch-up to the Financial sector. With that in mind, it is not surprising to see that the year/year deterioration in corporate profitability for non-financial companies is forecast to accelerate in 2009. While showing some sign of stabilizing, a recovery in Financial sector profitability is not expected to occur this year.

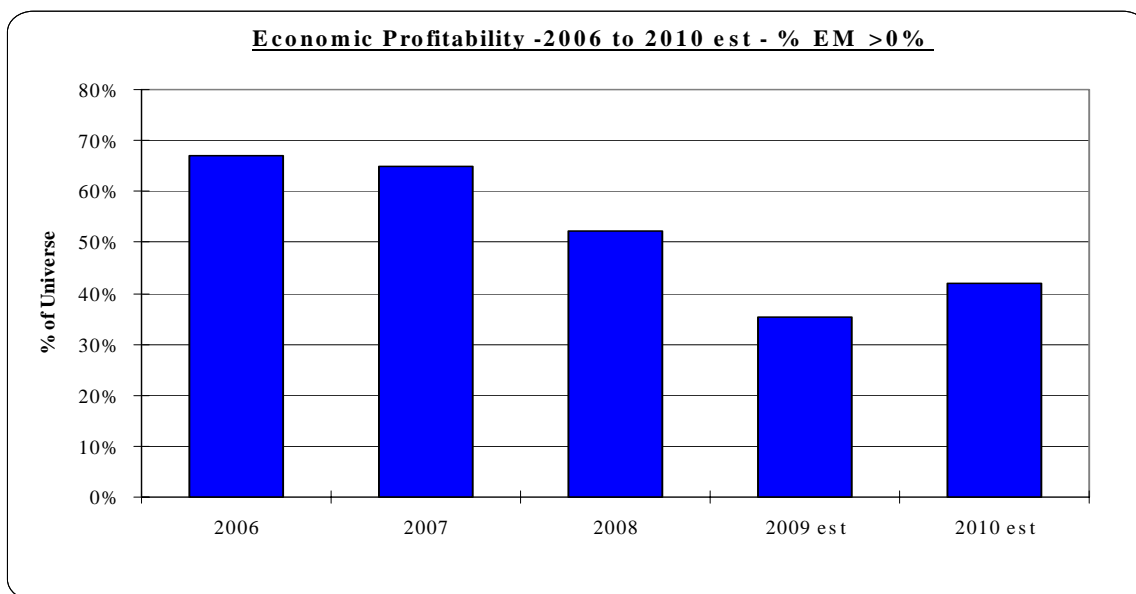


A greater percentage of large cap companies vs. mid- and small cap companies have managed to operate profitably during the economic and financial meltdowns. However, there has been a considerable decrease in the economic profitability of companies across all capitalization ranges from 2007 levels. As indicated in the accompanying chart, the large cap segment of the universe contains a greater percentage of economically profitable companies vs. mid- and small cap company segments. Also larger companies, while still considerable, have seen a less dramatic decrease in profitability, down 30% compared to 2007 levels vs. a 50% drop from 2007 levels for companies under \$2 billion.

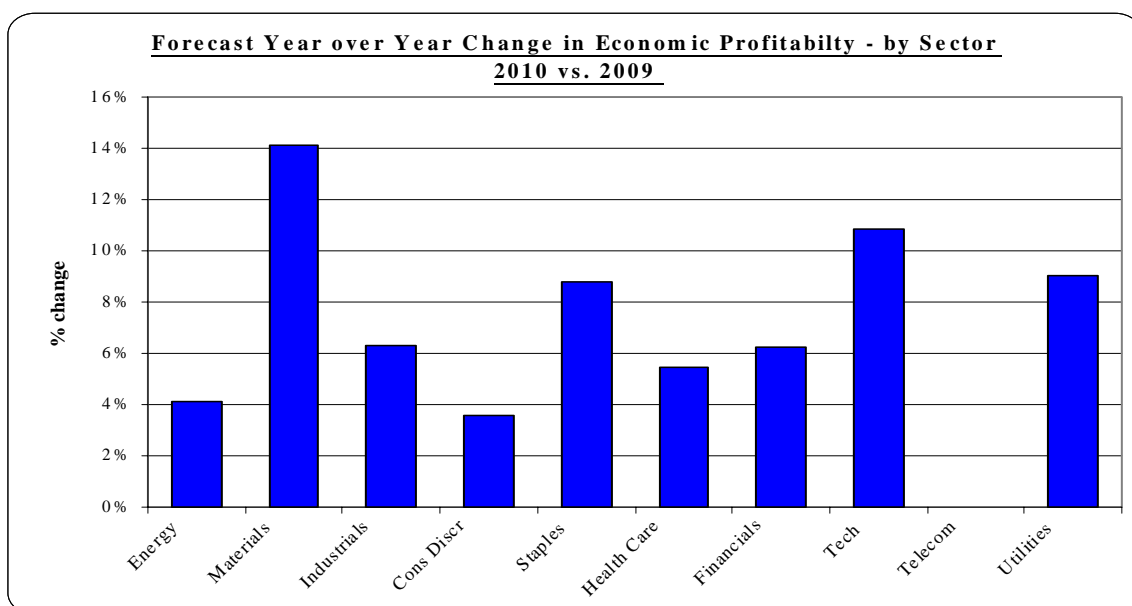


While current earnings estimates forecast above average year/year growth later this year and into 2010, the lack of significant improvement in near-term economic profitability may dampen broader equity market increases.

Based on current forecasts, 2009 is expected to mark the trough in economic profitability for this cycle. Recent announcements regarding cost cutting, restructuring or resizing of operations, mergers and acquisitions and of course bankruptcies are all examples of actions being taken by companies to increase economic profitability and/or to reduce the drag of unprofitable operations. That said, even with the considerable adjustments being made to increase corporate operating efficiency and capital utilization, the near-term improvement in corporate profitability is expected to be only moderate (like what occurred in 2003). Only 42% of the companies that comprise our broad universe are forecast to record economic margins >0% in 2010, up only modestly from 35% in 2009.



At the sector level, only the Materials and Technology sectors are forecast to see a double digit year/year increase in the percentage of companies that will be economically profitable in 2010 vs. 2009, albeit off a relatively low base. Average year/year improvement in the remaining sectors is forecast to be in the low to mid single digits.



Source: Economic Margin data is provided by Applied Finance Group (AFG).
Universe size: 3,000 to 5,000 companies