Too Big to Succeed?

Research on nonfinancial companies finds that larger companies typically grow more slowly and earn lower returns on capital.

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In economics classes, students typically learn that a company can drive down its average cost of production by expanding. The ability to spread fixed cost across a larger base of business is supposed to result in better financial performance. We often hear companies wax eloquently about such benefits of the economies of scale when they justify their acquisitive ways.

For example, consider the March 21 comments of Rick Lindner, CFO of AT&T, who described the corporation's pending $39 billion acquisition of T-Mobile from Deutsche Telekom by emphasizing that ". . . the scale and the combination of operational assets provide us with a path to industry-leading wireless margins. The synergies available from this combination are substantial, with a net present value that exceeds the purchase price."

Although AT&T might do very well with the acquisition of T-Mobile, the frequency of such claims by companies begs the question as to whether larger companies actually do benefit from scale. Do large companies perform better and create more value for shareholders?

Our capital-market research on the 1,000 largest nonfinancial U.S. companies, excluding those that were not public for the full decade of the 2000s (net sample size: 748 companies), indicates that size does indeed matter — but more as a shortcoming than an advantage.

We separated the companies into four categories based on their total size in terms of earnings before interest, taxes, depreciation, and amortization (EBITDA) for the full decade. Then we assessed various measures of share-price performance, valuation, and operating performance. Since executives in large companies indicate that it becomes more and more difficult to reinvest a large percentage of cash flow back into the business as cash flow grows, reinvestment rate seems to be one very useful categorization of size.

As shown in the table below, the largest companies delivered median annualized total shareholder returns (TSR) of 2.7%, including both dividends and capital gains, versus 9.7% for the smallest group. Although the results for individual companies varied, investors were typically much better off investing in smaller companies rather than large companies.

Small Is Beautiful

CUMULATIVE EBITDA	<$2 BIL	$2-4 BIL	$4-10 BIL	>$10 BIL
Number of Companies	203	174	180	191
Total Shareholder Return (TSR)	9.7%	6.0%	5.3%	2.7%
Forward Price/Earnings Ratio	20.9x	16.7x	16.4x	16.6x
Cash-on-cash Return on Capital	19.5%	16.4%	15.3%	15.8%
Revenue Growth (CAGR)	11.3%	7.7%	6.5%	7.0%
Reinvestment Rate	104%	96%	86%	72%
Distribution Rate	18.3%	20.9%	27.5%	30.5%

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The results also held when we assessed the valuation multiples. We examined the average forward price-earnings (PE) ratio based on the share price at the end of each of the ten years, divided by the consensus research analysts' estimates for earnings per share over the next twelve months. The median of the smallest companies have an average forward PE ratio of 20.9x, in contrast to 16.6x for the largest group.

Our analysis indicates these substantial share-price performance gaps can be at least partially explained by differences in operating performance. The largest companies generated 15.8% cash on cash returns on capital versus 19.5% for the smallest companies, notwithstanding the "scale" advantage of the biggest players. Despite the ability to spread fixed cost across a larger base of business, they are actually less profitable.

Beyond efficiency, growth seems to be a struggle as well. The median company in the largest group delivered 7.0% revenue growth per year — respectable, but quite a bit lower than the 11.3% delivered by the median company in the group of smallest companies. Part of this growth gap stems from large companies reinvesting substantially less of their cash flow in the future. The hypothesis by large company executives that it becomes harder to reinvest a large percentage of cash flow back into the business thus seems to hold true in practice.

If they don't invest in the business, what do the largest companies do with their cash flow? They distribute substantially more of it through dividends and share repurchases — 30.5% of their cash flow versus 18.3% for the smallest companies. While those distributions are often labeled "shareholder friendly," our research shows that reinvestment yields strong share-price performance benefits. (See "Are You Reinvesting Enough?")

Even though large companies tend to reinvest at a lower rate, they should still seek to reinvest at a high rate if possible. We separated the largest company sample into four groups based on how much of their cash flow they reinvest in the business and found that the highest reinvestment group delivered median annualized TSR of 5.9% versus 0.4% for the lowest reinvestment group.

Why do large companies tend to underperform smaller companies? The specific reasons vary greatly, but there are a number of common themes:

- Organizational distance from executives to the people running each business inhibits use of full and objective information in strategic decision-making at the top and tends to slow down the decision processes at the bottom.

- Managerial reliance on performance against budgets lessens the intensity for delivering true continuous improvement at the front line and introduces managerial stumbling blocks such as "sandbagging," "hockey-stick plans," and "spend it or lose it."

Capital deployment allocation between capital expenditures, research and development, mergers and acquisitions, share buybacks, and dividends are among the most important responsibilities of an executive team. But too many smear capital across their businesses regardless of true performance, often overinvesting in poor businesses and under-investing in strong ones.

What can a large company do? If it's a diverse business, perhaps splitting into two or more separate businesses would allow each business to focus on growth and returns to suit their own strategic best interests. Employing a life-cycle strategy, in which smaller, diverse businesses are nurtured inside a larger company until they can stand on their own and then spun off as separate entities, might also be a good idea.

On the other hand, businesses may be related enough to make staying together the best policy. In that case, perhaps management should impose more true owner-like opportunities and accountability. That could mimic the structure of a small company while still gaining the benefits of being together. In a sense, the best path forward for large companies is to act more like a group of small companies than as a bureaucratic conglomerate.

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