CFO

| January 06, 2012 | CFO.com | US

Growing Retailers Spark High Returns

The industry typically delivers value to shareholders when they invest in growth – but not when they repurchase stock.

Gregory V. Milano, Steven C. Treadwell

Initial 2011 results point to the second strong Christmas season in a row, with many retailers clearly on the upswing. Selling everything from apparel, jewelry, and fashion accessories to auto parts, electronics, and pharmaceuticals, the retail industry encompasses a broad assortment of businesses delivering on a plethora of customer needs.

To deliver value for shareholders, they must deliver value to their customers. How? By providing products they want at prices they're willing to pay in an inviting environment. The successful companies have learned to motivate buyer demand in the face of tough economic conditions, high unemployment, and low consumer confidence.

When all is said and done, there are three key messages for CFOs working in this sprawling industry to take away. First, for profitable businesses, the priority should be on growing the business, since robust revenue growth creates a tremendous advantage that is valued by shareholders.

Second, to support that growth, managers should be willing to invest more when returns are sufficient and market opportunities are available. They must ensure their management processes are not so conservative that they cause the companies to pass up desirable investments.

Finally, distributions should only be used to return excess capital and must not crowd out profitable reinvestment opportunities.

To arrive at those takeaways, we evaluated the performance of 103 public retailers (including restaurants but excluding auto dealers and gas stations) with market capitalizations above $500 million and listings on major U.S. exchanges between the end of December 2008 and September 2011. Over the last 12 months ending September 2011, those companies collectively produced about $1.7 trillion of sales and $150 billion of earnings before interest, taxes, depreciation, and amortization.

Companies in the retail industry can vary dramatically in size. Wal-Mart represents about 25% of the total revenue and EBITDA of the entire sector. At the other end of the spectrum, Zumiez generated revenue of $479 million and EBITDA of $60 million.

The retail sector has been a good investment in recent years. Overall, the median Total Shareholder Return (TSR) based on dividends and share-price appreciation for the period we studied was 107%. That's more than three times the 33% TSR for the S&P 500 over the same period. The top subsectors were Apparel & Accessories and Automotive, which achieved median TSR of 163% and 123%, respectively. The lowest TSR came from Food Retailers, which was only able to achieve a median TSR of 4%.

Obviously, if you manage a grocery store, the answer to accumulating TSR is not to start opening automotive supply stores. So what can executives learn from these results? Do some business and capital-deployment strategies lead to superior returns for shareholders? We evaluated the influence of sales growth, profitability, return on capital, reinvestment rates, and distribution policies on TSR.

Faster-growing companies delivered better returns to shareholders. We sorted the companies into three equal groups based on their sales growth through September 2011. The fastest-growing group delivered median sales growth of 12% per year, compared with 5% and 0% for the medium- and low-growth groups. The results for shareholders were quite compelling, with the fastest-growing group delivering median TSR of 136%, compared with 75% and 49% for the medium- and low-growth groups.

To achieve such strong increases in sales, the high-growth group tended to reinvest a greater percentage of their cash flow back into the business via capital expenditures, working capital, new lease obligations, and acquisitions. The median company in the fast-growing group reinvested 74% of its gross cash earnings (EBITDA plus rent minus taxes). The median companies in the medium- and low-growth groups reinvested only 54% and 33% of their gross cash earnings, respectively.

In many industries, growth can be very difficult to achieve without sacrificing return on capital. In retail, however, it would seem that growth and return go hand-in-hand. The median cash-on-cash return on capital of the high-growth group is 19%, which is substantially higher than the 15% and 12% median returns delivered by the medium- and low-growth groups.

This growth-versus-return tradeoff is of crucial strategic importance within a particular company and must be considered over time to determine the proper strategic answers. For example, near-term returns may be subdued by spending more on such growth-promoting activities as advertising, customer service, and store renovations. How much growth is needed to make these investments worthwhile?

That varies on a case-by-case basis depending on the profit contribution of the growth, as well as the company's cost structure, capital intensity, and performance sustainability.

While companies with superior growth, lofty reinvestment rates, and higher returns on capital delivered greater TSR to shareholders, companies that devoted more cash to shareholder distributions underperformed for their investors. Despite the common claims by investors, analysts, and journalists that paying dividends and buying back stock is "shareholder friendly," the retail companies that returned the most capital to shareholders actually delivered lower TSR.

For the finding that revealed that contrarian fact, we divided the companies into three new groups based on their distribution rate (the percentage of gross cash earnings returned to shareholders through dividends and share repurchases). The median company in the top group distributed 44% of gross cash earnings to investors, compared with the 22% and 0% distribution by the medium- and low-distribution groups. The high-distribution group delivered TSR of only 55%, which pales in comparison with the 116 % and 150 % delivered by the medium- and low-distribution groups.

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. Steven C. Treadwell, a partner of the firm, heads its Chicago office.*