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For Consumer Products Makers, Sales Growth Spurs Share Prices

In the face of lackluster consumer spending growth, consumer products companies created strong value for shareholders.

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In December The Conference Board announced that its monthly Consumer Confidence Index rose to 64.5, the highest level seen since April 2011. Consumer spending in the latest GDP report showed a 2% increase, up slightly from the 1.7 % increase in the third quarter. We were beginning to see signs of recovery for the consumer.

However, the good news was followed by conflicting data. January's Consumer Confidence Index fell to 61.1 after the gains of the previous two months. The index continues to lag far behind the prerecession levels of around 100, and despite some signs of consumer spending growth, the past two years were the weakest of any sequential two-year expansionary period since World War II.

With such wary consumers and weak spending, have consumer products companies managed to create value for their shareholders? To be sure, the largest and most recognized branded consumer products companies have continued to deliver old standby goods as well as new innovative entrants that appeal to consumers. But have they been able to do so efficiently and profitably enough to generate adequate growth and profitability in order to meet and exceed the expectations of their owners?

We examined the 106 largest U.S. consumer product companies in the household, personal, food, beverage, apparel, leisure equipment, household durables, and tobacco industries. Combined, these companies generated $893 billion in reported revenue and $149 billion in aggregated EBITDA (earnings before interest, taxes, depreciation, and amortization) over the four quarters ending September 2011.

In the face of lackluster consumer spending growth, consumer products companies created strong value for shareholders over one of the most tumultuous markets many investors have witnessed. Over the three years ending September 2011, median total shareholder return was 27%, compared with 4% for the S&P 500 over the same period. (The formula for the rate of TSR is [stock price at the end of a period – stock price at the start of a period + dividends paid] ÷ stock price at the start of a period.)

Leisure-equipment companies delivered the strongest rate of TSR for shareholders, 67%, while household durables delivered the lowest, 8%. We examined many performance metrics to determine which drivers of value led to the best share price performance for investors. We separated the companies into three equal groups based on their TSR.

Across all consumer product companies, the most significant difference between those with the highest and lowest TSRs was a difference in EBITDA growth. The highest TSR group delivered returns to shareholders of 109% while growing their EBITDA at an astounding annualized rate of 19%. The middle group of companies achieved TSR of 27% and delivered EBITDA growth of 8% per year, while the lowest TSR companies delivered -12% TSR with EBITDA growth of -2% per year.

Growing EBITDA was highly dependent on a company's ability to grow the top line, making sales growth the second-most-important driver of success. Of the 75 companies that grew their EBITDA, only 4 did so without growing their top line. Achieving strong EBITDA growth and TSR by simply squeezing costs and expanding margins was not as effective as growing the business, which is particularly notable during this slow economic recovery.

The lesson for the present and the future is that even during tough times, companies need to focus on sales growth as a driver of EBITDA growth if they seek to drive their share price higher. In this and many other industries, it seems that countless companies continue to focus relentlessly on cost cutting to maintain or enhance margins but have lost sight of how important growth is to driving improved profitability now and over the longer term.

Must a company sacrifice margins in order to accelerate top-line growth? The capital-market evidence suggests the benefit for shareholders of "investing" some EBITDA margin back into the business in order to drive higher growth is often worth the trade-off.

The fastest EBITDA growth companies had lower EBITDA margins and higher growth than the medium EBITDA growth companies. Over this period, the ability to drive growth more than offset the lower EBITDA margin, resulting in the creation of more than twice the TSR for shareholders.

That evidence should not be taken to imply that margins are unimportant, however. Concerning the general costs of running a business, it's of course generally better to have lower costs and higher margins. But within the breadth of costs expensed under generally accepted accounting principles are many investments important to consumer product companies. Some examples: product-development research, brand-building advertising, and promotion. Managements should be very willing to increase these expenditures even if margins decline, so long as the expected revenue growth is adequate.

What should companies that can't grow do with the cash flow they generate each year? It's a reality that some consumer product companies face such legitimate obstacles to growth as operating in mature markets or already holding dominant market share.

Are there, then, advantages to buying back stock with the excess cash? Over the past 12 quarters, TSR has been stronger for companies with available cash that deployed it to buy back shares. We grouped companies based on the total dollars spent on repurchases as a percentage of aftertax EBITDA. We found that the companies that devoted the most cash to repurchases delivered TSR of 33% compared with the middle and low repurchase groups, which delivered 26% and 15% TSR, respectively.

Returning cash to investors via buybacks has proved a positive value enhancer and should continue to be considered by companies that simply have no better use for the capital. But the incremental benefit of buying back shares is smaller than the incremental benefit of investing in future growth.

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