Cash Flow | May 17, 2012 | CFO.com | US

Why Isn't the Stock Market Higher?

What companies can do to help their share prices catch up with the surge in corporate net income.

Gregory V. Milano

It may seem an odd question to ask, what with Facebook's initial public offering expected to be valued at over $100 billion this week. But why isn't the stock market trading higher?

Equity analysts expect the companies in the S&P 500 index to collectively deliver 42% more net income before extraordinary items in 2012 than they did in 2007. Yet those companies now trade at a 7% lower aggregate market capitalization relative to the stock market peak.

With much higher earnings and a lower valuation, the implied aggregate price to earnings (P/E) multiple for these companies has fallen by a third, from 19.4 times actual 2007 earnings in October 2007 to 12.8 times estimated 2012 earnings now. At 2007 P/E multiples, these companies would be worth $6.7 trillion more. Why have valuations declined so much? What are the implications for corporate strategy?

Certainly some of this decline can be attributed to macroeconomic and market factors. The news coverage is replete with negative economic stories of one kind or another, and each reinforces a general undercurrent of fear.

For example, the economic turmoil in Greece grabs a lot of attention, both from journalists and policymakers. But perhaps this attention is exaggerated, given the 2010 GDP of Greece was about $300 billion, which would only place 15th among the states in this country.

OPINION

Can and should the success or failure of a distant nation that is only one half of one percent of the global economy really cause U.S. market valuations to drop by a third?

Perhaps not. But conceivably investors might view Greece as just the tip of the iceberg. Do the struggles facing Greece scare investors into thinking similar problems lie under the surface in other countries where debt is also higher than GDP, such as Japan, Italy, Portugal -- and maybe even the United States?

Given the persistently high U.S. unemployment rate and what many say is a lack of any clear Washington consensus on how our economy will get back on track, it may be reasonable for investors and even corporate executives to be concerned about the U.S. economy.

It is the latter point about corporate executives that is of particular concern. This fear may be manifesting itself in underinvestment, which would create a catch-22 scenario: the poor economic outlook leads to less corporate investment, which essentially ensures the continued weak economic outlook.

In nearly every industry, capital market research that I have done demonstrates that the companies with higher revenue growth over time tend to deliver higher total shareholder returns (TSR) in the form of dividends plus share price appreciation. That has continued to be true over the last five economically tumultuous years.

Another observation: companies that reinvest more back into the business in the form of capital expenditures, research and development, and acquisitions tend to deliver more revenue growth. An important driver of future share price performance is thus the propensity to reinvest back into the business.

But based on the consensus expectations of equity analysts, the companies in the S&P 500 have reduced their capital expenditures as a percent of net income from 70% in 2007 to 59% for 2012. The drop is even sharper if we examine only domestic reinvestment, since a greater proportion of investment is now going overseas versus 2007.

Executives do indeed seem to be cautious about the future, so they invest less of their earnings. If companies invest and grow less, the economy grows less.

What are companies doing with the cash instead? Some are stockpiling it. This tends to be a drag on share-price performance except for the companies that have above-average revenue growth and above-average returns on capital.

Others are buying back stock. But my research shows that those that deploy more toward buybacks tend to deliver lower TSRs. In fact, new research by my colleagues shows that those delivering increases in earnings per share via share buybacks tend to experience declines in their price-to-earnings multiple. And that typically offsets about half the potential benefit of the buyback.

Many companies have increased their dividends, and for all but the high growth and return companies, this seems to provide only a modest benefit to TSR. Yet for many companies, this is the most effective use of the cash if management truly cannot find productive ways to invest it back into the business.

But just because a company is reinvesting at a low rate does not suggest they do not have opportunities to invest. In my work with both senior executives and middle managers as well, I find that many seemingly desirable opportunities are going unfunded these days.

Innovation Squelched

Why are companies reinvesting less? In some cases the senior executives fear a downturn in the economy and are risk averse.

Indeed, some companies seem so preoccupied with risk management that they have squelched innovation, creativity, and entrepreneurism.

To be sure, we need sound risk management. But if the desire to protect us from an excessively risky company leads hundreds of companies to underinvest, the overall economy may be getting less value creation for shareholders and less job creation for employees.

Modern corporate governance and executive-pay trends seem to reinforce these developments as well. Shareholders and the public at large were justified in being outraged by some of the seemingly unwarranted pay packages 10 to 15 years ago. But the desire to limit the potential of pay packages may have inadvertently removed an important carrot aimed at promoting entrepreneurism.

What should a company do? Start by recognizing that growth is essential to delivering long-term value – and that growth requires investment. Benchmark the degree to which net income or earnings before interest, taxes, depreciation, and amortization (EBITDA) is being reinvested back into the business versus your peers. If the reinvestment rate is currently low, develop a multi-year plan to move toward a higher reinvestment rate.

Within your organization, stop saying no to investments and start saying yes more often. Make sure analytics and investment hurdle rates are realistic. At the same time, hold your team accountable for delivering reasonable results. If needed, change the way executives and managers are paid to reinforce owner-like behavior. And try to stimulate more innovation, creativity and entrepreneurism.

Companies taking these steps will be more likely to create value for shareholders. And if many companies embrace this mindset, it will give the economy and the stock market a stronger and more durable positive jolt than quantitative easing or any other new policies emanating from our nation's capital can.

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.*