WILLIS INVESTMENT COUNSEL
Principled Investing

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CORPORATE PROFITABILITY MATTERS

LOW DEBT, TONS OF CASH, AND SOLID PROFITABILITY

The continued weakness in the housing market, ongoing stress in southern Europe and the attendant market decline, along with stubbornly high unemployment have many investors believing companies must be struggling as well. It is quite the opposite. A story in the April 9 issue of the *Wall Street Journal* summed it up this way: 'Big U.S. companies have emerged from the deepest recession since World War II more productive, more profitable, flush with cash, and less burdened by debt'. The WSJ story goes on to note that aggregate sales and profits for 2011 of those companies that make up the S&P 500 (basically the 500 largest companies in America) exceeded 2007 levels. For good reason, economists often marvel at the resilience of the U.S. economic engine.

This does not come as a surprise to us. For years, we have paid more attention to the balance sheets and income statements of individual companies than to headlines and averages. But we went a step further in 2007-2009: we began stress-testing the companies we were invested in and evaluated the potential impact of sharply declining sales and margins – an outcome that we could not predict with accuracy but we knew possible. That exercise was ongoing throughout 2008 and 2009. We consistently noticed throughout the worst part of the recession and market storm that most companies were not falling off a cliff - sales were not collapsing and margins were not disappearing. We also examined balance sheets, especially paying attention to whether companies had adequate liquidity to get through the storm. The answer was usually an unqualified "yes". Perhaps more than any one single factor, the strength of balance sheets and the resilience of income statements gave us the confidence to stay-the-course during 2008-2009 with the companies we owned. Corporate profitability matters, balance sheet strength matters, and liquidity matters.

THE RATE OF EARNINGS GROWTH MAY NOW BE SLOWING

It will not be surprising if the *incremental* growth rate in sales and profits begins to slow. The quarter-to-quarter rate of change, or the change versus twelve months ago, consistently captures the headlines. If growth begins to decelerate, the media will certainly underline and bold that deceleration. It is important to not over-react to slowing, but still solid profitability. We continue to see across-the-board evidence of solid operating performance and cash flow generation. On the other hand, investors are more interested in future profitability and growth than the historical record. We find both to be important.

The historical record tells us a lot about a company's competitiveness (sales growth potential), earnings capacity, cash flow resiliency and debt, and overall balance sheet management. No one metric can capture everything but we pay a lot of attention to a company's return on equity (ROE, which is basically net income divided by shareholders' equity). Focusing on a company's ROE over the last 3, 5, and 10 years, and over the last twelve months, provides a good indication of a company's comprehensive financial health; and, ROE is a key input into our intrinsic value "equation". We have to balance a company's *historical* ROE trend with its *expected* ROE going forward. It is easy to be overly-influenced by an impressive historical ROE trend with seemingly stable operating margins and consistent sales growth. Strong historical trends can mask developing cracks in the foundation of future profitability and a deteriorating ROE. We have to remember while the past provides clues, extrapolation can be naïve.

Because a critical input into our intrinsic value equation is *forecasted* or *expected* ROE, we are also concerned with the future and not just with historical trends. Here, we pay attention to changes in (i) economic conditions (ii) competitive forces within an industry (iii) governmental regulation that increases cost, and (iv) other factors that could significantly impede sales growth or compress margins. The challenge is to discern changes in those forces that could materially undermine ROE (e.g., increased competition leading to operating margin compression) from relatively normal and benign interruptions in a healthy ROE trend. Evaluating issues that might cause us to change our underlying thesis on a company and reduce our ROE assumption, and possibly even sell the stock, consumes a lot of our time. Examples of such issues include increased governmental regulation in the banking sector, growing dominance of Apple in the consumer electronics sector, and possible higher tax rates in the pharmaceutical sector. An impressive ROE trend – say over the last 3-5 years – cannot be assumed impervious to the powerful competitive forces in the marketplace.

WHEN THE THESIS CHANGES, WE NEED TO CHANGE

In less than two years, Best Buy has endured a significant drop in its basic profitability due to Amazon's aggressive pricing. Competition has increased while consumers have become ever more willing to buy basic and high-end consumer items online (after first visiting Best Buy to see the product, but not buy it). Such changes in consumer buying habits, competitive pressure from Amazon that does not have the overhead of stores, along with how effectively management adapts can have a significant impact on how investors view the prospects of a company like Best Buy.

Sometimes that collective view by investors (i.e., the market) is too short-sighted and the markets over-react; but sometimes the market gets it right. Our challenge is to decide when the market is over-reacting to a problem that is fixable and relatively short-lived versus when the market is right and there is indeed a growing and material problem. Usually, when we believe the problem is not systemic and should be short-lived, we are patient and often add to the stock if it has declined in response to what we believe are short-term problems. On the other hand, if we believe the underlying forces that generated the historical ROE trend (which we were initially drawn to, our thesis, and which supports our intrinsic value) have materially changed, we have to change our view of the company and perhaps rethink the relative attractiveness of the stock. This is among our most important and most difficult tasks.

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