Digging Beyond Profit Margins

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Profit margins for the S&P 500 constituents, excluding financials and companies in volatile sectors such energy and materials, have been steadily rising since the end of the 2001-2002 recession (Chart 1). The median 2016 EBITDA margin for this group was 22.6%, an all-time high. The median net margin came in at 9.6%, also an all-time high.

Companies have boosted operating margins by doing more with less—optimizing administrative functions, cutting managerial layers, and restraining advertising and R&D expenditures. The S&P 500 constituents recorded median revenue of $360,000 per employee, up from $263,000 in 2003 (Chart 3). Further down the income statement, net margins have risen due to lower effective tax rates (as international revenues as a percent of total sales have risen), and record low interest rates.

Cash flow trends have not been as rosy. While profit margins have risen, cash flow return on invested capital (CFROIC)—operating cash flow generated as a percentage of the total economic capital employed to generate said cash flow—has been flat-lining. Chart 3 illustrates that the median CFROIC has actually declined since 2003, from 16.9% to 16.5% today.

Our read of this is that projects that produce returns above capital costs are hard to come by. Realizing this, the largest companies in the world have zeroed in on cost cuts and diverted cash to share buybacks to prop up bottom line results. For the full S&P 500, rather than our adjusted group referred to above, revenue per share grew at an

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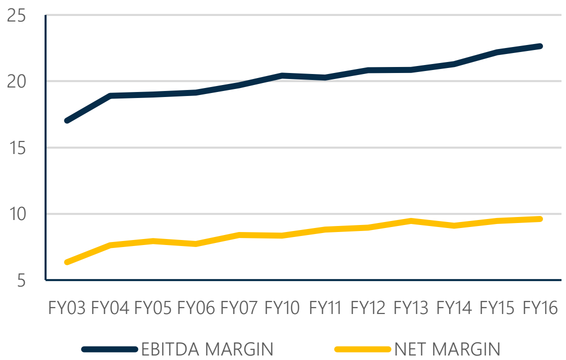
annualized 4.4% between 2003 and 2016 whereas earnings per share grew 6%. Over the same time period, ROIC declined from 7.8% to 7.2%.

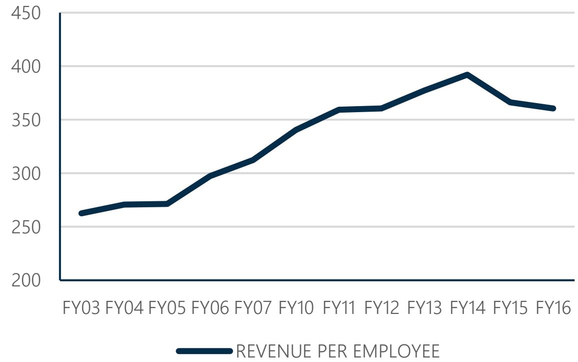
Ultimately, the chickens must come home to roost. We expect that investors will eventually zero in on free cash flow and the productivity of capital. The S&P 500 currently trades at just over 13x EV/EBITDA, reflecting optimism about margins, global growth, and continued favorable central bank monetary policy. Valuations are high on a historical basis, and may turn out to be unsustainably high should the productivity of invested capital continue to decline.

Chart 1. Median EBITDA and Net Margins for Adjusted S&P 500 Group (%)



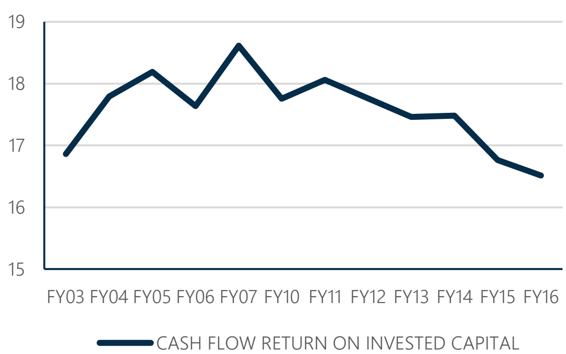
Source: FactSet, Trapeze Asset Management Inc.

Chart 2. Median Revenue per Employee for Adjusted S&P 500 Group ($, thousands)



Source: FactSet, Trapeze Asset Management Inc.

Chart 3. Median CFROIC for Adjusted S&P 500 Group (%)



Source: FactSet, Trapeze Asset Management Inc.

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