SUSTAINABILITY IN CORPORATE EARNINGS

Albin Kistler AG opinion piece
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The capacity to keep growing its bottom line over the long term is a key characteristic of an outstanding company. In this study, we consider why this is and what in particular to watch out for, illustrated with some real-life examples.

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Over the long term, a company's share price is a reflection of the profits that it delivers. Although the price is regularly at the mercy of exaggerations in both directions over the short term, the principle does hold true over the long run. Human emotions regularly cause stock market sentiment to lurch between despair and euphoria, producing price distortions that can at times appear erratic. Despite that, however, a company's long-term share price performance can rarely be decoupled from its operational performance. Sooner or later, the markets will reflect its inherent value.

Characteristics of excellent companies

For this reason, an assessment of the long-term earnings performance is central to corporate analysis. A company's ability to grow its profits over the long term is one of the key attributes of quality that we look for when choosing stocks to invest in. A company in possession of this, plus good management, market leadership, a return on capital that creates value and conservative funding, has what it takes to make an attractive long-term investment.

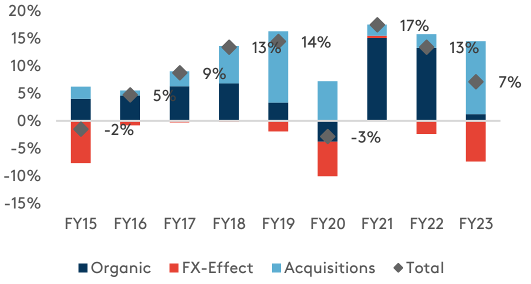
It goes without saying that estimates over a long timeframe are highly uncertain and must be revised from time to time. A structured approach to this process ensures that the important elements are given due consideration and allows a well-founded view to be formed. We think that the following should be incorporated into the analysis:

Growth prospects

The starting point for evaluating a company's growth prospects is to look at its long-term sales growth. This involves drawing up a picture of growth rates in the markets where the company operates. Unsurprisingly, it is easier for a company to grow when the underlying markets are enjoying attractive rates of growth; after all, a rising tide lifts all boats. Competition also tends to be less fierce in growing markets than where markets are stagnant or even shrinking – in which case firms often battle for market share via price reductions and special offers. It is important, however, to distinguish structural growth drivers delivering long-term support from short-term, cyclical effects. That is not a straightforward undertaking, as often trends that appear structural turn out in hindsight to have been largely cyclical. One frequently cited structural trend is demographic change (ageing population), which is favourable to sectors including medical technology. Two examples of prominent Swiss companies that stand to benefit from this trend over the coming decades are Sonova (hearing aids) and Straumann (dental implants).

As well as participating in structural market growth, companies can also grow by gaining market share, i.e. at the expense of their competitors. Growing in this way has the advantage that it can be achieved independently of the underlying market growth, making it relatively independent of the prevailing market environment. It is also in the company's own hands to increase its market share by implementing successful competition strategies. Sika is an example of a company that has followed such a growth strategy with success. The Swiss speciality chemicals firm, which mainly makes products for the construction industry, has consistently built up its market share in the fragmented global construction chemicals market over a number of years. This is thanks not least to the exemplary, well thought-through acquisition strategy, which produced nearly 20 takeovers in 2019–23 alone, supplementing the company's own organic growth.

Fig. 1: Sika – annual sales growth



Source: Sika, own presentation.

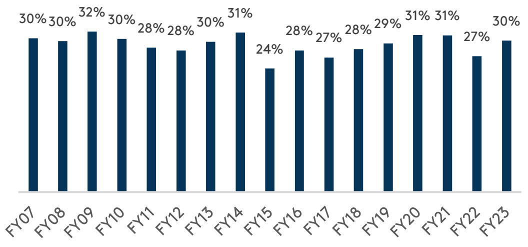
When growth slowly reaches its limits in a company's domestic market, it will often look to venture beyond national borders. That was the case at Emmi. Switzerland's largest dairy processor was finding it increasingly hard to record good growth rates, given that it already held a large share of a slow-growing domestic market. That is why, back before the turn of the millennium, Emmi had already begun to gradually tap foreign markets so as to support its group sales. This circumspect international expansion has largely been successful, with the result that today Emmi generates just 40% or so of its sales in Switzerland.

Margins

Alongside the long-term growth prospects, operating margin performance must also be closely assessed. The objective is not growth at any cost, but profitable growth. There are situations in which companies may decide to accept lower profitability for a limited period, e.g. to gain market share, but there must come a time when the focus returns to operating margins. Alongside the absolute level, operating margin trends and stability must also be considered.

One company with an impressive track record for its operating margin is Geberit. The European market leader in sanitaryware has highly efficient operations, allowing it to post remarkably high operating margins. What is more, the business model is extremely flexible, enabling the company to swiftly adjust the cost base when sales are down, thus protecting margins. Consequently, Geberit has succeeded for decades in posting EBITDA margins that are unusually high for an industrial firm – generally within a narrow range of 28–30%. The only occasion on which Geberit suffered substantial margin contraction was in 2015, when the SNB unexpectedly abandoned the floor against the euro.

Fig. 2: Geberit – EBITDA margin performance



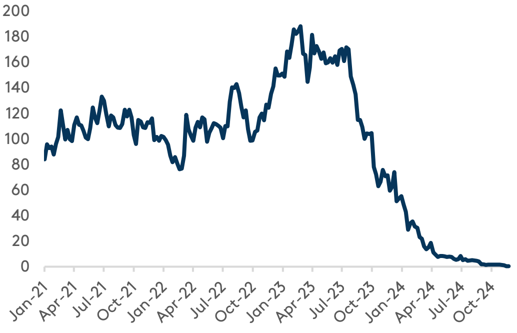
Source: Geberit, own presentation.

Risks

Once you have drawn up a picture of a company's long-term growth prospects and likely operating margin performance, the next step is to evaluate the possible risks. That is not a simple undertaking given the long timescale involved, making it all the more important to focus on those risks that either could have a big impact on the company's development or are deemed highly likely to materialise.

Risks relating to political decisions and subsidies should be considered especially serious and difficult to assess. The example of Meyer Burger serves as a warning of the potential consequences when such risks materialise. This manufacturer of solar modules operates in an industry that appears promising in light of the push to decarbonise, has still found itself in an impossible fix. Its western solar modules are simply unable to compete with those from cheaper Chinese manufacturers. The slide in prices has accelerated further since the Chinese market deteriorated in response to local economic weakness. The remaining hopes were pinned on political interventions in the form of subsidies to enable the company to keep its production locations in eastern Germany open. Since these hopes have now been dashed, the company is on the brink of insolvency, leaving its investors losing almost all the capital they invested.

Fig. 3: Meyer Burger – share price performance



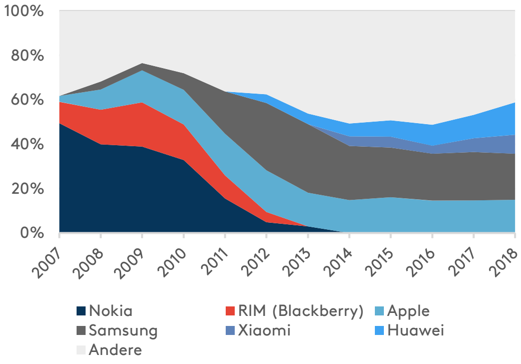
Source: SIX, own presentation.

Beyond this, potential disruptive changes should be accorded the utmost attention. That means far-reaching changes that could completely reshape the market structure. They have the potential to call into question the fundamentals of an existing business model and as such can pose a threat to a company's continued existence. It is therefore important to be able to recognise disruption risks at an early stage and to evaluate them accurately.

Smartphones are a prime example. These now omnipresent devices quickly gained a hold following the launch of the iPhone in 2007, causing dramatic upheaval in the mobile phone market.

Whereas in the pre-smartphone era competition had centred around price and improvements in areas such as camera quality and device size, the arrival of the smartphone suddenly shifted the focus to other features. An innovative operating system allied with a capacitive touch screen set new standards in user-friendliness – and set the iPhone far apart from the dominant mobile phones of the day. Within just five years, former industry giants Nokia and RIM (Blackberry) had collapsed and the market structure had been completely upended. As recently as 2007, Nokia was the undisputed market leader, with a global market share of close to 50%. However, it grossly underestimated the disruptive power of the new smartphone, which was the start of its downfall. Resting on the laurels of its past successes and over-focusing on short-term results came at the expense of innovation. This prevented Nokia from recognising the disruption risk of the smartphone early enough and reacting in time to nascent developments. Ultimately, the company was left with no choice but to sell this activity to Microsoft in 2013.

Fig. 4: Mobile phones – worldwide market share



Source: Statista, own presentation.

Confidence

As long-term forecasting entails a very high level of uncertainty, a degree of humility is called for. A structured process for incorporating all the key aspects into an evaluation and forming an well-founded opinion is of course a great help, but one should not lose sight of the inherent uncertainties. Of course, every prediction involves some uncertainty, but this varies in degree. Not all estimates are equally uncertain, and that needs to feed into considerations.

The history of a company and its industry can provide clues as to the reliability or confidence level of predictions. Market forces are more stable in some sectors than others, which can translate into lower variability in growth rates or stable market shares. By contrast, other industries are in a constant state of flux, perhaps because technological innovations have a large impact. It is evident that the forecasting certainty for a company in such an industry is significantly lower, and this must be taken into consideration.

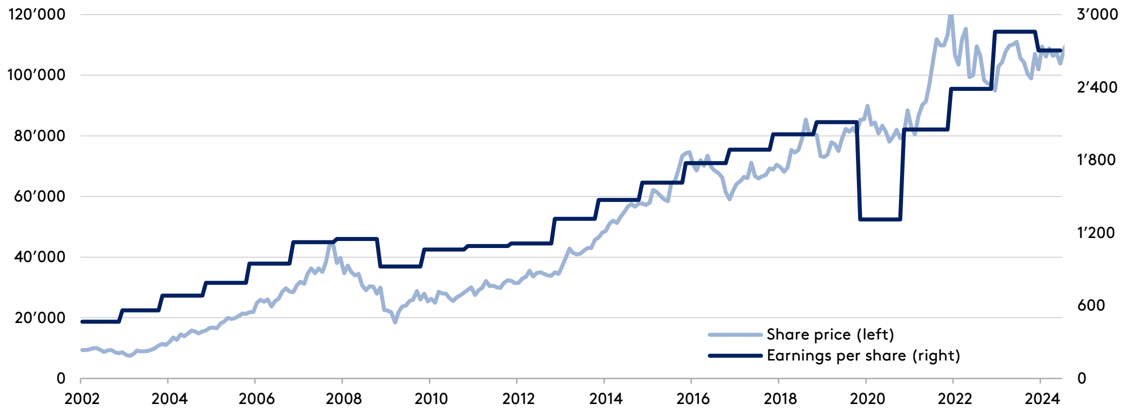
Conclusion

As a company's share price reflects its operating performance over the long run, assessing its long-term earnings prospects is a very important part of corporate analysis. Taking a structured approach as outlined above will help you to manage the inherent uncertainty associated with forecasts over such a long timescale.

It is also important to always maintain a critical eye. We not infrequently see in retrospect that the management teams at the companies being assessed, in particular, have been over-optimistic. Having blind faith in their objectives or forecasts is therefore fraught with danger. Nothing beats forming your own opinion of a company's long-term prospects.

Conversely, attempting to predict short-term share price movements is a far less promising and relevant undertaking. The strong influence of market sentiment leaves share prices prone to exaggerations and seemingly erratic swings. Past experience shows that many market participants focus too much on short-term movements and lose sight of what really counts. Instead, the key for long-term investors is to remain invested over an extended period in companies of excellent quality so that they can share in the growing earnings power of these firms. Sooner or later, share prices will reflect this.

Fig. 5: Lindt & Sprüngli – share price and earnings performance



Source: SIX, own presentation.

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