Defining Growth through Earnings Power

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We are fast approaching the date that will mark our current bull market as the longest in history. During this time, the global economy has generally featured modest growth with low levels of inflation. Also, during this record setting period, the global markets have inundated the global economy with "easy" money. Access to abundant capital encourages companies to accept greater risks for growth. We have witnessed numerous companies expand their businesses into adjacent markets or even new markets in which they do not necessarily possess a competitive advantage. Wall Street is largely pleased as these companies can demonstrate impressive short-term growth–both top and bottom line.

We hear the term "growth" constantly in our industry. Generally speaking, investors desire "growth" from the companies or assets in which they invest. This makes sense. After all, growth is normally required to make assets more valuable. Even value-oriented investors seek out companies that exhibit the potential to grow in the future.

But how do you define growth? Some investors define growth simply as revenue growth. Some focus on increasing profits or earnings per share. Margins, market share and many other metrics may be used as barometers of growth. All growth, however, is not created equally.

Enduring investments ultimately require companies to sell more of what they do. Many of our long-time constituents are aware that Riverbridge defines growth as unit growth. We invest in companies that consistently sell more of what they do year after year. The definition of units varies from company to company and can include the number of licensed seats for a software company or products sold for a manufacturing company.

Many managers use some level of profitability–such as net income or earnings per share–as their primary measure of growth. While these measures are an important piece of a company's overall analytic mosaic, they have limitations. Companies may increase their profitability through cost reductions. Costs can only be pared so far, however, before the fundamental vitality of a company is compromised. For ultimate sustainability, unit growth must be present.

Unit growth alone also has its limitations. Growing for growth's sake is a recipe for an underperforming investment. Riverbridge is not attracted to management teams whose aim is to grow at all costs. Instead, we focus on companies that are producing enduring unit growth while maintaining high returns on invested capital. We focus on management teams deploying their resources in a manner that will earn them a sustained superior return on their invested capital. We are willing to accept reduced revenue or earnings per share growth if management makes prudent investments in those parts of their businesses which can generate high returns over the long term. Sustained unit growth combined with increasing returns on invested capital creates earnings power.

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Riverbridge seeks management teams with the discipline to stay in businesses and allocate capital only to where they have an advantage. For management teams of public companies, the pressure from Wall Street to accelerate short-term growth is formidable. Too many company leaders move into lower return businesses attempting to chase growth. To do this, they may apply leverage. Borrowing is an effective but risky method to bolster growth. Unless this incremental growth offers a superior return on invested capital, applying leverage increases the risk to the business at a rate not commensurate with the benefits of the increased growth.

As we look at today's state of the economy, while Wall Street may be generally pleased with companies that are demonstrating current short-term growth, when access to this cheap capital evaporates, these companies will suffer and will likely experience stalled growth. This phenomenon has occurred repeatedly throughout market cycles in 1990, 2000, and 2008. Thus, we find it critical to look at unit growth and lean on our investment philosophy while investing in companies with growing demand for what they do combined with achieving superior returns on their invested capital. ■