

Lazard Insights

Conference Call Series

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Finding Growth in a Slow Growth Environment

Featured Speaker: **Chris Blake**, Managing Director, Portfolio Manager/Analyst

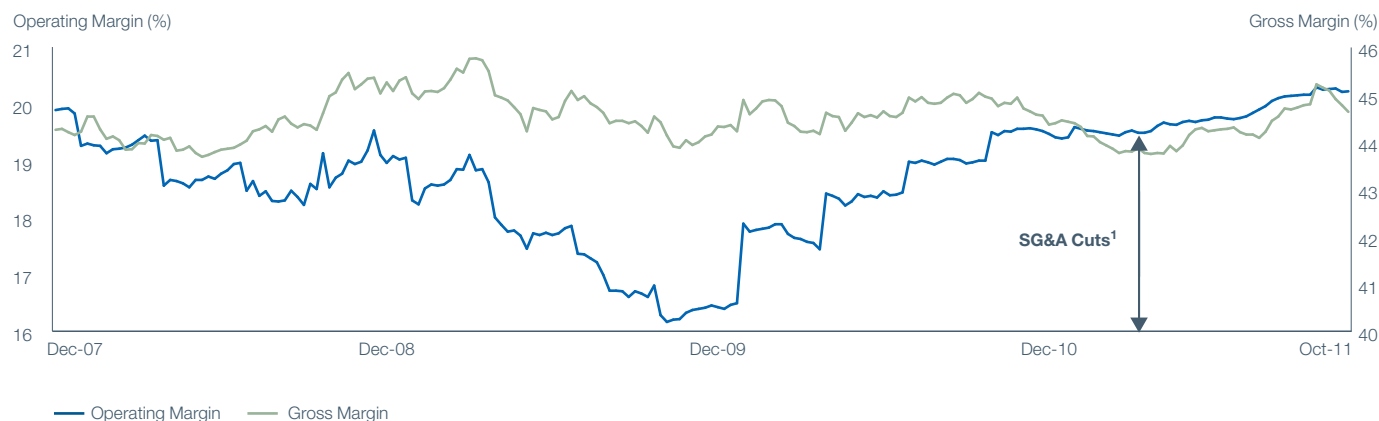
Given the current low growth expectations for global capital markets, companies are being challenged to find ways to sustainably grow their business and enterprise value. There are many levers available for companies to do so, but we believe that some are more sustainable, and are better indicators of future success than others. In the following discussion, we will explore the interplay among the profit and loss (P&L), balance sheet, and cash flow statements, explain how earnings can be driven by these and other factors, and discuss which elements we believe investors may want to focus on to identify the eventual winners.

Since the 2008 recession there has been a significant rebound in equity markets, driven by a multitude of factors, including revenue growth, balance sheet improvement, margin expansion, easy monetary policies and, to some extent, multiple expansion. Companies not positioned correctly, competitively, and/or through their balance sheets, either were consolidated or disappeared. This

occurred during a period of easy monetary policy, which provided a backdrop of increased marginal asset values.

Assessing the situation today, many levers, such as margin improvement and deleveraging, have been exhausted and companies must now make fundamental decisions about how to best deploy capital amid a slow growth landscape. This is where fundamental research and the examination of P&L, balance sheet, and cash flow statements allow us to differentiate between companies creating value and those masking their levels of growth (which will likely destroy their shareholder capital over time). We have been seeing a clear shift in how companies view the creation of growth and the focus on per share returns. While the return of capital in the form of share repurchase was historically viewed by many, particularly growth companies, as a sign of a lack of opportunities, it is now increasingly being viewed as a way to augment a company's growth and return profile.

Exhibit 1
S&P 500 Index: Operating and Gross Margins



As of 28 October 2011

1 SG&A refers to Sales, General and Administrative Expenses

Source: Bloomberg, Lazard, Standard & Poors

The Market in Context – Margins

Exhibit 1 provides additional context with regard to gross and operating margins for U.S. companies. From the end of 2007 through October 2011, gross margins in the S&P 500 Index have been relatively flat, as companies benefited from lower input costs in 2007 and 2008, and aggressively decreased inventories in 2009. However, operating margins improved dramatically between September 2009 and October 2011, rising 400bps to 20%, following significant cuts in fixed costs.

In Exhibit 2, we see that for the first two quarters of 2011, the S&P 500 Index's revenue run rate was almost identical to that of the first two quarters of 2008. However, earnings were 37% higher. This highlights the sizable productivity shift in the corporate profit complex, illustrating the contradiction between the blessings of the past and the headwinds of the future as we have entered uncharted waters in regard to margins.

Exhibit 2 The Market in Context – Earnings and Revenues

Revenues per Share	2008 (%)	2011 (%)
March	263.28	264.59
June	279.84	274.85
Total	543.12	539.44
% Change		-0.7

Earnings per Share	2008 (%)	2011 (%)
March	18.79	26.63
June	19.33	25.53
Total	38.12	52.16
% Change		36.8

As of October 2011

Data is represented by the S&P 500 Index.

Source: Bloomberg, Lazard, Standard & Poors

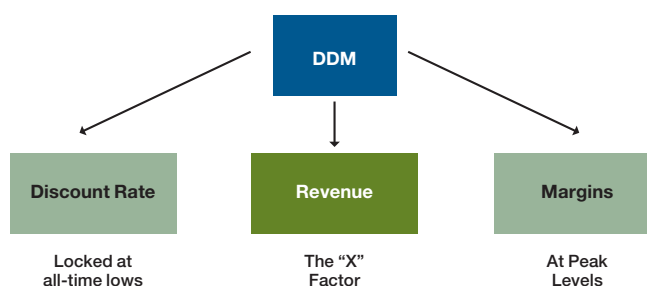
In order to fully understand the implications of the current margin structure, it is also important to consider what the market and economists are suggesting. Currently, consensus estimates for the S&P 500 for the next two years call for approximately 4% revenue growth and 10.5% earnings growth.¹ This is in an environment of 1% to 2% U.S. GDP growth, less than 1% (and potentially negative) European GDP growth, and 2% global GDP growth. These estimates suggest that margins will continue to expand at the recent trajectory despite higher input prices and/or flat-to-increasing unemployment in developed markets.

Drivers of Recent Market Volatility

Global growth rates are clearly in flux, driven by Eurozone fiscal challenges, U.S. budget decisions, and potential volatility in the emerging markets as they move from export to consumption economies.

In order to understand the current market volatility, we must first explore the very essence of how stocks are valued.

Exhibit 3 The Dividend Discount Model



For illustrative purposes only.

The fundamental driver of a stock (and the market) is the present value of future cash flows, also known as the dividend discount model (DDM), as shown in Exhibit 3. While this is admittedly only one of several valuation techniques, it does highlight some of the issues facing the market. When we think about the first component of the DDM, the discount rate, it is our view that the U.S. Federal Reserve's (the Fed) guarantee of low rates for the foreseeable future has essentially locked in a low discount rate. The equity risk premium may be higher today, but we believe absolute levels of borrowing costs are likely at or near all-time lows. Moving toward the margins component of the DDM, we believe that there is a greater risk of downward pressure on margins, due to the overall slowing of world GDP and higher commodity costs. Thus, the bulk of the value creation or destruction appears to be dependent on revenues. With regard to revenues, one thing we would highlight is how operating leverage affects earnings. There are two sides to leverage and though it has been strong on the upside, many companies today operate in such a lean capacity that revenue shortfalls will likely lead to significant volatility in earnings. When we examine how the market is looking at the components of revenue growth, and consider the macroeconomic situations in the Eurozone and the United States, one can see why the volatility in the market has been high.

Growth Varies by Business Type

At the most basic level, a company's growth is dependent on its business model and how it deploys capital (whether via the P&L, balance sheet, and/or cash flow statement); the type of company it is (deep cyclical, non-cyclical, market leader, or high/low cost); and where it falls on the maturation curve. Investment decisions, from a management perspective, are different for a young company than for one that is nearing maturation. As a company ages, the growth profile does not have to change on a per-share basis, but it may change in the absolute. This not only impacts how much capital is deployed, but also the composition of the capital. However, the key component of sustainable growth is whether management's growth vision is in line with their business model.

In order for us to understand whether management is creating sustainable growth, we will need to identify the various drivers of value, as illustrated in Exhibit 4. Sales drivers include industry growth, same-store-sales (for a retail company), market share, moving into new territories (and the associated cost), and new products and services. Each one of these drivers has varying implications on reported earnings and cash flow. A management team must also make decisions in their P&L, balance sheet, and cash flow to support growth. Profit and loss investments include investments in people, systems, advertising, and research and development. Profit and loss investments have an immediate impact on earnings and, in our view, reflect how management is thinking of their growth targets in real time. The balance sheet includes investments in working capital and the ability to either add to or detract from existing leverage. Balance sheet investments

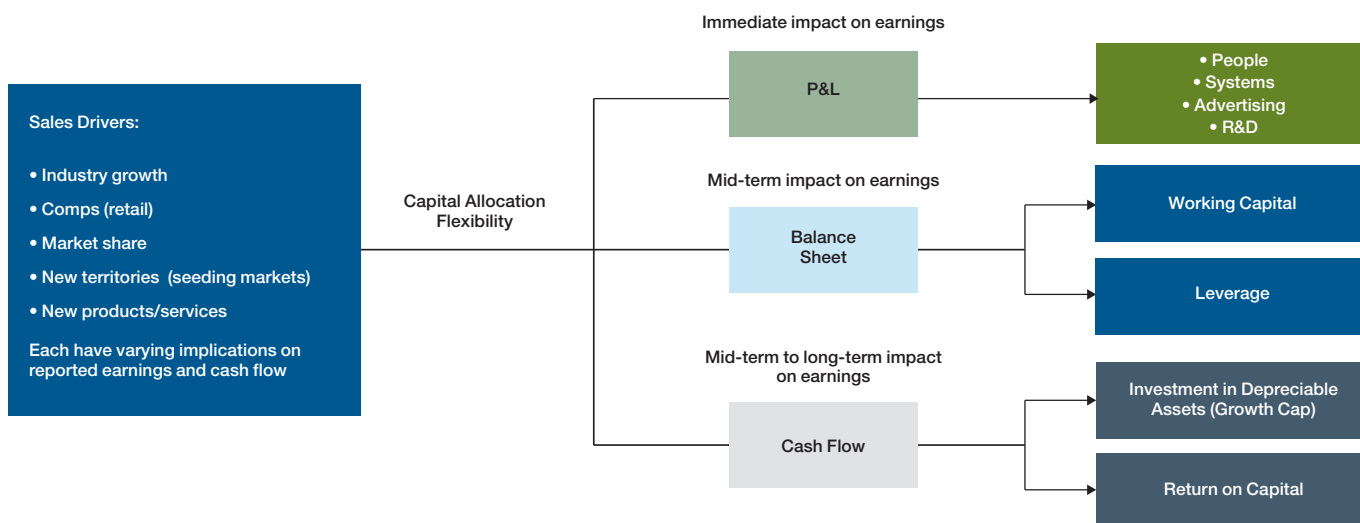
tend to have a medium-term impact on earnings. Finally, cash flow investments are investments in depreciable assets (i.e., capital expenditures) and the return of capital to shareholders in the form of share repurchases and/or dividends. These typically have a longer-term impact on the earnings-growth profile of a company. Each investment tactic needs to be considered in the context of the company type, how the company generates revenues (variability of cash flow stream), and its competitive advantage.

In our view, the sales, general and administrative expenses (SG&A) in the P&L statement are a real-time indicator of whether or not management understands the nature of their company. We believe that historical growth rates are in many cases an accident of the past. We have encountered management teams that believe their respective companies' growth rates are sustainable, and invest capital through their P&L statement accordingly.

As the economy emerged from the 2008 recession, many management teams were forced to rationalize their cost structures to reflect the slower revenue environment. As revenues decelerated and management's focus shifted to the process of cost control, companies became more proficient at managing their businesses. Although many companies delivered lower absolute levels of revenue growth, they were able to drive significant levels of *per share* profit growth by delivering capital back to shareholders. The focus on per share growth rather than absolute growth is a clear departure from the past behavior of management teams, in our view.

Next, we delve into the balance sheet by examining two companies in the consumer sector. In our view, both are "category killers," dominating their respective segments. While both

Exhibit 4 Is Management Pulling the Correct Levers?



For illustrative purposes only.

Exhibit 5 Company A and B Appear Similar in Many Ways...

Company A Margins



Company B Margins



As of October 2011

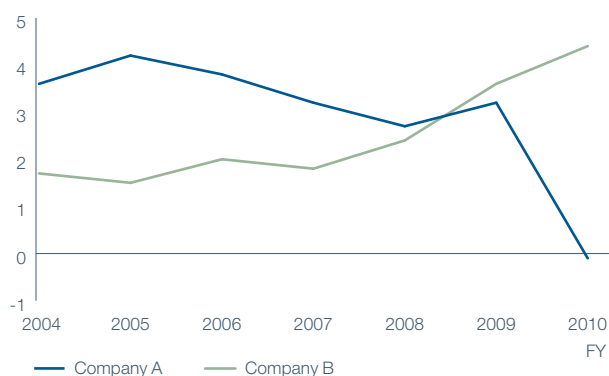
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companies tout the stability of their margin structure, fundamental analysis reveals that these companies are not as similar as they appear. As shown in Exhibit 5, both Company A and Company B appear to have stable gross and operating (EBITDA) margins. Although Company B's margins may be lower in absolute terms, it is important to note that they appear to be stable.

In Exhibit 6 we examine these two companies from another perspective, which highlights that one company may in fact be struggling, while the other is accelerating. Company A has decreased its working capital as a percentage of sales from 3.6% in fiscal year (FY) 2004 to -0.1% in FY 2010. In terms of the retail

Exhibit 6 ...However Their Working Capital is Managed Very Differently

Working Capital as a % of Sales



As of October 2011

For illustrative purposes only.

landscape, working capital is primarily composed of inventories less payables (as receivables is not much of a factor). This company has matched its inventories directly with its payables, in essence using the vendor's balance sheet to support inventories. Data for Company B indicate the exact opposite. In order for Company B to maintain its growth and margin stability, it has sacrificed its balance sheet, with working capital as a percentage of sales increasing from 1.7% in FY 2004 to 4.4% in FY 2010. This is capital that we believe belongs to shareholders; instead of being invested or redeployed, it is being tied up by the balance sheet.

In Exhibit 7, we examine these two companies from a cash flow perspective. Company A, on a ten-year basis, increased its revenues from \$4.8 billion to \$7.3 billion. Over this period, it used \$0.14 out of every incremental dollar of revenue to grow. In the last three years, its revenues increased from \$6.5 billion to \$7.3 billion, but at a cost of only \$0.07 for every incremental dollar of revenue. This illustrates how the company's competitive advantage has strengthened relative to its peer group.

On the other hand, Company B's degree of revenue growth is much higher than that of Company A on a ten-year basis. Revenues more than tripled from \$15 billion to \$50 billion at the cost of \$0.21 for every dollar of incremental revenue. However, on a three-year basis, the company's growth profile is similar to that of Company A, except it cost them \$0.41 of every incremental dollar to grow. During this time, the total cash outlay for Company B was approximately \$4.2 billion, which had been either tied up in capital expenditures or working capital. This significant increase in working capital was a result of the actions management deemed necessary to protect their competitive positioning. We believe

Exhibit 7 The Cost of Growth

Company A – Example of Good Growth

10 Year		5 Year		3 Year	
Revenue	\$4,818 to \$7,363	Revenue	\$5,948 to \$7,363	Revenue	\$6,523 to \$7,363
Change	\$2,544	Change	\$1,414	Change	\$840
Total Cash Outlay	\$352	Total Cash Outlay	\$192	Total Cash Outlay	\$62
Growth	\$0.14/\$1.00	Growth	\$0.14/\$1.00	Growth	\$0.07/\$1.00

Company B – Example of Bad Growth

10 Year		5 Year		3 Year	
Revenue	\$15,189 to \$50,386	Revenue	\$30,848 to \$50,386	Revenue	\$40,023 to \$50,386
Change	\$35,197	Change	\$19,538	Change	\$10,363
Total Cash Outlay	\$7,459	Total Cash Outlay	\$5,296	Total Cash Outlay	\$4,219
Growth	\$0.21/\$1.00	Growth	\$0.27/\$1.00	Growth	\$0.41/\$1.00

As of October 2011

Total cash outlay is capital expenditures – depreciation, net the change in working capital.

For illustrative purposes only.

these actions are an example of a structurally flawed company deploying shareholder capital in an inefficient pattern rather than adjusting to market dynamics.

From these examples, it is evident that all revenue and/or earnings growth is not created equal. Company A paired P&L growth with effective balance sheet management, while Company B destroyed capital by solely focusing on P&L growth.

Next, we will focus on the strategic uses of capital, which in this context is a mix of balance sheet and cash flow. We have found that there are varying degrees to which management teams understand the relationship between duration and the rate of debt. Many companies have emphasized that the interest rates on their debts continue to decline, although it is at the expense of shrinking duration. This not only makes them susceptible to exogenous shocks, in our opinion, but also adds risk to the operating structure. However, some corporations have taken a different approach by adopting a longer-term strategy, as they believe the market is extremely accommodative. An example is Norfolk Southern, which issued 100-year debt. This longer-term horizon mitigates event risk and, rather than following a more traditional view of debt, becomes a manageable expense. We believe that many companies' longer-term strategy is contrary to the Fed's policy goals. In our opinion, the Fed has attempted to push marginal investments further out in the risk spectrum, but companies have tactically moved in a different direction. For example, Intel and Amgen recently restructured their debt to terms of 20 years or longer at rates below their respective dividend rates. By issuing long-term-dated debt, these companies are able to buy back stock in the interim and improve their cash flow profiles. In our view, this is a more appropriate capital allocation, whereby a company

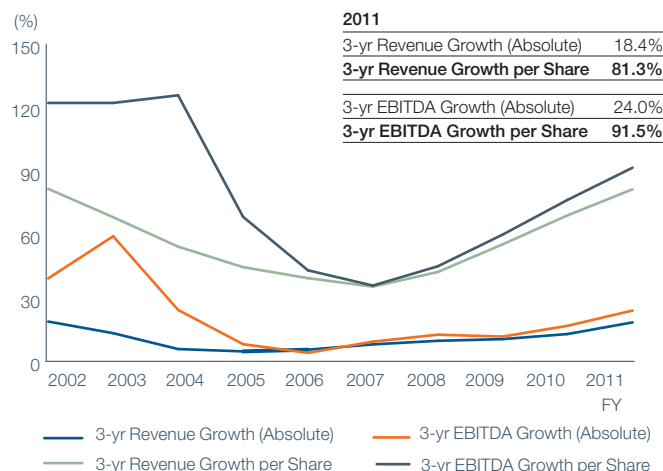
augments per share earnings growth by reducing share count and extending the dated maturities of its debt profile.

From a deployment perspective, it is also important to consider what companies can do by returning capital back to shareholders. Unless a company is one of the largest 20 to 40 companies in the world, the cost of penetrating the emerging markets is increasing (rising labor rates, increasing transportation costs). Therefore, the trade-off of sales diversification (emerging markets growth) versus share repurchase is tilting toward share repurchase as a more effective method of driving earnings growth.

Exhibit 8 exemplifies the amplifying power of share repurchase. When assessing management decisions to repurchase shares, it is important to note that the compounding effect accelerates the per share growth profile as time progresses. An examination of the company in Exhibit 8 reveals that the company's three-year rolling revenue growth rate is approximately 18%, with EBITDA growth at approximately 24%. The company modeled here has consistently adhered to a very strict plan of returning every dollar of excess capital back to shareholders without impinging upon its debt structure. The result is a three-year rolling revenue growth per share rate of 81%, and an EBITDA growth rate per share of 91.5%. This has been one of the best-performing companies in the Russell 3000 Index over the last decade, which we believe is attributable to its strict adherence to a simple, yet effective, business model.

This critical distinction is often overlooked in the analysis. Share repurchase done as a part of a methodical capital allocation strategy not only augments the return on equity of the remaining equity base, but also accelerates *per share* growth rates (both of which typically lead to higher valuation multiples). Over time, the

Exhibit 8 Company A: Revenue and EBITDA Growth



As of October 2011

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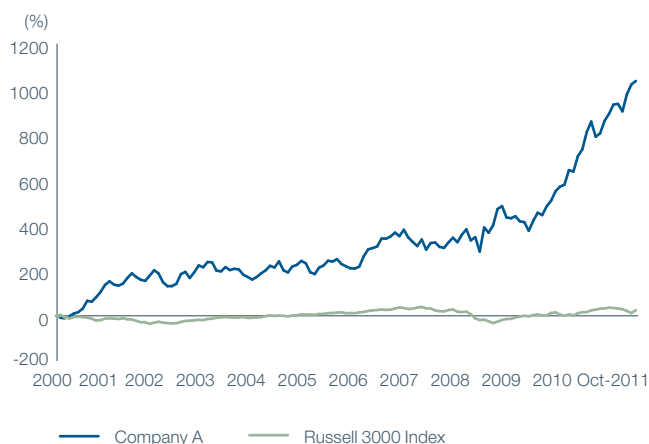
The data portray the effect of a company's share repurchase program.

Source: Bloomberg

company illustrated in Exhibit 8 maintained a strict adherence to a simple, yet effective, business model and coupled it with a consistent capital allocation strategy (in this case, returning capital in the form of share repurchases), which reliably rewarded shareholders relative to other equity investments, as shown in Exhibit 9.

To conclude, the companies that comprise many of the U.S. indices have transformed their business operations post the Great Recession, creating an exceptional profit margin structure that is unlikely to expand materially going forward. Over the past several quarters, we have identified a distinct shift in how companies approach capital allocation through their P&L, balance sheet and

Exhibit 9 Company A: Outperformed the Market



As of October 2011

For illustrative purposes only.

Source: Bloomberg, Russell

cash flow management, moving toward a redeployment of capital back to shareholders. Shifting political winds, macroeconomic uncertainties, and peak margins have all contributed to this change in mindset. We believe that companies that fully understand the boundaries of their operational competitive advantages and augment them with a balanced approach to capital allocation will be rewarded over time. That said, we expect the recent market volatility and high correlations to persist until a clearer direction of austerity in Europe and in the United States is established. However, during this volatile period, we continue to believe that a strict adherence to process and fundamental research will ultimately be rewarded.

Notes

1 As of October 31, 2011. Source: Bloomberg

Important Information

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