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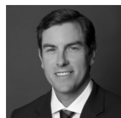

# At the Margin

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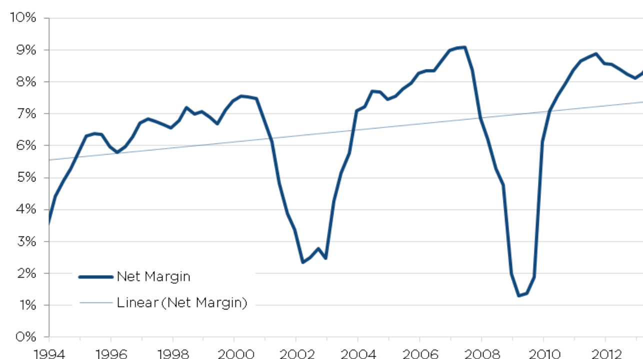
Given the earnings expansion over the past 5 years in the face of tepid economic growth and persistent unemployment, there has been considerable discussion of late about the strength and sustainability of profit margins. The common narrative about margins is that companies have done a miraculous job controlling costs. We decided to evaluate the historical trends in margins to see what items on the income statement are the primary drivers of the historically high net income margins, as seen in Exhibit #1 at right.

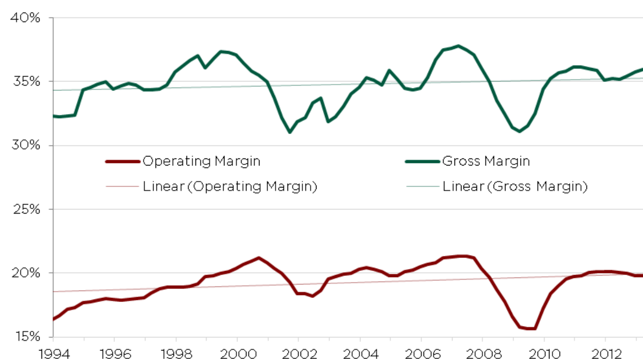
One method of evaluating financial ratios for the overall market (in this case, the S&P 500) is to view it as a single entity by summing up each constituent's reported financial data to create aggregated financial statements. This allows us to analyze the market much like we would a single company. While not perfect, it does allow for making comparative analysis to prior time periods to gain insight into the underlying trends driving profitability.

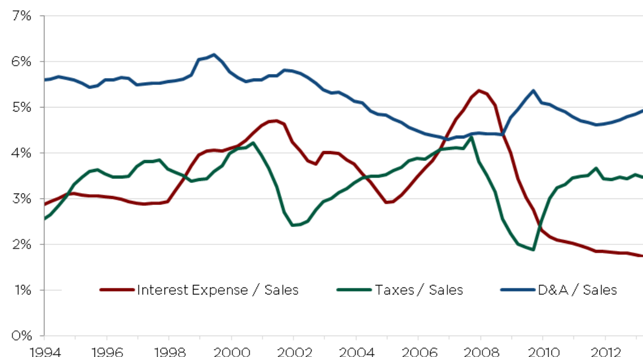
We first looked at the income statement of the market over various time periods going back to 1993. Exhibits #1 and #2 detail the three primary views of profitability; net margins, operating margins, and gross income margins. While there has been an increase in overall net income margins since 1993, there has been little increase in the overall gross margin or operating margin picture relative to historical averages.

From an income statement perspective, this means that current net income margins must be driven by something other than reductions in either costs of goods sold or SG&A as a percentage of sales. These are operating costs and are typically what investors think managers are controlling. Since the three most prominent cost items below the operating profit line are taxes, depreciation/amortization and interest expense, we illustrate the historical trends in Exhibit #3.

While depreciation and amortization is certainly lower than where it was in the 1990's, that trend began in 2001 when FASB eliminated amortization of goodwill. Taxes as a percent of sales also seems to be fairly consistent with historical averages, which leaves a large drop in interest expense (the red line) as the primary driver of improving profit margins for the current period.

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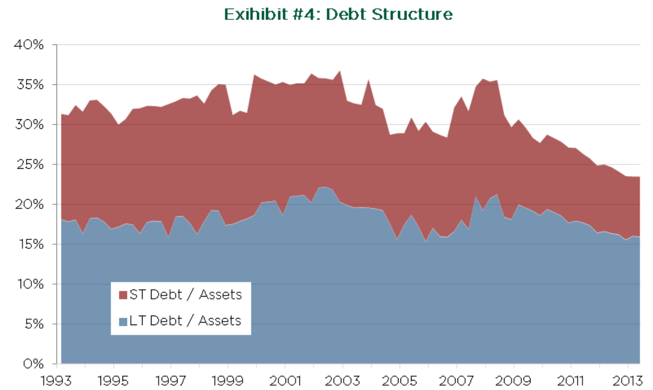
Of course, interest expense could be driven by several factors, most notably total debt levels or the level of interest rates associated with the debt. By looking at the balance sheet in the same way we looked at the income statement we can evaluate whether reductions in overall debt loads have taken place or whether the reduction in interest expense is driven merely by low rates.




While U.S. corporate debt issuance has hit an all time high in 2013, the structure of that debt has evolved substantially. In fact, Exhibit #4 at right shows there has been a clear deleveraging trend going on within the overall market since the financial crisis, although this is most likely heavily influenced by dramatic changes in bank balance sheets. In addition, it appears that companies, quite rationally, have been more aggressive in extending the duration of their debt as shown by the much larger reduction in short term debt relative to long term debt.

It would be natural to assume net margins might come under pressure as interest rates begin to rise. Over time that will become an issue, but longer maturities mean there will be a delayed effect. While there is a continuous need to refinance maturing debt, the sharp drop in short term liabilities will moderate that activity in the near term.