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Growing from the Top

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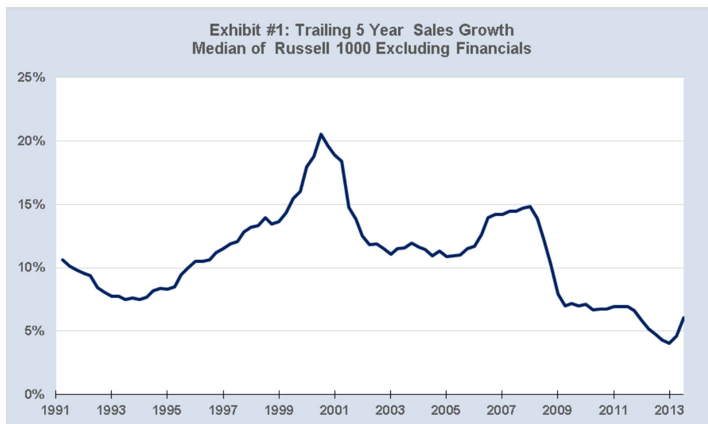
One of the most unusual aspects of the past six years has been the lack of revenue growth relative to past recovery periods. Despite this, companies have generally been able to support earnings per share growth largely through the expansion of margins and, to a lesser extent, share count reduction through stock buybacks. Exhibit #1 below is a look at the median sales growth rate over trailing 5 year periods for the top 1000 non-financial companies in the U.S.

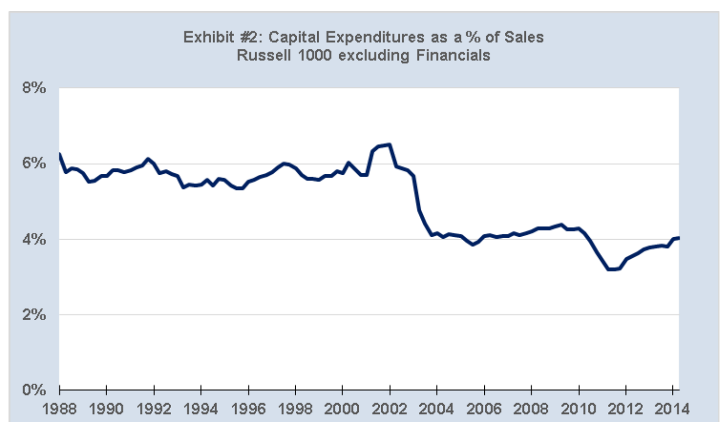


Not only is the post financial crisis period the deepest on record but top-line growth has remained at an incredibly low level versus prior periods. In fact, for the period ending December 2013, which also includes 2009, revenue growth hit its lowest level on record. This pattern also is consistent across economic sectors as shown in the table below comparing the historical 30 year median sales growth by sector versus the current sales growth figure.

	Median Annual Sales Growth	
	30 Year Median	Current
Consumer Discretionary	12.8%	7.3%
Consumer Staples	7.6%	6.5%
Energy	9.5%	14.4%
Financials	12.7%	5.1%
Health Care	18.2%	9.7%
Industrials	9.0%	6.0%
Information Technology	17.7%	11.9%
Materials	6.1%	5.7%
Telecommunication Services	13.2%	7.4%
Utilities	5.4%	1.8%

While technology and health care companies are generally growing revenues at a robust rate, they are still at half of their 30 year median revenue growth rates. This is also true of most other sectors of the economy. Energy companies are the only group that have seen an acceleration in revenue growth, which is to be expected given the rising price of the underlying commodities and the production boom taking place.

While there are a myriad of economic reasons that explain the low growth environment for sales, the most troubling aspect is the lack of investment given the record amount of cash on corporate balance sheets. The single best multiplier for stimulating spending is corporations spending amongst themselves. This has a far superior effect on aggregate demand versus any centrally planned activity via monetary or fiscal policy. Exhibit #2 below shows that beginning with the last recession, capital expenditures as a percentage of sales has significantly dropped, reaching an all-time low in 2011. This is true of all sectors in the economy except for, not surprisingly, energy companies which have actually doubled the level of capital investment versus their long-term averages.



As we've illustrated in past articles, the current recovery in corporate profits has largely been sustained through expanding margins fueled by cheap debt. In order for the market to support its current valuation level, revenue growth will need to drive profit growth going forward. We

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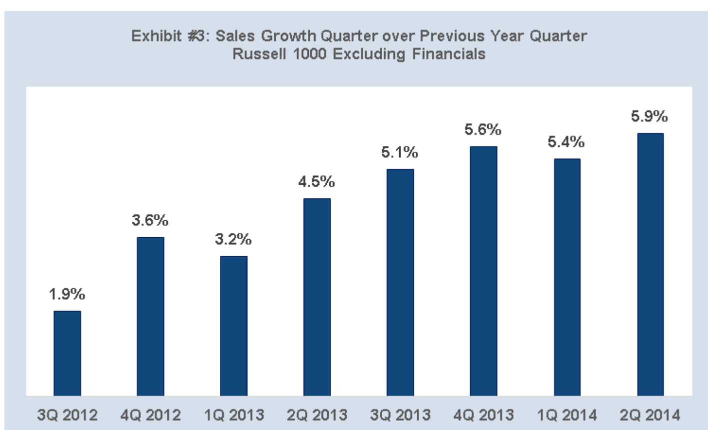
.believe that increases in the overall level of corporate investment via capital expenditures will be a critical element of the transition to a more sustainable growth phase in the economy. As Bill Ketterer notes in his article, we are seeing indications that this may be in the early stages of occurring.



You may have noticed in Exhibit #1 that it was common for sales growth to accelerate in the later stages of an earnings cycle. In fact, a nascent acceleration in sales has begun already, as Exhibit #3 shows. While still well below past growth peaks, sales are beginning to support earnings growth.

This earnings cycle has definitely been notable for its financial engineering and tepid revenues. Investors can either look at this as a negative or an opportunity for further expansion. We think the building blocks are falling into place for the next leg up in the earnings cycle .