

Monday, May 25, 2015

## No Light at the end of the Tunnel: Investing in Bad Businesses

I am a cynic when it comes to both CEOs and equity research analysts. I think that many CEOs are political animals, bereft of vision and masters at using strategic double-speak to say absolutely nothing. I also believe that many equity research analysts are creatures of mood and momentum, more market followers than leaders. Once in while, though, my cynicism is upended by a thoughtful CEO or a well-done equity research report and even more infrequently by both happening at the same time, as was the case in this recent interplay between Sergio Marchionne, Fiat Chrysler's CEO, and Max Warburton, the auto analyst at Sanford Bernstein.

### The CEO/Analyst Exchange on Fiat Chrysler

Sergio Marchionne is an unusual chief executive, a man who is not afraid to talk the language of investors and is open about the problems confronting not only his company, but also the entire automobile business. While he has been arguing that case for a while, sometimes in public and sometimes with other auto company executives, he crystallized it in a presentation he made in an analyst conference call, titled "Confessions of a Capital Junkie". In the presentation, he argues that the auto business has not generated its return on capital over its last cycle and that without significant structural changes, it will continue to under perform. He then diagnoses the reason for the under performance as over investment in R&D and capital costs, with companies duplicating each other's efforts. He concludes with the remedy of consolidation, where with mergers and joint ventures, companies could co-operate and reduce their capital costs, and asks analysts and investors in auto companies to apply pressure for change. Mr. Marchionne's pitch was unusual was two reasons. First, how many CEOs admit that their businesses have gone bad and that fundamental change is needed in how they are run? Second, it is unusual for a CEO to ask investors to become more activist and push for change, since most CEOs prefer a pliant and forgiving shareholder base.

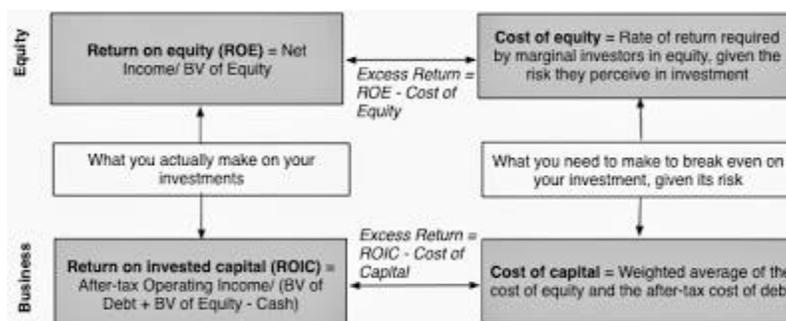
Max Warburton, Bernstein's auto analyst who was at the conference, responded by asking "'Do you think the German [car manufacturers] have any interest in what we say?', arguing that investors and analysts were powerless to push for change. In an extended analyst report, Mr. Warburton went further, making the point that shareholders are way down the list of priorities for the typical auto company, and especially so in Europe and Asia.

As I said at the start, this is the type of exchange between CEOs and analysts that you hope to see more of, and I agree with both Mr. Marchionne and Mr. Warburton on some aspects and disagree on others. I agree with both men that the auto business has been in trouble for a while and I made this point earlier in my post on GM buybacks. However, I don't think that the problem is one of duplication of expenses and that the answer is the consolidation of companies, as argued by Mr. Marchionne, and here is why. For consolidation to generate higher profits at auto companies, they will have to ensure that they don't pass the cost savings on to customers by cutting car prices, and nothing in the behavior of the auto industry in the last decade leads me to believe that they are capable of this concerted action. I agree with Mr. Warburton that the auto business is not shareholder-focused and that institutional forces (governments, unions) will make it difficult for investors to be heard. While there are investors in the market who will continue to supply capital at favorable terms to this business, sensible investors are under no obligation to play this game. Abandoning the auto business is not feasible if you are the auto analyst at Sanford Bernstein, but it is a viable option for the rest of us, at least until prices reflect the quality of these businesses. This debate also raises interesting fundamental questions that I hope to examine in the rest of the post, including how we categorize businesses into good and bad ones, why businesses become bad, why companies continue to operate and sometime expand in bad businesses and why investors may still seek to put their money in these companies.

### What is a bad business?

If Mr. Marchionne's point is that the automobile business is a bad one, it is worth starting this discussion with the question of what it is that make a business a bad one. At an extremely simplistic level, you can argue that a bad business is one where many or most companies lose money, but that definition would encompass young sectors (social media, biotechnology) that tend to lose money early in the life cycle. It

also would imply that any sector that collectively makes profits is a good one, which would not make sense, if the sector has huge amounts of capital invested in it. Thus, any good definition of business quality has to look at not only how much money a company makes but how much it needs to make, given its risk and the capital invested in that business. In corporate finance, we try, to capture this by looking at both sides of the equation:

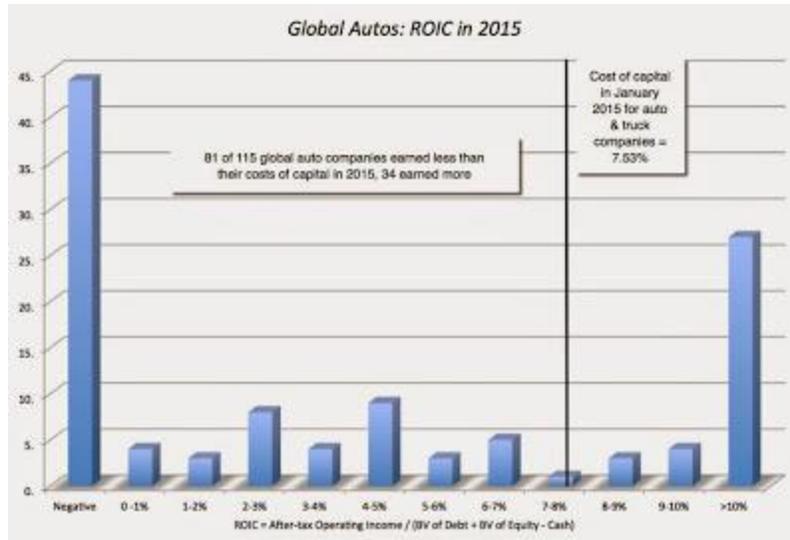


While there are some business (banks, investment banks and other financial service companies), where the equity comparison is more useful, in most businesses, it is the comparison on a overall capital basis that carries more weight. If you accept the proposition that the return on invested capital measures the quality of a company's investment and the cost of capital is the hurdle rate that you need to earn, given its risk, the spread between the two becomes a snapshot of the capacity of the company to generate value.

Why a snapshot? If the return on invested capital is estimated, as it usually is, using the operating income that the company generated in the most recent time period and the cost of capital reflects the expected return, given the risk free rate and equity risk premium in that period, it is also possible that looking at a single period can give you a misleading sense of whether the company in question is generating value. With cyclical and commodity companies, in particular, where earnings tend to move through cycles, a good case can be made that we should be looking at earnings over a cycle and not just the most recent year. Finally, the return on invested capital is an accounting number and is hence handicapped by all the limitations of accounting principles & rules, a point I made in this long, torturous examination of accounting returns. If you bring the two strands of discussion together, there are two levels at which a sector has to fail to be called a "bad" business.

1. Collective, weighted under performance: Most companies in the sector should be earning returns on their invested capital that are less than the cost of capital, not just a few, and the aggregate return on capital earned by a sector has to lag the cost of capital.
2. Consistent under performance: These excess returns (return on capital minus cost of capital) should be negative over many time periods.
3. No delayed payoff: There are some infrastructure businesses that require extended periods of large investment and negative excess returns, before they pay off in profitability.

In my post on GM, I made the case that the automobile business was a bad one, using these two metrics. Collectively, the distribution of returns on capital across global automobile companies in 2014 looked as follows:



If you look at the return on capital across time for the auto industry, you see the same phenomenon play out.

	ROIC	Cost of capital	ROIC - Cost of capital
2004	6.82%	7.93%	-1.11%
2005	10.47%	7.02%	3.45%
2006	4.60%	7.97%	-3.37%
2007	7.62%	8.50%	-0.88%
2008	3.48%	8.03%	-4.55%
2009	-4.97%	8.58%	-13.55%
2010	5.16%	8.03%	-2.87%
2011	7.55%	8.15%	-0.60%
2012	7.80%	8.55%	-0.75%
2013	7.83%	8.47%	-0.64%
2014	6.47%	7.53%	-1.06%

Only once in the last 10 years have auto companies collectively earned more than their cost of capital

It should come as no surprise that I agree with Mr. Marchionne that the auto business is a bad one and with Mr. Warburton that the companies in this business are in denial. The bad news for investors is that the auto business is not alone in this hall of shame. I computed returns on capital, costs of capital and excess returns for all non-financial US companies, by year from 2005 to 2014, and then looked for the sectors that delivered a negative excess return on average during the decade, while also generating in excess returns in at least 5 of the 10 years:

Industry	Annual Excess Returns from 2005 to 2014				
	Average Annual	Median Annual	Worst year	Best year	Number of negative years
Real Estate (General/Diversified)	-8.02%	-6.29%	-23.28%	5.17%	8
Green & Renewable Energy	-6.24%	-6.89%	-10.01%	-0.62%	10
R.E.I.T.	-5.07%	-5.11%	-6.59%	-3.83%	10
Auto & Truck	-15.67%	-5.90%	-127.69%	7.47%	9
Real Estate (Development)	-2.64%	-4.94%	-9.88%	13.93%	8
Homebuilding	-3.18%	-3.85%	-11.60%	9.04%	7
Diversified	-2.72%	-2.84%	-4.79%	-1.00%	10
Real Estate (Operations & Services)	-11.97%	-2.79%	-88.60%	0.68%	9
Telecom (Wireless)	-2.09%	-2.41%	-4.79%	0.52%	9
Shipbuilding & Marine	-1.47%	-1.74%	-3.27%	1.67%	9
Hotel/Gaming	-1.77%	-1.00%	-4.95%	0.19%	9
Utility (Water)	-1.03%	-0.93%	-3.80%	1.52%	6
Trucking	-0.60%	-0.81%	-5.52%	2.72%	6
Precious Metals	1.26%	0.77%	-3.60%	8.18%	6
Building Materials	1.40%	-0.51%	-4.53%	20.11%	5
Broadcasting	-0.46%	-0.94%	-3.87%	4.46%	5
Software (Entertainment)	-0.58%	-0.05%	-13.82%	12.71%	5

Annual Excess Return in year n = ROIC in year n - Cost of capital in year n

*Raw data from Capital IQ with my estimates of costs of capital by year*

Some of the businesses on this list have a good reason for being on the list and perhaps can be cut some slack. For instance, the green and renewable energy business has delivered negative excess returns both in the aggregate and in every year for the last decade, but in its defense, it may be a business that needs time to mature. The real estate sector is well represented on this list, with REITs, homebuilding, building materials and real estate operations & development all making the list with negative excess returns. An optimist may argue that the last decade created the perfect storm for real estate, unlikely to be repeated in the near future, and that these businesses will return to adding value in the future. There are some surprises, with entertainment software, wireless telecom and broadcasting all making the list, suggesting that you can have bad businesses that are growing. Finally, there were 169 companies that were classified as diversified, and their excess returns were negative every year for the entire decade, making a strong argument that many of these companies would be better off broken up into constituent parts. It is true that the returns on capital in this table were computed using standard accounting measures of operating income and debt, and I recomputed them, with leases capitalized as debt to derive the following table:

Industry	Annual Excess Returns from 2005 to 2014				
	Annual Average	Median	Worst year	Best year	# of Negative years
Real Estate (General/Diversified)	-7.93%	-8.23%	-22.83%	5.04%	8
Green & Renewable Energy	-6.11%	-6.34%	-9.41%	-1.83%	10
R.E.I.T.	-5.04%	-5.08%	-6.54%	-3.80%	10
Real Estate (Development)	-2.76%	-4.96%	-9.87%	15.84%	8
Auto & Truck	-12.87%	-4.80%	-101.15%	7.01%	9
Homebuilding	-2.90%	-3.52%	-11.04%	8.99%	7
Diversified	-2.64%	-2.75%	-4.68%	-0.93%	10
Real Estate (Operations & Services)	-13.17%	-2.67%	-112.30%	0.43%	8
Telecom (Wireless)	-2.12%	-2.13%	-4.12%	0.29%	9
Hotel/Gaming	-2.11%	-1.33%	-5.05%	-0.22%	10
Shipbuilding & Marine	-1.02%	-1.12%	-2.63%	1.92%	8
Utility (Water)	-1.03%	-0.94%	-3.78%	1.48%	6
Broadcasting	-0.61%	-0.45%	-3.69%	3.78%	5
Air Transport	-0.13%	-0.24%	-5.52%	8.33%	5
Trucking	0.06%	-0.23%	-4.57%	3.21%	6

*Operating Income and Invested Capital, adjusted for leases treated as debt*

The list looks almost identical to the unadjusted excess return rankings, though the excess returns for restaurants, retailers and other larger lessees became much smaller with the adjustment and airlines make the worst business list, once you consider leases as debt.

### How do businesses go bad?

So, why do businesses go bad? There are a number of reasons that can be pointed to, some rooted in sector aging, some in competition, some in business disruption and some in delusions about growth and profitability.

1. The Life Cycle: I have used the corporate life cycle repeatedly in my posts as an anchor in trying to explain shifts in capital structure, dividend policy and valuation challenges. It is a useful device for explaining why some sectors fail to deliver returns that meet their costs of capital. In particular, as sectors age, their returns seem to drift down and if the sector goes into decline, with revenues stagnant or falling, companies are hard pressed to generate their costs of capital. At the other end of the life cycle, young sectors that require large infrastructure investments often deliver extended periods of negative excess returns.
2. Competitive Changes: A business can be changed fundamentally if the competitive landscape changes. This can happen in many ways. A legal barrier to competition (patents, exclusive licenses) can be removed, opening up existing companies to price competition and lower margins. Globalization has played a role as well, as companies that used to generate excess returns with little effort in protected domestic markets find themselves at a disadvantage, relative to foreign competitors.
3. Disruption: Disruption is the catchword in strategy and in Silicon Valley, and while it is often hyped and over used, technology has disrupted established businesses. Uber and its counterparts are laying to waste the taxi business in many cities and Amazon has changed the

retail business beyond recognition, driving many of its brick and mortar competitors out of business.

4. Macro Delusion: While all of the above can be used to explain why an old business can become a bad one, there are new businesses that sometimes never make it off the ground, even though they are launched in markets with significant growth potential. One reason is what I have termed the macro delusion, where the sum of the dreams and forecasts of individual companies

### **Why do companies stay in bad businesses?**

If you are a company that finds itself in a bad business, there are four options to consider. The first is to *exit the business*, extracting as much of your capital you can to invest in other businesses or return to the suppliers of capital. While this may seem like the most logical choice (at least from a capital allocation standpoint), there is a catch. It is unlikely that you will be able to get your original capital back on exit, because buyers will have reassessed the value of your assets, based on their diminished earnings power. Consider, for instance, a company that generates a 3% return on capital on invested capital of \$1 billion and assume that its cost of capital is 6%. If a sale of the assets or business will deliver less than \$500 million, the best option for the company is to continue to operate in the bad business. The second is to retrench or shrink the business, by not reinvesting back into the business and returning cash from operations back to stockholders (as dividends or buybacks). That was the rationale that I used in supporting the GM buyback. The third is to continue to run the business the way you used to when the business was a good one, hoping (and praying) that things turn around. That seems to be the response of most in the auto business and explains the *cold shoulder* that they gave to Mr. Marchionne's prescription (of consolidation). The last is to aggressively attack a bad business, with the intent of changing its characteristics, to make it a good one. This is a strategy, with the potential for high returns if you do succeed, but with low odds of success. Not surprisingly, it is the strategy that appeals the most to CEOs who want to burnish their reputations and it one reason that I posited that my returns on my Yahoo! investment would be inversely proportional to Marissa Mayer's ambitions.

Of the four strategies, the one that is least defensible is to the third one (doing nothing), but that seems to be most common strategy adopted by companies in bad businesses and I can think of four reasons why it continues to dominate. The first is *inertia*, where managers are unwilling or unable to change their learned behavior, with the resistance become greater, if they have long tenure in the business. The second is *poor corporate governance*, where those who run firms view shareholders as just another stakeholder group and view costs of capital as abstractions rather than as opportunity costs. The third are *institutional factors which can conspire to preserve the status quo*, because there are benefits derived by others (labor unions, governments) from that status quo. The final factor is *behavioral*, where the easiest path for managers, when faced with fundamental changes in their businesses, is to do nothing and hope that the problem resolves itself.

### **Why do investors invest in these companies?**

If it is difficult to explain why companies choose to stay and sometimes grow in bad businesses, it is far easier to explain why investors may invest in these companies. At the right price, any company, no matter how bad its business, is a good investment, just as at the wrong price, any company, no matter how good its business, is a bad investment. To decide whether to invest in a company in a bad business, investors have to value these companies and there are challenges. The first is that with these companies, growth is almost always more likely to destroy value than to increase it. Consequently, the value of these companies is maximized as they minimize reinvestment, shrink their businesses and liquidate themselves over time. The second problem is that while designing a valuation model that allows for a shrinking company is easy enough to do, the value that you get is operational only if management in the company does not undercut you, by aggressively seeking out growth with expensive reinvestment. I present responses to these problems in this paper.

As a passive investor, you have to accept your powerlessness over management and build, into your expectations, what you believe that the management will do in terms of investment, financing and dividend policy, no matter how irrational or value destroying those actions may be. As an activist investor, though, you may be able to force managers to reassess the way they run the company. It should come as no surprise that the classic targets of activist investors tend to be companies in bad business that are run

by managers in denial. Finally, while the debate about corporate governance has atrophied into one about director independence, corporate governance scores and CEO pay, the real costs of poor corporate governance are felt most intensely in companies that operate in bad businesses, where without the threat of shareholder activism, managers often behave in irrational, value-destructive ways.

### **Closing Thoughts**

As I look at the excess returns generated by companies in different sectors, I am struck by how little margin for error there seem to be in many businesses, with excess returns hovering around zero. If we attach large values to the disruptors of existing businesses, consistency requires us to reassess the values of the disrupted companies. Thus, if we are bidding up the values of Tesla, Uber and Google (driverless cars) because they might disrupt the automotive business, does it not stand to reason that we should be bidding down (at least collectively) the values of Volkswagen, Ford and Toyota? More generally, we seem to be more willing to anoint the winners from disruption than we are in identifying and repricing the losers.

### **Datasets**

1. Industry averages excess returns, by year: 2005-2014
2. Industry average costs of capital: US
3. Industry average cost of capital: Global

### **Papers**

1. Measuring Accounting Returns
2. Valuing Companies in Decline

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