Long Term vs. Short Term...Where's the Payoff?

How do they do it? In last week's Valitas Insights article, we reported that the U.S. middle market is experiencing record levels of employment and revenue growth, but private-equity (PE) owned firms are way out ahead of the pack.

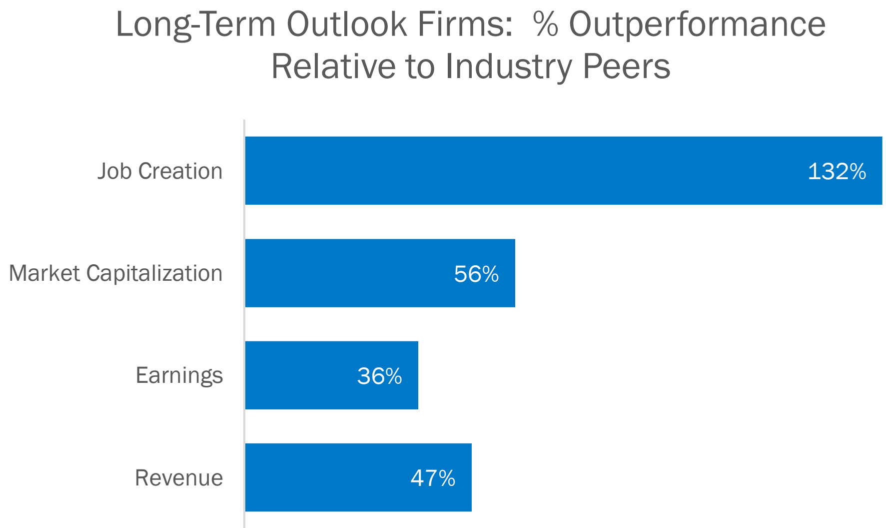
So again, how do they do it? We've previously discussed several factors underlying this outperformance, but a recent Harvard Business Review (HBR) article raises an additional compelling explanation. The article is aptly titled [Finally, Evidence That Managing for the Long Term Pays Off] (leaving no doubt about its contents). The authors contrast results generated by companies with a long-term outlook with those focused on "short-termism" - that is, a focus on quarterly earnings. PE firms, with their longer investment horizon, are a closer match to the former camp.

The evidence was drawn from a sample of 615 companies that reported continuously from 2001 to 2014, and represented 60 to 65% of U.S. public market capitalization over that period. Researchers used several indicators to identify long-term behavior including:

1. Ratio of capex to depreciation – long-term companies are expected to invest more, and more consistently;
2. Earnings quality – long-term companies are likely to have lower levels of accruals relative to revenue;
3. Margin Growth – long-term companies are less likely to grow margins unsustainably to meet short-term targets; and
4. Difference between earnings per share and earnings growth – long-term companies are less likely to influence EPS through share buybacks, with more focus on overall earnings performance.

After identifying 27% of their sample as having a long-term approach, with the remaining 73% falling into the baseline category, the researchers compared the two groups on several key financial measures. And the results?

While the HBR article title deprives us of a big reveal moment, it doesn't spell out the magnitude of difference in performance between the two groups. And it's significant. The study's long-term companies increased revenue and earnings, outperforming industry peers by, respectively, 47% and 36%, and creating significantly more jobs. Interesting to note, during the financial crisis, long-term companies experienced smaller drops in revenue and earnings, and continued to increase investment in research and development. While their share prices did take a greater hit than their industry peers during that period, afterwards, they outperformed.



Firms were tracked from 2001-2014. The above chart presents a snapshot of 2014, and shows the average percentage by which long term firms outperformed baseline peers on the listed metrics

It isn't news that a growing number of companies are choosing to stay private. At a recent SEC advisory committee meeting on small and emerging companies, this choice was explored in some detail. One rationale was that the new generation of entrepreneurs wants to focus on long-term growth, preferring to take a long-term view without concern for press and shareholders focused on quarterly earnings.

Circling back to our starting point, while the PE investment horizon is arguably less than long term, PE investors would certainly meet most of the long-term company indicators. As an example, we look to a Fortune magazine quote from a U.S. PE executive:

"When public companies run out of growth, they buy back stock at the worst times. We invest more in moments of dislocation" … That's a "long-term outlook" in our books!