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The Difference Between a Great Company and a Great Stock

By Joel Litman, Chief Investment Strategist, Valens Securities
The Institute of Strategy & Valuation

Overview

In mid-1998, Coca-Cola's (KO) stock price traded at a high of about $88 per share. Almost eight years later, the firm's stock price stood at half that mark: $44. Did the company lose their incredible competitive advantages?

Around the same time, an incredible stock price run was taking shape. A major discount retailer watched as its stock price soared more than tenfold from 1996 to 2000. It wasn't Wal-Mart, Best Buy, or some other popular store. It was AMES Department Store, which was bankrupt by 2002.

On the contrary, Coca-Cola continues to generate adjusted return on assets (ROA') at some of the highest levels in the entire Valens database of 4,000 companies. The flagship cola product is still regularly heralded as the world's top brand. Its venerable product distribution system may be called nearly unparalleled. As you read this, you are most likely less than 50 feet away from a place to purchase a Coke or one of its other products. So, what's the problem with KO?

The Difference Between a Great Company and a Great Stock

How do we decipher the problem of business profitability levels and stock returns seeming so greatly out of sync?

Coca-Cola was a victim of its own great prior performance. At exactly mid-year 1998, Coca-Cola was trading at a record high of $88 per share, having achieved a record 40% adjusted return on assets (ROA'). But at that share price, what did the market expect Coca-Cola to continue to do? In other words, what levels of performance would KO need to achieve to create the cash flows necessary to maintain its all-time stock price high?

Using Valens Securities' database and the ROA' framework, KO's stock price at the time reflected cash flow return levels that would essentially never, ever fall. It also embedded significant organic growth of more than twice U.S. GDP levels for decades.

The problem was not that KO had not achieved incredible performance. The problem was a question as to whether that performance was sustainable. Even if sustainable, where was the upside in owning the stock with that level of expectation already built into the price? There was really nowhere to go but down.

Eight years later we see the result of that unrealistic exuberance with a stock trading at half the price. This occurred not because the company isn't a great one, but because the stock's valuation simply wasn't justifiable.

Great stock prices and great companies can accompany each other, but one needs to examine sufficiently long time periods. Over 20 years, KO is still outperforming the market by two or three times. That time period is marked with periods of unrealistic expectations; so, we see the stock price falling for eight years.

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Ames Department Stores (Delisted as AMES Years Ago)

Around the same time that Coca-Cola's stock price hit its spectacular highs, a different, yet incredible stock price run was taking shape. A major discount retailer watched as its stock price soared from 1996 to 2000. Through that period, its shares rose more than tenfold, and investors and management seemed as happy as can be.

The retailer in question was not Wal-Mart, Costco, Best Buy, or any of the like. The firm was Ames Department Stores. Unfortunately, the epilogue is described too sadly by a string of empty buildings and emptier parking lots in strip malls across the Northeastern United States. By 2001, the firm had already been seeking bankruptcy protection. How could company performance and company stock price send such different messages?

At AMES, investor forecasts simply exceeded reality. The original march upward from lows of $2 in 1996 to $30 and higher was not because the company was incredibly profitable. During the five-year period, AMES' cash flow returns never once exceeded its cost of capital.

At $2, the stock was, for the most part, priced with the expectation that the firm would go into bankruptcy. However, AMES began avidly restructuring, divesting its least-performing assets. When a firm expected to go bankrupt doesn't go bankrupt, its stock price rises; sometimes by leaps and bounds.

At the time, you had to scratch your head as an investor, watching a retailer divest assets, close stores, yet demonstrate stock returns that were better than those of Wal-Mart. But stock prices are what they are. As expectations go from low to high, the stock price goes up. Or in this case, as expectations went from "abysmal" to "potential survival," the stock price ran from $2 to over $40 per share.

The closure on this case is interesting because it shows management's folly in not understanding the real drivers of stock price. Somehow, the company saw a signal to grow its business and shifted its strategy to acquisitions and store openings in 1998 and 1999. The management team had previously shown discipline in shutting down problematic stores. By this time, it showed the folly of growing a business model that had not yet proven economically profitable. At no time did AMES' cash flow returns appear to exceed even lower bars of opportunity costs.

By 2000, that folly had run its course. Growing a bad business is always a bad thing, no matter how well the stock price is doing. AMES' death came relatively quickly, as the share price fell fast and the chain finally closed for good in late 2002.

The Expectations Conundrum

With valuation levels based on expectations and not actual performance, there are troubling issues for investors and other decision-makers.

As a fundamentally based investor in 1998, would you short a stock that had risen for over 10 straight years? The market had priced in exuberant expectations; however, if expectations had reached that high level, maybe they could still go to ridiculously exuberant levels before the bottom fell out, so to speak. The entire internet bubble was a case study in this kind of market behavior.

As a board member, how do you align management's interests with those of shareholders, when options and stock shares priced at such levels can only serve as reverse motivators? As a company manager, how do you have the faith to know whether or not you are 'doing the right things' when the stock begins to fall precipitously despite profitability levels that remain the envy of the entire market?

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Cash Flows Reveal the Truth

Many examples exist of companies that are often thought to be great companies simply because they are great stocks, and vice versa. IBM and Federal Express stand out as two companies that continually receive high marks in the financial press such as "most admired" status. A simple look at the firms' cash flows, however, tells the tale: great turnarounds, not necessarily great companies. A series of other interesting examples are included at the back of this article.

Stock price alone can never reveal anything but changing expectations in a company's performance levels; nothing about the quality of the performance itself.

Sharp investors live by what many novice investors fail to understand: that great companies can be terrible investments and vice versa. Therefore, great investments are made by better understanding the fundamentals behind the expectations. Those fundamentals need to be linked to long-term cash flow expectations, and only long-term forecasted cash flow analysis can explain the story that is built into any stock price.

The goal of corporate management remains the maximization of shareholder wealth, but that doesn't guarantee premium shareholder returns. The market's cash flow expectations set the bar that determines the company's future stock price returns, regardless of the caliber of the management team. In the end, knowing the difference between a great company and a great stock is what differentiates great managers and investors from poor ones.

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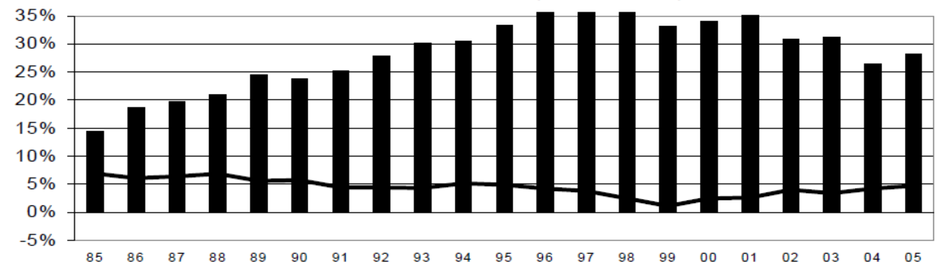
Appendix

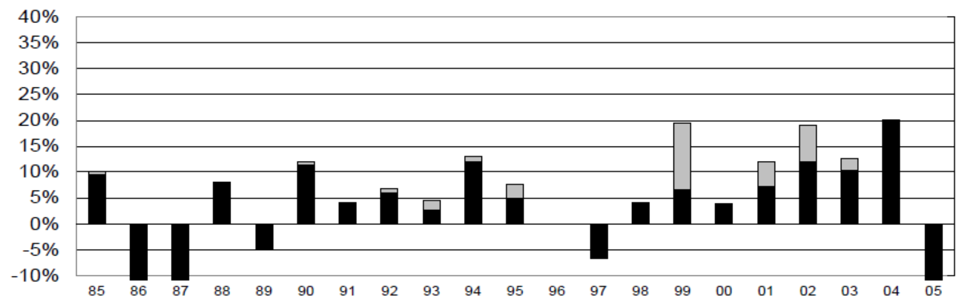
Coca-Cola (KO)

Cash Flow Return (CFROI®)



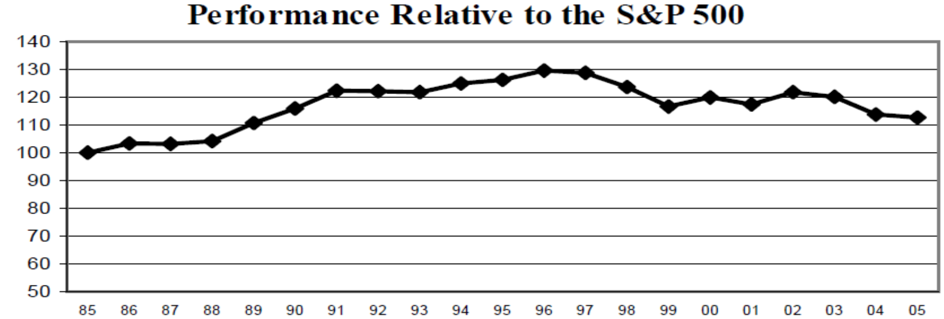
CFROI Panel: KO's CFROIs peaked in the mid 1990s. In recent years, returns for the company are still phenomenal., albeit lower than they were eight years ago.

Reinvestment Rate



Growth Panel: KO's growth over the last several years has stemmed mainly through acquisitions. Unfortunately, that type of growth is not usually as valuable as organic growth.

Performance Relative to the S&P 500



Shareholder Return Panel: In the mid-1990s, stock price implied continued high returns for decades. Since then, as performance remained very good, but short of expectations, stock price falls. Still a great company, but not a great stock.

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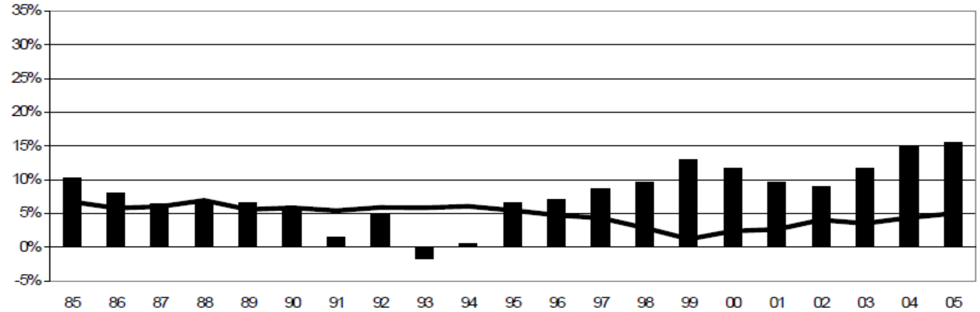
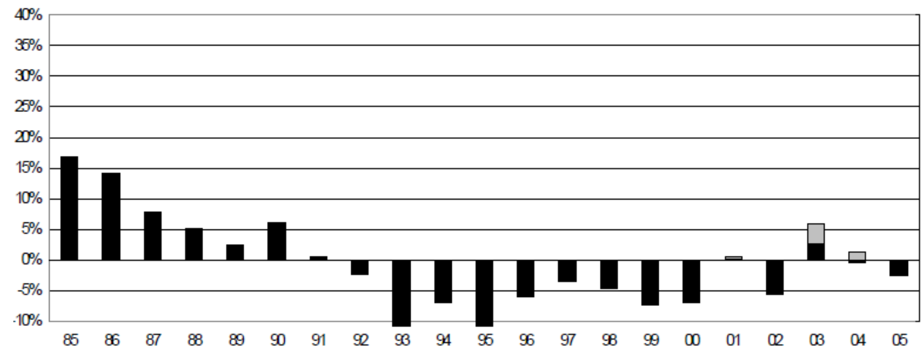
International Business Machines (IBM)

Cash Flow Return (CFROI®)



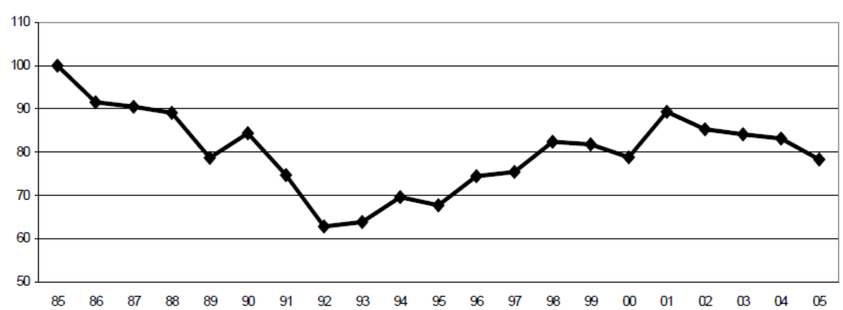
CFROI Panel: The low ROIs show how IBM was struggling to compete in the hardware market back to the late 80s. As it moved into services businesses, ROIs dramatically improved.

Reinvestment Rate



Growth Panel: To improve ROIs, IBM divested low return businesses over more than a decade. However, as returns improved, new growth opportunities could not be found.

Performance Relative to the S&P 500



Shareholder Return Panel: Rising and falling ROIs drove a rising and falling stock price. Without growth to compound the value of recent returns, stock returns in the last decade have still not made up for losses in the 80s and 90s.

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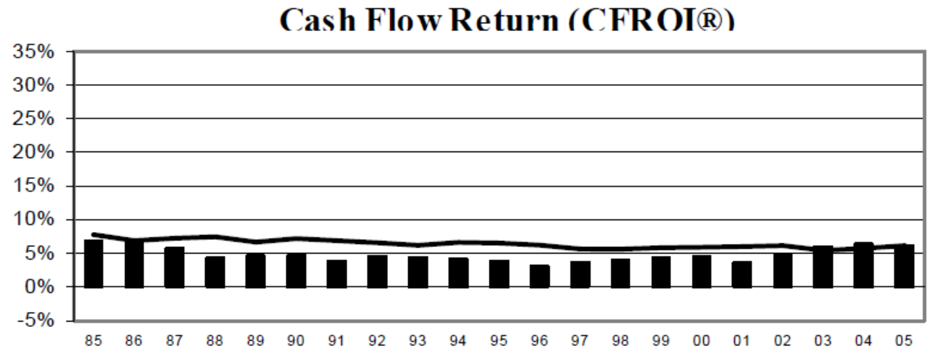
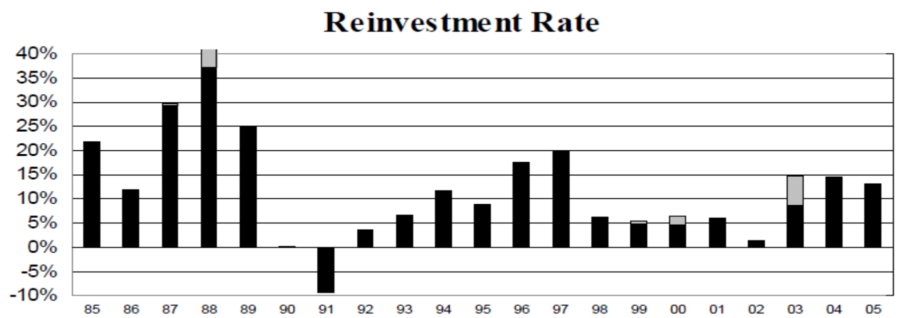
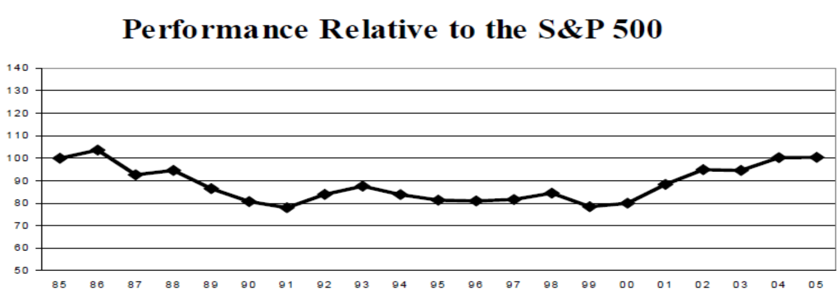
FedEx (FDX)



CFROI Panel: FDX has never realized ROIs at any comfort level above their cost of capital. While the company has a great product/service, it does not have a great business.



Growth Panel: FDX has a history of continually trying to grow a low ROI business. Only when ROIs appear to have broken above the cost of capital has growth helped the stock price.



Shareholder Return Panel: A clear example of the difference between a great company and a great stock. FDX's stock returns have come from its ability to generate ROIs above very low expectations set years ago, not from being a great business.

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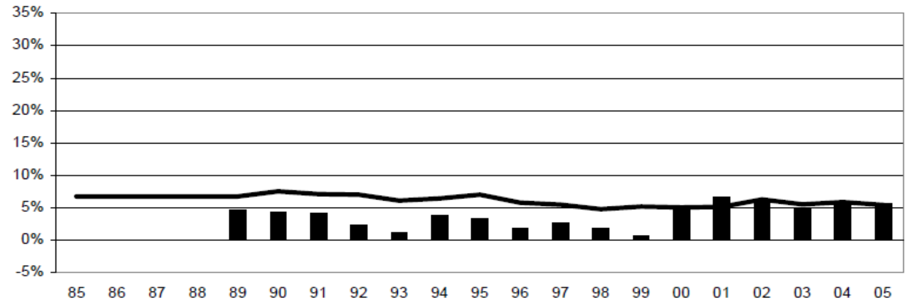
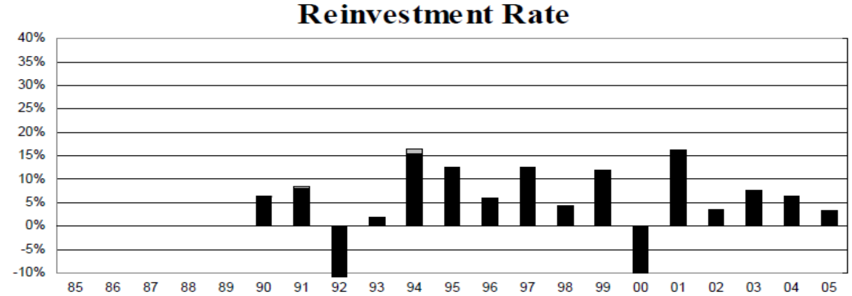
BMW (BMWG)

Cash Flow Return (CFROI®)



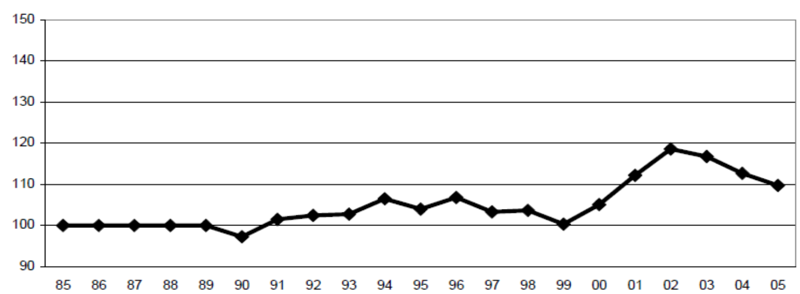
CFROI Panel: This shows the inability that BMW has in achieving its cost of capital, despite a strong customer following. Throughout the last few years a move from low to average returns marks a plateau shift in profitability levels.

Reinvestment Rate



Growth Panel: This shows a high reinvestment rate in the business. This has been quite consistent regardless of the cash flow returns over time.

Performance Relative to the Dax Index



Shareholder Return Panel: Growth when ROIs are not above the cost of capital results in nothing for stock price. However, an ROI plateau shift in the last few years has driven great stock price returns.

Data Period: 1985-2005

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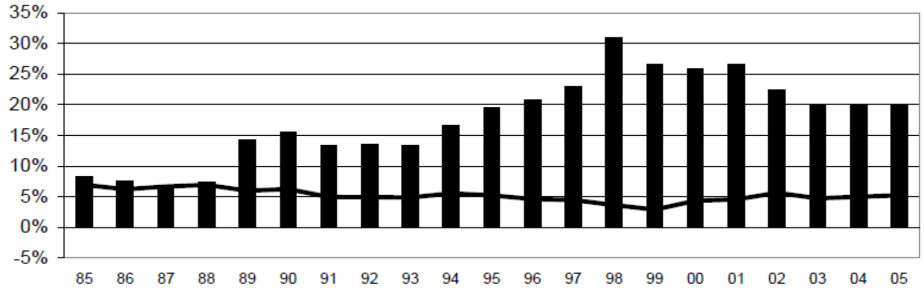
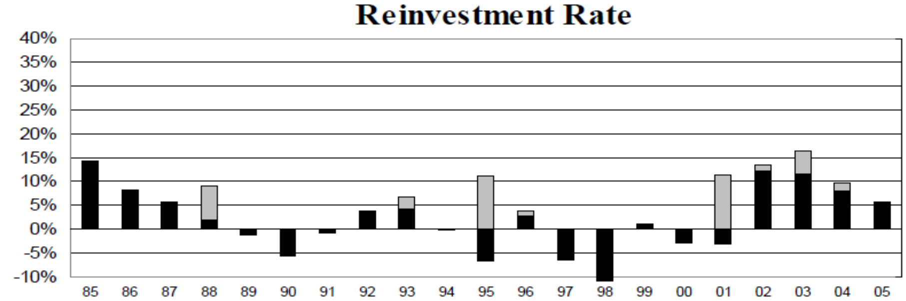
Campbell Soup (CPB)

Cash Flow Return (CFROI®)



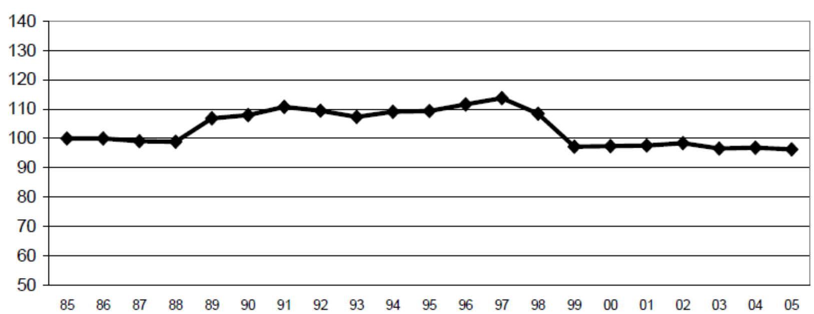
CFROI Panel: Campbell Soups' chart looks similar to that of Coca-Cola with peak returns years ago, falling since. It's a very profitable business, but not as profitable in recent years.

Reinvestment Rate



Growth Panel: Campbell Soup has not been able to grow organically for years. However, growth and acquisition strategies in recent years maybe the reason for falling ROIs.

Performance Relative to the S&P 500



Shareholder Return Panel: From 1997 to 2005, CPB shows an example of a company that is still extremely profitable, but not at levels the market had expected years ago, and so a stock price fall-off occurred from 1997 to 1999 with no recovery.

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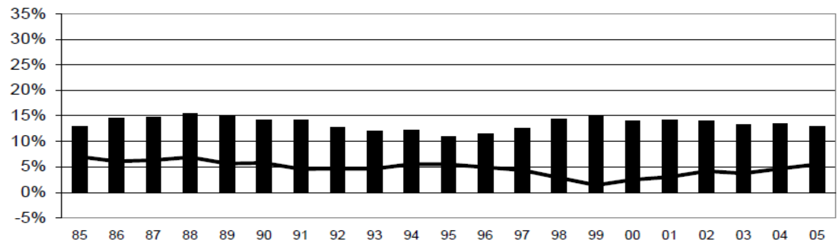
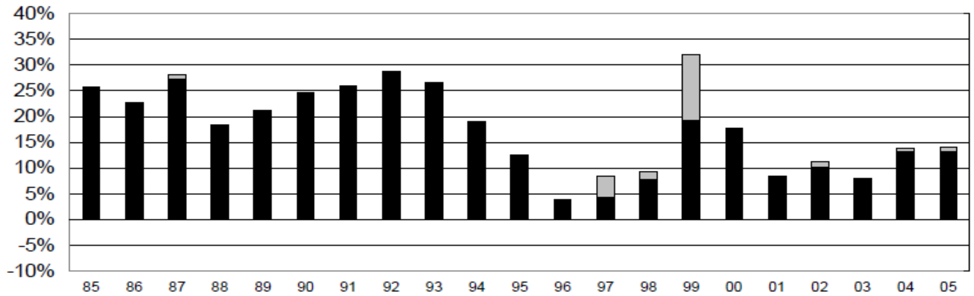
Wal-Mart Stores (WMT)

Cash Flow Return (CFROI®)



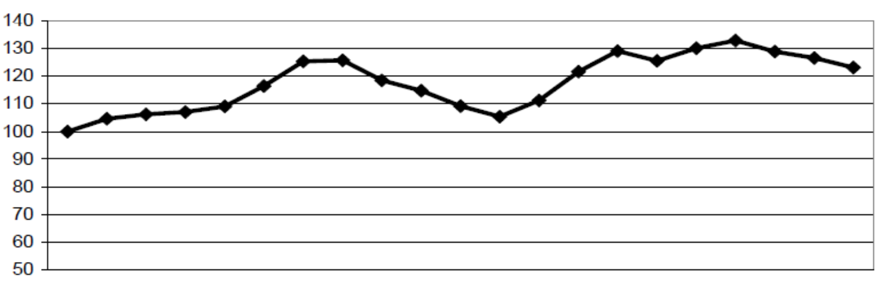
CFROI Panel: This shows us the ability that Wal-Mart has in creating a great business. With great asset efficiency and reasonable margins, Wal-Mart has delivered high returns over an extended period of time.

Reinvestment Rate



Growth Panel: This shows a high reinvestment rate in the business. It has grown its assets by moving into new business areas to meet customer's needs, and expanding in many ways.

Performance Relative to the S&P 500



Shareholder Return Panel: Wal-Mart's incredible profitability and growth is accompanied by a periods of high and low relative stock performance. Changing expectations in performance drive stock price, not performance levels alone.

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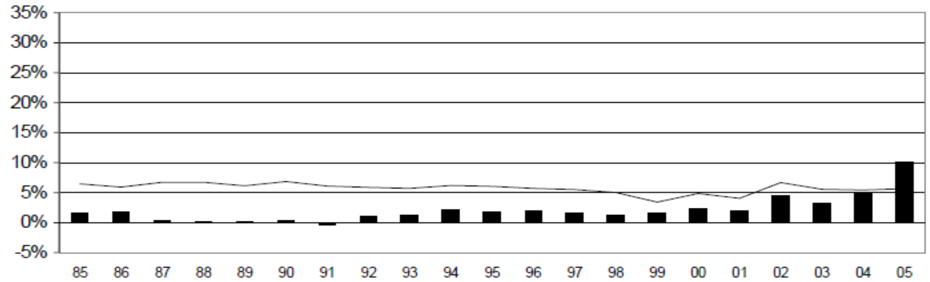
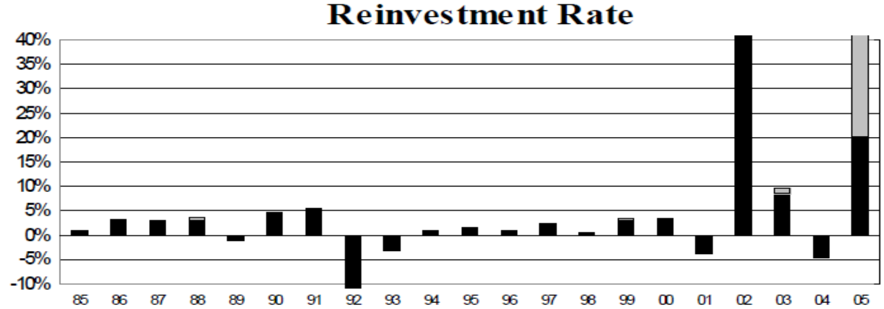
Molson Coors (TAP)

Cash Flow Return (CFROI®)



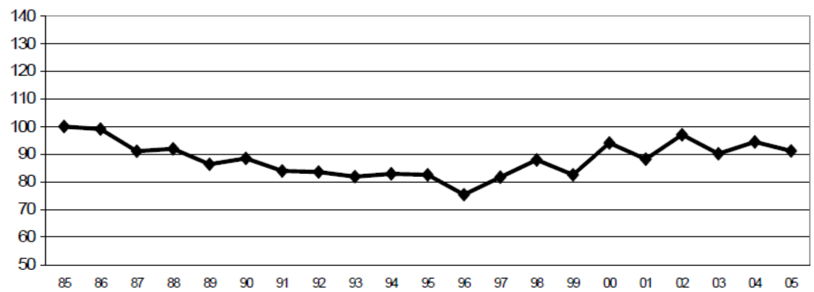
CFROI Panel: Prior to 2005, the chart is mainly the performance of Coors alone (formerly RKY) before the merged with Molson. For years, the company invested in bad business strategies. As major shift occurred when ROIs began rising above zero, and today even above its cost of capital.

Reinvestment Rate



Growth Panel: High growth spikes mark mergers for the company. Otherwise, growth has been minimal, though still problematic when it occurs with ROIs below the cost of capital.

Performance Relative to the S&P 500



Shareholder Return Panel: Though volatile, the stock would have been a great investment if purchased in 1996. The market has rewarded TAP for marching ROIs toward average levels.

Data Period: 1985-2005