

With a Steady Hand

Essays on Long-Term Investing

Number 10

The (not so) mysterious margin miracle

By Karl-Heinz Thielmann

How long can it go on for? Although the global economy was flagging, share prices have established a record-breaking trend. Sceptics believe that the stock market boom is primarily being driven by central banks' exorbitant money creation and have issued warnings about irrational excesses. Optimists point out that the majority of listed companies are currently recording spectacular results, and that valuations of a lot of shares have remained moderate. So who is right?

To answer this question, we need to take a look at the further development of the profit margins of major listed companies. There is one thing that is surprising in this stock market cycle. In the past, it was usual for economic downturns to be accompanied by a drop in profits, with growing competition putting pressure on margins. This is not the case this time. In recent quarters, typical comments made by analysts about a companies results have been: turnover slightly lower than expected, profit somewhat better than forecasted due to stable margins. The weak economy is only affecting turnover, whereas profitability has even partly increased.

What are the reasons for this unusual development? It can be put down to a whole set of factors:

- As a rule, company managements are strongly focusing on cutting costs. The adverse economic factors of the past years are generally known. Overoptimistic scenarios - which seduced company managers into making expensive errors or tolerating inefficiency in previous years - have become an rare exception nowadays. . From an organisational point of view, cost reductions are facilitated by the increasing pace of globalisation and the integration of the world economy. It is becoming increasingly easy to transfer production to low-cost locations.

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- Despite difficult economic conditions, profit margins of listed companies have remained exceptionally strong compared with historical values.
- One reason for this development was globalisation. Cost management has been improved, but also legal tax evasion and the establishment of dominant market positions were facilitated.
- Stock markets also have changed structurally: commoditised businesses lost in importance relative to high-margin-industries witch are based on complexity, knowledge, strong brands or social developments.
- Most of the arguments in favour of growing operating margins will continue to prevail in the future. However, tax evasion and market dominance do not seem sustainable factors for the long-term.

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- Globalisation also has a considerable impact on the improvement of profits after taxes. Indeed, legal tax avoidance has become a crucial success factor for companies operating worldwide. The application of internal transfer prices and corporate structures with subsidiaries in tax havens enable multinational companies to considerably reduce their tax burden. Although politicians and the press like to criticize this behaviour, low tax rates are becoming an increasingly important factor for encouraging foreign companies to establish themselves in a country. As long as countries such as the USA allow federal states, for example Delaware, to aggressively attract foreign investors with massive tax advantages, politicians' statements about combating tax avoidance remain mere lip service.
- One essential reason why companies, in particular US technology, are able to maintain high margins is that they hold a dominant position in their market segments across the globe. This dominance is primarily achieved by cleverly taking advantage of economies of scale. It can, however, become a problem if market power is exploited to prevent competition.
- The structures of the stock markets have changed. The importance of the traditional capital-intensive industries that process basic commodities is decreasing. Instead, knowledge-based companies are gaining power. They are much less sensitive to economic developments than traditional large corporate groups.
- The growing importance of knowledge-based industries is accompanied by the increasing complexity of products. This makes competition more difficult. In addition, the propensity of customers to pay high prices for quality and reliability is increasing.
- Furthermore, the intangible benefits linked with products are becoming increasingly important, strengthening the manufacturers with strong and credible brands. By positioning their brands effectively, some producers of consumer durables have even succeeded in making their business less dependent on cyclical fluctuations, enabling them to improve their profitability on a long-term basis.
- Mats Alvesson, Professor of Organisation at the renowned Swedish University of Lund, recently published a book "The Triumph of Emptiness". In this book, he points out that modern societies have a growing tendency to prefer goods and services that 1) enable consumers to differentiate their social status or 2) give relatively ordinary objects and events artificially inflated importance or 3) disguise insubstantial contents with elaborate "packaging" or staging. The real value of a product is becoming increasingly irrelevant, instead the intangible benefit, or more precisely the social positioning, is what matters. Increasingly the function of consumption is to create an identity. Thus, manufacturers who base their proposition on this mechanism can often very easily achieve high margins. Indeed, a high price can even give the buyer status and contribute to the customer benefit. The growing importance of lifestyle products or luxury goods with very high margins reflect this trend.

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It looks as if arguments in favour of growing operating margins will continue to prevail in the immediate future. In particular the structural shift to knowledge-based industries will lead to higher profit margins in the long term than in the past.

On the other hand, it is also clear that the process of raising margins cannot carry on endlessly. With tax evasion and market dominance, global corporate groups are currently taking advantage of the disputes and double standards in international politics. This could change in the future, particularly if the financial problems of government budgets increase further. Indeed, the intention was announced to coordinate measures combating tax avoidance at G8 level. It currently looks as if a process of rethinking is taking place especially in the USA. Whether this process actually results in concrete measures remains to be seen. The fight against tax avoidance can not be considered serious as long as it is common practice for major industrial nations such as the USA, Great Britain and the Netherlands to attract foreign companies or the super rich with tax benefits while scrutinising the tax accounting practices of domestic companies.

For the time being, the margin miracle will continue. However, before investing in a company, investors should take a careful look at what the profits are based on. High margins are sustainable with unique products and services offering outstanding quality. Optimising tax structuring and exploiting market power, however, are not lasting recipes for success.

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Karl-Heinz Thielmann holds a degree in Economics from the University of Cologne. His professional career started in 1990 as an Analyst of European stock markets with Dresdner Bank Investment Research. In 1993 he joined Deutscher Investment Trust DIT (today: Allianz Global Investors) as Fund Manager. During his time at DIT, Karl-Heinz Thielmann developed many successful products, e.g. the DIT Wachstum Europa, the first German equity fund to invest explicitly in quality growth shares. Furthermore he received numerous awards for outstanding performance, notably for DIT Großbritannien, a fund dedicated to investments in stocks of the United Kingdom. Since 2001, he has mainly worked as an independent consultant for companies, asset managers and private individuals on matters regarding the capital market. During his years working as an independent adviser, he has helped almost all of his customers to achieve a considerably above-average investment result. Furthermore, he is lecturer for Global Economics at Karlsruhochschule International University in Karlsruhe.

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Sources:

Mats Alvesson: "The Triumph of Emptiness - Consumption, Higher Education, and Work Organization", Oxford University Press 2013

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