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TRIVARIATE RESEARCH

GROSS MARGINS MATTER

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GROSS MARGINS MATTER

Gross profitability is the key investment controversy in today's market. We reached this conclusion after several months of creating investing frameworks, analyzing risks and sectors, and, more recently, after processing this quarter's earnings. At this point in the cycle it is logical that the focus is on financial leverage. Costs of goods sold vary by industry, but for many businesses gross profitability amounts to a combination of mix and pricing power on the revenue side, and labor, materials, logistics, and depreciation on the costs side. The challenge for investors today is to decide whether management teams can navigate and pass on an unusual number of external shocks. Rising wages, mostly higher raw good and commodity costs, supply chain and inventory disruptions, and logistics and transportation bottlenecks are among the many cost pressures that need to be passed on without a commensurate loss in revenue. The corporate earnings reported over the past three weeks have had more moving parts than normal for investors to digest and consider.

Recently, as we communicated our work to investors (we did 17 one-hour investor meetings this past week), it struck us as almost uncanny that so many of our research notes this year conclude that gross profitability is a key factor. As such, we wanted to take a step back from the short-term and focus this Sunday morning on gross profitability and show three research analyses we did in the last few months all resulted in the same conclusion – **the importance of gross margin expansion for subsequent stock performance.**

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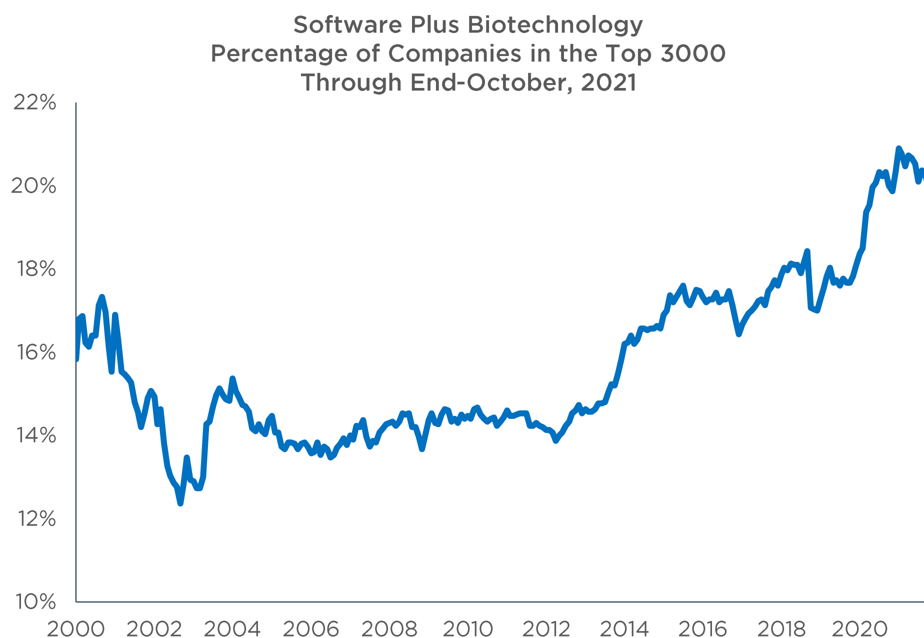
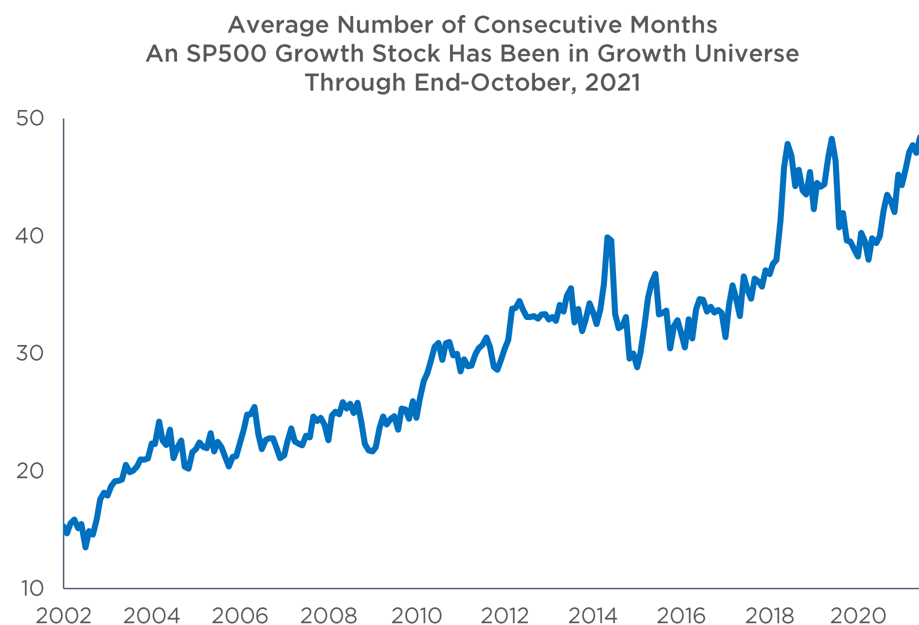
THE MARKET CONSTITUTION HAS CHANGE (PART 1 OF 2)

To level set, it is probably important to start with our long-held and strong conviction that historical comparisons on margins are flawed. Assuming today's margins will mean-revert back to some 50-year average is incredibly unlikely in our view because the constitution of the market is so meaningfully different than it was for much of history. In the mid-1980s eight of the ten biggest US equities were energy stocks. On the contrary, six hundred of the biggest 3000 US public companies are currently software and pharma/biotech, where current growth is less important to investors than the ability to grow for sustained periods, and where these companies can be bought on the gross profit line as costs below that can be absorbed by the acquirer. Additionally, companies are growing for longer than the past





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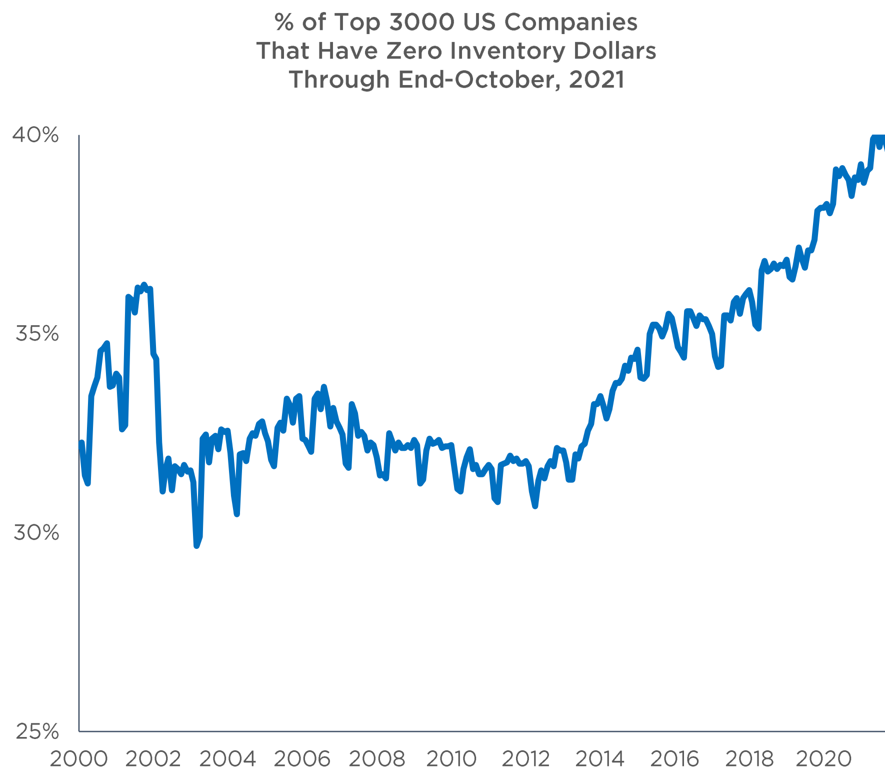
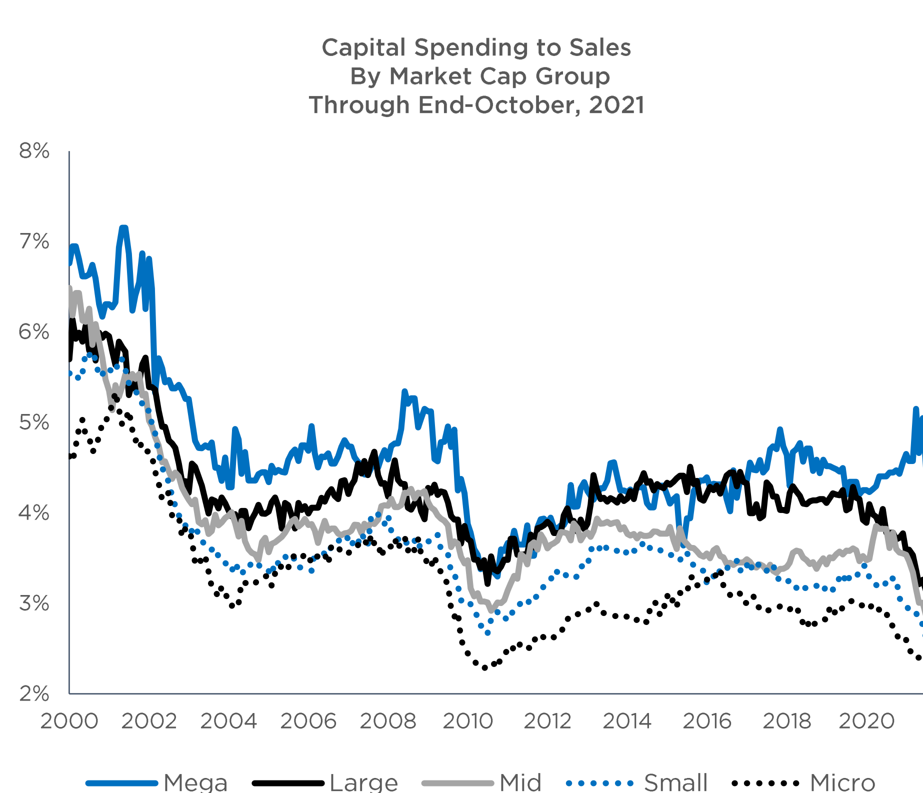
THE MARKET CONSTITUTION HAS CHANGE (PART 2 OF 2)

Capital intensity is far lower as well, with all but mega-cap companies at all-time low levels, and well over 40% of the top 3000 US equities are not manufacturers in the traditional sense, and hence have zero inventory dollars. Furthermore, FAANGM, the huge group of highly profitable technology companies, is well over 20% of the SP500 market capitalization, and will not have long-term margins in-line with traditional manufacturing. We could go on and on, but all of this is to stay that a framework for gross margins for the overall market should not include long-term mean reversion as a base case.





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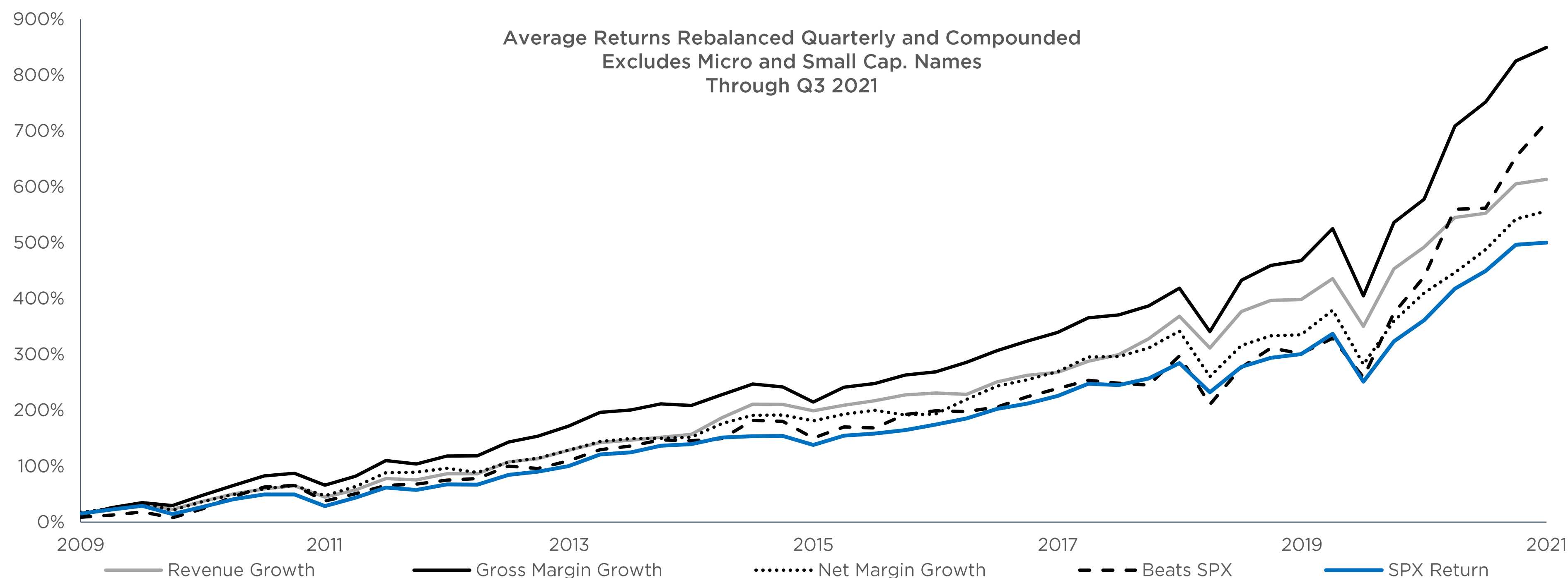
ANALYSIS #1: COMPOUNDERS

We are used to hearing from investors that they want to find "compounders" for multi-year investment. However, of late, this phrase has surfaced more frequently in our conversations, perhaps because investors want to find "compounding" businesses when they have a short-term sell-off. Growth, value, and hedge fund managers have all used the "C" word with us in the last few weeks, prompting us to study this idea more carefully. To study this, we needed to establish a definition of compounding, and we did this by analyzing the stocks that have seen sustained performance on four metrics (sustained defined as consecutive quarters) in the 90th percentile or above of names that have seen any consecutive growth. The four metrics we studied are: gross margin growth, revenue growth, net margin growth, and prior stock performance relative to the SP500. The answer? Of the four signals we studied (prior relative stock performance, revenue growth, gross margin expansion, and net margin expansion) buying stocks in the top 10% of consistent previous gross margin expansion resulted in the best subsequent stock performance. While all four approaches beat the SP500, the consistency and total performance of the gross margin approach far bested the others. Net margin growth was clearly the weakest. Prior stock performance was strong, but much of this was generated since COVID (see solid black line)



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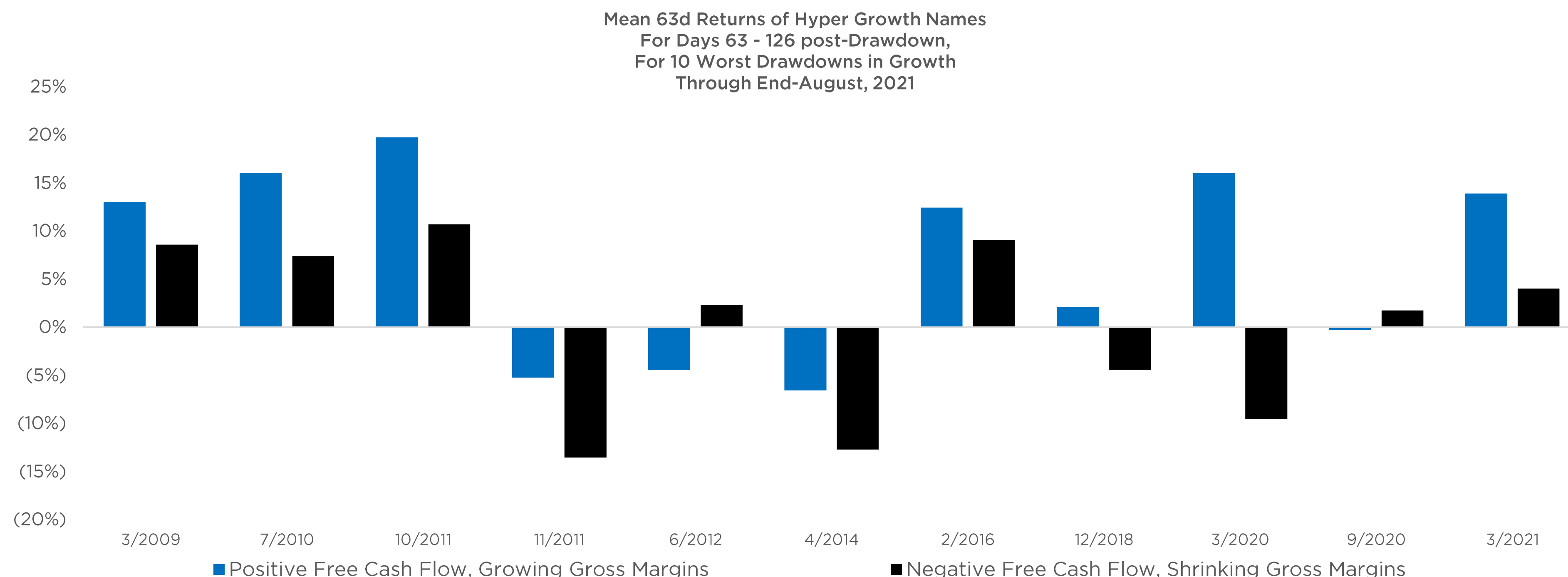
ANALYSIS #2: WHAT TO DO AFTER GROWTH STOCK SELL-OFFS?

A major investor focus early in 2021 was the sharp sell-off in growth stocks associated with fears of a "bear-steepening" interest rate curve. We have seen several short-lived but sharp growth style underperformance regimes in the last decade (Yellen's comments in 2014, Q4 of 2018, etc.), but the huge positive move in profitless technology companies and speculative securities in the second half of 2020 sparked fear among many funds that had done well in 2020 being long growth. As such, we evaluated 11 prior growth-stock sell-offs since 2008 and identified that the key signals to focus on following every sell-off are largely similar – positive free cash flow and gross margin expansion. These typically work better than very fast growing, high margin, and low free cash flow stocks, which were more the type of growth stock that worked in 2020. That has worked again this year since the bear-steepening fears abated in March



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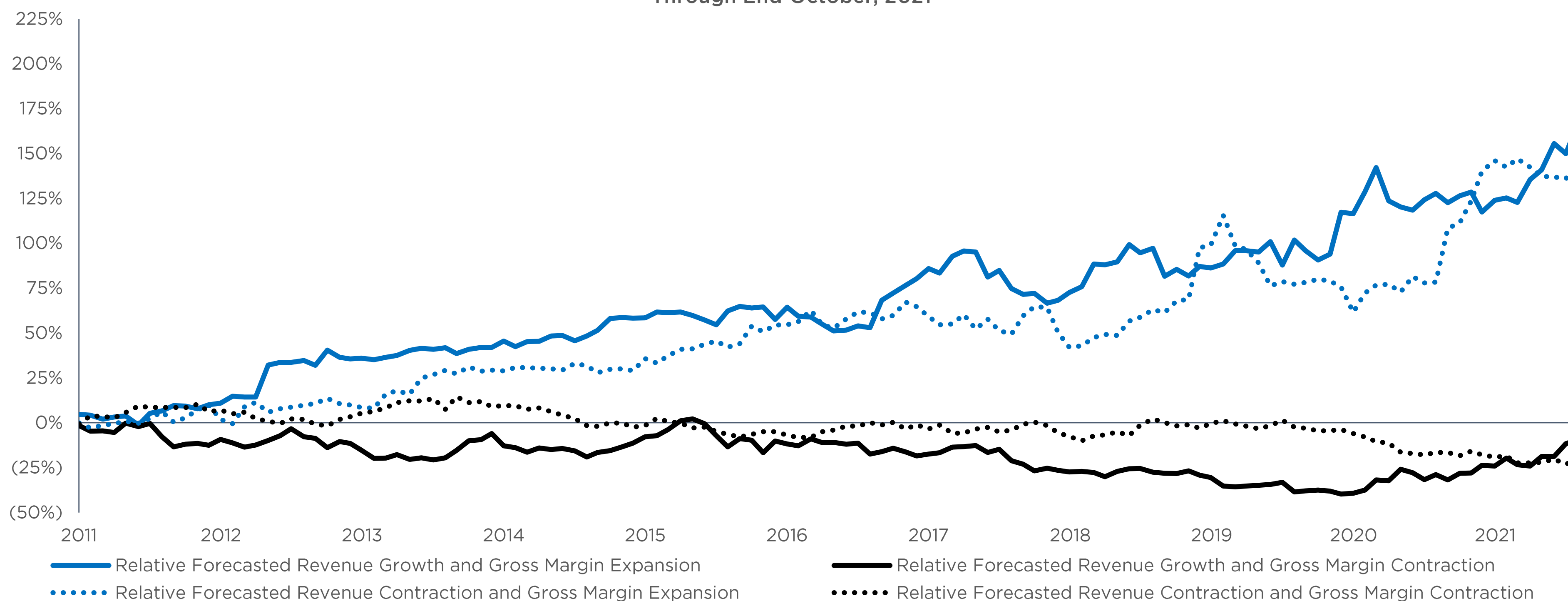
ANALYSIS #3: HOW TO PICK SEMICONDUCTOR COMPANIES

We took the high gross margin semiconductor companies and analyzed the subsequent performance of companies with share gain, share loss, gross margin expansion and gross margin contraction. Stock with share LOSS and margin expansion perform just as well as stocks with share gain and margin expansion. Semis with gross margin contraction massively underperform. For an old chip analyst, the playbook remains the same for fundamental analysts – focus on the consensus view of gross margins six months from now, and decide whether you have conviction that the numbers are materially off



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OUR TOP INVESTMENT CONCLUSION ON THIS THEME

Lastly, in thinking about gross margins for the market, we like the approach of taking a regression between the change in sales and the change in gross profits for each company. The slope of that line is the incremental margin, i.e. the "drop through" the company has historically been able to achieve. We then analyze the implied incremental gross margins embedded in the consensus expectations and compare this to the historical incremental margins the business has achieved. In general, absence a big shift in the cost structure of a company that a fundamental researcher has confidence in, we think buying stocks with low incremental margin expectations vs. the business model average and underweighting (shorting) those with high expectations vs. historical business model achievability is prudent.

Today, when we canvass the market, and area we see high incremental gross margin expectations is in the industrial sector. This potentially poor relative estimate achievability has fueled us to recommend an underweight on this sector, particularly in machinery and capital goods.

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