Earnings Are Growing Faster Than Sales

Mini Investment Class
by the OKI Tri-State Chapter

Courtesy Cincinnati Model Investment Club
Based on Original Presentation by Gretchen and Jim Hurt
Revised 2/1/10 by Sandy and Bob Lowery

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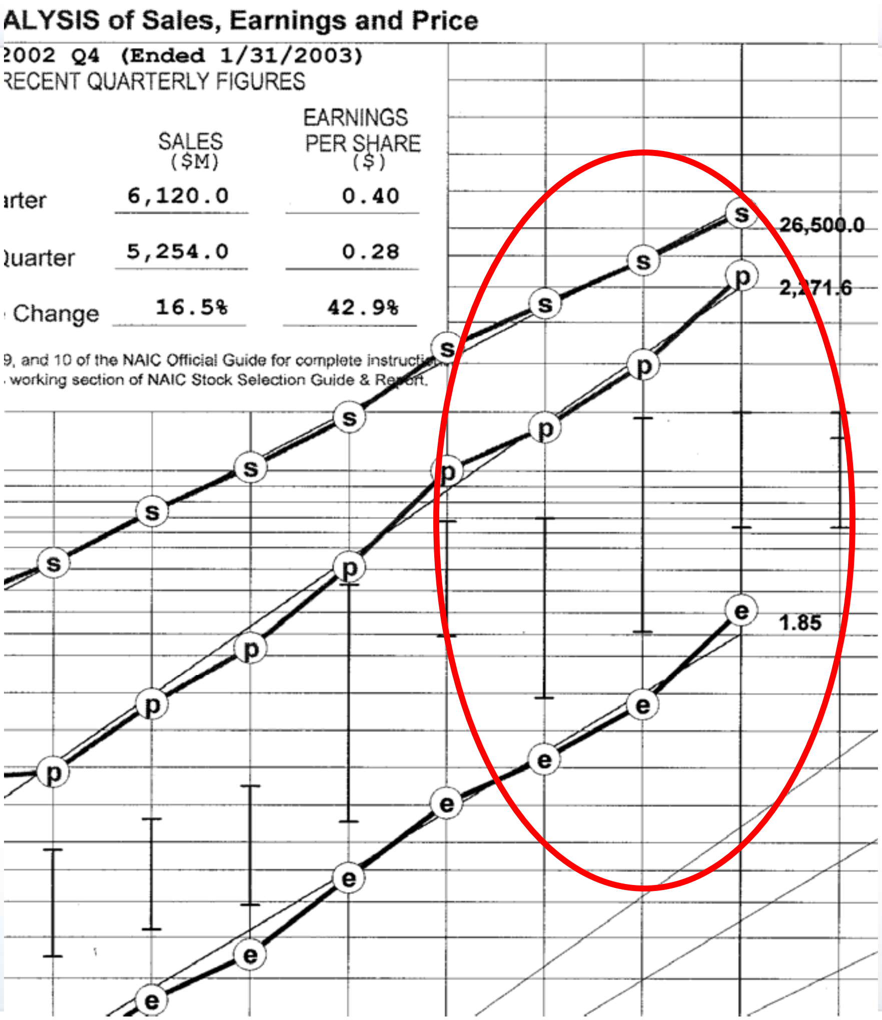
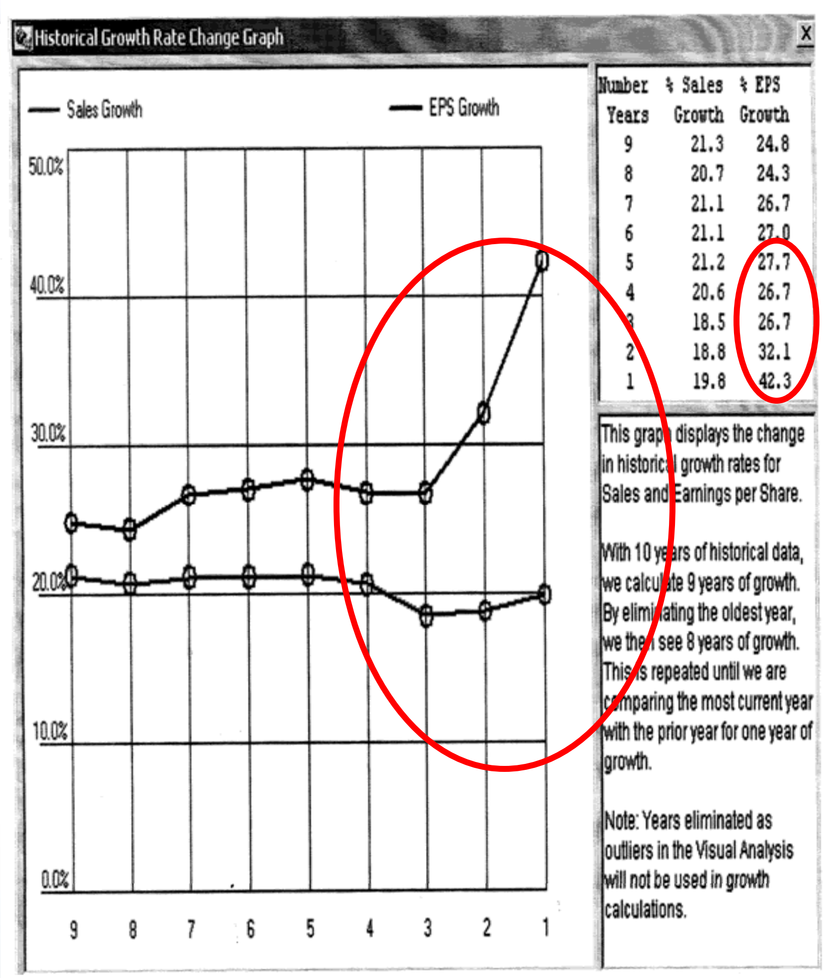
The Problem



The growth rate of the sales has slowed in the last few years but the growth rate of the pre-tax profit and earnings have grown substantially faster.

We need to understand what is happening

Another Look at the Problem



We like to see earnings growing because it will eventually mean the price of the stock will go up.

If the earnings are growing faster than the sales we need to find out what the company is doing to increase the earnings.

When we know how they are growing earnings we can decide how long they can continue doing it.

Earnings Come From Sales

- ***Earnings come from sales so we do not expect them to grow faster than sales.***

Sales
Minus Cost of Goods sold
Equals **Gross Profit**
Minus Overhead
Equals **Pre-Tax Profit**
Minus Taxes
Equals **Earnings**

Earnings Come From Sales

- **Companies can grow their earnings faster than sales by doing one or more of the following:**
  - **Lowering their tax rate**
  - **Buying back shares**
  - **Cutting the cost of goods sold or the overhead so that they are not growing as fast as sales or grow the sales faster than the CGS or Overhead.**
  - **Raising their prices (this is hard to do if they have competition)**

Did They Lower Their Tax Rate?

Hld's(000) 607411 618268 623397 ... 5 yr. 265.4 24.2

© VALUE LINE PUB., INC.	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	05-07
Sales per sh A	3.60	3.88	4.24	4.45	4.86	5.24	6.59	7.67	9.58	10.99	12.42	14.46	17.36	20.80	24.50	28.50	*33.85*	*39.65*	*63.60*
"Cash Flow" per sh	.14	.15	.19	.20	.21	.19	.26	.36	.52	.58	.71	.85	1.07	1.34	1.59	2.01	*2.60*	*3.10*	*5.15*
Earnings per sh A B	.09	.09	.11	.13	.12	.09	.15	.22	.35	.34	.43	.51	.68	.90	1.06	1.30	*1.78*	*2.10*	*3.60*
Div'ds Decl'd per sh C ■	.03	.03	.03	.03	.03	.03	.04	.04	.05	.05	.05	.06	.06	.06	.07	.08	*.08*	*.10*	*.12*
Book Value per sh	.85	.92	.99	1.08	1.17	1.15	1.26	1.48	2.23	2.57	3.20	3.71	4.45	6.14	7.17	8.60	*10.45*	*12.55*	*21.80*
Common Shs Outst'g D	633.98	629.85	594.22	596.09	583.41	583.04	583.78	591.55	638.11	643.67	692.40	701.26	705.29	764.72	766.48	775.71	*783.00*	*789.00*	*794.00*
Avg Ann'l P/E Ratio	22.3	17.7	11.4	13.5	15.6	21.2	17.8	23.2	25.2	23.5	21.2	19.5	28.2	30.1	22.0	27.5	***Bold figures are Value Line estimates***		*25.0*
Relative P/E Ratio	1.51	1.18	.95	1.02	1.16	1.35	1.08	1.37	1.65	1.57	1.33	1.12	1.47	1.72	1.43	1.40			*1.65*
Avg Ann'l Div'd Yield	1.3%	1.7%	2.2%	1.8%	1.7%	1.7%	1.4%	.8%	.5%	.6%	.6%	.6%	.3%	.2%	.3%	.2%			*.1%*
Sales ($mill) A							3846.4	4538.0	6110.5	7075.4	8600.2	10137	12245	15906	18779	22111	*26500*	*31300*	*50500*
Gross Margin							23.4%	23.8%	24.8%	24.9%	25.9%	26.5%	26.9%	27.5%	28.2%	28.9%	*29.5%*	*29.7%*	*30.0%*
Operating Margin							6.4%	7.4%	9.4%	9.0%	9.6%	9.9%	9.6%	10.1%	9.6%	10.5%	*11.5%*	*11.7%*	*12.0%*
Number of Stores							303	303	336	365	402	446	484	576	650	744	*867*	*997*	*1425*
Net Profit ($mill)							84.7	131.8	223.6	226.0	292.2	357.5	482.4	690.0	809.9	1023.3	*1422*	*1700*	*2905*
Income Tax Rate							32.7%	33.5%	34.9%	35.8%	35.6%	36.0%	36.4%	36.6%	36.8%	37.0%	*37.4%*	*37.5%*	*37.5%*
Net Profit Margin							2.2%	2.9%	3.7%	3.2%	3.4%	3.5%	3.9%	4.3%	4.3%	4.6%	*5.4%*	*5.4%*	*5.8%*
Working Cap'l ($mill)							246.0	402.7	611.3	653.8	502.9	660.3	820.3	1323.5	1246.4	1903.6	*2280*	*2450*	*4925*
Long-Term Debt ($mill)							313.6	592.3	681.2	866.2	767.3	1045.6	1283.1	1726.6	2697.7	3734.0	*3750*	*4000*	*4200*
Shr. Equity ($mill)							733.2	873.7	1419.9	1656.7	2217.5	2600.6	3136.0	4695.5	5494.9	6674.4	*8200*	*9920*	*17300*
Return on Total Cap'l							8.9%	9.6%	11.4%	9.8%	10.5%	10.7%	11.8%	11.5%	10.6%	10.6%	*12.5%*	*13.0%*	*14.0%*
Return on Shr. Equity							11.6%	15.1%	15.7%	13.6%	13.2%	13.7%	15.4%	14.7%	14.7%	15.3%	*17.5%*	*17.0%*	*17.0%*
Retained to Com Eq							8.7%	12.4%	13.8%	11.8%	11.6%	12.6%	13.8%	13.7%	13.8%	14.4%	*16.5%*	*16.5%*	*16.0%*
All Div'ds to Net Prof							25%	18%	12%	13%	12%	8%	11%	7%	7%	6%	*5%*	*5%*	*3%*

CAPITAL STRUCTURE as of 11/1/02

Tot. Debt $3828.1 mill. **Due in 5 Yrs** $804.2 mill.
LT Debt $3739.0 mill. **LT Interest** $170.0 mill.

(LT interest earned: 11.0x; total interest coverage: 8.8x)
(32% of Cap'l)

Leases, Uncapitalized Annual rentals $187.3 mill.
Pension Liability No defined benefit plan
Pfd Stock None
Common Stock 780,839,000 shs. (68% of Cap'l)

MARKET CAP: $29.3 billion (Large Cap)

CURRENT POSITION ($MILL.)	2000	2001	11/1/02
Cash Assets	468.5	853.2	1396.9
Receivables	161.0	165.6	186.9
Inventory (FIFO)	3285.4	3610.8	4150.5

BUSINESS: Lowe's Companies, Inc. operates a chain of building materials and home improvement superstores in 42 states. Average ... ing, 6%; hardware, 6%; paint, 6%. Acquired Eagle Hardware, 4/99. 2001 deprec. rate: 5.0%. Has about 87,000 employees, 19,277

Check your V. L. Sheet. This is not the cause of the increase in earnings.

Are they Buying Back Shares?

Hld's(000) 607411 618268 623397 … 5 yr. 265.4 24.2

1986	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	© VALUE LINE PUB., INC.	05-07
3.60	3.88	4.24	4.45	4.86	5.24	6.59	7.67	9.58	10.99	12.42	14.46	17.36	20.80	24.50	28.50	***33.85***	***39.65***	Sales per sh A	***63.60***
.14	.15	.19	.20	.21	.19	.26	.36	.52	.58	.71	.85	1.07	1.34	1.59	2.01	***2.60***	***3.10***	"Cash Flow"per sh	***5.15***
.09	.09	.11	.13	.12	.09	.15	.22	.35	.34	.43	.51	.68	.90	1.06	1.30	***1.78***	***2.10***	Earnings per sh A B	***3.60***
.03	.03	.03	.03	.03	.03	.04	.04	.05	.05	.05	.06	.06	.06	.07	.08	***.08***	***.10***	Div'ds Decl'd per sh C ■	***.12***
.85	.92	.99	1.08	1.17	1.15	1.26	1.48	2.23	2.57	3.20	3.71	4.45	6.14	7.17	8.60	***10.45***	***12.55***	Book Value per sh	***21.80***
633.98	629.85	594.22	596.09	583.41	583.04	583.78	591.55	638.11	643.67	692.40	701.26	705.29	764.72	766.48	775.71	***783.00***	***789.00***	Common Shs Outst'g D	***794.00***
22.3	17.7	11.4	13.5	15.6	21.2	17.8	23.2	25.2	23.5	21.2	19.5	28.2	30.1	22.0	27.5	***Bold figures are Value Line estimates***		Avg Ann'l P/E Ratio	***25.0***
1.51	1.18	.95	1.02	1.16	1.35	1.08	1.37	1.65	1.57	1.33	1.12	1.47	1.72	1.43	1.40			Relative P/E Ratio	***1.65***
1.3%	1.7%	2.2%	1.8%	1.7%	1.7%	1.4%	.8%	.5%	.6%	.6%	.6%	.3%	.2%	.3%	.2%			Avg Ann'l Div'd Yield	***.1%***
						3846.4	4538.0	6110.5	7075.4	8600.2	10137	12245	15906	18779	22111	***26500***	***31300***	Sales ($mill) A	***50500***
						23.4%	23.8%	24.8%	24.9%	25.9%	26.5%	26.9%	27.5%	28.2%	28.9%	***29.5%***	***29.7%***	Gross Margin	***30.0%***
						6.4%	7.4%	9.4%	9.0%	9.6%	9.9%	9.6%	10.1%	9.6%	10.5%	***11.5%***	***11.7%***	Operating Margin	***12.0%***
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						32.7%	33.5%	34.9%	35.8%	35.6%	36.0%	36.4%	36.6%	36.8%	37.0%	***37.4%***	***37.5%***	Income Tax Rate	***37.5%***
						2.2%	2.9%	3.7%	3.2%	3.4%	3.5%	3.9%	4.3%	4.3%	4.6%	***5.4%***	***5.4%***	Net Profit Margin	***5.8%***
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						313.6	592.3	681.2	866.2	767.3	1045.6	1283.1	1726.6	2697.7	3734.0	***3750***	***4000***	Long-Term Debt ($mill)	***4200***
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						8.9%	9.6%	11.4%	9.8%	10.5%	10.7%	11.8%	11.5%	10.6%	10.6%	***12.5%***	***13.0%***	Return on Total Cap'l	***14.0%***
						11.6%	15.1%	15.7%	13.6%	13.2%	13.7%	15.4%	14.7%	14.7%	15.3%	***17.5%***	***17.0%***	Return on Shr. Equity	***17.0%***
						8.7%	12.4%	13.8%	11.8%	11.6%	12.6%	13.8%	13.7%	13.8%	14.4%	***16.5%***	***16.5%***	Retained to Com Eq	***16.0%***
						25%	18%	12%	13%	12%	8%	11%	7%	7%	6%	***5%***	***5%***	All Div'ds to Net Prof	***3%***

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Again, Value Line shows this is not the answer.

Are They Cutting the Cost of Goods Sold or Overhead?

Lowe's Companies, Inc.
Consolidated Statements of Earnings

(In Thousands, Except Per Share Data) Years Ended on	February 1, 2002	% Sales	February 2, 2001	% Sales	January 28, 2000	% Sales
Net Sales	**$22,111,108**	**100.0%**	**$18,778,559**	**100.0%**	**$15,905,595**	**100.0%**
Cost of Sales	15,743,267	71.2	13,487,791	71.8	11,525,013	72.5
Gross Margin	**6,367,841**	**28.8**	**5,290,768**	**28.2**	**4,380,582**	**27.5**
Expenses:						
Selling, General and Administrative (Note 5)	3,913,355	17.7	3,348,060	17.8	2,772,428	17.4
Store Opening Costs	139,870	0.6	131,825	0.7	98,448	0.6
Depreciation	516,828	2.4	408,618	2.2	337,359	2.1
Interest (Note 15)	173,537	0.8	120,825	0.7	84,852	0.5
Nonrecurring Merger Costs (Note 2)	–	–	–	–	24,378	0.2
Total Expenses	**4,743,590**	**21.5**	**4,009,328**	**21.4**	**3,317,465**	**20.8**
Pre-Tax Earnings	1,624,251	7.3	1,281,440	6.8	1,063,117	6.7
Income Tax Provision (Note 13)	600,989	2.7	471,569	2.5	390,322	2.5
Net Earnings	**$ 1,023,262**	**4.6%**	**$ 809,871**	**4.3%**	**$ 672,795**	**4.2%**
Basic Earnings Per Share (Note 9)	**$ 1.33**		**$ 1.06**		**$ 0.88**	
Diluted Earnings Per Share (Note 9)	**$ 1.30**		**$ 1.05**		**$ 0.88**	
Cash Dividends Per Share	**$ 0.08**		**$ 0.07**		**$ 0.06**	

See accompanying notes to consolidated financial statements.

To find the answer we must go to their Income Statement and compare the growth in Sales to the growth in Cost of Goods Sold and the growth in Overhead.

Most of the time we will find that the company has cut either the Cost of Goods Sold or the Overhead or both.

Cost of Goods Sold (COGS)

Year	2002		2001	
	$ B	Margin	$ B	Margin
Sales	$22.1	100.0%	$18.8	100.0%
Growth	17.7%		18.1%	
COGS	$15.7	71.2%	$13.5	71.8%
Change	$1.1	-0.6%	$0.9	-0.7%
Growth	16.7%		17.0%	
Overhead	$4.7	21.5%	$4.0	21.4%
Change	$0.7	0.1%	$0.7	0.6%
Growth	18.3%		20.9%	
Net Profit	$1.0	4.6%	$0.8	4.3%
Change	$0.2	0.3%	$0.1	0.1%
Growth	26.4%		20.4%	

Are They Cutting the Cost of Overhead?

- **Overhead is growing faster than sales.**
- **Overhead margin is growing.**
- **When we check the MD&A section of the Annual report we read that the increase in Overhead was due to increase in payroll and Advertising Costs.**

That leaves only one other answer.

- **Somehow, while competing with Home Depot, Lowe's has managed to increase its gross profit margin on the items they are selling.**
- **How are they doing this?**
- **We find the answer in the Letter from the CEO in their Annual Report.**

How Lowe's Is Increasing Their Profit Margin

Another important merchandising and store operations initiative is our "Up The Continuum" strategy. Today, more than ever, our homeowner customers are spending more time in, and money on, their single most valuable asset…their home. And for the most part, they think of their expenditures as investments, which provide both current enjoyment as well as financial return.

Up The Continuum is simply recognizing the consumer's migration to quality when it comes to investing in their home. Customers tell us they want, and are willing to pay for, quality, brand-name merchandise that's unique, consistent with their lifestyle and tastes, and lasts longer and performs better. Lowe's merchants are shifting the product mix away from our historical dependency on opening-price-point merchandise on one end of the continuum to a more balanced mix within the middle and upper end of the lines, by profiling and marketing our assortments differently. We're not abandoning our opening price points, just focusing more of our resources (floor space, inventory investment and advertising) from the "Good" merchandise to the "Better, Best and Premium" products. This shift translates to a more profitable mix for both Lowe's and our vendors…and most importantly, a more satisfactory experience for our customers.

The "Why Lowe's?" story of differentiation isn't complete without the commitment and support of our

In other words, they have discovered that people will consider more than just price when buying things for their home, and Lowe's now sells more expensive items with higher profit margins.

Why Bother?

- **Why bother to find out how a company is growing its earnings faster than the sales?**
- **We do this because knowing where the additional earnings growth comes from helps us make a better decision about the future growth of the company.**

The Issue is Quality

- *Quality of Sales*
  - Goods and services the company produces provide high quality sales
  - Items that occur rarely or only once provide low quality sales.

- *Quality of Earnings*
  - Earnings from routine business have high quality
  - One time and Pro-Forma earnings have low quality.

For more ways to learn:

Contact the OKI Chapter Board for a One Hour "Classes to Clubs"

(We Bring OKI Classes Directly to Your Club) Or

Attend One of our OKI Special Events or Edufests

Cincinnati:

Mary Thomas
Mcthomasp@fuse.net

Dayton:

Gene Senter
EMIDDLE42@aol.com

Columbus:

Dianne Jordan
dijord00@aol.com

And . . . Don’t Forget

The OKI Online Classes

Learn From The Comfort
Of Your Own Home - For Details:

Refer To Your Printed OKI Newsletter

Or Visit The OKI Website:
www.betterinvesting.org/okitri