



SHAREHOLDER VALUE SUSTAINABILITY DRIVERS THROUGH THE PRISM OF OUT- AND UNDERPERFORMERS (EVIDENCE FROM CENTRAL AND EASTERN EUROPE)

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Abstract. The paper aims to investigate the key attributes of the leading and lagging companies in terms of the shareholder value sustainability. The companies classified as the sustainable outperformers and the sustainable underperformers were compared on the several dimensions of the financial aspects (profitability, capital financing, dividend payout ratios) and on the number of qualitative aspects such as industry, size and country of domicile. The results of the analysis conducted for the period of 2005-2012 makes it possible to enhance the investment strategy when building the stock portfolio by focusing on the attributes typical for the Central and Eastern European companies capable of delivering superior returns on the regular basis.

Keywords: shareholder value, sustainability, fundamental analysis, outperformers, underperformers.

JEL classification: G11, G14, G30.

1. Introduction

Though both private and institutional investors mind absolute returns (Blackrock 2012), still the private investors more often than the institutionals are focused on the absolute return as a part of his/her capital preservation policy or capital appreciation policy, while institutionals are more anxious about the generated alpha (Griffiths, Kessler 2012). Hedge fund managers have similar approach to the return perception as the private investors. Hedge funds often implement the absolute return strategies (Al-Sharkas 2005), which is partially explained by the fact that for the hedge fund it is relatively hard to determine the benchmark given the very lax regulations in this niche (Ammann *et al.* 2012; Amen, Goltz 2007), which do not require transparent structure and investment policy statement.

But the relative approach to the stock market investing is very crucial to the traditional asset managers and particularly to the fund managers, although for other groups of investors it is also rather important. In end the fund managers are paid fees for employing their investment skills and experience when managing the assets of the clients with the main purpose to beat the market index, to generate positive sustainable alpha and do not have high

risk exposure, as measured by the beta coefficient. Otherwise, the investors would prefer exchange-traded funds (ETFs), which track the particular stock index, and would pay significantly lower commissions.

This is one of the main reasons why the companies capable of beating the market index consistently become the main target for the investment traders, fund managers as well as the private investors willing to achieve superior returns. Undoubtedly the companies, able to deliver sustainable outperformance tend to get in the centre of attention of corporate management professionals as well as the consultants in the effort to discover the success factors.

Various studies and books (Collins 2001; Rappaport 2006, etc.) are available on the US companies mainly, but the stock exchange traded companies in Europe and especially in the emerging markets are rather underresearched. Thus, the authors contribute with their study on the Central and Eastern European (CEE) quoted companies to the existing literature by documenting the key attributes of the sustainable outperformers and comparing them to the attributes of the sustainable underperformers.

The study's principal hypothesis was advanced as followed:

There is a significant difference in the financial conditions between the companies being able to deliver superior returns on the regular basis and the companies, which tend to regularly underperform the benchmark.

Additionally, the authors also checked whether the company returns may receive certain tailwinds from other factors such as industry, country of domicile, firm's size. The aim of the study is to discover the particular attributes of the consistently outperforming companies, knowing which the investors would be able to develop his/her stock investment policy and, therefore, would be able to achieve higher than average performance 'fruits' in the long-term.

2. Distinguished features of the outperforming stocks

There are professional and academic discussions, papers and studies to find the *lapis philosophorum*, to discover the attributes of the stocks, which would deliver sustainable shareholder value at the above average speed.

E. Fama and K. French (1993) argue that most of the stock performance can be explained by considering three risk factors: market premium, size premium (small companies outperform large companies) and value premium (value stocks outperform growth stocks). However, these factors are insufficient to completely explain the performance as other factors have to be considered as well (Frazzini *et al.* 2013).

Jim Collins (2001) in its fundamental work "Good to Great" suggested seven factors, which make the company great in terms of the long-lasting financial and market performance: wise management (humble manager, putting the interests of the company to the first place and finding the right people for the key positions), ability to face the brutal truth, have a hedgehog concept (competitive advantage), install the disciplined approach, use technology for acceleration (be the pioneer), employ various initiatives to compound growth.

Another fundamental work on the sustainable outperformers was conducted by Boston Consulting Group (Olsen *et al.* 2009). The authors indicate four pathways the company can follow to get into the 'sustainable outperformer's club': 1) consistently deliver sales growth (growth engine); 2) 'cash machine', which assumes high payout ratios and necessary requirement for that condition – strong pricing power and high returns on capital; 3) 'portfolio migrator', which assumes successful acquisitions and divestitures strategy; 4) 'value impresario' – the pathway is taken by the large

well-known companies with the established business model, when they are using all available pathways to create value, but their approach is distinguished by the 'long-termism' concept.

Alfred Rappaport (2006) proposes 10 basic principles for the company to be able to deliver shareholder value on a consistent basis: avoidance of earnings management; successful investment history, which delivers return above cost of capital; returning cash to the shareholders in the form of the dividends and share buybacks, plausible executive compensation.

Relatively recent studies on the leaders and laggards of the stock exchanges focused on the crisis and post-crisis periods and to a lesser extent than the afore-mentioned research considered the company management specific qualitative factors.

CE Services in cooperation with Tallinn University of Technology (2009) conducted the study on the liquidity crisis winners and losers, looking at the sample of 977 European companies. According to the study results, the best performing (but still losers in absolute terms) were the companies quoted on the Western European stock markets, operating in the 'defensive' industries (healthcare, utilities, telecoms, consumer non-cyclical), have conservative balance sheets and large market capitalization, often being classified as value stocks.

After the "no-winners" period, global liquidity crisis, the industry professionals turned particular attention to the key characteristics of the top performing companies in the post-crisis period. According to the analysis made by Eric Parnell (2011), there are four key characteristics of the companies, which experienced insignificant declines during the market correction from April 2010 to August 2010 during the QE (Quantitative Easing) pause, or even managed to maintain the upward price momentum:

- Large capitalization;
- High quality of the companies (as determined by the S&P quality ratings);
- Low absolute and relative valuation (PE less than 20);
- High dividend yields.

JP Morgan's Corporate Finance Advisory (Zenner *et al.* 2013) made a research on the performance leaders and laggards in the post-crisis period to find out the distinguishing features between them. The learnings from the study state that the leaders have executed more cash-financed M&As, have lower international exposure (focused on the domestic US market), efficient inventory management and high returns on capital. The leaders benefited by the low-rate environment tak-

ing more debt, but retaining the same leverage ratios due to the operating efficiency. Besides, they were likely to increase their dividend payouts to become the favourite stocks in the situation of the low deposit rates.

3. Research design

The sample is limited by the quoted CEE companies, which were the components of the local stock exchanges main lists in the financial year 2010. The static sample composition was considered in order to avoid the survivorship bias. Thus, the companies, which were forced to go bankrupt, had not left the analyzed sample in advance. The sample list includes 117 companies, the components of the main indices of the CEE stock exchanges: 15 companies traded in the Czech Republic (PX Index), 10 companies traded in Croatia (CROBEX), 12 companies traded in Hungary (BUX), 20 companies traded in Poland (WIG), 10 companies traded in Romania (BET), 7 companies traded in Slovakia (SAX), 6 companies traded in Slovenia (SBI TOP), 13 companies traded in Estonia (OMX BBGI), 5 companies traded in Latvia (OMX BBGI), 19 companies traded in Lithuania (OMX BBGI). These are the largest companies traded in the CEE countries with relatively good liquidity and above average market capitalization compared to other companies traded on the CEE market. One company, Czech electricity company CEZ, has dual listing on Prague Stock Exchange and on Warsaw Stock Exchange, so it was considered only once leading to the overall sample of 116 companies.

The selection of the companies, which managed to deliver sustainable out- or underperformance was made on the annual basis, classifying the company if it managed to beat the equally-weighted performance of the market as the winning company (outperformer), and as the laggard (underperformer) if it delivered TSR below the market return. The timeline of the analysis included 8 annual periods: from 2005 till 2012, which also covered the financial crisis becoming an important milestone for the CEE equity market development. The company was classified as a sustainable outperformer if it delivered above average result for 5 years and more; and it was classified as a sustainable underperformer if it delivered below average result for 5 years and more. The analysis shows that the companies underperforming the market 5 times and more (48 firms) significantly exceed the number of the companies, outperforming the market for 5 years and more (15 firms). Therefore, it was decided to consider also the expanded sample of the

outperformers, i.e. the companies delivering alpha for 4 years and more (41 firm).

First, the outperformers and underperformers were compared on the three dimensions: industry, country of quotation (domicile) and the size. It was found out how many of out/underperformers belong to the particular classification group (e.g. industry) in comparison to the total number of companies in the sample.

The next step was to compare the financial ratios median of the outperformer and the underperformer groups. The financial aspects analyzed were the following: margin levels, capital profitability, debt burden, balance sheet stability, dividend payout policy (yield and payout ratio).

4. Research methodology and results

The analysis by the industries shows that it was worth investing in the pharmaceuticals as 7 out of 10 companies have high outperformance frequency (Table 1). Over half of the oil&gas, retail and food companies have also delivered sustainable outperformance.

Limited sample (outperformers for 5 years and more) analysis shows that telecommunications, pharmaceuticals and retailers are the most obvious applicants for the long-term above average performance.

According to the results of Table 1, the CEE investors should obviously be very careful with the financial sector, as over half of banks, real estate firms and investment companies were classified as sustainable underperformers. Media and agricultural industry groups primarily supplied the market with the sustainable underperformers during the period of 2005-2012.

Applying the same filter as in the case of industry analysis considering the countries' perspective, it becomes clear that the Polish, Romanian and Lithuanian equity markets are worth considering as the attractive investment locations as almost a half of the sample companies domiciled in these markets were classified as sustainable outperformers (Table 2). The limited leading companies sample analysis demonstrated that the Lithuanian and Polish equity markets were the leaders in creating sustainable outperformers (Table 2).

The lagging companies are most often domiciled in Hungary, Latvia and Slovenia, more than a half of the sample companies listed on the stock exchanges in the mentioned countries were classified as the underperformers, delivering the performance behind the market for 5 periods and more (Table 2).

Taking into account that the CEE stock markets are still in their development stage, market liquidity, which as a rule correlates with the company's market capitalization, might become an issue. The companies in the analyzed sample were divided into three groups according to their market capitalization:

- Small caps with market capitalization below 500 mn USD;
- Mid caps with market capitalization between 500 mn USD and 5 bn USD;
- Large caps with market capitalization above 5 bn USD;

The analysis of the leading and the lagging companies based on the market capitalization provides the evidence that the large cap companies have higher chances to become the ones, who generate sustainable performance alpha throughout different market phases – 55% of the large companies sample became the outperformers (Table 3).

The CEE companies of rather small market capitalization possess increased risk of being classified as the sustainable underperformers. The risk

of underperformance diminishes as the market capitalization increases (Table 3). It can be associated with the fact that small capitalization companies in the CEE equity markets have higher risk profile, they can swiftly lose the market positions, are unstable in their operations and business model structuring, do not have substantial experience on the market. This finding comes in contrast with the Fama-French statement that small companies tend to do better than the market as a whole (Fama, French, 1993). Possibly because the market is characterized by the low liquidity and the companies are truly small, the commonly accepted portfolio theories cannot be applied to the CEE market. Besides, small cap US companies obviously are significantly larger than small CEE companies.

Concentrating analysis mainly on the financial ratios, it was possible to determine the key features attributed to the companies capable of beating the market on the continuous basis.

Table 1. Out-/Underperformer Analysis by Industries

Industry Group	% of Outperformers (4 periods)	% of Outperformers (5 periods)	% of Underperformers (5 periods)
Telecommunications	38	25	25
Oil&Gas	60	10	40
Pharmaceuticals	88	25	-
Food	60	-	-
Retail	67	33	-
Engineering&Construction	33	22	33
Banks	33	13	67
Media	-	-	67
Real Estate	-	-	71
Investment Companies	-	-	100

Table 2. Out-/Underperformer Analysis by Countries

Country	% of Outperformers (4 periods)	% of Outperformers (5 periods)	% of Underperformers (5 periods)
Croatia	20	10	50
Czech Republic	20	13	47
Estonia	38	15	31
Hungary	25	8	58
Latvia	40	20	60
Lithuania	47	26	26
Poland	50	15	25
Romania	50	-	50
Slovak Republic	29	-	43
Slovenia	17	-	67

Table 3. Out-/Underperformer Analysis by Size

Size	% of Outperformers (4 periods)	% of Outperformers (5 periods)	% of Underperformers (5 periods)
Large	55	20	30
Middle	35	8	38
Small	31	13	45

Profitability

Among all profitability measures selected and researched within the present study (ROE, ROCE, Profit Margin, OPCF/Equity, sales dynamics, EVA dynamics) return on capital employed (ROCE) showed consistently good result in distinguishing the best performers (Fig. 1). Sustainable outperformers are identified by higher profitability on capital employed than the market average and the underperformers in almost all periods.

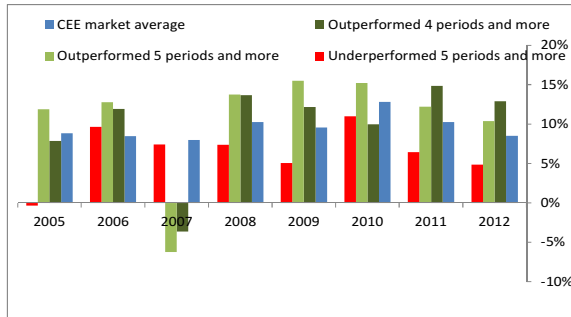


Fig. 1. Median ROCE of sustainable out- and underperformers

However, taking into account that ROCE measure forces to exclude banking industry representatives, the next plausible distinguisher of the outperformers in terms of the profitability appears to be the operating cash flow return over the equity capital - OpCF/Equity (Fig. 2).

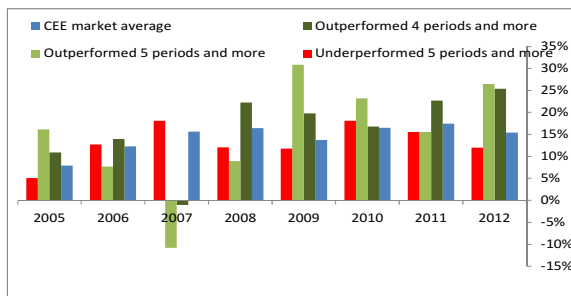


Fig. 2. Median OpCF/Equity of sustainable out- and underperformers

The median ROE and profit margin ratios of the sustainable outperformers are also higher, than those of the market and the underperformers, but in more periods than with OpCF/Equity and ROCE the opposite situation is observed. Considering the statistical significance of the difference in the averages with the help of the t-test, equity capital net profitability looks a bit more beneficial than others showing more cases of significantly higher mean profitability vs. averages of the market and underperformers.

Capital Management

Two sides of the capital management policies were analyzed: internal versus external financing as well as the profit retention versus the dividend payouts. Post-crisis period clearly shows that the

winning companies are the ones, having more conservative balance sheets and less debt on the accounts (Fig. 3).

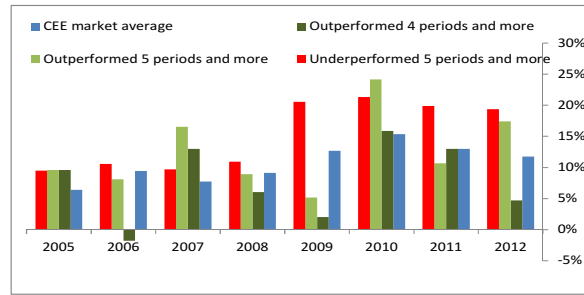


Fig. 3. Median Net debt to assets of sustainable out- and underperformers

Also before the liquidity crunch in 2008 the investors were attracted mainly by the companies with the stable balance sheets, but the statistical significance of the difference in means increased substantially after the crisis for the equity to assets ratio.

Outperforming companies can boast neither with the higher than the average dividend yields nor with the high dividend payouts (Figs. 4, 5).

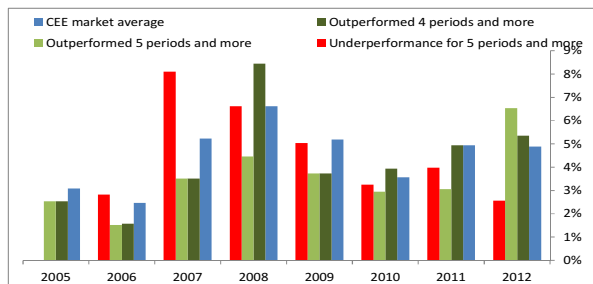


Fig. 4. Average Dividend yield ratio of sustainable out- and underperformers

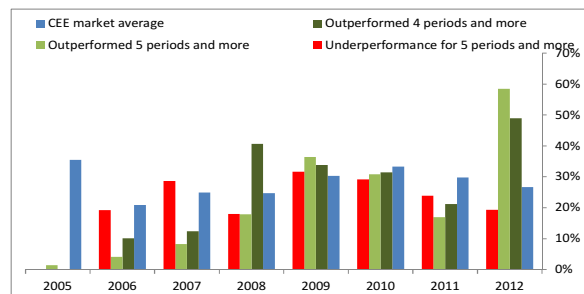


Fig. 5. Average Dividend payout of sustainable out- and underperformers

To add, it is possible to find good dividend payers also among the underperforming companies. This might be explained by the fact that often good dividend payers are the companies, having stable business models, single-digit earnings growth rate and low development opportunities (such as telecoms, for instance), which evidently is not very appreciated by the equity investors. And although in the low rate environment these companies might be valued more, in the longer term

high dividend payout is not able to support excellent performance.

In this case, dividend payments do not become a plausible shareholder value sustainability driver as dividends are not the key attribute of the outperforming company.

5. Conclusions

The research on the sustainable out and underperformers within the CEE equity markets over the period of 8 years (from 2005 till 2012) proved the hypothesis about the discrepancy in the financial condition of the best and the worst companies. Indeed, in the majority of cases the differences turned out to be rather substantial, therefore, making it possible to develop investment strategy in the CEE equity markets, which would deliver high performance “fruits” in the long term covering various market phases.

The research on the sustainable out- and underperformers on the CEE equity market focused on the difference of a number of the quantitative and qualitative aspects between these two types of companies. The leading companies obviously can boast of the sustained above average profitability and less riskier balance sheet, which was especially highly valued during the liquidity crunch in 2007-2009. However, high dividend paying companies did not demonstrate significant presence among the best performing companies. The analysis showed that rather often underperforming companies paid even larger portion of their earnings.

Besides, in the course of the research it was possible to define, which industries produce primarily the winner companies and which produce the stock market laggards.

Taking into account the obtained results on the key attributes of the sustainable above average shareholder value deliverers, the winning strategy of the CEE investor would be the following:

- To invest in the pharmaceutical and retail sectors, while avoid the financial and media industry sectors;
- Larger companies are more likely to become sustainable outperformers;
- It is preferable to invest in the Polish or Lithuanian stock markets (within the main list of the stock exchange), while avoid investment in the Hungarian, Latvian and Slovenian markets;
- Select the companies with the above average profitability as measured by ROCE or operating cash flow over the equity capital;

- Companies with rather conservative balance sheets, having lower debt burden on the accounts, are the ones to deliver sustainable outperformance.

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