FRANK J. GAMBINO, CFA
Chief Equity Strategist & Portfolio Manager

JEREMY R. BAIER, CFA
Senior Equity Analyst & Portfolio Manager

A Perspective on the Profitability and Valuation of the Largest Companies Over Time Through an EVA Lens

Background

The magnitude of outperformance of the top market constituents is one of the most well-documented dynamics of the US Equity market over the past several years. As hotly debated is the valuation of these members. While the monikers have changed, the theme that the megacaps have left the rest of the market in the dust is undisputed. What about the valuations of these members? While a straightforward application of (pick your) multiples can almost universally lead to the conclusion of stretched valuations, we believe a more nuanced approach which combines quality *and* valuation could lead to an alternative conclusion. This points us to the concept of Future Growth Reliance, or "FGR." Some background on its definition will provide reasoning for this metric to be interpreted as a valuation proxy. Conceptually, the value of any company can be broken down into three components:

1. Capital: Net business assets. It is all assets used in business operations, net of trade funding from accounts payable and accrued expenses. It is also equal to the total amount of debt and equity raised from investors or retained from earnings.

2. Current Value Added (CVA): current economic profit produced and capitalized at the cost of capital into perpetuity. Think of this as the portion of market value that is currently being "earned."

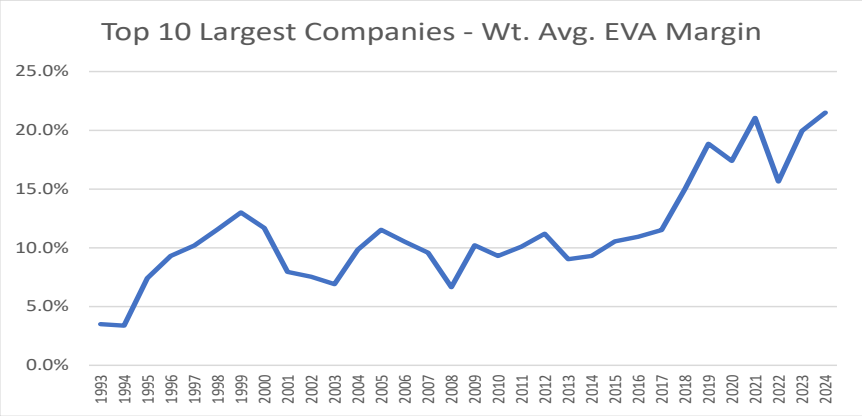
3. Future Value Added (FVA): the amount of market value not explained by (1) and (2). Alternatively, FVA can be perceived as the portion of the current market value represented by the *present value of the expected growth* in economic profit. Think of FVA as a plug figure and a proxy for investor expectations of future economic value added – the higher the number, the greater the expectation.

FGR is simply FVA divided by the market value of the stock and expressed as a percentage. As such, it quantifies the portion of a stock's market value that is dependent on future growth of economic profit. The ratio can be compared to peers, industry benchmarks and the stock's own history. It is this last comparison into which we aimed to dig further in order to discern how the top ten largest companies (by market capitalization) have trended over time. In doing so, we can compare the FGR for today's group to past groups to determine what amount of euphoria (as it relates to growth in economic profit) may exist today and what this may mean for investors.

Economic Value Added, or "EVA", measures a company's economic profit – the profit remaining after deducting all costs, including giving the stock's investors a full, fair, and competitive return on their investment. EVA Margin is simply a company's EVA divided by revenue. To study the EVA Margin and FGR characteristics of these companies, we first created a list of the ten largest US common stocks at 12/31 of each year going back to 1993. This gives us data that encompasses the dot-com bubble, the Great Recession, and the pandemic all the way through the end of 2024. From there it was pretty straightforward – simply pull the EVA Margin and FGR for each group as of those year-end points in time.

We first examine the EVA Margins of those groups. The result can be seen in the chart below:

Chart 1: Top 10 Largest Companies - Wt. Avg. EVA Margin

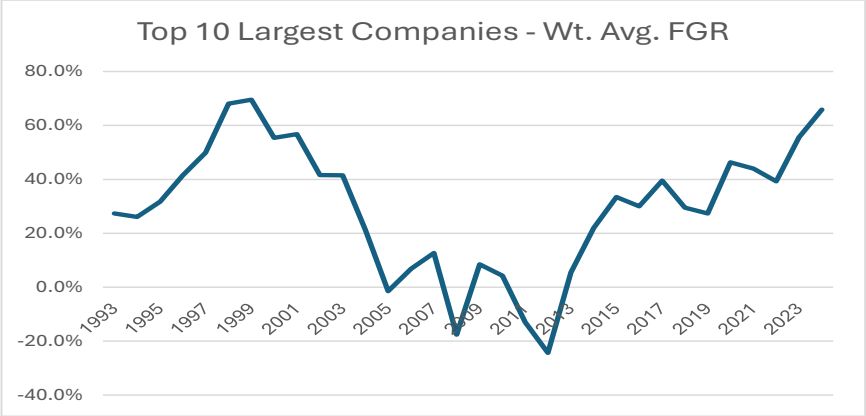


Source: ISS/EVA Investor Express

You will first note that this subset of companies has been consistently profitable over time – any figure greater than zero confers a company is adding economic value for its shareholders. One would hope so – these are the most valuable companies in the world! EVA Margins hovered in the high single digits and at times pushed above 10% for the first 25 years of the data. The trendline shown above compares favorably to some large datasets we have analyzed that show that less than one in five companies generate EVA Margins above 5%. Interestingly, we have seen a marked improvement higher since the latter part of last decade and sit today at record levels.

The size and make-up of the constituents has changed meaningfully over time. Back in 1993 household names like GE, AT&T, Coca-Cola, Walmart, and General Motors populated the list. Today the group is much more technology heavy – Apple, Nvidia, Microsoft, Alphabet, Amazon, and Meta for example. Even more impressively the total market cap of the top 10 companies in 1993 was just shy of $558 billion; as of 12/31/2024 it was nearly $20.5 **trillion**. We have learned the biggest companies are generating their best levels of profitability, as measured by EVA Margins, in at least the last 30 years. That said, we wanted to see what else there was to uncover in the numbers – after all, we have witnessed the immense index-lifting performance of these large companies in recent years. The next step was to analyze valuation through the aforementioned FGR framework. The FGR data is demonstrated in the chart below.

Chart 2: Top 10 Largest Companies - Wt. Avg. FGR

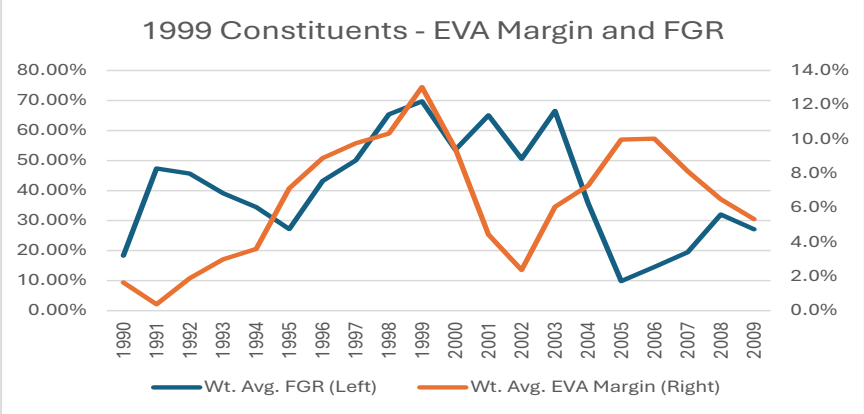


Source: ISS/EVA Investor Express

Perhaps it is not surprising to see a valuation metric skyrocket over 2.5 times higher into the culmination of the dot-com euphoria as demonstrated in the data from 1993 to 1999. What is just as interesting is the fact that today we are back at FGR levels that have not been seen since that time. In fact, we are barely over 10% from reaching an FGR level that would match the high seen at the end of 1999. Yes, EVA Margins of today's group are better than any other group in the last 30 years, but FGR is normalized to the profitability level of any given period. What it measures is the expected growth in profitability in the future that is required to justify today's prices. When looked at through that lens, we note that the improvement from today's historically elevated level of economic value creation that is required to justify the value in these ten companies is nearly the same as in 1999 when EVA Margins were nearly 40% lower.

We also thought it might be interesting to isolate and analyze the ten largest companies right before the dot-com crash. To do this we used the company list from 12/31/1999 and tallied data looking backwards and forwards ten years for the group. While some of the expected technology companies like Microsoft, Cisco, Intel, Lucent Technologies, and IBM enter the fray, there are still some legacy stalwarts like GE, Walmart, Exxon Mobil, Citigroup, and AIG that populate the list. As you would expect, the group's weighted average FGR began its ascent to peak levels between 1995 and 1999; we did see the weighted average EVA Margin of the group migrate higher in those years as well.

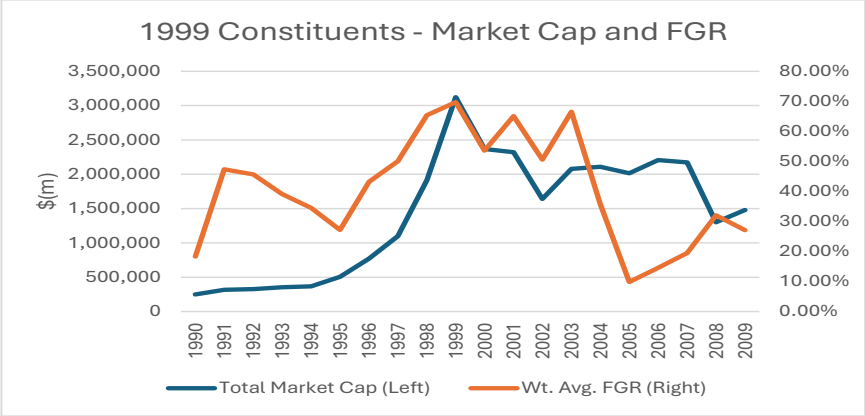
Chart 3: 1999 Constituents - EVA Margin and FGR



Source: ISS/EVA Investor Express

When the dot-com crash happened, it's interesting to observe that while EVA Margin declined precipitously (see above) and the total market cap of the group began its fall (see below), the FGR actually held in at elevated levels for a time – temporarily dampening the market decline - before following suit with a major move lower subsequent to 2003.

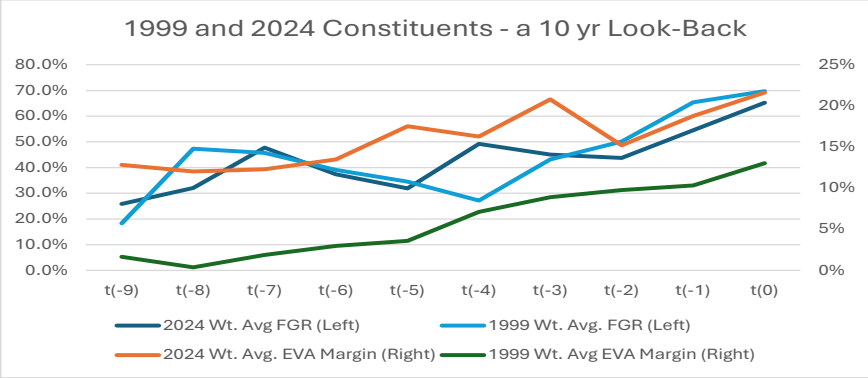
Chart 4: 1999 Constituents - Market Cap and FGR



Source: ISS/EVA Investor Express

So how can we use that information to analyze today's largest companies? We have demonstrated above that the ten largest companies in the market today are trading at valuations – through the FGR framework – that we have not seen since the internet bubble. In fact, the historical lead-up to these levels looks familiar, as seen in the chart below, with the main difference being the higher profitability of today's companies.

Chart 5: 1999 and 2024 Constituents - a 10-Year Look Bcak



Source: ISS/EVA Investor Express

Conclusion

As it relates to the largest companies, we believe we are in territory rarely seen as measured by FGR. Surprisingly, the data suggests that we are not "off the charts," yet implies that the expected level of economic profits will need to continue to grow to support current share prices. This dependency leaves little room for error and anything other than explosive and accelerating EVA growth forecasts could give rise to a reset. The dynamic nature of the makeup of the top ten over time is indicative that expectations do reset, economic profitability does wane, or a combination of the two transpires. If we see EVA Margins start to crack, we may notice that FGR will be able to stay buoyant for a time but could see downward pressure in fairly short order. It is for this reason that we constantly monitor the EVA Margins of both our holdings and other market constituents. We leave this analysis fairly observing that the runup in price of the current top ten constituents is not completely irrational based on the level of economic profit generation, yet the sustenance and growth of this metric may not hold. The good news is that investors have an ocean of economic profit- generating companies from which to choose if the price/value relationship offers an attractive potential rate of return. We believe FGR is an excellent guide for us to judge sentiment when we have identified a high quality candidate for our domestic equity strategies because it genuinely couples quality and valuation, core tenets that underlie our philosophy and process.