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What really drives returns? Earnings

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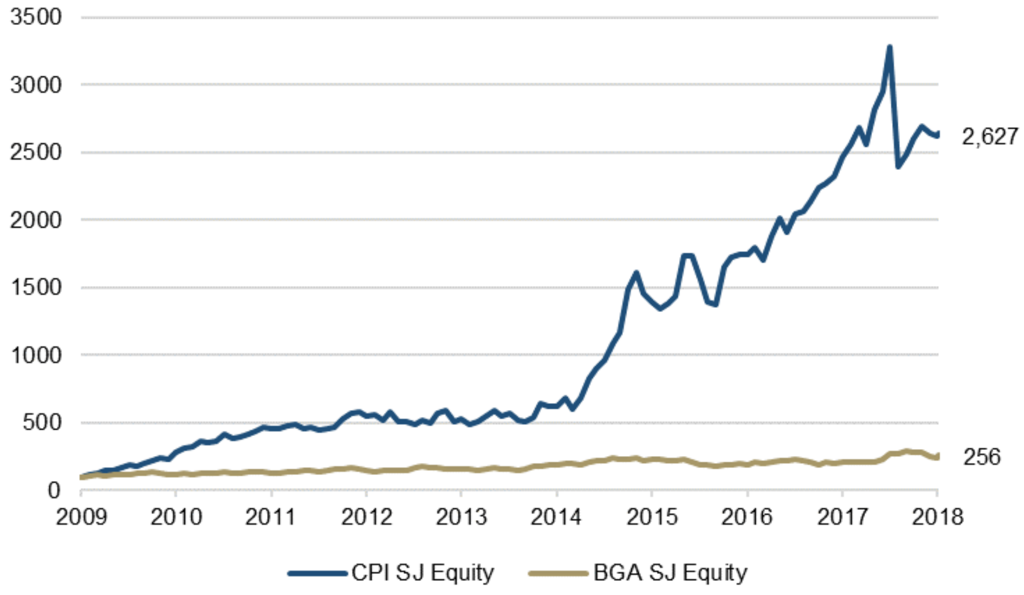
There is much debate on the drivers of stock market returns. To assess this, we compare Capitec to Absa by assessing the three factors that contribute to returns – re-rating (relative cheapness), dividends, and earnings growth. We find that while the re-rating component can play a sizeable role in total return, earnings growth is an under-appreciated driver.

A stock’s total return is made up of:

1. Re-rating
2. Dividends
3. Earnings growth

As shown in Figure 1 below, the total returns of Capitec have been drastically different to those of Absa Capitec stock has produced a cumulative total return of 2627% vs. Absa’s 256%. But what explains this difference? They are both banks operating in South Africa, affected by the same economic conditions, such as GDP growth and interest rates. We look to the sources of return to determine why Capitec has outperformed Absa by multiples.

Figure 2: Capitec vs. Absa Share Price (Total Return)

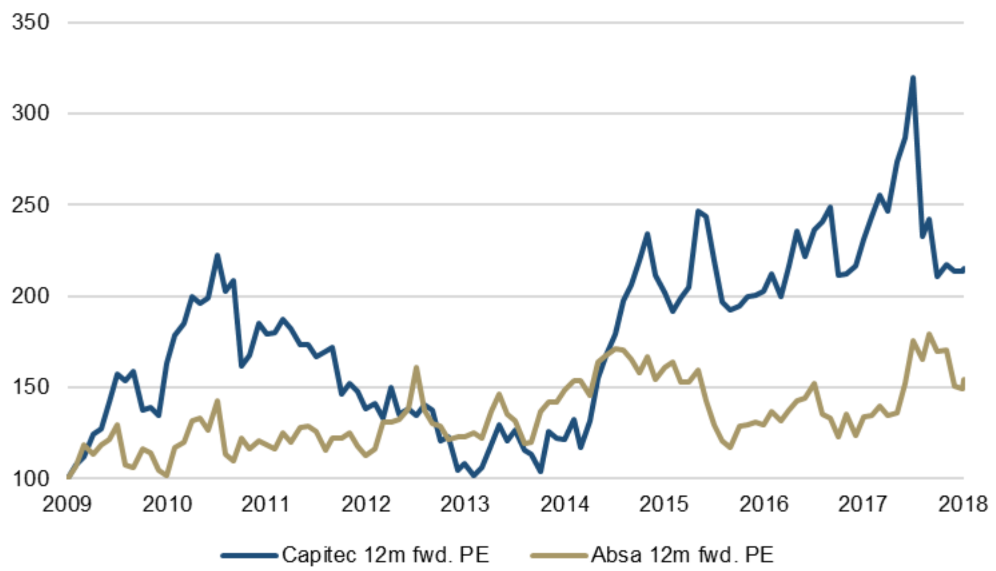


Source: Bloomberg

Re-Rating

In the case of both Capitec and Absa, re-rating can explain a sizeable proportion of returns over the last decade. As per figure 2, if you invested R1 000 in each company at the beginning of the period, the investment in Capitec would have grown 2.2 times vs. Absa's 1.5 times.

Figure 2: Capitec vs. Absa – 12 fwd. PE's indexed

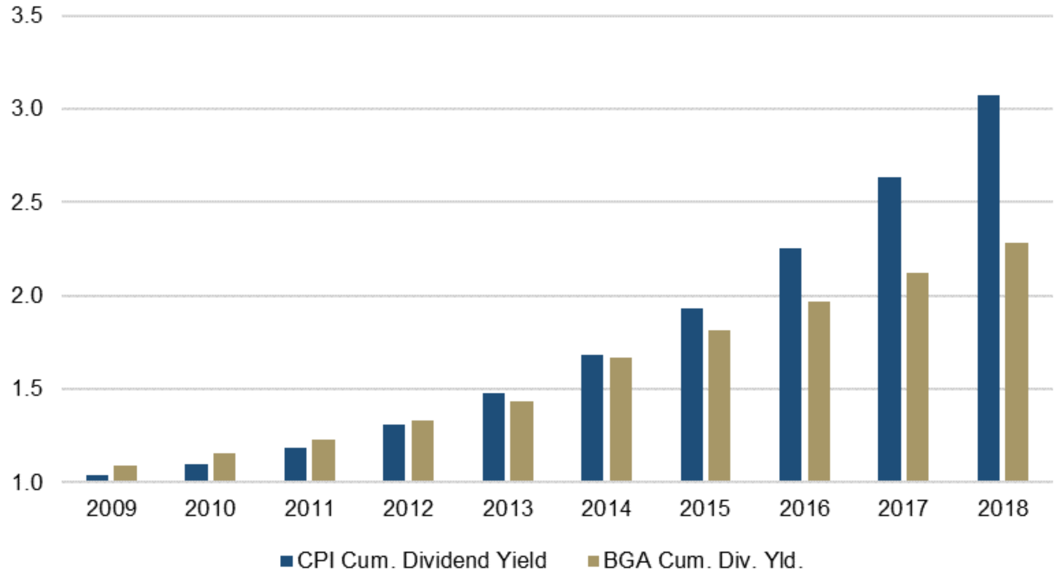


Source: Bloomberg

Dividends

However, this doesn't come close to explaining Capitec's outperformance. Figure 3 shows both companies' cumulative dividend yield over the period. In this case, Capitec still outperforms, but to a lesser extent.

Figure 3: Capitec vs. Absa – Cumulative Dividend Yield through Time

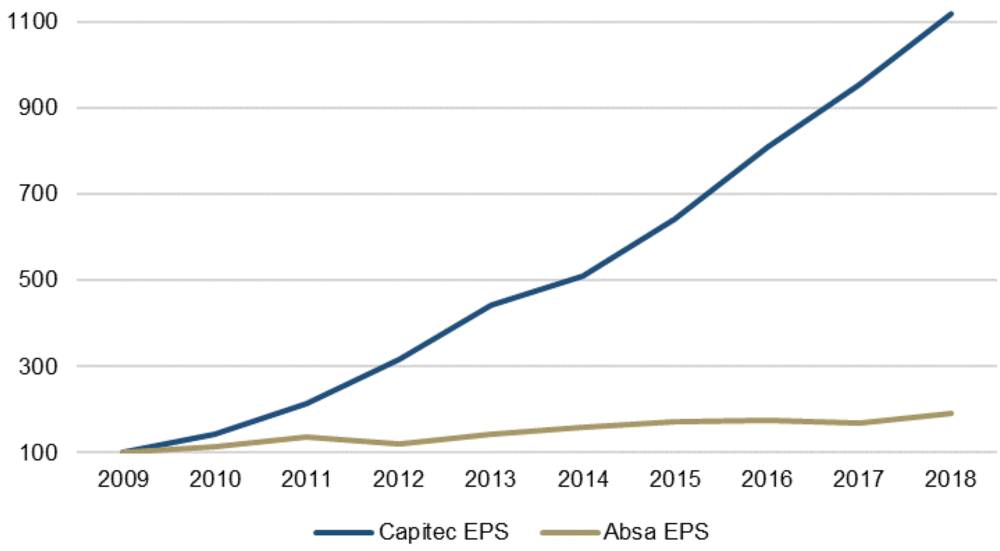


Source: Bloomberg

Earnings Growth

The last component – earnings growth, is the main driver of returns for both companies. However, as shown in Figure 4, Capitec has grown its earnings 11 times, vs. Absa's 2 times.

Figure 4: Capitec vs. Absa – Earnings per Share (Indexed)



Source: Bloomberg

In this case, Capitec's ability to consistently grow their earnings has proven to be the predominant driver of their total return. An investor that only looks at re-rating would have far underestimated Capitec's ability to command higher and higher valuations – likely calling it expensive over most of this period. Therefore, while value investors tend to focus on valuation, it pays to pay up for growth. In the case of Capitec, it paid off 10.3 times more than Absa.

Glacier Research would like to thank Nicola Broekhuysen for her contribution to this week's Funds on Friday.

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Nicola joined the BlueAlpha team in February 2016 as a Research Analyst. She has 6 years of financial markets experience and is part of the investment team, involved in company analysis, as well as performance and quantitative research. She holds a Bachelor of Social Science in Economics & Political Science from the University of Cape Town and is currently enrolled with the CFA Institute as a level 2 candidate