ARTICLE REPRINT

Stay Tuned... Mind Your P's & E's

by Hank Boerner

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Mind Your P's & E's

QUICK — WHAT'S YOUR COMPANY'S P/E? Most corporate financial executives will answer in a flash – "We have a price-to-earnings ratio (P/E) of 14-to-1."

OK – next question: What factor is your firm's other "P" and "E" in determining share price valuation, in shareholder attraction and retention, in telling your story to the Street, to investors, to journalists? It's your company's (or sector's) productivity and efficiency factors. This other P/E is how we measure the productivity of our output (our collective work effort), the overall efficiency of our company, and perhaps our sector or industry.

Think of what investors think your enterprise should be doing every day: Management increases efficiencies while simulataneously lowering costs, which equals improved productivity. Producivity gains should then drive share price and your market valuations. The bull market of 1995-2000 was one outcome of collective corporate increases in productivity and efficiencies.

There are two major aspects to the greater (and historic) corporate productivity and efficiency levels achieved over the past quarter-century: First, there is the enormous impact of technology advances on technology sector innovators and manufacturers themselves, as their new equipment, software and operating techniques boosted their own corporate productivity; and, second, there is the impact of that sector's technology innovations on productivity growth in all other industries and sectors.

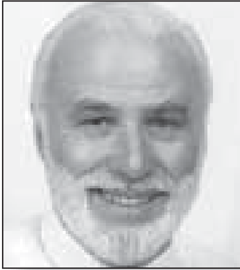
To visualize this in practical terms, think of the post-1970 office, plant, warehouse service facility or retail store, and the direct effects on your corporate operations as technology innovations were introduced: personal computer, laser printer, fax, cell phone, PDA, Internet, satellite communication, Google, fiber-optic networks, broadband communication, instant "swipe" credit card approval, capture of customer and transaction data at the point of sale, etc. Those are just a few of the drivers of increased productivity and efficiency for Corporate America.

Why is all this important to you, your company and your P/E (the traditional one as well as the other one)? Others who are evaluating and valuating your company may be considering the effects of productivity on your operations, finances and sustainability, and the economic outlook of your company, both short and long term. If productivity slows, then what?

STAY TUNED … to the experts on productivity. The best (in our opinion) are found in the ranks of the Federal Reserve System. In May 2006, economists Richard Anderson and Kevin Kliesen of the Federal Reserve Bank of St. Louis looked at the 1990s acceleration of American labor productivity, which they called "the defining economic event of the past decade." Anderson and Kliesen describe a major sea change early in the 1990s that played a key role in the investment market: After a slow build in business efficiencies over the prior 20 years, a period when more traditional manufacturing dominated the economic data, service-producing sectors — the early adopters of information and communication technologies (ICT) — began to lead the productivity increase, and even as manufacturing rebounded, services/information companies continued to lead in productivity gains. The productivity acceleration after 1995 was largely a services-sector story. So …

STAY TUNED … to the role of semiconductor prices to develop a better understanding of the acceleration of labor productivity. (Labor productivity is the time it takes in human hours to create output.) Labor productivity climbs as technology built on the foundation of semiconductors is deployed and improved over time. Semiconductor advances drive productivity growth. There are other elements in determining the productivity factor for economists, including measuring capital input, labor and capital flows. But just focus on the important "P" number when it is announced: the growth in labor productivity for the quarter or the year.

STAY TUNED … to slow or incomplete reporting on the important productivity growth rate by reliable aggregators of data. Even as the productivity rate began the fast climb up the charts, data collected in 1995 and 1996 by the Fed



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and other influential economists didn't catch the sea change. Not until two years into the bull market (1997) were productivity gains becoming clear. As economists Anderson and Kliesen say, "Our analysis suggests that [such] measurement delays and revisions are not uncommon." Lesson for IROs: Watch the Fed and other announcements, but these may be late in telling us why the capital markets are reacting.

STAY TUNED … to your gut feeling. In the absence of reliable data, what is corporate management to do? Some trust their intuition, which author Malcolm Gladwell (*Blink*) tells us can be extremely reliable in business decision-making. You can also regularly monitor key data points — every day business newspapers are loaded with output- and productivity-related numbers. Some are key indicators; checking a few of these data points may confirm the start of a trend to which you should "stay tuned."

STAY TUNED … to early signs of slowdown in productivity growth and an increase in the rate of inflation, such as the period we may be entering this summer. Janet Yellen, president and CEO of the Federal Reserve Bank of San Francisco, earlier this year addressed concerns that have been raised in Fed circles about a possible productivity slowdown in the U.S. that could affect economic growth and boost inflation. Many companies have had their prospects buoyed by the astonishing rate of 4.5 percent labor productivity growth in 2002, 2003 and much of 2004. In 2005, however, growth slipped below 1 percent by year-end. She also reported a slowing of technological innovation in the computer hardware sector and signs of same in software.

STAY TUNED … to the effects of outsourcing on American corporate productivity. Federal Reserve Bank of Dallas economist Thomas Siems in February wrote that outsourcing is not new for American companies, as management focuses on core competencies and contracts for those services and activities that can be done faster-cheaper-better elsewhere, usually by specialists. Siems believes that the best companies boost their productivity by doing what they do best and outsourcing everything else.

STAY TUNED … to productivity, American-style! It's helped the nation to lead the way in operating efficiencies, greater profits and dominance in world trade. IRU

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